William Chislett

The Internationalization of the Spanish Economy

Real Instituto Elcano
de Estudios Internacionales y Estratégicos

William Chislett

was born in Oxford in 1951. He reported on Spain's 1975-78 transition to democracy for The Times. Between 1978 and 1984 he was based in Mexico City for The Financial Times, covering Mexico and Central America, before returning to Madrid in 1986 as a writer and translator. He has written books on Spain, Portugal, Chile, Ecuador, Panama, Finland, El Salvador and Turkey for Euromoney Publications. The Writers and Scholars Educational Trust published his The Spanish Media since Franco in 1979. Banco Central Hispano published his book España: en busca del éxito in 1992 (originally published that same year by Euromoney), Spain: at a Turning Point in 1994, and Spain: the Central Hispano Handbook, a yearly review, between 1996 and 1998. Banco Santander Central Hispano published his dictionary of economic terms in 1999 and his Spain at a Glance in 2001. He wrote most of the section on Latin America for the World Business Almanac (Bloomsbury, 2002). He is currently writing a book on Spanish investment in Latin America for the Real Instituto Elcano, to be published in 2003. He is married and has two sons.

Some comments on previous books on Spain

The book is intelligent and authoritative and essential reading for anyone concerned with Spain.
Sir Raymond Carr

Stylish and impressive.
Eric Hobsbawm

For up-to-date information and perceptive analysis presented in an elegant and incisive style, academics, economists, journalists and Hispanophiles in general are in William Chislett's debt.
Paul Preston, Professor of International History, London School of Economics

No one surveys the data more comprehensively, digests it more efficiently, relates it more lucidly or presents it with more critical intelligence.
Felipe Fernández-Armesto

Crisply written and superbly well organised, it is a mine of information for businessmen, journalists and academics and indeed anyone with an interest in the country.
Edwin Williamson, Professor of Hispanic Studies, University of Edinburgh

My staff found it to be an extremely valuable resource.
Richard Gardner, former US Ambassador to Spain

A triumph of selection, concision and exposition.
Alex Longhurst, Professor of Hispanic Studies, University of Leeds, International Journal of Iberian Studies

Most skilful in combining information with readability ... my vade mecum for contemporary Spain.
Sir John Elliott, former Regius Professor of Modern History, University of Oxford

Jacket illustration: Facade of the Guggenheim Museum in Bilbao.

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For Tom Burns, Ian Gibson, Gabriel Jackson
and Michael Jacobs, *con afecto y admiración*

Spain is not so different, so special as it is manipulatively said to be. We must stamp out once and for all the idea that Spain is an anomalous country ... a case apart, an exception that justifies any action.

Julián Marías (1965)

Spain is different.
Tourism Ministry slogan in the 1960s

Acknowledgements

This book is an attempt to view Spain within the globalized context wherever possible. I have included "non-economic" subjects such as education, immigration and demographics because of their major impact on the economy. I am particularly grateful to Emilio Lamo de Espinosa, the director of the Real Instituto Elcano de Estudios Internacionales y Estratégicos, for commissioning this book.

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William Chislett
Madrid and Buendía, July 2002
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Preface

It is fitting that the first book published by the Real Instituto Elcano de Estudios Internacionales y Estratégicos be dedicated to the internationalization of the Spanish economy. Indeed, the Institute's namesake was an early Spanish harbinger of the dynamics of the global economy.

The Basque navigator Juan Sebastián Elcano (1487-1526) was a colleague of Ferdinand Magellan on the famous circumnavigation journey the Portuguese explorer undertook in the early 16th century. In the wake of Magellan's death in passage, Elcano became the first person to travel around the globe during an age when Spanish influence first emerged into the world. The Real Instituto Elcano, for its part, strives to understand and explain Spain's role in the increasingly globalised context of international relations at a time when the country has finally reclaimed its seat at the table of world affairs.

Just as Elcano sailed round the globe, Spain's presence in the world economy has now come full circle. From its early mercantilist and colonial expansion across the Atlantic and Pacific worlds, to its "autarkic" withdrawal after the 1936-39 Civil War, Spain has finally re-emerged as a mature, influential player in the global economy. As surprising as Elcano's reappearance on September 6, 1522 must have been to the inhabitants of Puerto de Santa María, so too has been the encouraging re-emergence of the Spanish economy into the European and international arenas.

For more than 100 years after the heyday of Spanish empire had passed, the Spanish economy became increasingly inward-looking, more highly regulated by the State, and all but completely isolated from the world. By the end of the 1950s, Spain had indeed become one of the most noticeable anomalies in Western Europe. Yet, in little more than a generation – and against the expectations of many, including a good number of Spaniards – Spain has achieved

the most exceptional transition from a state-dominated economy and authoritarian regime to a modern, prosperous market democracy. What is more, the renewed outward flow of Spanish investment and the increasingly visible Spanish role in international diplomacy has given Spain a voice in world affairs once again.

This book, *The Internationalization of the Spanish Economy*, written by William Chislett, one of our most valued collaborators, takes stock of the current Spanish economy and its renewed "globalized" dimensions. Not only should this book give international readers – to say nothing of fellow Spaniards – a clearer picture of the realities of the Spanish economy and its process of internationalization, it should also highlight lingering weaknesses and potential vulnerabilities.

While it remains necessary to undermine the power of the old "black legend" that so often continues to distort perceptions of Spain's economic reality, it would also be prudent for Spaniards and international colleagues alike to avoid singing victory too soon, thereby turning a false "black legend" into an equally-distorted "white legend."

In the spirit of Elcano, our adventuring ancestor who managed to find his way back home, charting this course through both delusions of grandeur and despair, this document – like the rest of the Elcano Institute's intellectual production – is meant to give policy makers and civil society actors, both in Spain and abroad, a reliable compass for interpreting Spain's true place in the world.

Eduardo Serra Rexach
Chairman

Chapter 1

Introduction: The New Spain

Nothing illustrates more poignantly the turnaround in the Spanish economy than its position vis-à-vis Argentina. In the "hungry" 1940s, in the aftermath of Spain's 1936-39 Civil War, Argentina came to the rescue of the dictatorship of General Franco and saved the country – a pariah excluded from the US's Marshall Plan – from starvation by supplying it with wheat and meat. In March 2002, the cargo ship Josephine Maersk docked at Buenos Aires with 300 tonnes of food and medicine donated by Spaniards, many of whose impoverished relatives emigrated to Argentina. The aid was sent after cash-strapped Argentina massively devalued the peso and defaulted on its $155 billion public sector foreign debt, the largest such default in history.

In 1950, Argentina's per capita GDP was $4,987 and Spain's was $2,397 (see Exhibit 1.1). At the prevailing exchange rates, Spain's is now approaching $15,000 and Argentina's, after its devaluation, was around $2,200 in 2002. The two economies have had widely differing regional environments over the past 15 years and different positions in the globalized context but, broadly speaking, Spain's success is the fruit of persistent free-market reforms, the rule of law, sustained macroeconomic stability and a strong tax system.

Argentina has attracted the most foreign direct investment from Spain, a mixed blessing, however, in the country's current crisis (see Chapter 5). Spanish banks and companies moved into Argentina during the 1990s and today they control around 16% of the country's deposits, its largest oil company (YPF), its national carrier (Aerolíneas Argentinas), its largest telephone company and parts of its electricity and water systems.

Before Spain joined the European Economic Community (EEC) in 1986, it had little investment abroad to boast of other than such exotic examples as Chupa Chups, whose lollipops are licked by

Exhibit 1.1. **Spain, Argentina and Total Western Europe – Per capita GDP[1], 1870-1998**

	1870	1913	1950	1973	1990	1998
Spain	**1,376**	**2,255**	**2,397**	**8,739**	**12,21**	**14,227**
Argentina	1,311	3,797	4,987	7,973	6,512	9,219
W. Europe	1,974	3,473	4,594	11,534	15,988	17,921

(1) 1990 international dollars.
Source: The World Economy, A Millennial Perspective, Angus Maddison (OECD Development Centre, 2001).

Exhibit 1.2. **World Ranking of Economies[1]**

United States	9,837
Japan	4,841
Germany	1,872
United Kingdom	1,414
France	1,294
China	1,079
Italy	1,073
Canada	687
Brazil	595
Mexico	574
Spain	**558**

(1) GDP at purchaser prices in $ billions in 2000.
Source: World Bank Development Indicators 2002.

Exhibit 1.3. **Real GDP Growth (%) in Spain and in the EU-15, 1995-2002**

	1995	1996	1997	1998	1999	2000	2001	2002[E]
Spain	**2.8**	**2.4**	**4.0**	**4.3**	**4.1**	**4.1**	**2.8**	**2.1**
EU-15	2.2	1.4	2.3	2.9	2.6	3.4	1.5	1.5

E = Estimate.
Source: Eurostat.

everyone from pop idol Britney Spears to Russian cosmonauts. And Chupa Chups itself has licked the world: it is present in 190 countries and has a one-third share of the global market.

Spain is the world's 51st largest country by size and the 30th by population, while its economy is the 11th biggest and the 8th among OECD countries (see Exhibit 1.2). The country became a developed one in terms of UN criteria when per capita GDP crossed the $500 threshold in 1963. Per capita income, in purchasing power parity exchange rates (PPPs), which convert GDP into a common currency, was $19,180 in 2000, the 21st highest in the world ranking. PPPs produce a better comparison of living standards than market exchange rates as they eliminate price distortions arising from different price levels: they use conversion factors calculated as a weighted average of the price ratios of a basket of goods and services that are homogeneous, comparable and representative.

Spain's economic success is beginning to move the country from the ranks of "middle powers" into the elite club of the European "major players". The country has also firmly consolidated its democracy, under King Juan Carlos, since the death of General Franco in 1975. The post-Franco constitution is 25 years old, almost the same number of years as the combined total life span of the previous constitutions based on sovereignty of the people and separation of powers, which started in 1812 and were frequently interrupted by military coups. A solid case can be made for including Spain in the G8's elite club of the wealthiest industrialised nations and renaming it G9. The original G7 group (the US, France, the UK, Japan, Italy, Germany and Canada) became the G8 in 1998 with the inclusion of Russia, despite not being a fully fledged market economy and its uncertain commitment to democratic principles. It was the crowing of the cold war victors that probably best explains the willingness of the G7 to give Russia a place at the table, although

Exhibit 1.4. **Convergence in GDP per capita in Purchasing Power Parity (EU-15 = 100)**

	2002E	1995
Austria	110.1	110.3
Belgium	106.0	112.6
Denmark	120.7	118.1
Finland	101.5	96.9
France	100.2	104.0
Germany	103.9	110.0
Greece	70.0	65.9
Ireland	121.7	93.3
Italy	102.9	103.4
Luxembourg	191.9	170.8
Netherlands	113.0	109.2
Portugal	73.9	70.5
Spain	**83.6**	**78.2**
Sweden	100.5	102.5
UK	102.7	96.5

E = Estimate.
Source: Eurostat.

it is excluded from some ministerial and informal presidential meetings. Moscow's dependence on IMF financing, its unstable transition to capitalism, and its war in Chechnya are among the factors that separate it from its partners in the G8 – hence the schizophrenic designation "G8/G7." Spain's credentials for joining are stronger than those of Russia, whose economy is half the size of Spain's.

The Socialists, headed by Felipe González, ruled from 1982 to 1996 and the centre-right Popular Party of José María Aznar has governed since then. Corruption has gradually abated, according to the Transparency International Corruption Perceptions Index. With a score of seven out of ten, where ten is the least corrupt, Spain was ranked 22nd in 2001, ahead of France and Italy. Its score in 1995, when the first TI index was produced, was 4.35.

Spain, which generates 7% of the GDP of the European Union (EU), was one of the founder members in 1999 of European Monetary Union (EMU) and the single currency, placing itself in the vanguard of a European movement after a long period of isolation. The euro became legal tender in 12 of the 15 EU member states in 2002. The macroeconomic stability required for EMU membership (see Chapter 2) has locked Spain into an unprecedented virtuous circle of non-inflationary growth that has been above the EU average since 1995 (see Exhibit 1.3). As a result of the higher growth, Spanish GDP per capita has moved closer to the EU average (see Exhibit 1.4).

The country achieved its highest-ever sovereign debt rating in December 2001, when Moody's Investors Services, the international credit rating agency, upgraded the rating of the Kingdom of Spain's euro- and foreign currency-denominated bonds from Aa2 to Aaa. This was an

Exhibit 1.5. **Countries with Aaa Rating**

Austria	Luxembourg
Denmark	Netherlands
Finland	Norway
France	**Spain**
Germany	Switzerland
Ireland	UK
Liechtenstein	US

Source: Eurostat.

important accolade marking the international recognition of Spain's advances in macroeconomic and financial management. Spain joined the select group of Aaa countries with maximum solvency (see Exhibit 1.5). The rating agency attributed the two-notch upgrade to a continuing improvement in the Spanish government's fiscal position.

Competiveness

The Spanish economy stood still in terms of competitiveness between 2000 and 2002 according to the International Institute for Management Development (IMD), which produces an annual ranking (see Exhibit 1.6). Spain was ranked 23rd for the third year running. The IMD defines competitiveness as the "ability of a country to create added value and thus increase national wealth by managing assets and processes, attractiveness and aggressiveness, globality and proximity, and by integrating these relationships into an economic and social model." One of the factors behind the stagnation of Spain's competitiveness is that its inflation is still higher than the EU average. Another negative factor is the fall in productivity (92% of the EU average in 2001 as against 96.8% in 1993, according to Eurostat, the EU's statistical office, and 76% of the US level in 2001 as measured by output per hour at 1996 purchasing power parity, according to the Conference Board).

Spain's position with regard to 1999, when it was ranked 20th, showed a notable improvement in economic performance but a slip in the other three competitiveness input factors (see Exhibit 1.7). Amongst the weakest criteria by factor identified taking the biggest value differences from the 49-country averages were the current account balance, the unemployment rate, the employer's social security contribution rate and new information

Exhibit 1.6. **World Competitiveness Ranking – Top 24 Countries, 2002 (2001 Figures in Brackets)**

1. United States (1)
2. Finland (3)
3. Luxembourg (4)
4. Netherlands (5)
5. Singapore (2)
6. Denmark (15)
7. Switzerland (10)
8. Canada (9)
9. Hong Kong (6)
10. Ireland (7)
11. Sweden (8)
12. Iceland (13)
13. Austria (14)
14. Australia (11)
15. Germany (12)
16. United Kingdom (19)
17. Norway (20)
18. Belgium (17)
19. New Zealand (21)
20. Chile (24)
21. Estonia (22)
22. France (25)
23. **Spain (23)**
24. Taiwan (18)

Note: Forty-nine countries are ranked.
Source: World Competitiveness Yearbook 2002, IMD, Switzerland.

Exhibit 1.7. **Competitiveness Input Factors, 1998-2002**

	2002	2001	2000	1999	1998
Economic performance	13	22	21	22	27
Government efficiency	20	21	20	12	22
Business efficiency	24	23	24	22	24
Infrastructure	25	25	24	23	25
Overall ranking	23	23	23	20	26

Source: World Competitiveness Yearbook 2002, IMD, Switzerland.

technology and its implementation. The strongest criteria included direct investment stocks abroad, consensus on policy direction inside the government, value traded on stock markets (US$ per capita) and air transportation.

In the rankings prepared by the World Economic Forum (WEF), Spain came 22nd in the 2001 Growth Competitiveness Index (27th in 2000) and remained in 23rd place in the Current Competitiveness Index. Whereas the Growth Competitiveness Index strives to estimate the underlying conditions for growth over the coming five years, the Current Competitiveness Index evaluates the underlying conditions defining the current level of productivity in the 75 economies covered. Among the notable competitive disadvantages listed by the WEF were the low level of innovation in companies, the administrative burden for start-ups, the state of cluster development and hiring and firing practices.

Human Development

Spain was ranked 21 out of 174 countries in the 2002 UN Human Development Index, which is a cocktail of life expectancy at birth, per capita income (measured by purchasing power parity as opposed to market exchange rates), adult literacy and the enrolment ratio in primary, secondary and tertiary education (see Exhibit 1.8).

Infrastructure

Spain has invested a lot of its own money and EU funds in improving its roads, railways, airports and ports. Anyone who has been visiting Spain over the past 20 years cannot help but

Exhibit 1.8. **UN Human Development Index for Selected Countries**

Ranking[1]	*Life Expectancy at Birth*	*Adult Literacy Rate (%)*	*Combined Gross Enrolment Ratio (%)*	*GDP per Capita (PPP US$)*	*Gini Income Distribution Index*[3]
1. Norway	78.5	99.0	97	29,918	25.8
2. Sweden	79.7	99.0	101[2]	24,277	28.7
6. United States	77.0	99.0	95	34,142	40.8
9. Japan	81.0	99.0	82	26,755	24.8
10. Finland	77.6	99.0	103[2]	24,996	25.6
12. France	78.6	99.0	94	24,223	32.7
13. United Kingdom	77.7	99.0	106[2]	23,509	36.8
14. Denmark	76.2	99.0	97	27,627	24.7
15. Austria	78.1	99.0	90	26,765	31.0
17. Germany	77.7	99.0	94	25,103	30.0
18. Ireland	76.6	99.0	91	29,866	35.9
20. Italy	78.5	98.4	84	23,626	27.3
21. Spain	78.5	97.6	95	19,472	32.5
24. Greece	78.2	97.2	81	16,501	32.7
28. Portugal	75.7	92.2	96	17,290	35.6

(1) Out of 173 countries.
(2) For the purposes of calculating the HDI a value of 100% was applied.
(3) The Gini index measures inequality over the entire distribution of income or consumption. A value of 0 represents perfect equality, and a value of 100 perfect inequality. The surveys for this information took place between 1987 and 1995.
Source: UN Human Development Report, 2002.

be impressed by the tremendous changes. For example, motorists can drive all the way from Madrid to the French border at Irún by state-owned and privately run motorways, virtually without passing a single traffic light. What used to take up to ten hours can now be comfortably done in five.

The showpiece project is the AVE, the high-speed train from Madrid to Seville, inaugurated in 1992, which has cut the travel time for the 471km to the Andalusian capital to two hours and 15 minutes. An AVE line between Madrid and Barcelona via Zaragoza is expected to be completed by 2004, with a line planned from the Catalan capital to the French border that would link up with the French TGV. A line from Madrid to Valladolid is also under construction. By 2007, Renfe, the state-owned railway company, expects to have extended its high–speed train services to many parts of the country. Other routes on the drawing board include those from Madrid to Murcia via Valencia, from Barcelona to Murcia and maybe one day from Madrid to Lisbon, the capital of Portugal.

The trains have a good record of punctuality: 98% arrive less than five minutes late, compared with an average 71% in the UK in the fourth quarter of 2001. Passengers on the AVE receive a refund if their train is more than ten minutes late. Such rebates in the UK would hit the privatised companies running the railways hard! The fast, clean and inexpensive Madrid Metro opened its transport interchange at Nuevos Ministerios in May 2002, which takes passengers to the city's airport in just 12 minutes.

By 2010, Spain plans to have added 5,000km to its current road network of 8,000km. The country's airports, particularly Madrid's Barajas, are among the most congested in Europe.

Unlike the trains, the airports do not have such a good record of punctuality. Spain topped the US in 2001 as the world's second-most visited country (49.5 million visitors and a 7.2% global market share), and its vital tourism industry (more than 10% of GDP) needs bigger airports to cope with the constantly growing volume of traffic. A new control tower and a third runway were built in record time at Barajas, and the whole airport is to be expanded to handle an estimated 70 million passengers in 2020 (32 million in 2001).

Barcelona, the largest port for cruise ships in the Mediterranean, is expanding with new quays and container, cruise and multi-purpose terminals. The Llobregat river is being redirected, bringing its delta 2.5km down the coast and increasing the land adjacent to the port by some 700ha, more than doubling the current 558ha. The aim is to be able to handle three million containers and double the amount of goods coming through the port annually by 2015. A new railway station is to be built at the port to take advantage of the introduction in 2004 of the European gauge. This will allow goods unloaded at the port to reach European destinations faster and more competitively. Spain's largest port is Algeciras, which has historically benefited from trade in oil and other industrial cargoes. Other major ports are Valencia and Bilbao.

Probably the most important infrastructure project of the future is the National Hydrological Plan (NHP), approved in 2001 and the first one since 1933 to create a long-term water policy for the whole of the country. The mismanagement and wasteful use of water in Spain is a huge problem that successive governments have failed to resolve. The country has an increasing problem of desertification: 63% of its land mass is semi-arid, compared with 40% in Italy and 16% in France. According to figures released at a UN conference in December 2000, one-fifth of Spanish land is so degraded that it is turning into desert. Historically, there has always been

a "wet" Spain and a "dry" Spain. One-third of the country's water is in Galicia and northern Spain, which occupy 19% of the land area and have 17% of the population. At the height of the 1993-96 drought, nearly one quarter of the population was subject to water restrictions, mostly in Andalusia in the south. The central axis of the NHP, whose total cost over eight years is €18 billion, is the transfer of water from the Lower Ebro to parts of south-eastern Spain as a way to redress structural hydrological imbalances. This water will only serve designated purposes (never for new irrigation or to enlarge irrigated land), and its users will pay a levy to offset the transfer costs (including the environmental costs to the assignor basin).

Demographics

Catholic Spain, where the family is strong, paradoxically has the world's second-lowest fertility rate. The average number of children per woman in 2000-2005 is estimated at 1.13, down from 2.2 (the "replacement" level) in 1980, according to the United Nations Population Division (UNPD). The population hardly increased during the 1990s and it is forecast to drop substantially between 2000 and 2050 (see Exhibit 1.9). The UN's projection assumes a future path of migration based on past estimates, which in Spain's case is probably conservative as the number of immigrants has been rising much faster than predicted (see next section). Indeed, in 2000 the country's population registered its largest rise in 30 years, almost entirely due to immigrants. The officially registered population increased from 40.4 million at January 1, 2000 to 41.1 million a year later, and 96% of the 617,051 increase was due to immigrants. This figure does not include illegal immigrants, for whom there are no reliable figures.

Exhibit 1.9. **Population, Fertility Rate and Percentage of Population over 60 of EU Countries**

	Population (millions)		*Fertility Rate*[1]		*Per Cent over 60*	
	2000	2050	2000	2050	2000	2050
Austria	8.0	6.4	1.24	1.65	20.7	41.0
Belgium	10.2	9.5	1.48	1.82	22.1	35.5
Denmark	5.3	5.0	1.65	1.90	20.0	31.8
Finland	5.1	4.6	1.55	1.94	19.9	34.4
France	59.2	61.8	1.80	1.90	20.5	32.7
Germany	82.0	70.8	1.29	1.61	23.2	38.1
Greece	10.6	8.9	1.24	1.85	23.4	40.7
Ireland	3.8	5.3	2.02	2.10	15.2	27.6
Italy	57.5	42.9	1.20	1.61	24.1	42.3
Luxembourg	0.4	0.7	1.76	1.90	19.4	25.2
Netherlands	15.8	15.8	1.50	1.81	18.3	32.8
Portugal	10.0	9.0	1.45	1.83	20.8	35.7
Spain[2]	**39.9**	**31.2**	**1.13**	**1.64**	**21.8**	**44.1**
Sweden	8.8	7.7	1.29	2.01	22.4	37.7
UK	59.4	58.9	1.60	1.90	20.6	34.0

(1) These figures are the medium-fertility variant.
(2) Spain's official population in 2000 was 41.1 million.
Source: World Population Prospects: 2000 revision (United Nations Population Division, 2001).

At the same time, the fast decline of fertility and rising life expectancy have accelerated the ageing process in Spain[1]. These trends have wide repercussions for the economy, particularly in terms of the potential growth of labour supply and productivity and on public sector saving patterns (which will be highly influenced by changes in spending on pensions, health and care for the aged).

Declining populations and ageing are Europe-wide phenomena, the extent and the pace of which vary from country to country. In Spain the trends are more acute. One major factor behind the sharp drop in the birth rate is the high level of unemployment among women, particularly those between the ages of 25 and 34 (still at 18% in early 2002). The female employment rate (employed persons aged 15-64 as a percentage of the total population aged 15-64) was 41.2% in early 2002 (66.6% for men). After Italy, Spain would register the sharpest proportional drop in population between 2000 and 2050 (22% against Italy's 25%). Among EU countries, only the populations of France, Ireland and Luxembourg would increase over the next 50 years on current trends. Also among EU countries, Spain would have the largest percentage of its total population over the age of 60 in 2050 (44%, compared with 22% in 2002), and the average age of its citizens in 2050 (55.2 years) would be the oldest in the world according to UNPD projections.

Spain already has a fairly high dependency ratio, with around 46 dependants (young and older persons) for every 100 persons aged between 15 and 64 years (working age). The ratio

[1] See *World Population Prospects: the 2000 Revision* (United Nations Population Division, 2002) and *Recent Demographic Developments in Europe, 2001* (Council of Europe, 2002).

will substantially increase over the next 50 years unless there is a significant rise in the fertility rate or a much larger influx of immigrants. The fertility rate of Spanish women has touched bottom and is beginning to rise a little. The number of births increased in 2001 for the third year running, the first sustained rise of this length since 1977. Meanwhile, the fertility rate of female immigrants from developing countries is double that of Spanish women. In 2000, non-Spanish mothers were responsible for 11.6% of the births in the Madrid region, three percentage points more than in 1999. However, the behaviour of second-generation immigrants in matters such as the number of children to have tends to be similar to that of the native population.

Spain could encourage women to have more children by giving families a more favourable financial treatment. Spain's family-oriented policies are the least generous in the EU. In 1994 Eurostat, the EU's statistics office, said a Spanish mother needed to have 50 children to receive the same financial aid from the state as a Belgian mother with three children. A start was made in improving the situation in 1995 when Spanish families with three children were officially defined as "large" and qualified for state aid. Previously, the minimum number was five children. In 1998, according to the latest comparative figures, the family/children function accounted for just 2.1% of total social benefits (EU-15 average of 8.3%). The tax reform that entered into force in 1999 is more generous towards families, as are the provisions contained in further income tax reforms that come into effect in 2003.

Immigration

Spain is finding it difficult to adjust to being a net importer as opposed to a net exporter of labour. The comparatively racially homogeneous country, unlike the UK, France and Germany,

has only recently become used to the arrival of immigrants in large numbers – a consequence of, and now a contributor to, Spain's prosperity.

Whereas between 1962 and 1974 close to one million Spaniards went to work in Germany, Switzerland and France, now North Africans, in particular, are increasingly making their way to Spain, braving the treacherous Strait of Gibraltar at night in *pateras*, basically small wooden boats with a single outboard motor. On some nights, as many as 500 illegal immigrants have been caught crossing Spain's equivalent of the Río Grande that separates Mexico from the US, the other fault line between the economically developing and developed words. Many of the crossings are organised by mafia groups who charge around €2,000 per illegal immigrant. Others arrive by even flimsier means of transport: four Chinese immigrants in a rubber dinghy propelled by a Moroccan with flippers were caught in 2002 crossing from Morocco to Benzú at Spain's North African enclave of Ceuta, from where they then hoped to reach the mainland. According to provisional figures from Eurostat, Spain received one in every four net migrants (immigrants less emigrants) in 2001, the largest proportion among EU countries.

Less than 14km separates Africa, the world's poorest continent, from increasingly affluent Spain, the gateway to southern Europe. Between 1990 and March 2002 the total number of foreigners legally resident in Spain increased from 278,700 (0.9% of the total population) to 1.2 million (3%). More than half of them are from non-EU countries. The 1.2 million foreign residents include everyone from British pensioners who retire to Spain to manual labourers from Latin America and North Africa who probably entered Spain illegally and then regularised their situation, but it excludes illegal immigrants, for whom there are no reliable estimates. Even with a maximum of 500,000 illegal immigrants (the estimate is

Exhibit 1.10. **Stocks of Foreign Population in EU Countries (% of Total Population)**

	1990	1999
Austria	5.9	9.2
Belgium	9.1	8.8
Denmark	3.1	4.9
Finland	0.5	1.7
France	6.3	5.6
Germany	8.4	8.9
Ireland	2.3	3.1
Italy	1.4	2.2
Luxembourg	29.4	36.0
Portugal	1.1	1.9
Spain	**0.7**	**2.0**
Sweden	5.6	5.5
UK	3.2	3.8

Source: OECD, 2001.

200,000), Spain's stock of foreign population at 4% of the total population would still be below the level of most EU countries (see Exhibit 1.10).

The push factor is poverty and the pull factor Spain's demand for menial jobs that Spaniards are no longer prepared to do, particularly in agriculture, construction and domestic services. Despite having the highest unemployment rate in the EU, there are jobs that Spaniards prefer not to do[2]. The system of unemployment benefits, a still flourishing black economy and the extended family network means that, unlike immigrants, Spaniards can to some extent afford to pick and choose. In 2001, for example, there were 223,000 agricultural workers in Andalusia and Extremadura being paid a subsidy at the same time as employers in Almería and Murcia could not find Spaniards to work on farms and so resorted to immigrants. The builder who fitted a new back door for this author's home was Romanian, the plumber who changed the pipes of his bathroom was Peruvian and the man who painted the bathroom was Brazilian. Were it not for immigrants, Spain would not be able to harvest its strawberries in Huelva, collect its pears in Lérida, build more flats, run some of its hotels in tourist areas, find nannies to look after children, people to care for the elderly in their homes and reduce the cost of keeping horses at livery. According to the UN, Spain will need between 12 million immigrants between now and 2050 in order to maintain the level of its population and guarantee the viability of its pensions system.

Not only has the number of immigrants shot up, particularly since the "regularisation" programme offered to illegal immigrants in 2000, which benefited more than 150,000 people,

[2] See *España ante la inmigración* (La Caixa Foundation, 2002)
by Víctor Pérez-Díaz, Berta Álvarez-Miranda and Carmen González-Enríquez.

Exhibit 1.11. **Spain and Morocco – Population (Millions)**

	1950	2000	2050
Spain	**28.0**	**39.9**	**31.2**
Morocco	8.9	29.8	50.3

Source: World Population Prospects: 2000 Revision (United Nations Population Division, 2001).

but the composition has radically changed. This process enabled Spain to partly gauge the number of illegal immigrants. The total number of legal Moroccans resident in Spain rose from 49,513[3] in 1991 to 220,000 in 2001, by far the largest country group. Islam is now the second-largest religion after Catholicism in Spain, large parts of which, between the early 8th century and 1492 when the last Arab emir was driven from the kingdom of Granada, were under Muslim rule. Over the same period legal immigrants from the whole of Latin America increased from 83,257 to around 200,000.

Morocco's tremendous demographic pressure and the country's inability to generate sufficient jobs are propelling thousands of Moroccans to risk their lives and cross the Strait of Gibraltar. Hundreds drown every year and scores are killed by the lethal chemical reaction of petrol from outboard motors and salt water. Between 1997 and 2001, the bodies of more than 3,200 immigrants were found on either side of the Strait. Fifty years ago, Spain's population was three times higher than Morocco's. By 2050, Morocco's population, on current projections, will be 60% more than Spain's (see Exhibit 1.11).

There is solid evidence that Spain is benefiting from immigration. Immigrants have made a significant contribution to the turnaround in the financial health of Spain's social security system, which in 2001 generated a surplus equivalent to 0.8% of GDP, offsetting the small deficits registered by the central, regional and local governments and producing a balanced general government budget. Of the total 15.7 million contributors in 2001, 604,900 were foreigners (452,671 in 2000), 157,394 from EU countries (who have an automatic right to work in Spain) and 447,506 from other nations. The total number of contributors continued to climb in 2002 and stood at 16.1 million in May, when 581,594 of them were from non-EU

Exhibit 1.12. **Unemployment (% of the Active Population)**

	1993	2001
Austria	3.9	3.6
Belgium	6.9	6.6
Denmark	9.5	4.3
Finland	16.4	9.1
France	11.3	8.6
Germany	7.9	7.9
Greece	8.6	10.5
Ireland	15.6	3.8
Italy	10.1	9.4
Luxembourg	2.6	2.0
Netherlands	6.2	2.4
Portugal	5.6	4.1
Spain	**22.5**	**10.6**
Sweden	9.1	5.1
UK	10.2	5.0
EU-15	10.5	7.4

Source: Eurostat.

countries (3.6% of the total) and 179,879 from EU nations. Between 1999 and May 2002 the number of contributors from EU countries rose from 120,563 to 179,879 and those from other nations from 211,844 to 581,594, 42% of them from Morocco, Ecuador, Colombia and Romania.

Immigrants could also help Spain to fill the depleted ranks of its army, which needs 90,000 soldiers and only had around 76,000 in 2002. The government abolished compulsory military service as of 2002 and it planned to recruit a maximum of 2,000 immigrants from Latin America. They would not be allowed to serve more than three years.

There were ugly anti-immigrant riots in Almería in 2000, where thousands of north Africans are employed in the plastic hothouses that produce Europe's winter vegetables. Rioters, some of them from right-wing extremist groups, destroyed allotments, shantytowns and a warehouse in the town of El Ejido after three local girls were murdered. El Ejido epitomises the affluence that parts of Spain have achieved, in large part due to immigrants, and the poor conditions in which the latter still live. The town is one of the richest in Spain in per capita income (there are 49 bank branches for a population of around 50,000) and it has virtual full employment, but little of the wealth has trickled down to the immigrants, who live in deplorable conditions. The Moroccan-based Spanish writer Juan Goytisolo described the town as "an eldorado of clandestine work and illegal exploitation."

Following its "regularisation" programme in 2000, the government tightened immigration controls with the entry into force of a new law in 2001, and it planned to get tougher. The law introduced heavier penalties against companies that employ illegal labour. It also made

Exhibit 1.13. **Structure of Employment (as a % of Total Economy)**

	Spain	EU-15
Agriculture	**6.6**	4.4
Manufacturing	**19.5**	19.7
Construction	**10.4**	7.2
Trade, transport, communication	**27.4**	25.4
Financial services, business activities	**9.4**	13.9
Public services	**26.7**	29.3

Source: Eurostat. Figures for 2000.

expulsions easier and obtaining residence more difficult. The yearly quotas for non-EU immigrants, based on the number of jobs that the government estimates will not be covered by Spaniards, and other factors have always fallen well short of the demand for labour[3]. The official policy needs to be brought into line with reality. Immigration should not be seen only as a security problem that can be solved by using more sophisticated detection equipment in the Strait of Gibraltar, but also as an issue about the demand for labour. As long as there is demand, immigrants in search of work will continue to arrive.

Labour Market

Spain has reduced its stated unemployment rate at a much faster pace than any other OECD country, but it comes from a much higher starting point and its jobless level, at more than 10%, is still the highest among developed countries (see Exhibit 1.12). The main factors behind the substantial improvement have been labour market reforms and buoyant economic activity. The country's employment structure is similar to that of the EU-15 except for a larger proportion of people working in agriculture and construction (see Exhibit 1.13).

The dramatic nature of Spain's longstanding unemployment problem is underscored by the fact that at the end of 2001 there were only 2.4 million more people employed than the 12.4 million in 1976, even though the size of the economy had more than doubled and the population had risen by 10%. This figure, however, needs to be qualified; statistics in

[3] See *Inmigración: algunas preguntas y respuestas*, by Manuel Pimentel, a former labour minister, in *El País* (March 9, 2002).

1976 were not as reliable as they are now, and the updating of the labour force census in 1996 showed that the number of jobholders had been substantially undervalued.

Also, methodological changes were introduced to the labour force survey in 1999 to adapt it to EU requirements. As of the first quarter of 2002, the National Statistics Office (INE) made the survey more representative of the population structure by taking into account new population projections with a much larger number of immigrants. The estimates of their number in the past were way out of line with reality. In addition, INE re-weighted the 25-54 year old age groups so that their relative importance in the survey would more closely match their proportion of the total population. The definition of unemployment became more restrictive after these changes, since unemployed people looking for work solely through INEM labour exchanges must have been in contact with them in the four weeks prior to the reference week (before, they only had to be in contact every three months), with the specific aim of looking for a job. The new methodology increased the size of the labour force by 1.2 million in 2001 and reduced the number of unemployed by 321,000. As a result the unemployment rate fell from 13% to 10.5%.

There are very wide disparities in unemployment by region. Five of Spain's 17 autonomous regions have unemployment levels below or in line with the EU average – Aragón, the Balearic Islands, Catalonia, Navarra and La Rioja – while two – Andalusia and Extremadura – have rates of more than 20%. While unemployment remains high, there is the paradox of unskilled and skilled labour shortages in certain sectors, particularly construction and agriculture, and increasingly in the ICT sector. In some areas, notably doctors and nurses, Spain has a glut and is sending them to the UK and Portugal. There is also a large surplus of lawyers, but they are not being "exported" and, far from giving Spain an agile judicature, the country is saddled with

a very inefficient legal system that moves at a snail's pace. Spain has around 142,000 lawyers (281 per 100,000 citizens). Only the US (800,000) has a larger number in absolute terms and its population is seven times larger than Spain's.

Spain's employment rate (employed persons aged 15-64 as a percentage of the total population aged 15-64) is still one of the lowest among EU countries. Between the unemployed, students, pensioners and other categories of "inactive" people, only 53.5% were employed in early 2002 (68% in Germany and 71% in the UK). Improving the employment rate is crucial for further real convergence by the Spanish economy with the EU.

The 1994 reforms liberalised the hiring end of the market but did not touch the level of statutory redundancy payments inherited from the Franco regime (relatively generous, as they were based on the job-for-life principle of the corporatist state in return for political obedience). The 1997 reforms represented a trade-off whereby unions accepted lower redundancy costs for new hirings while employers introduced more stable employment contracts in place of a vicious circle of rotating six-month jobs. Short-term contracts with no firing costs were introduced in the 1980s and ballooned as employers took advantage of a way to get round the costly permanent contracts. Redundancies for the permanent contract introduced in 1997, if "unjustified", cost a maximum of 33 days' salary per year worked, with a ceiling of 24 months, compared with the standard 45 days up to a 42-month maximum (still applied for unfair dismissals for workers on old permanent contracts). The reform excluded workers aged 30 to 45. Changes in 2001 applied the 33-day limit more widely and, in return, entitled people on short-term contracts to eight days of compensation and limited the use of such contracts in collective bargaining. Part-time employment (less than 10% of total employees, much lower than the EU

Exhibit 1.14. **Severance Payments for Permanent Contracts in Selected OECD Countries (Months of Salary)**

	Justified Dismissals After			Unjustified Dismissals
	9 Months	4 Years	20 Years	after 20 Years
Spain				
Special groups[1]	0.5	2.6	12.0	22
Others	0.8	4.1	12.0	30
France	0	0.4	2.7	15
Germany	0	0	0	18
Italy	0.7	3.5	18.0	32.5
United Kingdom	0	0	0	0
United States	0	0	0	Disparate rulings

(1) Long-term unemployed (over one year), temporary workers, young workers (aged 18-30) and women in special sectors.
Source: OECD.

Exhibit 1.15. **The Size of the Shadow Economy in OECD Countries (% of GDP Using the Currency Demand Method)**

	Average 1989/90	Average 2001/02
France	9.0	15.0
Germany	11.8	16.3
Greece	22.6	28.5
Italy	22.8	27.0
Spain	**16.1**	**22.5**
United Kingdom	9.6	12.5
United States	6.7	8.7

Source: Dr Friedrich Schneider.

average) was also made easier and subsidies were paid to employers' social-security costs to encourage more hiring of women. Part-time jobs are particularly essential in Spain to cut the high unemployment rates of women (18% in 2001, double the EU average) and the elderly who are capable of working. Part–timers also contribute to tax and social security revenues, whereas if unemployed they are a drain on national wealth.

There was no further reduction in dismissal costs for permanent contracts, leaving the segmentation between "expensive" (pre-1997) and "cheap" contracts unchanged in an even more fragmented labour market. The stringency of Spain's employment protection legislation for core workers is among the highest in the OECD countries (see Exhibit 1.14). At the end of the 1990s, Spain's labour market was still one of the most regulated. On a scale of 0 to 6, where 0 represents no regulation, Spain scored 3.1 compared with 0.5 in the US, 2.6 in Germany and 3.4 in Italy, according to the OECD.

The proportion of temporary workers has declined little since the 1997 reforms. Close to one-third of all workers in Spain are still on short-term contracts, three times the EU average. The lack of job security, along with inadequate training, is one factor behind the very large number of accidents at work every year. Employment still resembles what the sociologist Víctor Pérez-Díaz calls the "four-square society" after a children's game. People, especially the young, move between four points: a fixed-term, precarious job; the shadow economy; unemployment benefits; and, now increasingly, a stable job. After Greece and Italy, Spain has the largest shadow economy among OECD countries, and it has grown substantially over the last decade, largely because of the increase in tax and social security contribution burdens, cumbersome employment regulations and issues of ethics (see Exhibit 1.15).

Exhibit 1.16. **Tax Burden (Tax Receipts as a % of GDP)**

	2001E	1980
Austria	44.4	42.4
Belgium	46.1	48.5
Denmark	49.5	45.1
Finland	45.9	38.3
France	45.1	42.6
Germany	41.4	42.8
Greece	38.7	24.4
Ireland	31.5	31.2
Italy	42.1	31.8
Netherlands	39.7	43.6
Portugal	37.6	25.6
Spain	**35.8**	**28.2**
Sweden	52.8	48.4
UK	38.3	33.8

E: Estimate.
Source: IWD.

The wage bargaining system is in need of bold reform. Although trade union membership is very low in Spain at around 10% of total employees, binding statutory extensions ensure that wage agreements of a specific territorial scope (national or provincial level, for example) cover non-unionized companies across the whole territory. Small firms, the backbone of the Spanish economy, with no trade union representation must avail themselves of an agreement reached at a broader level than corresponds to them. These agreements are rarely attuned to their particularities. Clauses introduced in 1994 to allow ailing firms to opt out of the wage regime resulting from collective bargaining agreements have hardly been used. The system needs to be revamped from industry or regional settlements to company-level agreements geared to adapting wage demands more closely to increases in productivity. With unit labour costs rising above the Euro zone average as bargaining takes headline inflation as a reference (which is higher in Spain than the Euro zone average), the system is an obstacle to greater competitiveness.

Taxation

Spain's tax burden (tax revenue as a percentage of GDP) over the last 25 years has risen at a much faster pace than in other EU countries, except for Portugal and Greece, as it had to do if the country wanted to finance the building of much-needed infrastructure and create a welfare state almost from scratch without resorting to massive foreign borrowing or running up a substantial budget deficit. It rose from 28% in 1980 to nearly 36% in 2001, while the average over the same period for 14 EU countries (excluding Luxembourg) increased from 37.6% to close to 42% (see Exhibit 1.16). In 1970 only 303,000 people paid taxes – one in every 20 gainfully employed Spaniards. Today, more than 14 million people file income tax returns.

The first steps towards creating a modern tax system were taken in 1977, when the parliament passed an elementary reform that unified the income tax system, applying the same tax assessment rules to wage earners and non-wage earners, and, for the first time, outlawed tax evasion. A quarter of a century later, Spain's top marginal personal income tax rate of 48% (65.5% in 1979–81, 68.4% in 1982–88 and 56% in 1989–98) and corporate tax rate of 35% are at the higher end of the range among EU countries, while its standard VAT rate of 16% is among the lowest (see Exhibit 1.17). The top income tax rate will come down to 45% as of 2003 and the minimum rate from 18% to 15%.

Tax evasion is still high in Spain judging by the size of the shadow economy (22.5% of GDP) and the anecdotal evidence on the mountain of "black" money that surfaced with the launch of euro notes and coins in 2002 and the disappearance of the peseta. The small local bank branch of this author, one of close to 39,000 in all of Spain, received lump sums totalling Ptas120 million (€721,200), mainly in brand new 10,000-peseta notes, in the first six weeks of 2002 from customers exchanging pesetas over the counter. Pesetas ceased to be legal tender in March, but up to Ptas2.5 million could still be exchanged for euros until July without the bearers having to identify themselves or explain the provenance of the money. The 10,000-peseta note, the top denomination, was rarely seen in routine commerce and was widely used to hold *dinero negro*. The research department of Banco Bilbao Vizcaya Argentaria (BBVA) estimated that €17.2 billion of "black" money surfaced in 2001 (2.6% of GDP) because of the "euro effect". The flushing out of "black" pesetas fuelled a spending spree in 2001 and helped to push up house prices by an average of 11.4% in real terms, the largest rise among *The Economist's* house-price indices. The real increase in housing prices in Spain between 1980 and 2001 was 124%, compared with 19% growth in the global

***Exhibit 1.17*. Tax Rates in the European Union (%)**

	Top Marginal Income Tax	Corporate Tax	Standard VAT
Austria	43.7	34.00	20.0
Belgium	65.2	40.17	21.0
Denmark	63.5	30.00	25.0
Finland	58.6	29.00	22.0
France	51.4	34.30	19.6
Germany	49.8	38.36	16.0
Greece	40.0	25.00/35.00	18.0
Ireland	42.0	16.00	21.0
Italy	51.4	40.25	20.0
Luxembourg	38.0	30.38	15.0
Netherlands	52.0	29.00/34.50	17.5
Portugal	40.0	33.00	19.0
Spain	**48.0**	**35.00**	**16.0**
Sweden	55.6	28.00	25.0
UK	40.0	30.00	17.5

Source: KPMG. Figures for 2002.

***Exhibit 1.18.* Tax Wedges[1] as a Percentage of Labour Costs[2]**

	1997	2001
France	39.5	39.4
Germany	35.6	32.6
Ireland	23.8	12.8
Italy	43.3	35.6
Portugal	26.8	24.2
Spain	**33.7**	**31.0**
United Kingdom	24.8	17.8
United States	24.1	19.4

(1) Income tax plus employee and employer social security contributions less cash benefits.
(2) One-earner family with two children.
Source: OECD.

index. Spain has the highest percentage of households owning their own home in the EU (86%, compared with an average of 61%).

Tax experts say a flat income tax rate would make the Spanish tax system more efficient and reduce tax evasion. According to a simulation by economists at Santander Central Hispano, a reasonable alternative would be a minimum exempt of €12,000 and a flat rate of 28.8%, close to the country's average effective corporate rate.

Spain's tax wedge, which measures the share of labour costs attributable to income taxes and social security contributions less cash benefits (ie, the difference between workers' take-home pay and what it costs to employ them), has fallen, as it has in all OECD countries, and is lower than Germany's and Italy's but higher than the UK's and the US's (see Exhibit 1.18).

Welfare State

The Spanish welfare state was one of the last to arrive on the European scene. While most EU countries were busy between 1960 and 1975 constructing pensions, unemployment benefits, health and housing schemes, Spain's economy had a minimal government presence. Total public sector spending in 1975, the year that Franco died, represented close to 25% of GDP, compared with an average for the then European Community countries of 40%. But, once democracy was established, Spain began racing to catch up, without due regard as to whether the country could afford it or the tax system could sustain it. General government outlays peaked at 47.2% of GDP in 1993 and in 2002 were an estimated 38%.

Most of the growth in spending came from expenditure on social protection, but this figure in GDP terms is still below the EU-15 average (21.6% in 1998, the latest comparative figure available, compared with an average of 27.7%, according to Eurostat).

Income distribution is also more skewed than the EU average: in 1998 (latest available data), the share of the total income received by the 20% of the population with the highest income (top quintile) was 6.8 times higher than that of the lowest quintile, compared with the EU average of 5.4 times. It should be borne in mind, however, that income inequalities reflect factors that are not usually associated in people's minds with this issue, such as the overall unemployment rate (still high in Spain) and late entrance into the labour market of graduates.

Spain has built up a welfare state, but in some areas it still has a "social deficit". Nevertheless, it is a socially cohesive country. This is largely due to the country's extended-family based society, which the sociologist Víctor Pérez-Díaz calls the "cornerstone" of the Spanish welfare state. An estimated 60% of people aged between 25 and 30 live at home and only 13% of households have one occupant. The family is on the retreat throughout the developed world, particularly in northern Europe, but to a lesser extent in Spain. The extended family looks after unemployed members, enables the young, if they wish, to live at home and save while they are beginning their working life and allows the great majority of pensioners to live with their children. In the latter case, this informal assistance from families provides older persons with living standards similar to those of the rest of the population, making up for the shortfall in minimum pensions (one-third of all pensions range from 20% to 30% of the average wage).

The ageing population (Spain's life expectancy of 78 years is longer than the OECD average) and the very low birth rate, with the resulting rise in the dependency ratio (the population aged 65 and over as a percentage of the population aged 20 to 64), are putting the public pension and health systems under growing pressure. This is a Europe-wide problem, but relatively more acute in Spain, whose dependency ratio is projected to increase from 27% in 2000 to 62% in 2050 (from 26.5% to 52% over the same period for the EU as a whole). One factor that strains Spain's dependency ratio is late entry into the labour market because of the long time it takes students to complete their university studies and graduate. Most university degrees run for five years, and many students have to repeat courses (see the section on education). A student in the UK, for example, would tend to graduate at the age of 22/23 compared to over 25 in Spain in many cases.

The drain on Spain's public finances will increase appreciably as from 2020-25, when the "baby boom" generations born between 1954 and 1975 have retired and the burden of larger pension expenditure is borne by a dwindling cohort of taxpayers[4]. This scenario, of course, assumes a decline in the population which is by no means certain as the fertility rate of Spanish women could pick up and the number of immigrants be much larger than predicted. A group of experts drawing up a report for the European Commission calculated that Spain's spending on pensions would double to around 18% of GDP by 2050, the largest increase among EU countries, unless changes are made.

[4] This section draws on the chapter on pensions in the OECD's survey of Spain (June 2001).

Exhibit 1.19. **Main Parameters of Public Pension Schemes in Selected OECD Countries for Employees in the Private Sector, from 2000 Onwards**

	Statutory Retirement Age (Men/Women)	Contribution Period for Full Pension (Years)	Reference Period for Benefits	Maximum Replacement Ratio (%)
Spain	**65**	**35**	**Last 15 yrs**	**100**
Belgium	65/61	45/41	Career	60
Finland	65	38	Career after 23 yrs of age	60
France	60	40	25 yrs	80
Germany	65	45	Career	70
Italy	57-65	40	Career	No maximum
Japan	60/55	40	Career	30
Portugal	65	40	Best 10 yrs	80
United Kingdom	65/70	49	Career	20
United States	65	35	Best 35 yrs	41

Source: OECD.

For the moment, pension payments are not a problem. The social security system generated a surplus of 0.8% of GDP in 2001, when the number of contributors rose 3.3% to a record 15.7 million. The government's own estimates for the 2001-15 period, based on conservative assumptions for the main macroeconomic variables (real average GDP growth of 2.9%, inflation of 2% and average employment growth of 1% in terms of social security enrolments) show that the pension system will suffer relatively little change. Pension expenditure will hardly drop (from 8.4% of GDP to 8.25%), while revenue from social security contributions will decline from 10% to 8.5%. If correct, this would signify that there is time for the necessary reforms to be implemented and take effect.

The all-party 1995 Toledo Pact on pensions enshrined the pay-as-you-go (PAYG) system, where the social security contributions of today's workers pay for the pensions of the retired as the "essential" pillar of pensions, and commits governments to indexing state pensions to inflation. Amongst the timid reforms was increasing the eight-year base period of social security contributions for calculating pensions to 15 years by 2003, a year before the next general election and not one for taking unpopular decisions. In the majority of countries, pensions are computed on the basis of earnings over an entire working life and not just the latter part of it (see Exhibit 1.19). The replacement rate is seldom more than 75%, and in most countries the average annual rate of entitlement accrual ranges from 0.5% to 2%, much lower than Spain's 2.9%. Yet, despite this comparative generosity, public expenditure on pensions is lower than the European average. Average pensions (all categories combined and without adjustment for the different tax treatment across countries) represented only 64% of per capita GDP in 1998 (latest comparative figure available), compared with a European average of 75%.

There are two contradictory trends in Spain's pension system that are complicating the situation. On the one hand, the Toledo Pact is an attempt, albeit a modest one so far, to look ahead and prepare for the expected demographic changes. On the other hand, private-sector companies resorted in the 1990s to reducing their labour costs as part of corporate restructuring by paying off payroll workers over the age of 50 and employing younger people. Most of these "early retirements" are really long-term unemployed people who find it difficult to get another job and whose motivation to obtain one depends, to some extent, on the size of the severance payment. The government moved to counter this negative trend in March 2001 by providing incentives to extend working life beyond the age of 65. In 2002, 13% of men over the age of 60 were still working in Spain, compared with 23% in the US, 19% in the UK and only 6% in France. Employees are now allowed to receive a partial pension while continuing to work, which was very difficult before. Those that continue to work after 65 are exempt from social security contributions if they have already paid for 35 years. However, the government also extended the possibility of early retirement to new groups of agents, raising the risk that early retirement will start growing again.

The volume of private pensions – to supplement public pensions – is growing but is still comparatively small in Spain. Private pensions began in 1988. In 2001 these assets totalled €43.8 billion (6.7% of GDP) and there were 5.8 million participants in a population of 20.4 million aged between 25 and 64.

Public spending on health represents around 5.5% of GDP. Total spending is about 8%. Per capita expenditure, allowing for differences in living standards across countries, is close to the OECD average. However, the number of hospital beds and nurses per inhabitant is lower

than elsewhere in the OECD; there is a problem of waiting lists, though not as bad as that of the dire situation in the UK. Another weak area is the very low number of people over the age of 65 who receive some type of home service provided by the state (1.4% compared with 7% in France, 9% in the UK and 30% in Sweden, according to the OECD in 1998). Most of this work is done by private sector companies employing poorly paid Latin Americans.

Although public spending is below the OECD average, Spain scores very well in the World Health Organisation's ranking of health–care systems. In its World Health Report 2001, Spain was ranked 7th in overall health system performance, ahead of Germany (25th), the United Kingdom (18th) and the United States (37th). The ranking is based on five measures. Among them is the overall population health as determined by "disability-adjusted life expectancy" (DALE), the number of good years of health that an average baby can expect in his or her lifetime. The study also rates the "responsiveness" of health-care systems, according to how promptly they provide medical attention, how much choice they offer and how well they respect the confidentiality and autonomy of patients. The WHO uses a measure of efficiency which assesses health-care systems on the basis of inputs as well as outputs, including per capita spending and the average number of years a country's citizens spend in school.

Education

Spain's education system is beginning to undergo much-needed reforms. The country's qualitative education indicators lag behind most OECD countries, the drop-out rate among secondary school students is particularly high (around one in four leave school without their certificate), a mass university system has been created and there is a mismatch between labour

market requirements and available skills. The generally mediocre education system, however, has not been an obstacle to Spain's success so far, but it is fair to say that it has prevented the country from realising its full potential, and the more the economy becomes globalized the more the shortcomings will be felt.

The state of Spanish secondary education was underscored by the country's poor showing in the OECD's survey among 15-year olds, carried out in 2001 by the Programme for International Student Assessment (PISA). Spain was significantly below the OECD average in all three literacy categories (see Exhibit 1.20). The government said the "worrying" results backed the need for its reforms, while the opposition parties said they highlighted the "disastrous management" by the education ministry and the effect of budget cutting.

Spain's expenditure on public education (4.4% of GDP, according to the latest available figures in the 2001 edition of the OECD's *Education at a Glance*) is not far from the country mean of 5.0%. The spending per student and the ratio of students to teaching staff are mostly lower than the average but not by a huge margin. Nevertheless, Spain performed badly in the PISA survey. The reforms in primary and secondary education include teaching a first foreign language and computers at an earlier age (6-8 and 8-10 years, respectively) and establishing a minimum content in the secondary and *bachiller* curricula for the whole of the country. Students would be channelled into vocational training or towards universities at the age of 14, two years earlier than at the moment. Less than 40% of secondary students opt for vocational training courses compared with an EU average of 57.6%[5]. As regards the content, the

[5] See *La educación y la formación lo son casi todo* by Guillermo de la Dehesa (*El País*, May 25, 2002).

Exhibit 1.20. **Schooling Outcomes – Ranking by Countries**

Reading Literacy[1]		Mathematical Literacy[2]		Scientific Literacy[3]	
Finland	546	Japan	557	Japan	557
Canada	534	Korea	547	Korea	547
New Zealand	529	New Zealand	537	New Zealand	537
Australia	528	Finland	536	Finland	536
Ireland	527	Australia	533	UK	532
Korea	525	Canada	533	Canada	529
UK	523	Switzerland	529	New Zealand	528
Japan	522	UK	529	Australia	528
Sweden	516	Belgium	520	Austria	519
Austria	507	France	517	Ireland	513
Belgium	507	Austria	515	Sweden	512
Iceland	507	Denmark	514	Czech Rep.	511
Norway	505	Iceland	514	France	500
France	505	Liechenstein	514	Norway	500
US	504	Sweden	510	US	499
Denmark	497	Ireland	503	Hungary	496
Switzerland	494	Norway	499	Iceland	496
Spain	**493**	Czech Rep.	498	Belgium	496
Czech Rep.	492	US	493	Switzerland	496
Italy	487	Germany	490	**Spain**	**491**
Germany	484	Hungary	488	Germany	487
Liechenstein	483	Russian Fed.	478	Poland	483
Hungary	480	**Spain**	**476**	Denmark	481

(1) Mean performance on the combined reading literacy scale.
(2) Mean performance on the mathematical literacy scale.
(3) Mean performance on the scientific literacy scale.
Source: OECD PISA Study, December 2001.

Exhibit 1.21. **Educational Attainment of the Population in Selected OECD Countries (% Distribution by Level of Attainment in 1999)**

	At Least Upper Secondary		Total Tertiary Education	
	25-64 Years	25-34 Years	25-64 Years	25-34 Years
Finland	72	86	31	37
France	62	76	21	31
Germany	81	85	23	22
Italy	42	55	9	10
Spain	**35**	**55**	**21**	**33**
United Kingdom	62	66	25	27

Source: OECD and Educación superior y futuro de España *by Víctor Pérez-Díaz and Juan Carlos Rodríguez (Fundación Santillana, 2001).*

devolution process has made it difficult to establish a basic and common educational standard. The content varies from region to region, particularly in the most nationalistic regions, such as Catalonia and the Basque Country. For example, the government's proposed changes to the national curriculum for history stirred up a hornets' nest of complaints from the Basque and Catalan governments. They were incensed by the phrase "understand and evaluate the unitary character of Spain's history"; the ministry of the central government in Madrid agreed to replace "unitary" with "common".

There are 1.6 million university students – 16 times higher than in 1950 and five times more per capita than the Netherlands. About 40% of students drop out before graduation and between 40% and 45% repeat courses[6]. When the 1990 education law, which raised the school-leaving age from 14 to 16, was enacted it was forecast that 40% of 16-year-old students wishing to continue their studies would sign up for vocational courses. The vast majority, however, chose to remain at school for a further two years to obtain the *bachiller* (senior secondary schooling certificate), which is required to sit for university entrance exams. There was a change of trend in 2001/2002 towards vocational courses.

Spain ranks well (7th among 29 OECD countries) on the basis of the percentage of people (33%) aged 25 to 34 with a university degree or higher (see Exhibit 1.21). It is well ahead of Italy and above France and Germany. The same figure for the whole population aged 25 to 64, however, drops to 21% (17th in the ranking). The problem is not one of quantity but of quality. A high proportion of graduates are over qualified for the jobs they get, and so do not need to spend

[6] See pages 35 to 60 of *Una interpretación liberal del futuro de España* by Víctor Pérez-Díaz (Taurus, 2002).

so much time at university, and at the same time many graduates need further studies after leaving university in order to carry out their professional activities. The answer is not just one of spending more money: the level of Spain's spending on university education in GDP terms is already similar to that of France, Germany and the UK, whose per capita income is higher than Spain's.

The respective figures for upper secondary education attainment are far worse: 55% for those between 25 and 34 (23rd position) and 35% for the 25 to 64 age group, far from the average of 62% and the fourth lowest rate among OECD countries after Mexico, Portugal and Turkey.[7] These figures show that Spain still has a long way to go in secondary education, but it is a problem that should improve with the passing of time provided the drop-out rate among teenagers is reduced. The proportion of individuals aged 25 to 34 at the moment with at least upper secondary education is more than three times as high as in the age group 55 to 64.

There is little competition between the state-owned Spanish universities. The arrival of private universities, which account for 20%–25% of students in Madrid, Catalonia and the Basque Country, has injected some competition into the system and, together with the low birth rate, which is sharply reducing the entry of new students each year, has eased the overcrowding problem. There is also little quality assessment and no relationship between this and the funds received (which means there is no control of standards and no effective penalisation), and over 90% of lecturers teach in the very same department where they completed their first degree. This rate of "inbreeding" resulting from social networks that,

[7] See chapter 3 of *Educación superior y futuro de España* by Víctor Pérez-Díaz and Juan Carlos Rodríguez (Fundación Santillana, 2001).

regardless of the candidates' merits, systematically award positions to one of their members, is much higher than in other countries. There is very little outside competition for lectureships. Many of the best brains, especially in science, end up in universities abroad, and those who complete doctoral or postdoctoral training abroad and return to Spain are often discriminated against when they apply for posts in their former universities[8]. According to a study by two Spanish scientists working in the UK, 93% of researchers holding permanent faculty positions in science departments in the US had been external candidates for the posts, 83% in the UK, 50% in France and only 5% in Spain[9]. These endogamic practices are a barrier to high-quality research and teaching in universities.

The university reforms that came into effect in 2002 amidst uproar from teachers and rectors defending the status quo aim to improve the quality of universities and the way they are administered, while devolving more responsibility for them to the regions. The national selection exam known as *selectividad* for admissions will end in 2004, leaving each university free to use whatever procedures it chooses. Despite its name, the exam is far from selective: eight out of every ten students are accepted, though not necessarily for the course they want unless they obtain the required grade. Would-be doctors can end up studying history, for example, because they do not get the more demanding grade for medicine. "Under the slogan 'universities for everyone' overcrowding has been confused with equality of opportunities", lamented José A. Herce San Miguel, director of the Foundation of Applied Economic Studies[10].

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[8] See the letter *"Returners Not Welcome at Spanish Universities"* in *Nature* (October 26, 2000).
[9] See the letter *"High Rate of Inbreeding in Spanish Universities"* in *Nature* (Volume 410, March 2001).
[10] See *La Universidad española y el factor 1/2* in *El País* (January 17, 2002).

Exhibit 1.22. **R&D Expenditure (% of GDP)**

	1995	2000
Austria	1.56	1.79
Belgium	1.72	NA
Denmark	1.84	NA
Finland	2.29	3.3
France	2.37	2.15
Germany	2.31	2.45
Greece	0.49	NA
Ireland	1.35	NA
Italy	1.00	NA
Netherlands	1.99	NA
Portugal	0.57	NA
Spain	**0.81**	**0.94**
Sweden	3.46	NA
UK	1.99	1.84

Source: Eurostat.

The cliquey system of patronage and internal promotion will be opened up, and those who want to be teachers will face national tests to join a pool from which universities will have to choose. In public universities – 48 out of Spain's 66, and accounting for over 90% of the students – almost half the teaching posts (against today's limit of 30%) will not carry tenure, and non-tenured staff will be more closely vetted.

R&D

Spain's progress in modernizing its economy has not been matched by a similar drive in R&D expenditure. It is striking that the last Spaniard to win a Nobel prize for science was Santiago Ramón y Cajal in 1906 (for medicine). The country's R&D spending is still only half the EU-15 average and one-third that of leaders such as Finland, despite the priority given to this area since the EU Lisbon summit in December 2000. However, taking into account differences in per capita income Spain's expenditure is not so far behind (see Exhibit 1.22). The country, however, has a relatively high rate of technology dependence, as measured by the technology balance of payments, and a low rate of inventiveness. The number of European Patent Office applications per million population was 14.7 in 1997, compared with an OECD average of 75.5, according to the latest comparative figures in the 2001 edition of the OECD's Science, Technology and Industry Scoreboard.

Under the 2000-03 National Plan for Scientific Research, Development and Technological Innovation, the modest goal is for R&D spending to reach 1.3% of GDP in 2003. Whereas in the most industrialised countries R&D is mainly funded by the private sector (accounting, on average, for 70% of investment), in Spain spending is fairly evenly divided between the

Exhibit 1.23. **Internet Penetration Rates (%)**

	2002E	2006F
France		
Individuals	27	44
Households	31	44
Germany		
Individuals	41	54
Households	42	53
Italy		
Individuals	34	44
Households	31	44
Spain		
Individuals	**23**	**39**
Households	**22**	**38**
UK		
Individuals	43	54
Households	41	53

E= Estimates. F= Forecasts.
Source: Jupiter Media Metrix.

public and private sectors in the richer regions, and in the poorer ones the state accounts for 70%. One of the goals of the Plan is to increase the private sector's share of the national total to 65% through tax measures and increased public funding. Another priority is to increase the number of research positions and long-term contracts (more than 800 in 2001) to 2,000 by 2003.

There is a substantial mismatch between the supply (inadequate) of researchers and the demand for them (growing). Higher education expenditure on R&D remained unchanged between 1994 and 2000 at 0.27% of GDP – half that of Finland. Despite the generally low R&D effort, although expenditure is growing substantially above the average government spending, Spain is advanced in some areas. CASA, Spain's state-owned aircraft company, was one of the three companies that created the European Aeronautic Defence and Space Company (EADS), Europe's premier aerospace and defence company and number three worldwide. The other two founding companies are Aerospatiale Matra (France) and DaimlerChrysler Aerospace Group (Germany). Other innovative high-tech Spanish companies are Indra and Zeltia.

Information and Communications Technology (ICT)

Spain needs to make greater progress in the main indicators of Information and Communications Technology (defined as information technology plus telecommunication equipment and services). The Spanish Association of Technology and Information Companies (Sedisi) says Spain is 12 years behind the EU average. The country is still what the World Economic Forum (WEF) calls a "non-core economy" in matters of technological advancement (countries with less than 15 patents per million population). Economic growth in the core

Exhibit 1.24. **ICT Spending by Selected OECD Countries, (% of GDP)**

	1993	2001
United Kingdom	7.4	9.7
France	6.0	9.1
Germany	5.5	7.9
United States	7.3	7.9
Italy	3.8	5.7
Spain	**3.8**	**5.1**

Source: Digital Planet 2002, published by WITSA.
Based on research by International Data Corporation.

economies is powered, fundamentally, by their capacity to innovate. Spain was ranked 21st in the WEF's 2001 Innovation Capacity Index and 34th in the Economic Creativity Index. The first index assesses a nation's innovation environment including the ability to retain scientists and engineers and the second gauges economies' involvement in new technologies, combining pure innovation with transfers of technology and start–ups.

The Spanish government's INFO XXI Action plan for 2001-03 has made modest progress, even though the tax framework supporting corporate R&D and technological innovation is now one of the most favourable in the OECD. Digital training programmes for users and professionals, programmes to promote the use of new technologies in companies and electronic security programmes were slow to get under way.

The liberalization of the telecommunications market (see Chapter 3) has produced notable results, the clearest sign of which is the surge in the penetration rate of mobile telephony (more than 75% and close to a level of saturation). Nevertheless, the problems encountered in developing the project to create "virtual mobile operators" (without networks), which would generate a more competitive environment, and the fact that Internet is still not a "universal telephony service", which would provide access to the Web for the whole of the Spanish population, are holding back progress. Spain's Internet penetration rate is well below the EU average (see Exhibit 1.23).

Spain's total ICT spending rose from $19.2 billion in 1993 to $30.3 billion in 2001. In GDP terms, Spain spent 5.1% – below the world average of 7.6% (see Exhibit 1.24). ICT per capita was $768 in 2001 as against $2,933 in the US, $1,880 in Germany, $2,318 in the UK and $1,116 in Italy. As regards the value added of ICT branches, growth has been more dynamic than the

Exhibit 1.25. **Investment in Knowledge, (% of GDP, 1998)**

	Total	R&D	Software	Public and Private Spending on Higher Education
Finland	5.2	2.9	1.2	1.1
France	4.1	2.2	1.2	0.8
Germany	4.2	2.3	1.2	0.7
Italy	2.1	1.0	0.5	0.6
Spain	**2.2**	**0.9**	**0.5**	**0.8**
UK	3.9	1.8	1.3	0.8
US	6.0	2.6	1.5	1.9

Source: OECD Science, Technology and Industry Scoreboard, 2001

economy as a whole, especially in IT-related activities. Productivity, which is at a relatively high level, has also performed better. However, as the weight of ICT activities in the whole economy remains small, their contribution to overall growth has been modest. ICT manufacturing in countries such as France, Ireland, Finland, the UK, the Netherlands and Sweden account for a proportion of total manufacturing that is almost twice that of Spain. An encouraging sign, however, is the increase in the number of computers connected to the Internet in schools, which in 2001 stood at three computers per 100 pupils, but still below the EU average. Spain needs to invest a lot more in knowledge (see Exhibit 1.25).

The portal *www.administracion.es* gives access to all the online services provided by the government. Users can make enquiries and complete the paperwork of different government departments, some of which offer online capabilities, such as social security on the Net and Internet tax returns.

Chapter 2

The Economy

Spain has become increasingly prosperous since it began to open and liberalize its economy. The first tentative steps came in the 1960s, but liberalization began in earnest during the 1980s and has continued to the present day. Spain's gradual transition to a market economy – taking advantage of rapid European regional integration – has arguably been the most successful among the former state-dominated economies.

Twenty years of autarky, following the 1936-39 Civil War, came to an end in 1959 with the Stabilization Plan, which encouraged foreign investment, opened the country to tourism and began to integrate the peseta into a transnational monetary system. The plan ushered in a long period of "miracle" growth. Between 1961 and 1973 real GDP increased 7% per year – the fastest growth of among member states of the OECD apart from Japan. The economy then went into the doldrums (growth averaged 1.4% in 1974-84) as Spain tackled its transition to democracy and coped belatedly with the 1973 oil-price shock, which triggered a slump worldwide.

In 1986 Spain joined the European Economic Community (EEC) and embarked on another sustained period of high growth, fuelled by greater macroeconomic stability, EEC funds, foreign investment and freer international trade. The economy expanded on average by 3.1% in 1986-98, with one year of recession in 1993. In 1999 Spain was one of the founders of European Monetary Union (EMU) and the single currency, the euro, which became legal tender in 12 of the 15 EU countries in 2002. Growth between 1999 and 2002 was more than 3% a year. Since 1986 economic growth has almost consistently been higher than the OECD average.

It is instructive to remember that in the 1960s the GDP per capita of Spain, Portugal, Greece and Turkey was almost the same. By 2000, Spain's was five times higher than that of Turkey,

Exhibit 2.1. Top 20 Most Global Nations

1.	Ireland	11.	Norway
2.	Switzerland	12.	United States
3.	Singapore	13.	France
4.	Netherlands	14.	Germany
5.	Sweden	15.	Portugal
6.	Finland	16.	Czech Republic
7.	Canada	**17.**	**Spain**
8.	Denmark	18.	Israel
9.	Austria	19.	New Zealand
10.	United Kingdom	20.	Malaysia

Source: A.T. Kearney/Foreign Policy Magazine, January/February 2002.

which only now is a candidate for full EU membership. Of course, there are many other issues apart from the purely economic, such as its demographics, which have helped Spain to achieve higher per capita wealth, but this is not to belittle the country's progress.

EU membership, followed by EMU membership, has rapidly integrated Spain into the world economy and helped it to sustain the most robust period of growth since the return to democracy in the late 1970s. The country was ranked the 17th most global nation in the A.T. Kearney/Foreign Policy Magazine Globalization Index, based on economic integration, personal contact (including cross-border transfers and tourism), technology and political engagement (see Exhibit 2.1). In the US Heritage Foundation's Index of Economic Freedom, Spain was ranked 26th (see Exhibit 2.2). This ranking is based on trade policy, fiscal burden, government intervention in the economy, monetary policy, capital flows and foreign investment, banking and finance, wages and prices, property rights, regulation and the black market.

The macroeconomic stability criteria required for EMU membership (in terms of lower inflation, low interest rates and fiscal discipline) has locked Spain into a virtuous circle of sustained growth with low inflation, albeit still above the European average. However, its budget and public debt levels in GDP terms are lower (see Exhibit 2.3). By assuming these stability standards and adding to them improvements in the workings of markets and in the flexibility of the economy, a change has been wrought in the Spanish economy's pattern of behaviour over the course of the cycle. The pattern has differed from previous cycles, where the imbalances incubated in expansionary phases would inescapably result in periods of recession and job destruction. Unlike in the past, the slowdown in the Spanish economy as of 2001 has been marked by the maintenance of positive rates of growth, job creation and real

Exhibit 2.2. Index of Economic Freedom Rankings, 2002

1. Hong Kong	4. United States	15. Bahrain	20. Germany
2. Singapore	9. Australia	15. Canada	23. Cyprus
3. New Zealand	9. Chile	17. Bahamas	23. United Arab Emirates
4. Ireland	9. United Kingdom	17. El Salvador	23. Iceland
4. Estonia	12. Denmark	17. Sweden	26. Barbados
4. Luxembourg	12. Switzerland	20. Austria	26. Portugal
4. Netherlands	14. Finland	20. Belgium	**26. Spain**

Note: A total of 155 countries are ranked.
Source: Heritage Foundation.

Exhibit 2.3. Inflation, General Government Budget and Public Debt[1]

	Inflation (%)	Budget (% of GDP)	Public Debt (% of GDP)
Spain	**2.8**	**0**	**57.2**
Euro-12 average	2.3	-1.3	69.1

(1) 2001 figures.
Source: Eurostat.

convergence with the EU. Moreover headway has continued to be made in fiscal consolidation, to the point that budget balance was attained.

Furthermore, according to the theory of optimum currency zones, the Spanish economy should fit well within the EMU and still has much potential to gain from – and incentives to push – future economic reforms. First, the Spanish economy, like most of its EU partners, meets the first criteria for establishing a fruitful common currency, as it exhibits a high degree of intra-area trade openness (ie, exports and imports measured against GDP). Spain's intra-EU trade represented 31.1% of GDP in 2001 (23.7% in 1995), higher than Italy and the UK and just below Germany and France (see Exhibit 2.3).

An optimum currency area should also be internally characterized by mobile resources (particularly capital and labour) and flexible wages and prices. This is because, while monetary policy flexibility no longer exists at the nation-state level, fiscal policy sovereignty must be sacrificed upon the altar of shared fiscal austerity, particularly given that discretionary fiscal policy is of little counter-cyclical use under the euro's flexible exchange rate regime vis-à-vis other currencies like the dollar and yen (see below). Hence, the Stability Pact and the emphasis on each member state minimizing the government's budget deficit even in the middle of a mild recession. Under such common currency conditions, discretionary use of national fiscal policy would be of macroeconomic counter-cyclical use only in the event of highly effective fiscal policy coordination among the member states (ie, looser fiscal policy in the areas experiencing the sharpest recession and tighter fiscal policy in the areas experiencing the mildest slowdown) or the existence of a centralized fiscal policy for the EMU area as a whole, including the capacity for more significant internal EMU transfer payments. While the former objective

may be increasingly possible under the auspices of the Stability Pact, the latter certainly appears to be a long way off in the future.

Because labour market flexibility is the principal economic area where Spain might still improve in the future, it does stand to gain in the context of the common currency area in the event of future labour market reform. Many would even argue that, now that Spain is in the common currency area, the economy's excess unemployment, particularly in the event of a future asymmetric shock (see below), might only be reduced by further labour market reforms which increase wage and price flexibility and improve labour mobility both within Spain and between it and other parts of the EMU.

The cost of EMU membership for Spain in terms of economic policy is the loss of the exchange rate as an instrument to offset external shocks and the forfeiture of control over its monetary policy, which is now set for all EMU countries by the European Central Bank with a single interest rate. There are two kinds of shocks: symmetric (ie, one affecting all EMU countries with the same intensity) and asymmetric (ie, one affecting countries in varying degrees). If the shock were symmetric, then the exchange rate of the common currency, in this case the euro, could be modified to offset the upset. In this case, the loss of a national currency would imply no loss of economic policy capacity. If the shock were asymmetric, then the loss of the exchange rate would represent a cost if there were no other factors within EMU to offset the shock: price and wage flexibility, labour mobility between member countries or a centralised budget which acts as an automatic stabiliser. In the event that these three factors were insufficient, loss of the exchange rate would represent a higher cost.

Exhibit 2.4. Intra-EU Trade (% of GDP)

Austria	49.2
Belgium	113.8
Denmark	39.8
Finland	35.6
France	32.2
Germany	32.2
Greece	16.4
Ireland	79.4
Italy	24.2
Luxembourg	86.0
Netherlands	76.8
Portugal	42.4
Spain	**31.1**
Sweden	39.4
UK	22.0

Estimates for 2001.
Source: Eurostat.

Spain's costs are those linked to the probability of suffering an asymmetric shock, which, in turn, depends on the degree of similarity between the economies comprising EMU. The more similar they are, the lower the probability of asymmetric shocks is. By calculating the coefficient of correlation between Spain's GDP growth and that of the core EMU countries (Germany, France, the Netherlands, Belgium and Luxembourg) over a long period, one can evaluate whether the Spanish economy is one that has been traditionally characterized by asymmetric shocks: the closer the coefficient is to one, the fewer asymmetric shocks have been suffered. Spain's coefficient between 1974 and 1986 was 0.66, the second highest after Italy of the countries not in this group, and 0.80 between 1986 (when Spain joined the EC) and 1996, which shows that its economic cycles have become increasingly closer to those of the hard core countries.

In 1994-99, the coefficient with the European Union as a whole, measured by the output gap, was 0.96 (see Exhibit 2.4), underscoring the increasing synchronization of economic cycles.[1] The output gap is the difference between the economy's actual output and the level of production it can achieve with existing labour, capital and technology without putting sustained upward pressure on inflation. Spain is the country that has moved the closest to the economic cycle of EMU countries. It started later than countries like Germany and France, whose economies were integrated into Europe before Spain, but once it was integrated it converged at a faster pace.

What would have happened if Spain had turned its back on globalization and not joined the Euro zone? It is impossible to give a scientific reply, but several consequences can be

[1] See chapter 10, by José Antonio Martínez Serrano and Vicente Pallardó López, in *Del real al euro, una historia de la peseta* (La Caixa, 2000).

briefly pointed out. The country's traditional macroeconomic imbalances in inflation, the budget, balance of payments and unemployment would have improved – but not to the same extent – without joining the single currency because Spain could not have afforded to be too much out of line with its main trading partners. The Euro zone imposes a discipline on Spain. Interest rates would not have come down anywhere near as much had Spain remained outside the euro. One reason why they have declined is the disappearance of the risk premium, as the peseta (a weak currency in the past) is now part of the euro and this has been discounted by the markets. Lower interest rates have "saved" the public sector a considerable sum of money in debt financing costs (see Chapter 8). The euro has also helped Spain to withstand international economic crises better than in the past, particularly the contagion from problems in Latin America, where Spanish companies have major interests (see Chapter 5).

Budget

The most significant achievement has been the turnaround in the general government financial balance – from a deficit of 6.6% of GDP in 1995 to a balanced budget in 2001 for the first time since democracy was restored. Without the fiscal discipline imposed by Brussels, it is quite likely that such progress would never have been made. Over the same period the average for the Euro zone went from a deficit of 5.8% of GDP to a deficit of 1.3% in 2001. A significant proportion of Spain's reduction was due to lower spending and not to increased revenues. Indeed, personal income tax rates were reduced in 1999, although overall tax receipts have risen because of increased revenues from consumption-based and corporate taxes and the surge in the number of social security contributors, all of this reflecting a buoyant economy.

The prospects for a sustained improvement on the budgetary front are good. The fiscal stability law, to be implemented for the first time in the 2003 budget, abandons deficit financing as one way of financing public expenditure and seeks to ensure that government accounts always balance or show a surplus. The law enshrining the balanced budget principle is more binding than the rule imposed by the EU's Stability and Growth Pact and tougher (the Pact allows a maximum deficit of 3% of GDP).

The economic logic behind fiscal austerity – which may not be quickly or easily grasped by a simplistic understanding of macroeconomics – is a powerful one, particularly now that the EU is structured in macroeconomic policy terms in a similar way to the US. The Euro zone is now a large, relatively closed economy (international trade accounts for some 15% of Euro zone GDP, compared with 30%-50% of the individual pre-Euro zone economies) with a single continental currency that fluctuates freely again the dollar and the yen. Under these new exchange rate circumstances, the European Central Bank (like its US counterpart, the Fed, the policy-making body responsible for monetary policy) effectively wields all macroeconomic influence over the Euro zone economy. Under the new exchange rate regime, with highly mobile international capital, fiscal policy cannot constructively influence macroeconomic variables in a sustainable fashion. This new scenario contrasts with a fixed exchange rate regime – the one previously dominant for decades in Europe – in which Keynesian deficit spending could often have a sustainable constructive effect upon the economic cycle. On the other hand, monetary policy's power to influence the economic cycle was neutralized under fixed rates by the necessity of using interest rate policy to defend the exchange rate.

It has therefore become imperative for countries like Spain to hold the budgetary line, particularly since, in the absence of a centralized Euro zone budget, there are now 12 potential (nation-state) points of deficit abuse in the euro area. Budget deficits now, under the new exchange rate regime, can only lead to increasing debt burden while failing to inject any sustainable stimulus into the Euro zone economy (to say nothing of the Euro zone's incapacity to induce stabilizing cross-country transfer payments to offset the effects of a possible asymmetric shock, given the lack of a centralized fiscal policy).

Encouragingly, despite its negative fiscal reputation, which until recently still tainted the image of Spain, the country has so far made a greater contribution to EU budgetary stability – and therefore to successful Euro zone economic management – than other economies like Germany or Portugal, which have only narrowly missed being reprimanded for their deficits by the European Commission.

Spain moved, in less than 25 years, from the unitary state ruthlessly upheld during General Franco's 1939-75 regime to one of the most decentralized nations in Europe with 17 "autonomous" regions. Given the high degree of decentralization, the fiscal stability law wisely imposes balanced budgets at all levels: central, regional, local and social security, as well as state companies and the semi-public bodies that have proliferated. Each level of government is free to decide whether this objective should be achieved by increasing revenue or trimming expenditure. The possibility of running deficits is not ruled out, but is restricted to temporary and exceptional circumstances. At the start of each year, the government sets three-year overall fiscal stability targets for all government levels. Once approved by parliament, the budgets of the various authorities are then drawn up.

Compliance will be checked through a new statistical information system that is more transparent and more effective in monitoring the accounts of regional governments. In the event of non-compliance, the central government can curb the borrowing capacity of regional governments and impose penalties. Lastly, a cap is put on spending within the framework of multi-annual scenarios and a contingency fund (representing 2% of expenditure) is set up to cover unscheduled expenditure. In the words of the OECD, the law "strengthens fiscal discipline at a timely moment, since that discipline is not as firmly entrenched in Spain as in some other countries." Spain's general government deficit averaged 4.1% of GDP in 1980-2000, compared with an OECD average of 3.1%.

Another important change is the new regional financing system that came into effect in 2002. Devolution began after the death of General Franco in 1975 and the restoration of democracy, defusing regional conflicts with the central government. Spaniards are innately tied to their region. The English writer Richard Ford noted in *Handbook for Travellers in Spain*, first published in 1845, that the country was a "bundle of local units tied together by a rope of sand." Ford said that Spain was the country of the *patria chica*. Patria is first and foremost place of origin – more than mother country – and chica means little and hence something that has to be protected. This is still the case today: in a survey of 24 countries published in UNESCO's World Culture Report (2000 edition) a higher percentage of Spaniards identified more with their province than with their country (46% compared with an average of 28%) and only 25% of respondents agreed with the statement that they wanted to be a citizen of their country against an average of 47%.

Two of the negative consequences of devolution are the excessive rise in the number of civil servants employed by regional and local administrations and the growth of territorial

debt. Close to 120,000 fewer civil servants worked for the central government between 1990 and 1999 while the number employed by regional and local governments increased by 165,000 and 125,000, respectively. For every civil servant who stopped working for the central government, two posts were created at regional and local levels. The debt of territorial governments rose from 2.7% of GDP in 1984 to 9.8% in 2001. There has also been a sharp rise in extra-budgetary debt. While the number of state companies has fallen dramatically as a result of privatizations, hundreds of entities have been created by regional and local governments. Few of them respond to social needs; in many cases they only serve to cover a volume of extra-budgetary debt that represents more than 1.5% of GDP.

The central government took the view that with completion of the transfer of health care, social services and education to the regions a new financing system was needed to increase fiscal co-responsibility, enhance transparency, secure budgetary stability and guarantee the principles of financial solidarity and resource sufficiency. The regions have widely varying levels of wealth (the Balearic Islands' GDP per capita is more than 140% of the EU-15 average and Andalusia's is just over 70%), which have not narrowed in spite of the country's success in making up economic ground over the past decade[2]. If anything, they have widened. Most of the economic activity and wealth is still concentrated in the northeast quarter of the country as far as Madrid, while the south and northwest hold the unfortunate record for the highest unemployment rates in Europe.

[2] See the section on Spain in *OECD Territorial Outlook* (2001 edition).

Exhibit 2.5. Correlation of Economic Cycles between Spain and Selected EU Countries (measured by the output gap)

	1973-85	1986-93	1994-99
France	0.52	0.93	0.95
Germany	0.31	0.61	0.11
Italy	0.02	0.97	0.65
United Kingdom	0.67	0.50	0.47
European Union	0.31	0.95	0.96

Source: Del real al euro, una historia de la peseta*, La Caixa (2000).*

The new system assigns new tax resources to the regions: a tax rate schedule equivalent to 33% of personal income tax, with regulatory powers and allowances; 35% of VAT revenue; 40% of special tax revenue and 100% of revenue raised by the tax on electricity and the special tax on specific means of transport. The revenue dynamics of the regions now depend to a greater extent on the tax revenue performance of the region itself, a positive step as it encourages regional governments to do more to reduce tax evasion.

Inflation

Spain's headline inflation has remained stubbornly above the Euro-12 average (2.8% in 2001 against 2.3%). The differential reflects several factors over and above oil price rises, the euro's depreciation and the European Central Bank's common monetary policy, which has been too expansive for Spain: the country's more rigid product and factor markets, the strong growth of domestic demand and growth in labour costs, which has been well above the EU-15 average since 1998. Over time the inflation differential could jeopardize continued convergence with the EU's per capita GDP.[3] The government has used fiscal policy within the euro to offset the ECB's monetary policy, which has been too soft for the country's strong economic cycle. Its fiscal policy has been anti-cyclical, but not as much as could have been desired. This may well change for the better in the future as a result of the legal changes already explained.

[3] See *La política anticíclica española dentro del euro* by José Luis Feito (Círculo de Empresarios, 2002) for a full discussion of this issue.

Exhibit 2.6. Macroeconomic Forecasts: Baseline Scenario (% real growth unless otherwise stated)

	2002	2003	2004	2005
Internal demand (contribution to GDP growth in pp)	2.5	3.2	3.2	3.2
Exports of goods and services	4.5	7.6	7.6	7.6
Imports of goods and services	4.6	7.7	7.7	7.7
Net exports (contribution to GDP growth in pp)	-0.1	-0.2	-0.2	-0.2
GDP	2.4	3.0	3.0	3.0
Unit labour costs in full-time equivalent jobs	1.7	1.3	1.3	1.3
Employment (% change)	1.1	1.8	1.8	1.8
Net lending (+) or borrowing (-) vs rest of world (% of GDP)	-2.4	-2.5	-2.6	-2.8
Unemployment (% of labour force)	12.4	11.7	11.0	10.3

Source: Ministry of Economy and Finance, December 2001.

Prospects

Spain entered a period of slower growth in 2001, and the government does not expect the economy to regain the 4.1% growth achieved in 2001 during its 2001-2005 Stability Programme (see Exhibit 2.6). Nevertheless, the economy will probably continue to grow at a faster pace than the EU-15 average and so continue to narrow the gap between Spain's GDP per capita and the EU average.

The global economic slowdown constrained export growth in 2002, but as world trade regains momentum Spain's sales abroad should increase from 2003. At the same time, domestic demand should revive on the back of a moderate advance in government and private consumption and higher investment spending.

Two problems limiting Spain's expansion capacity are moderate productivity growth and inflation that is higher than the EU average. However, as the Bank of Spain pointed out in its 2001 annual report, the lacklustre performance of productivity, that is a difficult variable to measure, reflects to some extent the job-creation-intensive pattern of growth that needs to be maintained to continue reducing the gap in terms of economic welfare with the more advanced EU countries. But the low gains also reflect an insufficient incorporation of technological progress. Spanish unit labour cost indices have also been increasing, drawing closer to those of the main EU economies. Many of the products of the newly industrialized economies (some of which will become part of the EU) are already competing under very favourable cost conditions with Spanish goods (see next section).

Exhibit 2.7. Distribution of Structural Funds by Selected Countries (millions of euros)

	1989-93			1994-99			2000-06		
	Total	Obj 1 Regions	Cohesion Fund	Total	Obj 1 Regions	Cohesion Fund	Total	Obj 1 Regions	Cohesion Fund
France	6,473	957		14,939	2,190		15,666	3,805	
Germany	6,431	2,955		21,73	13,640		29,674	19,958	
Greece	8,240	7,528	280	15,134	13,980	7,950	24,883	20,961	3,060
Ireland	4,755	4,460	142	6,104	5,620	1,301	3,974	3,088	720
Italy	11,420	8,504		21,649	14,860		29,656	22,122	
Portugal	9,174	8,450	284	15,041	13,980	2,601	22,76	19,029	3,060
Spain	**14,229**	**10,171**	**859**	**34,449**	**26,300**	**2,602**	**56,205**	**38,096**	**11,160**
Total	68,236	43,818	1.565	152,219	93,972	14,454	211,854	135,954	18,000

The total is for the 15 EU countries.
Source: First and second reports on Economic and Social Cohesion (1996 and 2001).

In order to ensure in the long run that the economy continues to grow at higher rates than those posted by the core EU countries and that it obtains all the potential benefits from EMU membership, prices and costs must be prevented from systematically outgrowing those of Spain's European partners. The persistence of any such gap would worsen Spain's competitive position internationally and jeopardize the possibilities of growth fulfilling its potential.

Impact of EU Enlargement

The entry of new countries into the EU will greatly reduce the volume of funds that Spain receives to help poorer countries catch up economically with their better-off partners. Indeed, Spain would probably become a net contributor country to the EU budget. In 2000, Spain was the largest net beneficiary country in absolute terms, receiving €5,056 million (27.6% of total net subsidies). In per capita terms, Ireland was the main beneficiary country. The largest net contributor country by far is Germany (50.6% of total net contributions in 2000).

Thirteen mostly former communist nations are candidates to join the 15 that are already EU members, and by 2004 as many as ten of them could be members of the club. The main exception is Turkey (pop. 65 million). The combined GDP of these ten economies, with a total population of 105 million (two and a half times more than Spain's and 28% of the EU-15), is not much larger than Spain's, but their per capita GDP, in purchasing power parity terms, is only 34% of the EU average – much lower than Spain's when it joined the EU in 1986.[4]

[4] This section draws on *La ampliación de la Unión Europea, efectos sobre la economía española* (La Caixa, 2002) by Carmela Martín, José Antonio Herce, Simón Sosvilla-Rivero and Francisco J. Velázquez.

A lot of money is at stake. The budget for the so-called Structural Funds between 2000 and 2006 is €211.8 billion at 1999 prices, around a third of total spending (see Exhibit 2.7). A special Cohesion Fund – for projects in the EU's four poorest countries, including Spain – is worth an additional €18 billion over the same period, and Spain also does well from the EU's common agricultural policy (CAP) transfer scheme (FEOGA-Guarantee). Spain received €6,175 million in FEOGA funds in 2001, 15% of the total and the second-largest amount after France in absolute terms. Over 60% of Structural Funds are earmarked for what are called Objective 1 regions, where per capita GDP is less than 75% of the EU average. Objective 1 regions in Spain cover 76% of the territory but are home to only 58% of the population. They are: Andalusia, Asturias, the Canary Islands, Cantabria, Castilla-La Mancha, Castilla y León, Extremadura, Galicia, Murcia, Valencia and the north African enclaves of Ceuta and Melilla. The per capita GDP of these areas in 1999 was 66.5% of the EU average, well below the 75% threshold.

Spain stands to receive €38 billion between 2000 and 2006 for the regions covered by Objective 1 (28% of the total for the regions) and €11 billion in Cohesion Funds (61% of this total). Overall, it will receive €56,200 billion (26% of total Structural Funds). The grants are mainly targeted at supporting small companies, promoting investment, improving infrastructure and furthering local development.

The accession of 12 new countries would lift Spain's average per capita GDP from 83% of the EU-15 average in 2002 to 94% of the EU-27 average in 2005. According to estimates based on population and GDP assumptions and no change in the current eligibility criteria, Spain would only have three regions (Andalusia, Extremadura and Galicia – by the skin of its teeth)

Exhibit 2.8. Per capita GDP in Spain's Regions Measured against the EU-15 and EU-27 Averages[1]

	Per capita GDP in 1999		Per capita GDP in 2005	
	Spain=100	EU-15 = 100	Spain=100	EU-27=100
Andalusia	71.7	**57.8**	58.9	**67.2**
Aragón	109.8	88.5	90.3	102.9
Asturias	90.2	**72.7**	74.1	84.5
Balearic Islands	119.6	96.4	98.3	112.1
Basque Country	122.3	98.6	100.6	144.7
Canary Islands	93.1	**75.0**	76.5	87.2
Cantabria	94.8	**76.4**	77.9	88.9
Castilla y León	92.6	**74.6**	76.1	86.8
Castilla-La Mancha	82.9	**66.8**	68.1	77.6
Catalonia	123.1	99.2	101.2	115.4
Ceuta and Melilla	80.4	**64.8**	66.1	75.4
Extremadura	62.9	**50.7**	51.7	**59.0**
Galicia	80.0	**64.5**	65.8	**75.0**
La Rioja	114.8	92.6	94.4	107.6
Madrid	135.1	108.9	111.1	126.6
Murcia	82.5	**66.5**	67.8	77.3
Navarra	129.9	104.7	106.8	121.7
Valencia	94.7	76.3	77.9	88.8
Total Objective 1 regions	82.5	66.5		
Other regions	125.8	101.4		
Spain	100	80.6	82.2	93.7
EU-15		100	100	114.0
EU-27				100

(1) The highlighted figures in the second and fourth columns are current and future. Objective 1 regions assuming no change in the eligibility criteria.
Source: La Caixa and European Commission.

Exhibit 2.9. Geographic Distribution of the Stock of Foreign Direct Investment in EU Candidate Countries[1]

Germany	19.4	United Kingdom	5.5	Korea	2.1	Norway	0.9
Netherlands	13.9	Italy	4.8	Russia	1.6	Cyprus	0.9
United States	10.7	Sweden	2.9	Finland	1.5	Liechenstein	0.9
Austria	7.1	Belgium	2.4	Denmark	1.4	Luxembourg	0.5
France	7.0	Switzerland	2.2	Ireland	1.1	**Spain**	**0.5**

(1) Percentage of the total stock of foreign capital in 1999.
Source: Table prepared by La Caixa from various sources.

qualifying for Objective 1 funds in 2005 (see Exhibit 2.8)[5]. Spain would also lose aid from the Cohesion Fund. The impact of the entry of new countries is "statistical", but it will call for a revamping of the policies which are bound to hit Spain. Although Spain stands to lose structural, cohesion and CAP funds, Spaniards are still one of the more enthusiastic countries about EU enlargement, as measured by Eurobarometer surveys.

The enlargement will also have repercussions on trade and investment flows. In 1999 Spain accounted for 1.8% of the exports to the 12 candidate countries expected to join the EU and received 1.4% of their imports. Germany (25% of exports and 33% of imports) is by far the main client of the candidate countries. When these countries are fully inside the EU their exports to Spain will probably increase at a faster pace than Spain's exports to them, turning the current combined trade surplus with them into a deficit. The investment impact will be greater than that for trade and can already be seen in the flows since these countries signed agreements for the free circulation of direct investment. Spain had a symbolic 0.5% of the total stock of foreign direct investment in these countries in 1999, compared with 19% for Germany and 14% for the Netherlands (see Exhibit 2.9). Their much lower labour costs (about one-sixth of Spain's), "central" geographic location in Europe and the quality of their human capital, which is not far from – and in some cases is better than – Spain's (for example, the Czech Republic scored better than Spain in the PISA mathematical and scientific literacy tests, see Chapter 1), make them attractive alternatives to Spain for foreign direct investment. It is important for Spain to boost its expenditure on R&D and on information technologies, which is currently not much higher in GDP terms than what these countries spend. Even in the relatively short period between 1992

[5] Ibid.

and 1998 there was a significant change in the structure of the exports of some of the candidate countries, reflecting the transformations achieved by multinationals that have invested heavily in them. Exports have become technologically much more intensive in areas such as office equipment and cars and compete more fiercely with Spain.

Privatizations

Spain has virtually completed its privatization process. By 2004, when the next general election is slated to be held, Sepi, the state holding company, intends to have sold the few remaining companies under its wings apart from Hunosa (coal), RTVE (television) and Efe (news agency), which will remain wholly in the public sector. Other, non-Sepi companies that will remain state-owned are the national railway Renfe, the postal service, Enresa (nuclear waste), the parador hotels and little else.

Proceeds from privatizations represented 1.6% of GDP in 1996-98, up from 0.5% in 1993-95 and the second highest among OECD countries. The state's industrial presence in the economy has been reduced from 1.6% of GDP in 1996 to less than 1%, and the state's share of the market capitalization of the Spanish stock market has fallen from 9% to less than 0.5%.

The first government of the Popular Party (1996-2000) continued, but at a much faster pace, the privatizations begun by the Socialists in 1983. The PP sold 43 companies, mainly from the telecommunications (Telefónica), electricity (Endesa), oil (Repsol), tobacco (Tabacalera), steel (Aceralia) and banking (Argentaria) sectors. The last big operation was in 2001 when Sepi sold 48.5% of Iberia, the country's flag carrier.

As a result of the wave of privatizations, all the Spanish groups ranking among Europe's top 500 listed companies drawn up by the *Financial Times* are now fully in the private sector.

The Size of Spanish Companies

Big is not necessarily beautiful, but many Spanish companies do need to be larger in order to take full advantage of globalization and the opportunities offered by the Euro zone. Over the past decade there has been a significant increase in the size of Spanish companies through mergers and acquisitions at home and abroad. In 2002, six of Spain's companies were among the 500 largest companies in Europe ranked by the *Financial Times* on the basis of market capitalization (see Exhibit 2.10). The largest company is Telefónica.

The FT's focus on market capitalization as the way to measure corporate size sets it apart from other league tables. Market capitalization is the number of shares the company has in issue, multiplied by the market price of these shares on the day the snapshot is taken.
A common method ranks companies by their annual revenues, an approach pioneered by Fortune magazine in its US 500. A drawback to this approach, the FT points out, is that it does not allow proper representation for banks and other financial services companies. It also tends to exaggerate the importance of companies with very high turnover, relative to profits, such as some trading businesses. In addition, a company's sales are not a reliable guide to its profitability or dynamism. Companies can also be ranked by profits, but the problem here is the under-representation of groups that have taken one-time write-offs, which distort their performance for a particular whole year, or which have moved into loss. All these methods

Exhibit 2.10. Spain's Largest Companies by Market Capitalization and Ranking in the FT 500, (US$ million)[1]

Company	Ranking	Value
Telefónica	69	53,691
Santander Central Hispano	105	38,395
BBVA	106	38,249
Repsol YPF	285	15,468
Iberdrola	387	11,825

(1) Information at March 28, 2002.
Source: Financial Times.

also have a timing problem: they are based on information in annual reports, publication of which is staggered throughout the year. Comparisons, therefore, are not like for like. Market capitalization overcomes many of these problems, but it also has its own shortcomings. Because market value reveals what shareholders think a company might be in the future, not what it is today, many companies included in the ranking are newcomers, who may be forced to exit just as quickly. And given that markets are volatile, the rankings would be different if they were calculated on any other date. Finally, the figures have to be converted into a single currency to permit comparisons, in this case the US dollar. This means that rankings will be affected by exchange rate movements against the US currency.

Since the launch of the euro in 1999, Spain has seen the creation of two giants in financial services – through Banco Santander's merger with Banco Central Hispano and Banco Bilbao Vizcaya's with Argentaria. Both Santander Central Hispano (SCH) and Banco Bilbao Vizcaya Argentaria (BBVA) are very strong in Latin America and a growing force in Europe (see Chapters 5 and 7). Enhanced size has very much gone hand in hand with the expansion abroad of Spanish companies. The energy group Repsol became the largest private sector energy group in Latin America after it acquired Argentina's YPF in 1999. Similarly, Endesa, Spain's largest electricity company, has become a major group in Latin America through acquisitions of power companies in several countries, including Brazil and Chile. Aceralia welded itself to Arbed of Luxembourg and Usinor of France in 2000 to form the world's largest steel producer, with a combined annual output of about 46 million tonnes of crude steel and share of global output of 6% (12% including alliances with Posco of Korea and Nippon Steel of Japan).

Many Spanish companies have become substantially larger, but the quality of corporate governance leaves a lot to be desired. There are, for example, very few truly independent directors that are willing to represent the interests of a majority of shareholders and those that exist are really only independent in name, as they are usually chosen by the chairman/chief executive officer and the choices were only perfunctorily approved by shareholders. There were positive moves in 2002, particularly by the two big banks, Santander Central Hispano and Banco Bilbao Vizcaya Argentaria.

Liberalization

Spain, which held the EU presidency during the first half of 2002, has been at the forefront of promoting greater liberalization of the European economy.

In energy the country has moved at a faster pace than required by EU directives. All electricity consumers can choose their suppliers as of 2003. The competition authorities placed very strict conditions on the merger of Endesa and Iberdola, the two largest power producers, which account for 80% of electricity output. The government largely followed them and, as a result, the betrothed utilities called off their engagement just before going to the altar because of "unacceptable uncertainties". The joint company would have been limited to 42% of generating capacity, 48% of distribution and 40% of the final market. It would also have had to sell its excess capacity by auction, not in cosy share exchanges with friendly foreign companies, and would have lost the subsidies that the once monopolistic power industry enjoys to meet the costs of transition to a more competitive market. The collapse of the largest merger ever attempted in Spain was a turning point in the relations between the government and the

Exhibit 2.11. **Liberalization Measures**

Electricity
Consumers can choose their supplier as of 2003. Power companies with a market share of more than 40% (Endesa) cannot increase their output capacity until June 25, 2005 and those with a 20%-40% share until June 25, 2003.

Gas
The deadline for open competition (a near monopoly for Gas Natural) is 2003. Gas Natural's stake in its distribution company Enagas will be cut to a maximum of 35%, and the company has to make a quarter of its main supply contract with Algeria available to other operators.

Hydrocarbons
Oil companies with a market share of more than 30% (Repsol) cannot open new service stations until June 25, 2005, and those with a 15% market share until June 25, 2003. Hypermarkets can sell petrol. Repsol gave up majority control of the wholesale distribution company CLH, in which individual holdings are capped at 25%.

Telecommunications
Flat charge for Internet of a maximum of €16.50 per month between certain hours. Users have been able to choose their operators for all calls as of 2001 without changing their number.

Shopping hours
No restrictions for small shops (less than 300 square metres) and an increase from 72 to 90 hours a week for others.

Source: Economy Ministry.

business establishment and was meant to send a signal that Madrid was serious about competition.[6]

The Iberian electricity market will start in 2003, with stepped-up cross-border exchanges between Spain and Portugal (see Chapter 3).

The last element of Telefónica's former telephone monopoly ended in 2001, when users were free to choose their operator for all calls without changing their number (see Exhibit 2.11). Telefónica's market share of fixed telephony was 89% in 2001 and the next largest operator, Retevisión, had around 5%. In mobile telephony, Telefónica Móviles had 56% and Vodafone-Airtel 27%.

Regulatory Reform

The liberalization and opening-up of markets have been driving forces behind Spain's high economic growth. Trade and foreign investment liberalization, the privatization of almost all state-owned companies, a stronger competition policy and other matters have produced significant benefits in terms of sustainable growth, lower prices and interest rates, wider consumer choice and quality of services. But the country needs to go further with regulatory reforms. The OECD says that, if the country is to succeed in its process of real convergence with the rest of Europe, regulatory reform is even more important in Spain than elsewhere in the EU and that it must seek to exceed the average progress in introducing competition.[7]

[6] See *Aznar Makes a Break with the Past* by Leslie Crawford and Andrew Taylor (*Financial Times*, February 7, 2001).
[7] See *Regulatory Reform in Spain* (OECD July 2000).

Exhibit 2.12. **Total Entrepreneurial Activity Prevalence Rate by Country**

1. Mexico	18.74	11. Argentina	10.52	21. France	7.24
2. N. Zealand	18.23	12. Italy	10.17	22. Portugal	7.09
3. Australia	16.21	13. Poland	9.99	23. Russia	6.91
4. S. Korea	14.85	14. S. Africa	9.37	24. Sweden	6.67
5. Brazil	14.21	15. Finland	9.33	25. Netherlands	6.38
6. Ireland	12.12	16. Norway	8.70	26. Singapore	6.00
7. US	11.66	17. Denmark	8.07	27. Israel	5.98
8. Hungary	11.42	**18. Spain**	**7.78**	28. Japan	5.08
9. India	11.25	19. Germany	7.71	29. Belgium	4.59
10. Canada	10.98	20. UK	7.69	All countries	9.77

Source: 2001 Global Entrepreneurship Monitor.

One notable area where Spain lags behind most of Europe is the amount of red tape that is still required to set up a business. The process in Spain can take half a year. Another market distortion is the discretionary power held by mayors to authorize land zoning permits, which the OECD pointed out establish "an environment favourable to corruption ... In a few cases this has created incentives to ask for 'contributions', either in money or in kind in exchange for the prompt delivery [of building permits]. This system has worked as a substitute for unpopular local tax increases".

The amount of bureaucracy has not, however, deterred Spaniards from starting up businesses. Spain was ranked 18th out of 29 countries in the 2001 entrepreneurial activity index drawn up by the Global Entrepreneurship Monitor (see Exhibit 2.12). Almost eight in every 100 people, a similar level to the UK, Germany and France, were involved in starting businesses or running a new firm.

Chapter 3

Sector Overview

The structure of the Spanish economy has changed dramatically over the past 50 years. What was predominantly an agricultural country, with some basic industries, today has the world's sixth-largest motor industry, two of the biggest banks in Europe, one of which is the largest foreign bank in Latin America, and the world's second-largest tourism industry in terms of number of visitors, to mention but a few of the notable changes. The economy is diversified and broadly similar in structure to the EU's as a whole (see Exhibit 3.1).

Agriculture, Fisheries and Wine

Although agriculture's importance in the overall economy has declined, it is still at the heart of Spanish life. Most city dwellers have family connections with the countryside (many have second homes) and professional people are often absentee landlords. The sector generates less than 4% of GDP and accounts for around 6.5% of total employment (still proportionately more than in most EU countries).

More than 700,000 jobs in net terms have been lost in agriculture since Spain joined the European Economic Community in 1986. As in other EU countries, the sector benefits from substantial support. Most of the transfers come in the form of payments via the EU's common agricultural policy (CAP) transfer schemes (FEOGA-Guarantee). Spain received €6,175 million in FEOGA funds in 2001 – 15% of the total and the second-largest amount after France in absolute terms. This gigantic subsidy works out roughly at €542 per month per agricultural worker and is bound to be reduced as a result of the enlargement of the EU to the East (see Chapter 2). Poland, in particular, amongst the first wave of candidates, is a large country (40 million) with a big agricultural sector (accounting for 18% of the civilian working population – four times the EU average). To extend CAP

Exhibit 3.1. **Structure of the Economy (as a % of Total Gross Value Added), 2000**

	Spain	EU-15
Agriculture	**3.5**	2.2
Manufacturing	**20.9**	22.9
Construction	**8.5**	5.3
Trade, transport, communication	**27.5**	21.0
Financial services, business activities	**19.1**	27.2
Public services	**20.4**	21.4

Source: Eurostat.
Figures for 2000.

support prices to Polish (and Hungarian) output would be very costly.[1] The CAP is not financed entirely by the EU budget; consumers also pay prices higher than those on world markets.

Spain has the widest range of agricultural products in the EU. In the Atlantic provinces in the north, between 65% and 90% of production comes from the livestock sector (mainly diary products), and a similar proportion comes from horticulture in the Mediterranean coastal provinces. Spain is the world's fourth-largest producer of citrus fruits after Brazil, the US and China. Most of the production comes from the region of Valencia. In the central plain the main products are cereals and wine. Jaén, in Andalusia in the south, has Europe's highest concentration of olive oil production. Andalusia produces about a quarter of the world's olives (an estimated 850,000 tonnes in 2002). By contrast, the main activity in Badajoz and Salamanca in the west, bordering with Portugal, is meat production, and Lérida in the northeast is famous for its intensive pork production.

The great variety of products is due to the diversity of weather and terrain. Spain is criss-crossed with mountain ranges, and the altitude of nearly 60% of its territory exceeds 600 metres, making it the second most mountainous country in Europe after Switzerland. The climate varies from mild and wet conditions in the north, where the average yearly rainfall can be as much as 1,600 millimetres (the North Atlantic coastal area is known as "Green Spain"), to the arid desert of Almería in the southeast, where as little as 100 millimetres of rain can fall a year. Almería and Huelva are focal points of the Spanish agricultural "miracle." Investment in irrigation and in plastic greenhouses produced an increase in the total area intensively cultivated for horticultural produce from 300

[1] See the chapter on CAP reform in the *Report on the European Economy 2002* (IFO Institute for Economic Research, February 2002).

hectares to around 50,000 hectares between 1970 and 2001, of which 27,000 hectares are in Almería. Beans, peppers, papaya and, particularly, strawberries grow under miles of shimmering plastic. Latin American and North African immigrants now do most of the menial labour in this area.

In a borderless Europe that consumes a lot of EU products, Spanish fruit, vegetables, olive oil and wine have become much more prominent in European markets. Olive oil, for example, is increasingly being recommended as part of a balanced diet, particularly as an alternative to fat-saturated butter and lard, too much of which is not good for cholesterol. Olive oil is one of the elements behind Spaniards' longevity (the average Spaniard lives 78 years). Extra-quality "virgin" oil (not filtered or refined) is becoming more and more popular.

Spain is the top producer of dry-cured ham in the world, but Italy's *proscuitto* is better known because Spain has only been exporting its *serrano* ham since the early 1990s, although it produces more hams than Italy. The Spanish Serrano Ham Consortium, which accounts for 70% of exports, is now promoting the product abroad much more actively.

There is a drive to realise Spain's potential in organic and integrated agriculture. Organically farmed land has risen from 4,000 hectares in 1992 to more than 300,000 hectares in 2001. The range of products, much of which is exported, includes honeys, jams, cured olives, fruit juices, dried fruits, nuts, and cheeses.

Spain is world's third-largest wine producer after France and Italy. There are more than 60 regulated winemaking districts, up from four in 1932. These areas guarantee that a wine meets certain standards and are important for the export market, as wines under the *denominación de origen* scheme (the

equivalent of France's *appellation contrôlée* system) automatically receive the European distinction as "quality wines produced in a given area" which appears as the initials VCPRD on the label.

Spurred by falling domestic consumption of basic table wines, the need to compete internationally (only possible through high-quality wines), and EU restrictions on the amount of land that may be planted with vines, the industry is going through a seminal period of change. The UK's Allied Domecq, the world's second-largest wine and spirits group, bought Bodegas & Bebidas in 2001 for €279.2 million. Its well-known brands include *Campo Viejo*, *Siglo* and *Viña Alcorta*. Allied already had two main Rioja brands in its portfolio: *Marqués de Arienzo* and *Vina Equia*.

The Catalan company Freixenet is the world's largest producer of sparkling wines under the *méthode champenoise*. Another big producer, and also Catalan, is Cordorniú.

In fisheries, Spain has the largest share of the EU fishing fleet in terms of tonnage (more than 25%) and number of vessels. The country receives by far the largest share of the €1.1 billion in public subsidies that are spent on the Common Fisheries Policy. Vigo, in Galicia, Spain's north-western region, is the largest fishing port in Europe, and its worldwide haul exemplifies the energy of the Spanish fleet[2]. Vessels from Vigo go as far away as Argentina because of the depleted stocks in EU waters. The European Commission warned that "if current trends continue, many stocks will collapse."

Spain will be hit by the Commission's draconian reforms if they are approved and come into effect in 2003. Franz Fischler, the EU agriculture and fisheries commissioner, called for an overall cut of

[2] See the article *Too Much Vigour in Vigo* (*Economist*, March 30, 2002).

between 30% and 60% in "fishing effort" – the amount of time that boats can spend at sea. This would probably mean a reduction of 13% in the Spanish fleet's tonnage, compared with a cut of 29% for Britain's. The problem for Spain is that its industry directly employs 65,000 (compared with 16,000 in Britain) and 350,000 indirectly. Loyola de Palacio, a former Spanish fisheries minister who is also a vice-president of the Commission in charge of energy and transport, called the proposals "brutal." Spain gains access to the North Sea at the end of 2002, under the agreement negotiated when it joined the EU, but it is unlikely to be allocated quotas allowing it to fish these new waters.

Automotive

In 1963 Spain's motor industry was in its infancy, with the tiny Seat 600 (the equivalent of the Mini in Britain) the most popular car. Today, Spain's motor industry is the third largest in Europe (the first in the category of commercial vehicles) and the sixth worldwide. The industry, which overtook Italy in the early 1990s, generates around 6% of GDP, employs some two million people and accounts for one-quarter of exports. It has been in top gear for several years, and in 2001 a record 1.43 million vehicles were sold in Spain.

The industry is entirely dominated by multinationals, following the sale of Seat to Volkswagen in the 1980s.

Commercial Property

Madrid's office rentals are among the world's 20 most expensive (see Exhibit 3.2). Prices spiralled between 1985 and 1990 because demand, which had been building up over the years,

Exhibit 3.2. **Global 50 Index of Office Rentals (by Total Occupation Cost in US$/sq ft/year)**

1.	London (West End)	146.33	10.	Edinburgh	58.27
2.	Tokyo (inner central)	122.34	11.	Mumbai (Bombay)	56.90
3.	London (City)	112.23	12.	Boston	54.91
4.	Tokyo (outer central)	106.72	13.	Dublin	52.74
5.	Paris	76.59	14.	Zurich	52.30
6.	Hong Kong	70.37	15.	Manchester	52.16
7.	Moscow	64.49	16.	Birmingham	51.80
8.	New York (Manhattan)	63.22	**17.**	**Madrid**	**51.53**
9.	Frankfurt	60.48	**45.**	**Barcelona**	**34.15**

Source: Global Market Rents, CB Richard Elllis, January 2002.

flooded onto the market after Spain joined the European Economic Community. They then fell sharply when many developments came onto the market and touched bottom in 1993 when the Spanish economy was in recession. Prices inched up as of 1995 and in 2000/2001 were just above the previous peak in the central business district (CBD) encompassing either side of the Paseo de la Castellana and Paseo de Recoletos, between Plaza de Cibeles and Plaza Gregorio Marañón, as well as the Torre Picasso, the tallest building in the city. Barcelona's office rentals are considerably lower than Madrid's.

Office take-up in 2001 was 461,000 square metres, just over half the total for 2000. At the same time as take-up has been declining, reflecting the economic slowdown and in particular a lack of demand from new technology companies, the level of development completions has been peaking. The vacancy rate for Madrid as a whole reached 3.8% at the end of 2001 (1.6% at the beginning of the year). Madrid's tight office market will be eased by the corporate campus being built by Santander Central Hispano 17km outside of Madrid, scheduled to be ready in December 2004, which will release 157,000 square metres of office space. The bank intends to sell 14 buildings in the centre of the city and the leases for another 11 will be ended. The 160-hectare mixed-use complex, dubbed the Financial City, is said to be the world's largest corporate headquarters.

Construction

The construction sector is the most dynamic of Spain's basic sectors, both in terms of activity and job creation. It generates around 8% of GDP, one of the highest proportions among Euro zone countries, and officially employs over 11% of the working population (more than 70% are hired on a temporary

basis). The sector has a big knock-on impact on the rest of the economy. It is estimated that a one-percentage point rise in construction demand produces a multiplier effect of almost double that on the country's overall output. Spanish companies, notably Dragados, Spain's second-largest constructor and the third-largest in Europe, have won major contracts abroad (see Chapter 5).

The number of housing starts averaged around 500,000 a year in 1999-2001, a level not seen since the 1970s, and the pace was expected to slow down considerably as of 2002. Much lower mortgage interest rates, higher disposable household income and considerable sums of "black" money have spurred residential construction. Spain has the highest proportion of home ownership in the EU (86% against an average of 61%).

House prices have shot through the roof (see Exhibit 3.3). Spain's average real house prices rose 124% between 1980 and 2001, the highest growth in the world. One major factor behind this jump is the shortage of land supply, particularly in cities. It can take municipalities up to five years to provide a licence to use land for construction. Moreover, they apply arbitrary criteria in granting licences, and land buyers may have to cede a share of the land to the town hall for urban development purposes (an area where corruption has flourished). This share was reduced from 15% to 10% in 1998. Local governments, which control most of the supply of urban land, have a vested interest in keeping prices high, as land sales represent a significant share of municipal income.

After the construction of new homes, the most dynamic part of the construction sector has been civil engineering related to infrastructure works. Spain built more new motorways than any other EU country between 1990 and 1999 (see Exhibit 3.4).

Exhibit 3.3. **House Price Rises, 1980-2001[1]**

	Nominal Change (%)	Real[2] Change (%)
Spain	**726**	**124**
Ireland	451	95
Britain	389	89
Netherlands	181	66
Belgium[3]	140	23
US	158	20
France	155	15
Global index	148	19

(1) Nationwide average.
(2) Adjusting for consumer price index.
(3) 2001 based on Q1-Q3 data.
Source: The Economist.

Exhibit 3.4. **Length and Density of Motorways in EU Countries**

	Length in Kilometres 1990	1999	Density in 1999 (kms/1,000 sq kms)
Austria	1,445	1,613	19.2
Belgium	1,931	1,682	55.1
Denmark	601	861	20.0
Finland	225	467	1.4
France	6,824	9,303	17.1
Germany	1,089	11,427	32.0
Greece	190	500	3.8
Ireland	26	94	1.4
Italy	6,193	6,453	21.4
Luxembourg	78	115	44.5
Netherlands	2,092	2,360	57.5
Portugal	316	1,252	13.6
Spain	**4,693**	**8,257**	**16.4**
Sweden	939	1,428	3.5
UK	3,181	3,421	14.2
EU-15	39,242	49,233	15.8

Source: Eurostat.

Exhibit 3.5. **Structure of Primary Energy Supply (% of Total, 2000)**

	Coal	Oil	Gas	Renewable	Hydro	Nuclear	Other
France	5.8	33.9	13.7	4.4	2.2	42.0	-2.01
Germany	23.7	38.7	21.1	2.4	0.5	13.0	0.6
Italy	7.3	51.4	33.7	1.2	2.2	0	4.2
Spain	**16.7**	**51.9**	**12.2**	**3.5**	**1.9**	**13.0**	**0.8**
UK	15.4	35.7	37.6	0.9	0.2	9.5	0.7
EU	14.5	40.6	23.1	3.7	1.8	15.4	0.9

(1) Net figure.
Source: International Energy Agency.

Energy

The pace of liberalization in the electricity, gas and oil markets has been faster than that required by European directives. The electricity and gas markets will be fully liberalised in 2003. The main challenges facing Spain are to ensure that the energy supply will satisfy growing demand, curb CO_2 emissions to meet the country's Kyoto target and increase true competition.[3]

Total primary energy supply (TPES) grew at an average annual rate of 3% during the 1990s, well above the 1.4% average of International Energy Agency (IEA) countries. The major contributor to energy production from indigenous sources is nuclear power, followed by coal, hydro and other renewable energies. Spain has few crude oil and natural gas resources of its own, though it exports oil products. Oil's share of total primary energy supply dropped from 73.3% in 1973, at the time of the oil price shock, to 51.9% in 2000, while that of natural gas climbed over the same period from 1.8% to 12.2%. The proportion of nuclear power rose from 3.3% to 13%, and that of coal inched down from 17.2% to 16.7% (see Exhibit 3.5). Other energy sources, such as hydro and wind power, have marginal shares. The IEA forecasts that in 2010 coal's share will be down to 8.4%, oil's to almost 50%, gas's will continue to rise (17%), nuclear's will drop a little to 12.2%, hydro's will reach 2.4% and that of renewable energy – waste, solar and wind power – will increase to 10%.

Because Spain has limited energy resources, which cover only 25% of TPES, security of supply is an important aspect of energy policy. The Hydrocarbons Act of 1998 sets an

[3] This section draws on the 2001 Review of Spain by the International Energy Agency.

indicative limit of gas supplies from any single country and for each supplier at 60%, with the exception of gas supplied to facilities with guaranteed alternative supplies of other fuels. The reason for the ceiling is that Spain was and still is heavily dependent on Algeria (which in 2001 supplied the maximum limit of imported natural gas). Algeria has used the Maghreb-Europe pipeline since 1996. Around half of Algerian supplies are imported as liquefied natural gas (LNG). Oil supplies are more diversified – none of the ten suppliers in 2001 provided more than 15% of total imports. The three largest suppliers are Nigeria, Mexico and Libya.

Spain's energy intensity (TPES per unit of GDP) increased during the 1990s. The difference between its energy intensity and the average of IEA Europe, however, has been decreasing and is now marginal. Thanks to more energy-efficient policies and structural changes, the energy intensity is expected to continue to decline. For example, the energy-intensive steel industry is in decline, and consumption in the residential and transport sectors will eventually slow down as the demand for new appliances and cars weakens because the market has become saturated.

The energy markets are highly concentrated, in both the production and distribution and marketing segments. About 80% of electricity distribution is still in the hands of two companies (Endesa and Iberdrola) and the Gas Natural Group is by far the dominant player in the gas market. Endesa and Iberdrola tried to merge, but they called off their marriage in 2001 after the government imposed strict conditions on the recommendation of the National Energy Commission. Market liberalization allows in new entrants, but true competition is developing slowly. Most restrictions on foreign ownership in the Spanish energy industry have been removed. The only remaining regulations apply to foreign publicly owned energy companies, whose shares and voting rights in Spanish companies are limited to 3%. This limit

was set to protect the privatized utilities from being acquired by foreign companies that have not yet been privatized. Endesa, by far the biggest company with close to half the market, was privatized in 1998. The government retains a "golden share" in Endesa, which gives it the power of veto in matters of national energy policy.

Natural gas was introduced on a large scale in Spain in the 1990s, later than in many other European countries. The supplies from Algeria, the cheapest source for natural gas, are based on long-term contracts. The government has recognised the problems that are caused to new entrants by the pipeline supply contract between Gas Natural and Algeria, and as of 2003 one-quarter of the gas imported through the pipeline is to be allocated to the trading companies (ie, to the liberalized markets), and the remainder goes to the distribution companies to be sold at regulated rates. This, together with access to Algerian LNG supplies after 2004, is likely to increase the competitiveness of new entrants. Gas is set to become the main source of energy for producing electricity. The target is for it to generate 34% of total electricity in 2010, up from 10% in 2001. Coal's share is forecast to decline from 36% to 12% and oil's to halve to 5%.

Strongly growing energy consumption is complicating the efforts to meet the country's total greenhouse gas (GHG) omission objective which, under the EU's "burden-sharing" agreement, is set at 15% above the 1990 level for the 2008-2012 commitment period of the Kyoto Protocol. In 1999, Spain's CO_2 emissions from energy transformation and use were 28.6% above the 1990 level. So far, Spanish fiscal policy for energy and environmental issues has been not to financially "punish" technologies that emit more, but instead to give financial incentives to cleaner technologies. However, as the IEA noted in its 2001 review of Spain, this does not ensure that the "polluter pays principle" (or the "user pays principle") is respected. Another

element of the policy to try to meet the GHG emissions target is to promote greater use of renewable sources. Under the Plan for the Promotion of Renewable Energy, hydropower production is expected to remain at the current level and a significant increase is envisaged for energy from biomass and wind. Waste from forestry, wood processing industries, agriculture and agricultural industries and energy crops will be the main sources of biomass. The target for new electricity generation from biomass is set at 1,708MW of new capacity and for wind power it is 8,140MW. The overall aim is to achieve a 12% share of renewables in TPES by 2010 (around 6% in 1999), in line with the EU target set in the European Community's White Paper for Renewable Energy Sources. In a country where tilting at windmills has a certain tradition, the number of giant power-generating windmills has doubled each year since 1995 and is forecast to reach 9,000 by 2010. And after creating a highly successful industry based on selling its sun to tourists, Spain now uses it to produce more than 9MW of electricity with solar cells, about half the European total.

Spain and Portugal were due to integrate their electricity markets in 2003. If the project is a success, the Iberian peninsula will join Scandinavia as a model for cross-border energy markets. The potential gains are clear. For consumers, a jointly-managed network will supply electricity to the regions with the biggest needs at lower prices. Producers will gain access to new markets. A common stance will also strengthen Spain's bargaining power in negotiations to increase its inter-connection capacity with France. Endesa is well positioned to take advantage of the liberalization process. It is strong in the so-called Mediterranean arch, which includes Spain, Portugal, France and Italy, with generating and marketing companies in all of these countries.

Exhibit 3.6. **Mobile Telephone Penetration Rates (% of Residential Population)**

Austria	78.9
Belgium	71.6
Denmark	74.1
Finland	84.9
France	63.1
Germany	65.6
Greece	63.4
Ireland	79.9
Italy	88.1
Netherlands	75.1
Portugal	88.9
Spain	**75.4**
Sweden	80.1
UK	78.4

Source: Mobile Communications, April 2002.

A 90km, 400-kilovolt tension line being built between Alqueva in southern Portugal and Balboa, Spain, is expected to come onstream in 2004. Enlargements of the three existing electricity connections between the two countries are expected to be completed in 2006. The accord does not set a time frame for the integration of the markets for natural gas, which fuel electricity plants in both countries, but the nature of gas supply has already made the sector work together. Ships delivering liquid natural gas to Portugal dock in Spanish ports and inject the supply into the Spanish system, which delivers an equal amount to the Portuguese system via pipeline.

Telecommunications

A telling indicator of the rapid transformation of the telecommunications sector is that Spain already has more mobile telephone subscribers than fixed lines. In March 2002, there were 21.1 million fixed lines and 30.5 million mobile phone customers. The penetration rate in mobile phones is more than 75% (see Exhibit 3.6).

The spectacular growth in mobile phones is just one facet of a sector that has taken off since Spain fully liberalized the sector in December 1998, almost one year later than most other EU countries. To prepare for the new competitive environment, the government passed a telecommunications law in June 1996 that created a second operator in basic telephony services (Retevisión), which began to compete with Telefónica, the incumbent operator, in early 1997. The monopolistic market structure was converted into a private duopoly for long-distance fixed telephony during the transition period. This followed the creation of a duopoly in mobile telephony in 1995, when private consortium Airtel (now

owned by Vodafone) received a 25-year licence and broke Telefónica's monopoly in mobile telephone services. This model has only had one European equivalent, the UK. However, the British case took place over a period of 14 years, whereas in Spain it took place in only 18 months.

The Spanish market is fiercely competitive. There are more than 60 operators of one type or another as well as cable operators, trunking and Internet service providers. Notwithstanding the above, the average cost of fixed telephony is still higher in Spain than on average in the EU, and competition in the final network segment is advancing slowly owing to the difficulties the new operators faced in gaining access to the subscriber loop. Telefónica is still very much the dominant player: its market share on the basis of total billings was just under 90% in 2001 (91.5% in 2000), but it has lost a larger slice of the cake in terms of the number of customers. Several of the new players struggled to survive. Jazztel, for example, had to restructure its high-yield debt after Moody's, the ratings agency, downgraded the bonds in March 2002 to Caa3, nine notches below investment grade and one above default. Quiero TV, Spain's first experiment with terrestrial digital pay-TV, closed down in April 2002, with estimated losses of €600 million. The two satellite-TV companies, Sogecable and Vía Digital, plan to merge in 2002 in the hope of stemming their losses.

The rates of regulated basic services provided by Telefónica have been reduced significantly. As the dominant player, Telefónica's rates are still controlled by the government, even in the liberalized market. Telefónica is not only the leader in Spain, but also the leading telecoms operator in the Spanish- and Portuguese-speaking world and the only European operator that obtains close to 50% of its EBITDA outside its home country (see Chapter 5).

Exhibit 3.7. **World's Top Five Tourism Destinations (Millions of Arrivals)**

	2001E	Market Share (%)
France	76.5	11.1
Spain	**49.5**	**7.2**
United States	44.5	6.5
Italy	39.1	5.7
China	33.2	4.8

E = Estimate.
Source: World Tourism Organisation.

Four consortia, which included British Telecom, Vodafone, Telecom Italia, Telefónica and France's Vivendi, were awarded third-generation mobile phone licences in 2000 at bargain prices. The Spanish government, which opted for a "beauty contest" approach in which licences were awarded for fixed fees based on the merit of bidders' technical proposals and business plans, raised a mere €520 million from allocating the licences. Licence auctions in Germany and the UK raised €50.5 billion (US$46.1 billion) and £22.4 billion (US$35.4 billion), respectively. The government tried to claw back the revenue that it could have earned by raising the annual fees charged to holders of the licences.

Telefónica Móviles, Spain's largest mobile telephony operator, with 16.8 million customers in 2001 (56% market share), was the first European operator to offer General Packet Radio Service (GPRS) nationwide coverage and the first to use 3G technology in a real-life setting. GPRS is a service based on the transmission of packets at speeds of up to 114 kbit/s and connection to the Internet.

Tourism

Spain has overtaken the US to become the world's second-largest tourism destination (see Exhibit 3.7). The sector, which employs more than 1.4 million people (roughly one in every ten people with a job) and generates around 12% of GDP, has long been a key corrector of Spain's current account as its receipts offset the traditional trade deficit. If it were not for the tourism sector, which year after year sets new records, Spain would have a larger current account deficit. Tourism has also played an important role in Spain's democratic development, because it brought Spaniards into contact with different peoples and ideas and broadened their horizon

(entry visas for tourists from Western Europe were abolished in 1959, 16 years before the end of the Franco dictatorship).

Spain was awarded 423 "blue flags" in 2002 for its beaches and 96 for recreational ports and marinas (44 more than in 2001) by the European Federation of Environmental Education. For the first time, Spain topped France. The blue flag is an eco-label, which places a beach in the first division and is awarded on the basis of the quality of water, the helpfulness of signposts, beach hygiene, general security, water safety and lifeguard protection. Catalonia is the leading region, with 86 blue flags.

As well as being more environmentally conscious, Spain is also succeeding in promoting tourism away from the crowded beaches towards the relatively unexplored interior of the country. Spain had 37 buildings, towns and landscapes in Unesco's 2001 World Heritage List, more than any other country (and this despite being a late joiner, for Spain subscribed to the convention in 1984 – 12 years after its approval at Unesco's General Conference in 1972). Unesco chooses from what is proposed, not from what exists. For example, both the Burgos and León cathedrals are comparably fine examples of Gothic architecture, but only the former enjoys World Heritage status.

The list is wide and testimony to Spain's situation as a cradle of different cultures and civilizations. It takes in almost the entire history and geography of Spain, including Atapuerca near Burgos, where archaeologists discovered human bones in the late 1990s that date back 800,000 years. The find doubled the known length of time that human beings have existed in Europe. *Homo antecessor* (Ancestor Man) is believed to have been a cannibal who originated

in Africa up to 1.2 million years ago; he appears to be "the missing link", the species which stands at the crossroads leading to the Neanderthals and ourselves. Other sites include Mérida's Roman remains, Teruel's Moorish architecture and the *modernista* Güell park created by Antoni Gaudi.

Madrid is on the map of Europe's principal art capitals, with the Prado Museum, the Thyssen Museum and the Reina Sofía Centre forming what is known as the "golden triangle" within 10 minutes' walking distance of one another. Bilbao, in the Basque Country, has the Guggenheim Museum, an extraordinary Noah's Ark-type building on the banks of the river Nervión. Barcelona, the capital of Catalonia, Spain's most industrially developed and diversified region, has also undergone a facelift as a result of hosting the 1992 Olympic Games. The city has become a role model for the regeneration of other European cities; in 1999 Lord Norman Foster, a British architect with a long association with Spain, presented the Royal Gold Medal for Architecture to Barcelona. This was the first time that a city had won the medal and was, post George Orwell, the ultimate homage to Catalonia. Seville, too, was transformed by holding the 1992 World Exposition and Valencia by its spectacular City of Arts and Sciences, designed by Santiago Calatrava.

Chapter 4

Foreign Trade

The Spanish economy is among the most open of the large OECD economies, as measured by total exports and imports of goods and services as a percentage of GDP. Its trade openness is more than 62% of GDP, higher than Italy and France, and its advance over the past 30 years has been greater than these two countries (see Exhibit 4.1). More than 55,000 companies export, with around a quarter of the total accounted for by four multinationals: Ford, Opel, Seat (Volkswagen) and Citroën.

Trade was not liberalised until the 1980s, except for a few timid moves in the 1960s and 1970s, and has been intense since the country joined the European Economic Community (EEC) in 1986 and also within the multilateral trade regime (World Trade Organisation). Traditionally an exporter of vegetables, fruit and wine, Spain is exporting an increasingly diversified range of products – from oddities such as doughnuts (Panrico/Donut has a plant in Beijing) to information and air traffic control systems (Indra, Spain's leading IT company, won contracts in Amsterdam, Frankfurt, Bombay and Uruguay). Spain is a mature market both for the little pastry with the hole in the middle – the average Spaniard eats his way through 12 kilos of industrial pastries a year – and for air traffic control systems, and the respective companies have successfully sought out new markets. A telling sign of the greater sophistication of Spanish exports is the increased share of high-technology industries in total manufacturing exports, from 8.4% in 1990 to 10.1% in 1999, although it was still less than half the OECD average of 25.4% (see Exhibit 4.2). The share of medium-high technology exports over the same period grew from 43.3% to 47.3% (above the OECD average of 40.8%).

In 2001 Spain's merchandise exports accounted for 1.8% of the world total (1% in 1980), the 16th largest global share (see Exhibit 4.3). Average nominal growth of exports was

Exhibit 4.1. **Exports and Imports of Goods and Services (% of GDP)**

France	30.4	55.9
Germany	39.0	67.0
Italy	32.1	55.6
Spain	**26.1**	**62.2**
UK	43.8	57.9
US	11.2	26.2
EU-15	41.9	71.1

Source: OECD Historical Statistics 1970-2000.

Exhibit 4.2. **Share of High-Technology and Medium-High-Technology Industries in Total Manufacturing Exports**

	High-Technology[1]		Medium-High-Technology[2]	
	1990	1999	1990	1999
US	32.7	38.3	39.3	37.1
Mexico	7.0	26.9	53.0	47.2
Finland	8.8	24.1	27.1	24.5
France	16.2	23.9	40.8	40.5
Germany	13.8	18.5	51.1	51.2
Ireland	35.5	49.2	20.8	30.0
Italy	10.2	10.6	37.8	40.1
Spain	**8.4**	**10.1**	**43.3**	**47.3**

(1) Aircraft and spacecraft, pharmaceuticals, office accounting and computing machinery, radio, television and communication equipment and medical, precision and optical instruments.
(2) Electrical machinery and apparatus, motor vehicles, trailers and semi-trailers, chemicals excluding pharmaceuticals, railroad equipment and transport equipment, machinery and equipment.
Source: 2001 OECD Science, Technology and Industry Scoreboard.

Exhibit 4.3. **Merchandise Exports (% of the World Total)[1]**

1	United States	11.86
2	Germany	9.24
3	Japan	6.57
4	France	5.18
5	Britain	4.44
6	Canada	4.26
7	China	4.32
8	Italy	3.92
9	Netherlands	3.73
10	Hong Kong[1]	3.09
11	Belgium	2.92
12	South Korea	2.44
13	Mexico	2.57
14	Taiwan	1.99
15	Singapore[2]	1.98
16	**Spain**	**1.80**

(1) 2001.
(2) Includes re-exports.
Source: World Trade Organisation, 2001

Exhibit 4.4. **The Ten Largest Exporters of Commercial Services (% of World Total)[1]**

United States	18.27
Britain	7.53
France	5.49
Germany	5.54
Japan	4.40
Italy	4.13
Spain	3.94
Netherlands	3.54
Hong Kong	2.99
Belgium/Luxembourg	2.96

(1) 2001
Source: World Trade Organisation, 2001.

Exhibit 4.5. **Foreign Trade by Geographic Areas (% of total)**

	1981	2001
Exports		
EU	47.3	71.3
US	6.7	4.4
Japan	1.6	1.0
Latin America	10.4	6.1
E. Europe	NM	3.2
Rest	34.0	14.0
Imports		
EU	31.3	63.9
US	13.9	4.6
Japan	2.7	2.5
Latin America	11.9	4.2
E. Europe	NM	3.6
OPEC	30.3	7.3
Rest	9.9	13.9

Note: E. Europe includes the former Soviet Union and the share in 1981 was not meaningful. It is included in the figure for the rest.
Source: Spanish Customs.

substantially higher in the first decade after joining the EEC (22.3% in 1986-96) than in 1975-85 (16.5%). The coverage ratio – imports "paid for" by exports – remained virtually unchanged during this period at about 75%. The buoyant growth in exports, with many companies working at full capacity, has been an important factor behind Spain's strong job creation. But the trade deficit is too high (5.4% of GDP in 2001 and around 5% in 2002), giving rise to an imbalance that limits the economy's growth possibilities.

The country's trade in commercial services enjoys a higher global share of 3.9%, the seventh largest (see Exhibit 4.4). And success has been achieved without resorting to much bribery. Spain, with a score of 5.8, where 10 is the perfect score, was ranked 11th in the 2002 International Bribe Payers Index, ahead of France (5.5), the US (5.3) and Italy (4.1). The index, drawn up by Transparency International, the anticorruption organisation, attempts to gauge the propensity of companies to pay bribes in 15 emerging market countries in order to win export contracts.

As regards the distribution of foreign trade, the European Union's share of Spain's total exports increased from 52% in 1985 to 71.3% in 2001, around ten percentage points higher than the EU-15 average. Spain received 63.9% of its imports from the EU in 2001, also higher than the EU average (see Exhibit 4.5). Intra-EU trade varies widely from one member state to another (see Chapter 2). As a general rule, the level is higher for small countries, such as Luxembourg, Portugal, Belgium, the Netherlands and Austria, and lower for Germany and the United Kingdom. Spain is in an intermediate position.

Sectoral Trade Performance

A novel approach developed by the International Trade Centre, a joint subsidiary of the United Nations Conference on Trade and Development (UNCTAD) and the World Trade Organisation (WTO), enables one to gauge a country's trade performance both as a snapshot in a particular year and in terms of its evolution over a five-year period[1]. This is done using two indices. On the one hand, the *trade performance current index* is based on five indicators: (1) the share of the country's export sector in world trade; (2) the sectoral trade balance (net exports); and (3) per capita exports (in order to control for the size of the economy). The fourth and fifth indicators relate to export competitiveness and the ability to (4) differentiate export products within a given sector; and (5) diversify export markets. On the other hand, the *change index* is based on five dynamic indicators: (1) the change in the country's sector-specific share in world exports; (2) the ability of exporters to increase their sectoral trade surplus or reduce their deficit; (3) the degree of specialization in particular products within a given sector; (4) changes in product differentiation; and (5) market diversification.

In 11 of the 14 sectors (not IT, consumer electronics, electronic components and clothing) Spain is ranked in the "most competitive" quintile in the Current Index and/or the Change Index (see Exhibit 4.6). More specifically, within each sector, Spain has the tenth largest share of world exports in automotive components and accessories, the 15th in industrial machinery and equipment, the 17th in image, sound equipment and accessories, the 15th in organic and inorganic chemicals, the 13th in metal and metal products and the third in footwear (see Exhibit 4.7).

[1] This section is taken from *"Sectoral Trade Performance"* by several authors in *The Global Competitiveness Report 2001-2002* (World Economic Forum).

Exhibit 4.6. **Spain's Trade Performance Index[1]**

	Current Ind	Change Ind		Current Ind	Change Ind
Transport equipment	6	26	Miscellaneous manufactures	21	56
Chemicals	18	44	Fresh food	8	25
Non-electronic machinery	19	79	Processed food	15	61
IT & consumer electronics	24	33	Wood products	27	22
Electronic components	17	49	Clothing	37	63
Minerals	25	38	Textiles	17	56
Basic manufactures	10	89	Leather products	5	56

(1) Current Index and Change Index on Export Competitiveness in 14 sectors in 75 Countries (position 1 being the most competitive).
Source: International Trade Centre UNCTAD/WTO.

Exhibit 4.7. **Spain's Share in World Exports in Various Sectors (% of total and World Position, 1999)**

	% of Total	World Position
Automotive components and accessories	4.1	10
Industral machinery and equipment	1.5	15
Image, sound equipment and accessories	1.3	17
Organic and inorganic chemicals	1.3	15
Metal and metal products	2.2	13
Footwear	6.1	3

Source: International Trade Centre.

Brand Image

Spain's export performance would appear to be good, but if one bears in mind that the country is the eleventh-largest economy in the world (the ninth among OECD countries), the sixth-largest international investor (the second in Latin America), the second-biggest tourism destination and the sixth-largest car producer, there is substantial unrealised potential. A study of the country's image in Germany, France, Italy, the UK and within Spain itself concluded that "Spain is for many foreigners the ideal place for holidays and even for living. On the other hand, it is not regarded as the ideal place for working nor is it held up as an example of a modern and dynamic economy. What is clear is that we are a new frontier, a country with big possibilities and unrealised potential."[2]

The gap between Spain's potential and reality is reflected in the comparatively low level of exports in per head terms at under $3,000 (see Exhibit 4.8) and in surveys that show that the country's image and position in the minds of international buyers is not what it should be.[3] A major factor behind this, generally speaking, is the stereotyped view of Spain, which influences perceptions of its brands. While Germany, for example, has a positive image as its products are viewed as innovative, expensive and of high quality, surveys show that Spanish goods are still widely seen as cheap, poorly designed and unreliable. This negative image reflects the situation in some areas; the problem is that it also affects those areas where Spain

[2] *La imagen exterior de España* (Instituto Universitario Ortega y Gasset, 1996).
[3] See *"El posicionamiento internacional de la marca en España"* by Raul Peralba Fortuny and other chapters in *Las marcas renombradas españolas, un activo estratégico para la internacionalización de España* (Foro de Marcas Renombradas Españolas, 2002).

Exhibit 4.8. **Goods Exports per Head ($)**

Singapore	$34,451	Britain	$4,733
Hong Kong	$28,914	Malaysia	$4,269
Netherlands	$13,281	Italy	$4,094
Switzerland	$11,642	Japan	$3,773
Sweden	$9,655	South Korea	$3,663
Germany	$6,725	Australia	$3,357
France	$5,052	**Spain**	**$2,915**

Source: based on World Bank figures of exports and population for 2000.

can match the best. More needs to be done to reinforce brand image. Except for Airbus Industrie, in which Spain participates along with France, Germany and the UK, not a single Spanish company made it into the Financial Times' 2001 ranking of the 50 most respected companies in the world. Nevertheless, Spain has made substantial progress in improving the quality of its products. There has been a surge in the number of quality guarantee certificates awarded by Aenor, the Spanish association responsible for developing the internationally recognized ISO 9000 regulations: from 62 in 1991 to 9,500 in 2001.

Spain has yet to achieve a critical mass of well-known global brands, which would help companies to compete more successfully in international markets. Three elements are holding the country back: technological weakness, a comparatively scant presence of well-known Spanish brands abroad and a lack of institutional support. A better "Made in Spain" image would in itself help to internationalize companies.[4]

Spain is one of the five top countries in the world in terms of the number of brands registered at home (70,921 in 1998), but few of them are well known outside the country. Probably the two most globally known brands are the football clubs Real Madrid and FC Barcelona. Telefónica (telecommunications), Repsol (oil) and the banks BBVA and SCH are well known in Latin America, but not really globally yet, and companies such as Chupa Chups (lollipops), Lladró (porcelain figurines) and Freixenet (*cava* or sparkling wine) have a solid reputation in specific segments (see Exhibit 4.9).

[4] This section draws on *Las marcas renombradas españolas, un activo estratégico para la internacionalización de España* (Foro de Marcas Renombradas Españolas, 2002).

Despite the success of some brands, not a single one of them is among the world's 100 best known brands, drawn up every year by Interbrand. Having just one very well known global brand can make a big difference as it acts as a locomotive pulling behind it other lesser known brands, particularly if they are in the same sector. Finland, for example, whose global share of goods exports is half that of Spain's at 0.9%, has one such brand in the Interbrand list – Nokia, the world's largest manufacturer of mobile phones. Spain's economic and trade offices abroad carried out the first ever survey in 2001 to find out which were the country's best known brands globally and also by geographic area. Chupa Chups topped the global ranking, followed by Seat, the car producer owned by Volkswagen (see Exhibit 4.10).

There are marked differences among the best known Spanish brands by geographic area. While in the US and Canada the best known ones are all luxury goods, in Latin America the top three are service companies (Iberia, the flag carrier, and the banks BBVA and SCH). Latin America has been the focus of the direct investment drive by Spain's main multinationals (see Chapter 5). Spain had one transnational corporation (TNC), Repsol, in the world's 25 largest TNCs ranked by foreign assets and drawn up by UNCTAD in 2001 (based on 1999 information). Repsol was ranked 16th with foreign assets of $29.6 billion out of total assets of $42.1 billion. This was the first time a Spanish company had entered this list, which was headed by General Electric of the US. Telefónica was ranked 30th.

As regards the distribution by sectors, food and drink, not surprisingly, have by far the largest number of best-known brands (see Exhibit 4.11). Only eight brands were 100%

Exhibit 4.9. **The Leading Spanish Brands in International Segments**

World Position	Brand	Sector
Leader	Freixenet	Sparkling wines
Leader	Chupa Chups	Lollipops
Leader	Pronovias	Wedding dresses
Leader	Lladró	Porcelain figurines
Top 3	Zara	Clothes for young people
Top 3	Kelme	Football boots
Top 3	Roca	Bathroom equipment
Top 5	Simon	Domestic electrical equipment
Top 5	Sos	Rice
Top 5	Keraben	Floor and wall ceramic tiles
Top 5	Sol Meliá	Hotels
Top 5	Puig, Myrurgia, Gal	Perfumery
Top 5	Telefónica Móviles	Mobile telephony
Top 10	Telefónica	Communications
Top 10	Repsol	Oil
Top 10	Springfield	Clothing for young men
Top 10	Panama Jack	Adventure shoes
Top 10	Borges	Olive oil, dried fruit
Top 10	Mango	Clothes for young people

Based on company figures and press reports.
Source: Julian Cerviño in his chapter "Gestión estratégica de las marcas. Especial referencia al caso español" *in* Las marcas renombradas españolas, un activo estratégico para la internacionalización de España *(Foro de Marcas Renombradas Españolas, 2002).*

Exhibit 4.10. **Geographic Distribution of the Main Spanish Brands[1]**

Global Ranking*		European Union		Latin America		Asia		East Europe	
Chupa Chups	27	Seat	7	Iberia	8	Chupa Chups	7	Seat	6
Seat	22	Chupa Chups	5	BBVA	8	Lladró	5	Chupa Chups	4
Iberia	16	Zara	5	SCH	6	Loewe	4	Gallina Blanca	4
Freixenet	15	Iberia	4	Zara	4	Torres	3	Fagor	3
Lladró	14	Freixenet	4	Freixenet	4	Majórica	3	Roca	3
Zara	14	Lladró	2	Telefónica	4	Freixenet	2	Mango	2
Mango	12	Camper	2	Terra	4	Roca	2	Campofrio	2
Fagor	11	González Byass	2	Repsol-YPF	3	Jumbo	2	Carbonell	2
BBVA	10			Seat	2	Sol Meliá	2		
SCH	9			UFESA	2				
Torres	9			Isabel	2				
Roca	8			Barcelo	2			**Arab countries**	
Telefónica	7	**United States**		Mapfre	2			Mango	6
Majórica	6	**and Canada**						Fagor	5
Gallina Blanca	5	Lladró	4					Seat	5
Loewe	5	Freixenet	3					Chupa Chups	4
Repsol-YPF	5	Carolina Herrera	2					Roca	2
Terra	5	Torres	2					Zara	2

(1) The only brands included are those that were among the five most mentioned in the survey conducted by Spain's economic and trade offices abroad (July-September 2001). The figures refer to the number of times these brands were mentioned among the five best–known brands, both globally and by geographic area.
Source: Juan José Durán in his chapter "El capital comercial y la internacionalización de la marca" *in* Las marcas renombradas españolas, un activo estratégico para la internacionalización de España *(Foro de Marcas Renombradas Españolas, 2002).*

Exhibit 4.11. **Distribution by Sectors of Spain's Best-known Brands[1]**

Food		**Drinks**		**Vehicles**		**Luxury Goods**		**Banks/Insurers**	
Chupa Chups	40	Freixenet	37	Seat	36	Carolina Herrera	27	BBVA	27
Carbonell	25	Torres	32	Irizar	8	Paco Rabanne	25	SCH	25
Borges	23	M. de Cáceres	20	Derbi	6	Lladró	26	Mapfre	16
Campofrio	16	Codorniu	16	CAF	6	Majorica	25	Sabadell	8
Isabel	13	Don Simon	14	*No of brands cited*	*27*	Puig	15	Popular	5
La Española	11	Tío Pepe	13			Nina Ricci	15	*No of brands cited*	*19*
Pescanova	9	Osborne	7	**Household**		Loewe	10		
Cola Cao	8	M. de Riscal	6	**Appliances**		Myrurgia	7	**Technology &**	
Ybarra	6	Sangre de Toro	6	Fagor	40	Carrera y Carrera	5	**Infrastructure**	
Gallina Blanca	6	*No of brands cited*	*57*	Porcelanosa	34	*No of brands cited*	*39*	Repsol-YPF	15
Arroz SOS	6			Gres Nules	16			Unión Fenosa	11
Smint	5	**Fashion**		Roca	16	**Tourism**		Dragados	11
No of brands cited	*76*	Mango	37	Ufesa	11	Sol Meliá	26	Endesa	7
		Zara	28	Keraben	9	Iberia	15	Telefónica	6
		Camper	15	Teka	9	Barceló	13	Terra	5
		Springfield	14	Tau	8	NH Hoteles	6	Ferrovial	5
		Adolfo Dominguez	7	Pamesa	8	*No of brands cited*	*24*	*No of brands cited*	*36*
		Lois	6	Zirconio	6				
		Panama Jack	6	Solac	5				
		No of brands cited	*56*	Aparici	5				
				No of brands cited	*78*				

(1) The only brands included are those that were among the five most mentioned in the survey conducted by Spain's economic and trade offices abroad (July-September 2001). The figures refer to the number of times these brands were mentioned among the five best-known brands.
Source: Juan José Durán in his chapter "El capital comercial y la internacionalización de la marca" in Las marcas renombradas españolas, un activo estratégico para la internacionalización de España (Foro de Marcas Renombradas Españolas, 2002).

identified in the surveys as being Spanish: Iberia, SCH, Carbonell (olive oil), Vega Sicilia (wine), Pamesa (ceramic wall and floor tiles), Tio Pepe (sherry), Osborne (brandy) and Terra (Internet).

The olive oil industry is an illustrative example of Spain's failure to promote the "Made in Spain" image more and of the progress that can be made when the problems are identified. Spain is by far the world's largest producer of olive oil (one million tonnes in the 2000-2001 harvest), and yet Italy (450,000 tonnes) is the country that is best known for its exports of the product because of the good reputation it has built up in quality and presentation, partly at Spain's expense. In order to meet its domestic and export needs, Italy has to import around one-third of its olive oil from various countries (an average of 200,000 tonnes a year from Spain, which in the 2000-2001 harvest represented close to half of Italy's total production). Spanish olive oil is blended with Italian oil and then re-exported as made in Italy. Over the past few years, Spanish olive oil producers, backed by ASOLIVA, have made a big effort to improve and promote the quality of their own exports. The pace of growth in olive oil with a brand name has averaged 10%-15% over the past few years, and more than 80,000 tonnes is now exported to around 100 countries, compared with a past average of 20,000 to 30,000 tonnes. One of the most successful markets has been Australia, where Spain has a 60% market share.

There is a close relationship between brand image and the image of a country. Spain's image has changed very much for the best since the end of the Franco dictatorship in 1975 and the restoration of democracy. There has also been notable progress in the following competitiveness assets: opening of the economy and massive direct investment abroad;

a giant leap in infrastructure; greater use of technologies and development of know-how; much improved business management; higher quality of products; better educated workforce and greater self-esteem among the population. There have also been landmark events that have enhanced Spain's image as a modern country, most notably the 1992 Olympics in Barcelona and the World Exposition in Seville. The country's films have won Oscars (José L. García and Pedro Almodóvar), the writer Camilo José Cela won the 1989 Nobel Prize for Literature, there is a bevy of top-notch opera singers (Plácido Domingo, José Carreras, Montserrat Caballé) and several internationally renowned architects (Ricardo Bofill, Santiago Calatrava and Rafael Moneo). Spanish is also a language that is very much on the rise and is increasingly the second language that children are learning after English. But when clients evaluate Spain with subjective criteria in surveys that measure country perceptions/stereotypes, the image is still somewhat backward and does not correspond to what it should be. Spain scored badly in a survey conducted on the brand image of various countries by the European Society for Opinion and Marketing Research (ESOMAR).

Spain enjoys esteem in various countries of Latin America, with whom it shares historic, linguistic, cultural and religious roots, and its brands benefit from this. But this is not always the case in the US, where awareness of Spain is much less, although the Hispanic population (35.3 million in 2000 out of a total population of 282 million) is the largest ethnic minority. And at the other extreme, in countries such as India, China and Russia, all of them big markets, ignorance of Spain is an entry barrier for even well-known brands. Notwithstanding this, however, there have been some notable exceptions. Chupa Chups, for example, has a plant in China.

Exhibit 4.12. **Main Spanish Brands Abroad via Franchises**

Brand/ Company	Establishments Abroad	Countries
TelePizza	292	Mexico, Chile, Poland, France, UK, Portugal
Mango	271	Europe, Latin America, Japan, south-east Asia, Africa
Ka Internacional	152	Europe, Latin America, Canada, New Zealand, Morocco, Cyprus, Lebanon
Pressto	112	UK, Morocco, Portugal, Mexico, Chile, Venezuela, Peru
Tintoretto	104	Europe, Saudi Arabia, Taiwan, Philippines
Cedosce-C2C	102	Europe, Japan, Mexico, Saudi Arabia, Kuwait, Arab Emirates, Philippines
Adolfo Domínguez	59	Europe, Saudi Arabia, Japan, China, Mexico, Argentina
Coronel Tapioca	43	Greece, Italy, Portugal, Andorra, Belgium
Artesanos Camiseros	35	EU, Switzerland, Panama, Dominican Republic, Colombia, Costa Rica, Mexico, Venezuela, US
Amichi	25	Europe, Saudi Arabia, Central America, Venezuela
Pans & Company	22	Andorra, France, Portugal, Venezuela
Sintesis	12	Switzerland, France, Portugal, Venezuela
Bocatta	9	Andorra, France, Portugal, Venezuela
Pronovias	950	All continents and in most US states.

Franchises are being used by some sectors as a way to compete better in a globalized world, both for reasons of economies of scale and the learning curve generated as well as to better defend themselves against competitors (see Exhibit 4.12).

Chapter 5

Spanish Outward Direct Investment

One of the clearest signs of the internationalization of the Spanish economy is the surge in outward direct investment over the last decade, especially in Latin America. After Spain joined the European Union in 1986, the strategic focus of large companies, in particular, gradually changed from one of defending their relatively mature home market to aggressively expanding abroad. Outward direct investment climbed from an average of $2.3 billion in 1985-95 to $12.6 billion in 1997, $18.9 billion in 1998, $42.1 billion in 1999, $53.7 billion in 2000 and then fell sharply to $26.2 billion in 2001, according to the United Nations Conference on Trade and Development (UNCTAD). The stock of outward investment increased from $4.5 billion in 1985 to $186.4 billion in 2001. In 2000 it exceeded that of inward investment for the first time. Spain was the world's eighth-largest outward investor in 2001 (see Exhibit 5.1).

The move abroad was aptly symbolised in the late 1990s by the decision of the telecommunications giant Telefónica to drop "de España" from its name. No longer did the telecommunications group view Latin America as just emerging markets; they were seen as a natural extension of its domestic market.

Before Spain joined the EU, it had little investment abroad to boast of other than exotic examples, such as Chupa Chups, the lollipop company which produces in half a dozen countries (including China), and the international networks of banks. Not all the investment has been in Latin America, the natural market for expansion, but as of 1995 the region has regularly accounted for the largest share. Net outward direct investment (ie, investments less disinvestments and repatriation of earnings and dividends) in Latin America between 1999 and 2001 amounted to €51,514 million, 41.2% of the total (see Exhibit 5.2). Not surprisingly, the US is the most important source of foreign direct investment for the region. More remarkable is

Exhibit 5.1. **Foreign Direct Investment Outflows from Developed Countries[1]**

(US$ billions)	2000	Jan-Sept 2001
Belgium/Luxembourg	218.0	17.12
Canada	63.3	20.4
France	172.5	68.9
Germany	48.6	50.1
Italy	12.3	12.6
Netherlands	72.1	36.8
Spain	**53.7**	**26.4**
United Kingdom	255.0	35.6
United States	152.4	134.1

(1) On a balance-of-payments basis.
(2) January-June only.
Source: UNCTAD.

the fact that Spain is already in second place after the US (whose economy is 15 times larger than Spain's) and in 1999 it was the largest investor. Investment declined sharply in 2001, mainly because of Argentina's meltdown – and the fear of a knock-on effect – following the implosion of its fixed exchange-rate system and its sovereign debt default. Net investment in Latin America in 2001 was 83.4% lower than in 2000 and overall investment was down 34%.

The gold, silver, emeralds and raw materials brought by the Spanish conquistadors from Latin America, which for three centuries was largely under the Spanish crown, to finance costly wars in Europe are today replaced by investments in strategic sectors in Argentina, Brazil, Chile, Mexico and Peru. Awash with cash during the 1990s, Spain's big companies and banks – Telefónica, Endesa and Iberdrola (electricity), Repsol and Gas Natural (oil and gas), Dragados (construction), Santander Central Hispano and Banco Bilbao Vizcaya Argentaria (banking, see Chapter 7) – went on a buying spree in Latin America in the 1990s. Iberia, the Spanish flag carrier, has 300 weekly flights between Europe and Latin America to 22 destinations, more than any other airline. It claims 15% of the traffic from Latin America to Europe. The one notable area where Spain lacks a multinational of a significant size is the media, despite a Hispanic market of more than 350 million people in Latin America and the US. This is partly because of restrictions on foreign ownership of media in most Latin American countries.

Not all the investment comes from Spain's handful of multinationals. A growing number of relatively small and often family-controlled companies – so-called "pocket-sized" multinationals – are also investing abroad: Ficosa International, which makes rear-view windows, windscreen washers and the like, has plants on four continents and conducts 70% of its business abroad; the Spanish perfumer Antonio Puig bought France's Nina Ricci; and Indo,

Exhibit 5.2. **Spain's Net Outward Direct Investment by Areas, 1999-2001**

(Millions of euros)	1999	2000	2001
European Union	11,340	20,111	25,688
Non-EU European countries	1,600	925	1,227
Non-European OECD countries	197	6,473	2,225
Tax havens	768	438	-12
Central and Eastern Europe	107	1,265	222
Africa	213	85	31
Latin America	27,629	20,490	3,395
Asia (excluding Japan)	254	43	49
Total	42,108	49,830	32,825

Note: Figures rounded up.
Source: Directorate General of Trade and Investment.

an optical company, makes lenses in Tangiers and frames in China. The industrial co-operatives of Mondragón in the Basque Country have subsidiaries and joint ventures that run hypermarkets in France, make gas boilers and washing machines in Egypt and refrigerators in Morocco. Ferrovial, the Spanish construction group, led the winning consortium to operate a pioneering electronic toll highway in the province of Ontario, Canada. Mango and Zara, two clothing chains, have outlets in many countries. Talgo's ultramodern locomotives and passenger cars are used in the US, Germany and Finland, and it is preparing to enter Russia.

Latin America

There are several pull factors that have spurred Spanish investment in Latin America. Two of these are purely economic: liberalization and privatization have opened up sectors of the Latin American economy that were hitherto off limits, and there is an enormous need for capital to develop the region's infrastructure. Two are cultural: the first is the common language (apart from Portuguese-speaking Brazil, although Spanish is increasingly being taught in Brazilian schools), and the second relates to the similarities throughout the upper strata of society. Another major attraction is the size of the Latin American market. While the UN forecasts that the population of Europe will drop over the next 50 years (from 727 million to 603 million), the population of Latin America (including the Caribbean) is expected to increase from 519 million in 2000 to 806 million in 2050. One-third of Latin America's population is under the age of 14, compared with 17% in the Euro-12 countries and only 7% is over 60 (21% in the Euro zone).

The region's economic growth potential is also higher than Europe's. Growth has been similar to that of the EU over the last two decades, including the "lost decade" of the 1980s.

The structural reforms undertaken in many countries should provide scope for higher growth in coming years. On the basis of a 1.3% rate of population growth, a 1.4% increase in the stock of capital and a 1.8% rate of productivity growth, BBVA's Research Department estimates the potential annual growth rate in Latin America is around 4.5%[1]. The Spanish economic cycle is highly correlated with that of the Euro zone (see Chapter 2), but the Spanish and Latin American economic cycles have been negatively correlated for a long time. In addition to the low correlation between cycles for the region as a whole, the correlation among the cycles of Latin American countries themselves is not very high, making it possible to capitalise further on the advantages of diversification and to help dispel the notion that investment in Latin America involves an excessive concentration of risk[2].

A large part of Spain's official development assistance (ODA) goes to Latin America. The country's strong linguistic, historical and cultural ties with the region and its recent experience of building a democratic state mean it is in a good position to share its experiences with Latin America. The main push factor has been the liberalization of the domestic market in Spain as European single market directives began to unfold, making the big Spanish monopolies more conscious of the need to reposition themselves in the more competitive environment.

The macroeconomic fundamentals of Latin America as a whole have also become sounder and the corporate sector is much more dynamic. For example, the number of Latin American

[1] See *The Spanish Banks' Strategy in Latin America* by C. Hernansanz and M. Sebastián (BBVA Working Paper 3/00).
[2] Ibid.

companies listed on the New York Stock Exchange has climbed from one in 1990 to more than 100 today. And democracy is more firmly rooted; Cuba's Fidel Castro is the only dictator left in the region. All of this has tended to facilitate economic stability and help make the region a more stable market for investment. Increasingly it can be said, in the vein of "what is good for General Motors is good for the US", that what is good for Latin America is good for Spain.

By the same token, however, a crisis in a big country where a Spanish company has invested heavily can have a major impact on the bottom line, as Argentina's problems have painfully exposed (see separate section). But Latin America should not be seen as a monolithic whole. The major economies – Mexico, Brazil, Chile, Venezuela and Argentina – are increasingly decoupling from each other, both in terms of real economic links and in the minds of the investment community. For example, Brazil looked as if it would hold the line with respect to Argentina, and Mexico moved more in sync with the US economy. While Europe and North America are increasingly melding into one large market, facilitating investment, Latin America is fragmenting economically. Brazil, Chile and Mexico are pressing ahead with reforms and integration into the global economy, while Argentina and Venezuela are beset by economic and political problems that hinder growth. Brazil and Mexico are the second- and third-largest recipients, respectively, of foreign direct investment (FDI) among developing markets after China. Brazil's market is larger than Mexico's (respective populations of 172 million and 100 million in 2002), but Mexico enjoys preferential access to 850 million consumers in 32 countries through the network of free trade agreements it has in place in North America, Latin America, Europe and the Middle East[3].

[3] See *The Importance of Foreign Direct Investment in the Economic Development of Mexico* by Luis de la Calle Pardo in *New Horizons for Foreign Direct Investment* (OECD, March 2002).

Mexico has received around $12 billion a year of FDI since 1994, three times the annual amount received in the five years prior to its North American Free Trade Agreement (NAFTA).

In addition to the big Spanish companies, which have commanding or strong positions in telecommunications, electricity, energy and financial services, more than 50 other companies have invested in the region. In 2001, earnings from Latin America represented almost one-third of the total of these companies and were generated on investments mainly over the past five years amounting to €102 billion (see Exhibit 5.3). This "push" has inevitably raised concerns, most notably in Argentina, which has one-third of the investment and where Spanish companies, an easy scapegoat for a discredited political class, are implicated in the country's crisis. The Spanish presence has given Madrid a privileged position in Latin America. As a founder member of European Monetary Union, whose single currency is bound to play an increasing role as a source of investment and financing, Spain is ideally placed as a bridge between the Euro zone and Latin America, between US dollar and euro flows into the region. A triangular relationship between the US, Latin America and Spain is emerging as the euro gains influence in the world. Spain has also forged closer economic links with Latin America by establishing at the Madrid Stock Exchange, the largest in the Spanish-speaking world and the fourth biggest in Europe in terms of trading volume, a market in euros for blue chip Latin American securities (Latibex). This market offers European investors the possibility of trading the stocks in a single currency, in their own time zones and through an electronic trading and settlement system to which they are already accustomed (see Chapter 8). For Latin American companies, Latibex raises their profile in Europe and opens the door to funding in euros.

Exhibit 5.3. **Latin American Exposure of Spanish Companies**

	€ mn End-2001	Investment in Latam [1] As % of Market Cap March 2002	Net Attributable Income [2] 2001 (% of Total)
FINANCIALS			
BBVA[3]	**8,800**	**19.64**	**18.80**
- Brazil	884	1.97	0.20
- Argentina	1,308	2.92	-9.20
- Mexico	3,606	8.05	16.80
- Chile	843	1.88	3.30
SCH[3]	**15,961**	**35.10**	**38.20**
- Argentina	2,394	5.26	1.30
- Brazil	6,794	14.94	15.00
- Chile	1,708	3.76	6.50
- Mexico	2,600	5.72	15.72
C. Mapfre	**460**	**32.69**	**19.20**
ELECTRIC UTILITIES			
REE	**6**	**0.37**	**1.00**
Endesa	**11,781**	**64.02**	**-**
- Brazil	2,261	12.29	-
- Argentina	2,737	14.87	
- Chile	3,332	18.11	-
Iberdrola	**2,920**	**22.02**	**3.50**
- Brazil	1,752	13.21	2.00
- Mexico	584	4.40	0.50
Fenosa	**1,367**	**24.32**	**20.00**
Gas Natural	**1,440**	**16.07**	**15.00**
- Argentina	390	4.35	7.00
- Mexico	350	3.91	-
- Brazil	500	5.58	-
Aguas Barcelona	**558**	**29.16**	**-**
- Argentina	85	0.95	20.00
- Chile	470	5.25	14.20
CONSTRUCTION			
OHL	**166**	**10.96**	**-6.60**
- Argentina	40	7.50	-18.62
- Brazil	60	7.50	12.02
Dragados	**262**	**10.50**	**-9.00**
- Argentina	104	4.17	-
- Chile	28	1.12	-
- Brazil	37	1.48	-
- Mexico	75	3.01	-
Ferrovial	**323**	**9.16**	**3.50**
ACS	**-**	**-**	**4.60**
- Argentina	-	-	1.50
- Mexico	-	-	3.10
FCC	**-**	**-**	**3.00**
- Argentina	-	-	0.50
- Mexico	-	-	2.50
Uralita	**13**	**3.33**	**1.04**

TELECOMMUNICATIONS			
Telefónica	**32,649**	**50.50**	**57.00**
- Brazil	12,800	20.00	21.00
- Argentina	9,800	15.31	14.00
- Mexico	2,180	3.41	5.00
- Chile	500	0.78	5.00
TEF Móviles	**5,329**	**16.43**	**22.00**
- Brazil	2,780	4.34	16.00
- Argentina	810	1.27	3.00
Aumar	**117**	**7.47**	**22.00**
- Argentina	88	5.60	6.00
Acesa	**127**	**4.02**	**4.50**
TECHNOLOGY			
Terra	**227**	**4.09**	**36.70**
- Brazil	110	1.99	12.70
- Argentina	16	0.29	0.30
- Mexico	5	0.09	9.20
TPI	**35**	**1.97**	**-30.10**
- Brazil	11	0.61	-33.14
- Peru	12	0.68	1.39
Amadeus[4]	**23**	**40.47**	**10.00**
Recoletos	**18**	**2.62**	**10.00**
- Argentina	17	2.49	-12.00
OIL			
Repsol	**18,750**	**97.57**	**54.00**
- Argentina	16,875	87.82	48.60
Aldeasa	**16**	**4.26**	**5.22**
Metrovacesa	**8**	**0.75**	**0.70**
NH Hoteles	**137**	**8.79**	**3.84**
Sol	**361**	**22.08**	**23.00**
- Mexico	-	31.06	10.50
Telepizza	**5**	**1.35**	**3.54**
Prosegur	**322**	**34.55**	**34.00**
% Brazil	**27,998**	**8.30**	**5.48**
% Argentina	**34,753**	**10.30**	**5.93**
% Mexico	**9,520**	**2.82**	**3.60**
% Chile	**7,370**	**2.19**	**0.52**
% Others	**23,596**	**7.00**	**12.87**
Total	**102,181**	**30.61**	

(1) At historic prices.
(2) Net attributable income where available, otherwise EBIT.
(3) For banks, Latam investment refers to current BV (ie, after goodwill write-offs). Contribution to earnings after Latam minorities and pre-consolidation charges.
(4) Percentage of T/A bookings generated in Latam.
Source: Company data and Santander Central Hispano Bolsa estimates.

Exhibit 5.4. **Telefónica – Distribution of EBITDA by Country, 2001**

	% of Total EBITDA
Spain	56.9
Brazil	20.9
Argentina	11.3
Peru	5.4
Chile	5.5

Source: Telefónica.

The subsidiaries of multinationals in Spain are also investing in Latin America. According to a study by KPMG, 62 Spanish companies controlled by foreign capital invested in Latin America between 1993 and 1999. The main reasons for investing were cultural and linguistic similarities (86% of those surveyed) and the belief that Spain is the best platform for entering the Latin American market (83%). Other important factors were previous business relationships in the region (60%) and supplying Spanish companies already present in the region (30%).

Most of the sectors where the Spanish companies operate in Latin America are undergoing liberalization and deregulation within the frameworks of the General Agreement on Trade in Services (GATS), European Commission directives and the worldwide restructuring resulting from mega mergers. In these and other service areas, which since January 2000 are the subject of multilateral trade negotiations, both established world leaders and those companies with aspirations to become worldwide operators are using foreign direct investment and strategic alliances to further their interests.

Some of the main Spanish transnational corporations (TNCs) emerging as global players or mega-region players arose from privatization processes of their own. In Latin America, they have taken advantage of similar processes to expand internationally. According to the Economic Commission for Latin America and the Caribbean (ECLAC), 40 of the 500 largest Latin American companies in 1998 were state-owned, compared with 93 in the period 1990-92. Spain had one TNC, Repsol, among the world's 25 largest TNCs ranked by foreign assets and drawn up by UNCTAD in 2001 (based on 1999 information). Repsol was ranked 16th with foreign assets of $29.6 billion out of total assets of $42.1 billion (Telefónica was ranked 30th). This was the first time a Spanish company had entered this list, which was headed by General

Exhibit 5.5. **Telefónica Group – Market Size, 2001**

('000)	Fixed Lines	Mobile Customers	Pay-TV Customers
Argentina	4,556	1,794	
Brazil	12,616	5,643	
Chile	2,723	1,57	
El Salvador		238	
Guatemala		156	
Mexico		1,212	
Morocco		1,112	
Peru	1,716	1,087	341
Spain	20,646	16,793	806
Venezuela	2,697	2,461	

Source: Telefónica.

Electric of the US. UNCTAD measures the degree of international involvement of a firm through its "transnationality index" which is the average of three ratios: foreign assets/total assets; foreign sales/total sales and foreign employment/total employment. Repsol's value in this index was 51.6% and Telefónica's 38%.

Since it was privatized, Telefónica has become the largest telecommunications company in the Spanish- and Portuguese-speaking world. A monopoly to varying degrees in Spain until the sector was fully liberalized in December 1998, Telefónica is the only European telecoms operator that obtains close to 50% of its EBITDA (earnings before interest, taxes, depreciation and amortisation) outside its home country (see Exhibit 5.4). The company in Spain also has the highest number of lines per employee in the European sector (505 in 2001, compared with 354 for British Telecom, 253 for France Télécom and 448 for Telecom Italia). This is an important factor since personnel expenses and capex are the two largest cash outflows in the fixed line business. At the end of 2001, Telefónica had 78.3 million customers worldwide, of which 44.9 million were fixed line telephony users, 32.2 million mobile telephone users, and 1.14 million pay-TV customers (see Exhibit 5.5). The total number of subscribers is expected to reach 100 million in 2004.

Brazil and Mexico (which together generate more than 60% of Latin America's total GDP) are the key countries for Telefónica in Latin America. Telefónica first entered Brazil in 1996 as head of a consortium which paid $655 million for 35% of the voting shares of CRT in the southern state of Rio Grande do Sul. It then acquired controlling stakes in three regional operating companies in the 1998 auction of Brazil's Telebras system, the largest being Telesp, the fixed-line operator in Sao Paulo state. As a result of the elimination of Telesp's customer waiting list in 2001, two years ahead of the regulatory objectives, in 2002 the Brazilian regulator Anatel authorised Telefónica to provide

Exhibit 5.6. **Repsol YPF – Operations in Latin America**

	Exploration	Production	Refining	Marketing	LPG	Chemicals	Gas & Power
Argentina	√	√	√	√	√	√	√
Bolivia	√	√			√		
Brazil	√	√	√	√		√	√
Chile				√	√		√
Colombia	√	√					√
Cuba	√						
Ecuador	√	√		√	√		
Guyana	√						
Mexico						√	√
Peru	√		√	√	√		
Venezuela	√	√					
Trinidad & Tobago	√	√					√

Source: Repsol YPF.

nationwide local telephony services, as well as national and international long-distance services. Telesp, in which Telefónica has an 87% stake, was Brazil's first fixed line operator to receive such authorization. Until then it was only allowed to provide local telephony and domestic long-distance services within Sao Paulo state. Anatel certification was also a requisite for going ahead with the mobile telephony joint venture between Telefónica Móviles and Portugal Telecom in Brazil.

Telefónica made its first incursion into the Mexican market in 2000 when it acquired four regional operators in northern Mexico. In May 2002 Telefónica Móviles, Spain's largest mobile telephony operator, reached an agreement to gain control of Pegaso, the heavily indebted Mexican mobile operator. The $87 million acquisition of 65% of Pegaso's equity made it the country's second-largest operator behind Telcel. Pegaso contributed 800,000 customers in Mexico, increasing the total to 2.2 million, or a market share of 10%. The company expects the subscriber base to grow to between 6 million and 7 million subscribers by 2005, but Telefónica will still be a distant second to Telcel, which claimed 78% of the market in 2001. Mexico's mobile telephone penetration rate was about 21% in 2002 and is expected to double over the next five years. Fixed lines are hard to come by in many parts of the country, which has 14 lines per 100 inhabitants nationwide, and less than four in rural states such as Chiapas. For many Mexicans, mobile is the only way to access telephony services.

Telefónica's organic growth will come from the substantial potential to broaden the group's customer base, mainly in mobile telephony.[4] Regarding the fixed-line business, Telefónica has an aggressive plan for broadband based on ADSL. It expects the number of its broadband users in

[4] See Santander Central Hispano Bolsa's report on Telefónica, *From Sad Tango to Cheerful Samba* (April 9, 2002).

Exhibit 5.7. **Repsol YPF – Selected Operating Data**

	2001		2001		2001
Crude oil reserves (1)		**Refining capacity (4)**		**Sale of petroleum products (7)**	
Spain	6,962	Spain	740	Spain	25,641
Argentina	1,487,696	Argentina	334	Argentina	8,550
Rest of the world	800,330	Rest of the world	102	Rest of the world	15,491
Gas reserves (2)		**Crude oil processing (5)**		**LPG sales (7)**	
Spain	–	Spain	32.3	Spain	2,102
Argentina	10,122,647	Argentina	14.5	Argentina	363
Rest of the world	8,469,916	Rest of the world	4.2	Rest of the world	780
Hydrocarbon production (3)		**Number of service stations (6)**		**Natural gas sales (8)**	
Spain	2,244	Spain	3,704	Spain	180,260
Argentina	262,430	Argentina	2,018	Argentina	48,325
Rest of the world	105,670	Rest of the world	914	Rest of the world	15,931

(1) Thousands of barrels of crude oil. (2) Millions of cubic feet of gas. (3) Thousands of barrels of oil equivalent.(4) Thousands of barrels per day. (5) Millions of tonnes of oil equivalent. (6) Service stations located at both sides of a road are considered two points of sale. (7) Thousands of tonnes. (8) Millions of thermies. Source: Repsol YPF.

Spain and Latin America to rise from 620,000 in 2001 to over 4.5 million in 2005. Non-organic growth would involve selective acquisitions, mainly in Mexico and Brazil. The focus in Latin America is on consolidating positions rather than expanding into new areas.

The biggest investor in Latin America has been Repsol, which in 1999 acquired Argentina's YPF for $14.9 billion. The acquisition of YPF transformed Repsol, the dominant energy company in Spain, into the largest non-government-controlled producer of oil and gas in Latin America. Its proved oil and gas reserves quadrupled overnight to 4.53 billion barrels of oil equivalent. Repsol YPF has operations in 12 Latin American and Caribbean countries, with Argentina accounting for the bulk of businesses (see Exhibits 5.6 and 5.7). The €12,122 million of operating revenue generated in Argentina and the rest of Latin America represented 28% of the total in 2001.

Under a deal in 2000 with Petrobras, Brazil's state-controlled oil company, Repsol YPF swapped assets in Argentina and Brazil worth more than $1 billion. Petrobras acquired a large network of petrol stations and a refinery, while Repsol YPF obtained a 10% stake in the Albacora Leste block, a deep-water oilfield in the offshore Campos basin with a potential estimated at 1.3 billion barrels of crude oil, as well as a network of 240 service stations. In addition, Repsol YPF acquired a 30% stake in Petrobras' REFAP refinery in southern Brazil. The deal was largely the result of rulings by Argentina's antitrust agency following Repsol's acquisition of YPF. The agency ordered Repsol YPF to sell many of its petrol stations and part of its local refining capacity. Repsol YPF was the first foreign oil company to enter the refining business in Brazil.

In 2001 Repsol YPF also swapped assets in Bolivia with Perez Companc, whereby it received 20.25% of Empresa Petrolera Andina and a 50% stake in the fields of Manantiales

Exhibit 5.8. **Endesa's main presence in Latin America**

Country	Company	Generation/Customers
Argentina	Dock Sud	775 MW[1]
	Yacylec	500 KV
	Costanera	2,302 MW
	El Chocón	1,320 MW
	Edesur	2.1 million
Brazil	Cerj	1.7 million
	Coelce	1.9 million
	Cachoeira Dourada	658 MW
	CIEN (Brazil-Argentina interconnector)	2,000 MW
Colombia	Betania	540 MW
	Emgesa	2,510 MW
	Codensa	1.8 million
Chile	Endesa Chile	3,959 MW
	Chilectra	1.3 million
	Rio Maipo	0.3 million
Dominican Republic	Cepm	70 MW
Peru	Etevensa	322 MW
	Edegel	1,003 MW
	Edelnor	0.9 million
	Piura	151 MW

(1) Under construction.
Source: Endesa.

Behr and Restinga Alí, in the San Jorge Gulf basin in Argentina. In exchange, Repsol YPF transferred to Perez Companc its stake in the Santa Cruz (30%) and Santa Cruz II (62.2%) oil and gas fields, both in the Austral basin in southern Argentina. In addition, Repsol YPF also acquired a 9.5% stake in Andina from Pluspetrol Bolivia Corporation. The total value of the assets involved in this agreement was $434.5 million. As a result, Repsol YPF increased its stake in Empresa Petrolera Andina to 50%, enabling it to take control of the Bolivian company.

In Ecuador, Repsol YPF is involved in the building of the heavy oil pipeline that is essential to eliminate a bottleneck affecting the transportation of heavy oil. Once the pipeline begins operations in 2003, it will allow the company to double its production.

Three other big players in Latin America are the power companies Endesa, Iberdrola and Gas Natural. Endesa, the market leader in Spain (with a market share of around 45%), first entered Latin America in 1992 when it acquired (as part of a consortium) Edenor, which distributes electricity to northern Buenos Aires. It then purchased a 22% stake in Yacylec and a 35% stake in the Dock Sud power plant. In 2001, Endesa controlled 12.4GW of generating capacity in Latin America (20.3GW in Spain) and had more than 10 million customers (see Exhibit 5.8), making it the leading private–sector electricity multinational in the region. Energy-hungry Brazil (which had to ration electricity in 2001 because of a drought that had reduced reservoir levels) is the greatest attraction for Endesa. The company entered Brazil through Enersis, the Chilean company that built up a considerable share in the electricity markets of other countries. Endesa established a strategic alliance with Enersis in 1997 and took a 29% stake in the company, and then the two firms headed a consortium which was awarded the Brazilian distributor Coelce.

Exhibit 5.9. **Iberdrola's Main Presence in Latin America**

Country	Company	Customers/generation	
Bolivia	Electropaz	0.3 million	
	Elfeo	0.04 million	
Brazil	Celpe	2.1 million	
	Coelba	3.1 million	
	Cosern	0.7 million	
	Itapebi		450MW*
	Termopernambuco		540MW*
	Termoacu		340MW*
Guatemala	Eegsa	0.6 million	
Mexico	Monterrey I and II		500MW
	Alfa-Pegi III		250MW
	Alfa-Pegi IV		250MW*
	Enertek		120MW
	Femsa-Titán		37MW*
	Altamira III and IV		1,036MW*
Chile	Ibener		124MW

(*) Under construction. Source: Iberdrola.

Endesa enlarged its stake in Enersis and took management control in 1999. Upon taking control of Enersis, Endesa acquired a leading position in Argentina, Chile and Peru. The company has not confined its activities to electricity: in 2000 it acquired Smartcom, Chile's second mobile operator, which by the end of 2001 had increased its customer base more than eightfold, from 70,000 to 609,000.[5]

Endesa is to participate in building a $320 million single electricity grid for Central America by 2005. A 1,830km, 230kv line will connect Guatemala, Honduras, El Salvador, Nicaragua, Costa Rica and Panama. The region has an abundance of hydroelectric resources and is close to gas producers. However, the small size of each country has stymied investment in large projects, leaving it reliant on small, oil-powered generators. Latin America's energy needs are huge: the International Finance Corporation, the private-sector arm of the World Bank, estimated that it needs to install 100,000MW of new generating capacity by 2010.

Iberdrola, Spain's second-largest electric utility, participates in the management of 26 companies in Brazil, Mexico, Bolivia, Chile, Guatemala and Uruguay. It is the largest electricity distributor in the northeast of Brazil, with nearly 6 million customers (see Exhibit 5.9). Construction work began in 2001 at the 520MW Termopernambuco power station, which will be the biggest electricity generator in north and northeast Brazil, and at the 340MW TermoAçu facility, the largest cogeneration project in Latin America. In Mexico, Iberdrola is the leading independent generator of electricity, with 2,193MW of installed capacity contracted at the end of 2001, of which 1,524MW are to supply the Federal Electricity Commission. Under its 2002-

[5] See Santander Central Hispano Bolsa's report on Endesa, *A Look Beyond 2002* (May 6, 2002).

Exhibit 5.10. **Gas Natural – Main Presence in Latin America**

Country	Company	Customers (mn)
Argentina	Gas Natural BAN	1.2
Brazil	CEG/CEG RIO	0.6
Colombia	Gas Natural ESP	1.1
Mexico	Gas Natural Mexico	0.7

Source: Gas Natural.

2006 Strategic Plan, Iberdrola aims to double its revenues through €12 billion of investments in its core Spanish market, Mexico and, to a lesser extent, Brazil.

Gas Natural, Spain's former gas monopoly, had 3.6 million natural gas customers in 2001 in Argentina, Brazil, Colombia and Mexico (see Exhibit 5.10). In 1997 it teamed up with Iberdrola, Enron and Pluspetrol and won the tender for the privatization of Brazil's CEG and CEG Rio. These companies distribute piped gas to the metropolitan area of Rio de Janeiro and throughout the rest of the state and have a potential market of 14.5 million people. In 2000, Gas Natural obtained the concession for distributing piped gas in the southern area of the state of Sao Paulo.

Particularly active among the construction companies is Dragados, which built the second runway at the El Dorado airport in Colombia and the toll road in Buenos Aires. The travel group Marsans and its partners in the Air Comet group bought the bankrupt Aerolíneas Argentinas, the national carrier, in 2001 from Sepi, Spain's state holding company. Sepi acquired the airline in 1991 when Argentina was wracked by hyperinflation and eager to sell off state assets, but it never turned a profit. Sepi abandoned most of Aerolíneas's international routes and cut staff, despite investing $1.8 billion in the airline. The new owners assumed responsibility for paying off half the airline's $1.2 billion debt.

In tourism, Sol Meliá, Spain's leading hotel management company and one of the foremost in the world, has 74 hotels in Latin America and the Caribbean, where it is the market leader, and another 20 were due to be opened during 2002.

The Impact of Argentina's Crisis

Spain suffered more than any other European country from Argentina's crisis because of its large volume of investment in that country and the sectors in which it is concentrated, essentially services. The country's meltdown severely gored company results for 2001 and 2002 (see Chapter 7 for the impact on banks). One rough estimate put the total "cost" in 2001 at €9.8bn (at an exchange rate of AR$1.70/US$1.00), based on extraordinary provisions, the fall in equity and net income and foreign exchange losses. On top of this, the Madrid stock exchange was pulled down by the "tango effect" as the shares of the main Spanish companies with interests in Latin America account for around three-quarters of the total trading volume (see Chapter 8).

With a financial system shattered by the massive devaluation of the peso and capital flight, the largest-ever sovereign debt default, companies struggling to pay dollar debts with peso revenues, the threat of a return to hyperinflation and an economy that was in recession long before the crisis came to a head, Argentina tested the nerve of many a company chairman. Adolfo Domínguez, the textiles group, and Mango, the women's clothes retailer, were able to decide relatively easily and quickly to scale down their not very large presence. However, for Spain's multinationals, such as Repsol (energy), Telefónica (telecommunications) and Endesa (electricity) and the banks Santander Central Hispano and BBVA (see Chapter 7), the decision whether to pull out or put in more money was a much more complex and costly matter and one that would be politically awkward for the Spanish government. Latin American governments treat the chairmen of Spain's multinationals and big banks as if they were heads of state. At the end of the day, any

decision on whether to abandon Argentina depended on the speed and seriousness with which the government put its house in order and established a viable market economy and a viable financial system.

The hardest hit among the non-financial companies was Repsol, which put many eggs into the Argentine basket after buying YPF for close to $15 billion in 1999. The *Financial Times*' prestigious Lex said "YPF has become not a nice Spanish omelette, but a sorry mess".[6] Repsol YPF, with close to 70% of its net oil production and 75% of net natural gas output coming from Argentina, faced lower sales, restrictions on the transfer of hard currency outside Argentina, difficulties in transferring costs incurred in dollars to sale prices fixed in pesos, a 20% tax on crude oil exports and a 5% tax on refined products. Its net income dropped 58% in 2001 to €1.03 billion as it was forced to set aside €2.7 billion in extraordinary provisions and write-offs. Net income in the first quarter of 2002 fell by almost 50% when it set aside a further €1 billion against equity for exchange rate fluctuations in Argentina.

One way in which Repsol YPF offset the impact of its ill-fated expansion into Argentina was to shed some of its assets. It cut its stake in Gas Natural from 47% to 24% in a deal worth more than €2 billion. This enabled it to pay off part of its debt and, from an accounting point of view, remove Gas Natural from its consolidated accounts. Under Spanish accounting rules, Repsol YPF was obliged to consolidate 45% of Gas Natural's debt, and this weighed on its share price performance, which was already affected by the crisis in Argentina, where its investments came to be regarded as more of a liability than an asset.

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[6] *Financial Times*, January 9, 2002.

Telefónica's net income fell 72% in the first quarter of 2002 over the same period of 2001 as foreign exchange losses in Argentina took their toll. The company took a further €254 million charge related to the Argentine business and wrote down its reserves by another €839 million. This was in addition to a €369 million charge and a €1.42 billion write-down in 2001. Excluding Argentina, profits would have been up 10.1% year-on-year.

Endesa was less affected by Argentina as the country represents a small portion of its assets and liabilities in Latin America. The company is also well diversified geographically: negative cycles in some countries are offset by positive ones in others (for example, deteriorating conditions in Brazil and Argentina were offset by an improvement in Chile). Net income rose 5.2% in 2001 and doubled in the first quarter of 2002, although this was due to a one-off gain of €1 billion from the sale of the group's Viesgo unit to Enel of Italy. The gain, however, was partially offset by €368 million of provisions to cover risks, €210 million of them in Argentina. The company is taking a breather from its aggressive period of growth between 1997 and 2001 that placed the company among Europe's five largest utilities. Endesa said in 2002 that there would be no new acquisitions in Latin America and Europe over the next three years. The focus is on developing is core energy business and lowering its debt. The investment budget for 2002 to 2006 was cut from €20 billion to €13 billion and Endesa intends to sell its non-core assets (telecoms, water and financial investments).

Other Areas

While Latin America has been very much the focus of investment since the mid-1990s, Spanish companies have also invested in many other parts of the world, particularly Europe. Net

investment in EU countries rose 27.7% in 2001 to €25.6 billion, taking up the slack in investment in Latin America (see Exhibit 5.2).

The investments have varied from the purchase by the perfumer Antonio Puig of France's Nina Ricci and Unión Fenosa's acquisition of Cambridge Water in the UK to the establishment by the industrial co-operatives of Mondragón of manufacturing facilities for gas boilers and washing machines in Egypt and the building by the Dragados Group of the Platinum Toll Highway in South Africa, the first in that country to incorporate dynamic toll, a system which enables vehicles to go through the toll station without having to stop. This is thanks to an electronic device developed by SICE, a division of Dragados specialised in traffic control, which reads the number plate and then automatically charges the toll fee to the driver's bank account. Dragados is ranked first in the world in transport infrastructure concessions, an activity that it develops in all the stages from contracting to financial arrangements and managing the concessions. Its emblematic construction projects include a fertilizer plant in the Philippines, a thermal power plant in Egypt, Scott Platform in the North Sea and the Öresund Bridge between Sweden and Denmark. Dragados built 49 deck segments of steel and concrete for this bridge at its yard in Cadiz, most of them 140 metres long, and shipped them in huge barges to the Baltic Sea. It took one year of technical and laboratory testing in Spain to develop, for the first time, the concrete for these elements that had to be resistant to freezing.

Spain's big companies – Endesa, Repsol, Telefónica and the banks Santander Central Hispano and Bilbao Vizcaya Argentaria – have concentrated on Latin America, but not to the exclusion of other parts of the world. Endesa is strong in the so-called Mediterranean arch, which includes Spain, Portugal, France and Italy, with generating and marketing companies in all of

these countries. In early 2002, Endesa had 51% of Endesa Italia, with 5,720MW of installed capacity in Italy (7% of the generation market), 30% of France's Snet (a 15% market share) and 35% of Portugal's Tejo. Repsol's non-Latin American interests include mineral rights in two production blocks in Algeria and 103 points of sale in Portugal, while Telefónica has more than one million mobile telephone customers in Morocco, third generation mobile telephony licences in Germany, Italy, Switzerland and Austria, and it owns 37% of Terra Lycos, one of the most visited Internet networks in the world. Telefónica's Terra, Spain's leading access and portal player, acquired the US Lycos in 2000 for $12.5 billion. Terra Lycos has portals in 43 countries and in 2001 became the first Internet company to offer CheckM8 technology which, among other advantages, permits format transparency and does not affect page content, as well as an advertising sequence that has different sizes, formats and locations, and follows the user as he browses.

The one geographic area where Spanish investment needs to be stronger is Central and Eastern Europe, most of whose countries are expected to be in an enlarged EU by 2005. Spain had a symbolic 0.5% of the total stock of foreign direct investment in these countries in 1999, compared with 19% for Germany and 14% for the Netherlands (see Exhibit 2.8 in Chapter 2).

Spain and Portugal

The internationalization of the Spanish and Portuguese economies since their entry into the EU in 1986 has produced a substantial integration of the two neighbouring countries. The growing links are very much symbolised by the 600km of motorway that join Madrid and Lisbon as of 1999, a border that was one of the first to do away with regular controls in the EU, a single

Iberian electricity market that is due to begin in 2003 and the mobile telephony joint venture between Telefónica Móviles and Portugal Telecom in Brazil. One day there could be a high-speed train between the Spanish and Portuguese capitals, like the one linking Madrid and Seville, which would reduce the journey to less than two hours. A process of irreversible convergence is under way between the two countries.

After the restoration of Portuguese independence from Spain in 1640, the two countries turned inwards and lived like "Siamese twins joined at the back" – in the words of the leading Spanish daily, *El País*[7] – for more than 300 years until they both entered the EU and had to come face to face. Portugal long mistrusted Spain, expressed in the still popular saying that "Spain produces neither good wine nor good marriages", and Spain took a lofty approach to its neighbour and ignored it.

The truth of the saying is a matter of individual choice, but there is no denying that the Portuguese like Spanish products and Spaniards love visiting Portugal (around 6 million of the 12 million annual tourists). Spain's exports to Portugal are close to double the total to Latin America, and in 2001 they represented 10% of total sales abroad (2.2% in 1985). Since 1990 Spain has been Portugal's leading or second-largest supplier after Germany, and Spain is Portugal's main export market.

Spanish banks and companies have invested heavily in Portugal. The first Spanish bank to make a big investment in Portugal was Banco Bilbao Vizcaya (now Banco Bilbao Vizcaya

[7] *Portugal-España: siameses unidos por la espalda* (*El País*, January 6, 2002).

Exhibit 5.11. **Spain and Portugal, Comparative Indicators**

	Population (mn)	GDP (US$ bn)	Exports[1] 1985	Exports[1] 2001	Imports[2] 1985	Imports[2] 2001
Spain	**39.5**	**558.5**	**2.2**	**10**	**0.8**	**2.7**
Portugal	10	105	4.1	23.3	7.4	35.7

Note: Population and GDP figures are for the year 2000.
(1) Exports of each country to the other as a percentage of each country's total.
(2) Imports of each country from the other as a percentage of each country's total.
Source: World Bank, Spanish Customs and Portuguese Economy Ministry.

Argentaria), which in 1991 bought the business and retail network of Lloyds Bank. Lloyds had been in Portugal for 128 years and was known simply as *o banco inglês*, the English bank. For a bank of Portugal's oldest ally to decide to pull out was a bad enough blow for the government. Selling it to Portugal's historical enemy was tantamount to being stabbed in the back by one's best friend. Until the wave of Spanish investment in Latin America as of the mid-1990s, more investment went "next door" than to virtually any other country. And the volume is still large: gross direct investment in Portugal averaged €890 million between 1998 and 2001. The increasingly strong Spanish presence plays on Portuguese fears that they are being swallowed up by their economically more powerful neighbour (see Exhibit 5.11).

Portuguese sensitivity to Spanish investment was highlighted by Santander Central Hispano's (SCH) attempt in 1999 to forge an alliance with the Champalimaud group. Antonio Champalimaud, Portugal's richest individual, agreed to sell to SCH his family's 40% controlling stake in Mundial Confiança, an insurance company, which in turn controlled Portugal's third-largest financial group. The Portuguese government blocked the deal, ostensibly because it said insurance sector regulations had been breached, even though the European Commission had given its blessing to the sale. The legal battle ended with a negotiated settlement that gave Champalimaud a 4% stake in SCH in return for his 52% holding in the Portuguese group. The state-owned Caixa Geral de Depôsito, Portugal's biggest bank, then acquired this stake from SCH before selling Banco Totta & Açores and Crédito Predial Português back to SCH. The Spanish banks dwarf their Portuguese counterparts: the total assets of just SCH, Spain's largest banking group, at the end of 2001 were €358.1 billion, 123% of the total assets of Portuguese banks. La Caixa, the big Spanish savings bank, is a core shareholder in BPI.

Today, SCH (which set up in Portugal in 1993 with its own bank and largely pioneered pure investment banking activities in the country) is the third-largest banking group in Portugal by assets, with a market share in 2001 of 10% in on-balance sheet funds, 11% in loans and 13% in mutual funds. Overall, SCH is the largest bank in the Iberian peninsular. In 2002, it made Portuguese one of its two official languages, on a par with Spanish. This has far-reaching implications and reflects the group's strategy of focusing on southern Europe and Latin America while maintaining strong local roots and domestic brands.

After banking, the sectors that Spanish companies have most invested in are energy, textiles, food, real estate and retailing. El Corte Inglés, Spain's largest department store chain, opened an imposing complex in Lisbon in 2001. About one-third of the store's products are Portuguese and the rest imported. The Inditex group, with its five fashion chains – ZARA, Pull & Bear, Massimo Dutti, Bershka and Stradivarius –, has around one-third of its almost 500 stores in Portugal, its second-largest market. Mango, Cortefiel and Springfield are also present in Portugal.

Chapter 6

Foreign Direct Investment in Spain

Foreign direct investment (FDI) has played a prominent role in Spain's industrial modernization over the last 40 years. The country was all but off limits to foreign investment for 20 years after the 1936-39 Civil War; the country was not able to benefit from foreign loans until IMF and OECD accords were ratified in 1959-60. The impact of these agreements, coinciding with Spain's Stabilization Plan which encouraged foreign investment, opened the country to tourism and began to integrate the peseta into a transnational monetary system, was almost immediate. Foreign investment began to take off, rising from $12 million in 1958 to $86 million in 1960. While much of Europe had, for over a decade by 1960, been enjoying the benefits of the US Marshall Aid programme following the end of the Second World War, Spain had spent 20 years hauling itself back from the devastation of the Civil War by its boot straps.

The surge in FDI since Spain joined the European Economic Community (EEC) in 1986 has been such that it seemed at times as if the country was up for sale. Inward investment rose from an average of $8.2 billion a year between 1985 and 1995 to $14.2 billion in 1998, $15.8 billion in 1999, $36.6 billion in 2000 and dropped sharply in 2001 to $20.2 billion, according to the United Nations Conference on Trade and Development (UNCTAD). The stock of inward investment stood at $162.6 billion in 2001, up from $8.9 billion in 1985. FDI as a percentage of gross fixed formation rose from an annual average of 8.8% in 1985-95 to 25.6% in 2000 (4.4% and 17.4%, respectively, in France and 10.6% and 47.6% in the UK).

In the 1997-2001 period Spain obtained 2% of the world's total FDI (see Exhibit 6.1). FDI helped Spain to sustain economic growth above that of other OECD countries by offsetting the current account deficit. The bulk of the FDI, with a few notable exceptions, is not greenfield but the result of mergers and acquisitions. Sales of companies rose from $3.6 billion in 1994

Exhibit 6.1. **Foreign Direct Investment Inflows – Average, 1997-2001**

	US$ bn	% of World Total
1. US	211.1	24.2
2. UK	76.6	8.8
3. Germany	61.4	7.0
4. Belgium	55.8	6.7
5. China	42.2	4.9
6. Netherlands	40.3	4.6
7. France	37.4	4.3
8. Canada	30.0	3.4
9. Hong Kong	27.9	3.2
10. Brazil	27.1	3.1
11. Sweden	24.7	2.8
12. Spain	**17.9**	**2.0**

Source: Economist Intelligence Unit.

to a peak of $22.2 billion in 2000 and $8.7 billion in 2001, while purchases increased from $3.8 billion to a high of $39.4 billion in 2000 and $11.2 billion in 2001.

Liberalization of the economy after 1986 opened up opportunities for foreigners, while many Spanish companies, particularly family-owned ones, preferred to sell out rather than adjust to survive the greater competition. Foreign companies control the motor industry (Ford, Nissan, Opel, Peugeot, Renault and Volkswagen) and are strong in cement (Portland and Lafarge Asland), electrical appliances (Sony, Philips and Electrolux), electronic components (Siemens and Robert Bosch) electronics (Philips and Honeywell), computers (Hewlett Packard and IBM) and consumer products (Unilever and Procter & Gamble). The French Auchan (known in Spain as Alcampo) and Carrefour groups, have led a revolution in Spanish retailing, opening hypermarkets in the outskirts of cities which have drained customers away from traditional corner shops. Marks & Spencer's first store in Madrid was an extraordinary success until it closed at the end of 2001 because of the closure of all non-UK operations. Several foreign banks (Barclays, Citibank and Deutsche Bank) have acquired networks from Spanish banks, though their share of the total banking market remains small, and foreign firms have a growing share of the insurance market (Allianz, Axa and Generali). Not even the wine industry has been immune from foreign takeovers: in 1994 Allied-Lyons acquired Pedro Domecq, the leading spirits company in Spain and Mexico, and in 2001 the renamed Allied Domecq bought Bodegas y Bebidas, Spain's largest wine producer.

Spain has the third largest number of foreign affiliates in the EU after Germany and France (see Exhibit 6.2). Of the total 53,753 foreign affiliates located in the EU, 7,465 of them are in Spain.

Exhibit 6.2. **Foreign Affiliates by EU Countries[1]**

Austria	2,464 (1997)
Belgium/Luxembourg	1,504 (1997)
Denmark	2,305 (1998)
Finland	2,006 (2000)
France	9,494 (1998)
Germany	12,042 (1998)
Greece	798 (1991)
Ireland	1,140 (1998)
Italy	1,769 (1997)
Netherlands	2,259 (1993)
Portugal	3,500 (1999)
Spain	**7,465 (1998)**
Sweden	4,324 (2000)
United Kingdom	2,683 (1998)

(1) The year is in brackets.
Source: World Investment Report 2001, UNCTAD.

Exhibit 6.3. **World Business Cost Comparisions, 2001**

1. Japan	7. France	13. Argentina	19. Russia	25. Malaysia	31. Hungary
2. US	8. Netherlands	14. Hong Kong	20. Mexico	26. Chile	
3. Germany	9. Canada	15. S. Korea	21. Brazil	27. India	
4. UK	10. Italy	16. Taiwan	22. S. Africa	28. China	
5. Belgium	**11. Spain**	17. Singapore	23. Czech Rep.	29. Thailand	
6. Sweden	12. Australia	18. Venezuela	24. Poland	30. Indonesia	

Source: Economist Intelligence Unit.

Exhibit 6.4. **Hourly Compensation Costs for Production Workers in Manufacturing**

(amounts in US$)	1975	1990	2000
US	6.36	14.91	19.86
Japan	3.0	8.55	12.88
France	4.52	15.49	16.38
Germany	6.29	21.81	24.01
Italy	4.67	17.45	14.66
Portugal	1.58	3.77	4.75
Spain	**2.53**	**11.38**	**10.85**
UK	3.37	12.70	15.88
OECD	4.25	13.48	16.31

Source: U.S. Labor Department.

A study by the EIU of the 31 countries in the world that attract the most investment or have the potential to do so ranked Spain as the cheapest of the eight EU nations included in the report (see Exhibit 6.3). The report analyzed the basic business costs and classified them into eight categories: labour costs, travel expenses, expatriate costs, corporate taxation, the perceived level of corruption, the cost of property, telecommunications and road transport[1]. Japan headed the list as the most expensive country to do business in and Hungary the cheapest. Spain ranked about middle in all the categories analyzed apart from corporate tax, where, with a rate of 35%, it was the eighth most expensive. Its hourly compensation costs, however, are the lowest of the eight EU countries (see Exhibit 6.4), and office rents in Madrid and Barcelona, the two business centres, compare favourably with other European cities.

Other key attractions for foreign companies are the size of Spain's home market and the strength of consumption, export possibilities and growth potential. A study by the real estate consultants Healey & Baker, which was carried out at almost the same time as the EIU survey in 2001, rated Barcelona, the capital of Catalonia, and Madrid as the sixth and eighth, respectively, best European cities to locate a business[2]. Companies were asked in which city they already had offices, manufacturing, distribution, or sales outlets and what were their expansion plans. Whereas 33% of the companies surveyed had a presence in Madrid in 2001, 38% of the same firms said they would have one in 2006. The figures for Barcelona were 28% and 31%, respectively. According to the EIU, Spain will attract a larger share of world FDI inflows in the 2002-06 period than in 1997-2001 (see Exhibit 6.5).

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[1] *Worldwide Business Costs*, Economist Intelligence Unit (December 2001).
[2] *European Cities Monitor*, Healey and Baker (October 2001).

Exhibit 6.5. **Foreign Direct Investment Inflows – 2002-06 Forecasts[1]**

	US$bn	% of World Total
1. US	234.6	23.9
2. UK	81.2	8.3
3. Germany	66.7	6.8
4. China	60.4	6.1
5. Netherlands	53.2	5.4
6. France	51.4	5.2
7. Belgium	33.0	3.4
8. Canada	31.7	3.2
9. Hong Kong	28.0	2.9
10. Brazil	24.2	2.5
11. Spain	**23.1**	**2.3**

(1) Annual average.
Source: Economist Intelligence Unit.

The EU is the leader in FDI in Spain followed by the US (see Exhibit 6.6). Within the EU the main investors in Spain are the Netherlands, Germany, France and the UK. Madrid and Barcelona have traditionally taken the lion's share of FDI. Greater Barcelona, with a long manufacturing tradition that began with textiles in the 19th century, has attracted vehicle components, consumer electronics, chemicals and pharmaceutical research. Seat, acquired by Volkswagen in the late 1980s, produces most of its cars at a plant near the city. Barcelona is the favoured location of Japanese and South Korean companies and increasingly of Shared Services Centres in Europe (eg, Citibank, Agilent Technologies, General Motors-Andersen and ICI Packaging and Coatings). Although Japan accounts for a fraction of total FDI in the country, Spain has the fourth largest number of Japanese production facilities in the EU (75 including Nissan Motor, Honda, Pioneer and Asahi Glass). Madrid, the headquarters of most large Spanish companies, banks and insurance firms, is the head office in Spain for such global leaders as Nokia, Shell, Philips and Xerox. The Coslada Logistics Centre, the largest in southern Europe and near to the Barajas airport, has a "dry port" connecting Madrid by rail to four ports (Barcelona, Bilbao, Valencia and Algeciras).

Valencia, which along with Catalonia and Murcia, lies on the edge of the so-called Mediterranean arch, a massive crescent, taking in the major industrialized regions of Italy, France and Spain, is increasingly gaining ground as an investment location. Its showpiece investment is the Ford plant at Almussafes, which in 2003 will begin to produce the small B-class car for the European market for its Japanese affiliate Mazda. The plant is also producing the next-generation Fiesta model. Traditionally known abroad for its oranges and its *fallas* (an annual festival held in March, where gigantic papier-maché figures – many representing politicians – are irreverently burned in a huge bonfire), Valencia is home to

Exhibit 6.6. **Gross Foreign Direct Investment Inflows by Countries, 1999-2001 (% of total)**

	1999	2000	2001
European Union	57.8	56.3	68.8
France	5.8	5.3	9.0
Germany	4.3	2.2	2.1
Netherlands	25.8	14.5	14.5
United Kingdom	9.7	24.2	8.0
United States	37.0	40.7	17.1
Other countries	5.2	3.0	14.1

Source: Directorate General of Trade and Investment.

myriad small- and medium-sized companies in the agricultural, electrical machinery, plastics, furniture, glass, ceramics and toy sectors are successful exporters.

Some investment projects in other parts of the country have helped Spain to reindustrialize blighted areas. A notable example is the plant of GE Plastics in the southeastern industrial port town of Cartagena, where thousands of jobs were lost in obsolete fertilizer plants and exhausted mines. GE Plastics, a division of the US General Electric, invested $600 million in a plant, surrounded by acres of orange and almond groves, which produces LEXAN® polycarbonate resin for mobile phone and computer housings, CD, DVD, CD-R optical products, automotive glazing and even water bottles. A second plant is due to come onstream in 2005. At the other end of Spain in Avilés in Asturias, the heart of the country's decaying integrated steel and coal industries, Dupont Ibérica, the subsidiary of the US chemical conglomerate, has a $1 billion plant that produces Nomex, a heat-resistant meta-aramid fibre, and Sontara, a non-woven cloth that forms the basis for products such as bandages and baby wipes.

UNCTAD has developed an index to gauge the relative importance of FDI in an economy. This is measured by the transnationality index of host countries, which is calculated as the average of the following four shares: FDI inflows as a percentage of gross fixed capital formation; FDI inward stock as a percentage of GDP; value added of foreign affiliates as a percentage of GDP and employment of foreign affiliates as a percentage of total employment. In its 2001 World Investment Report, Spain was ranked sixth among developed countries based on 1998 data (see Exhibit 6.7). The most transnationalized host country economy in the world was Hong Kong. In general, the transnationality is higher in developing countries than in developed ones.

Exhibit 6.7. **Transnationality Index of Developed Countries, %**

1.	New Zealand	34.3	7.	Greece	17.4
2.	Belgium and Luxembourg	34.3	8.	Australia	16.6
3.	Ireland	26.8	9.	Canada	15.1
4.	Netherlands	22.7	10.	Denmark	14.9
5.	Sweden	22.5	11.	UK	14.6
6.	**Spain**	**17.4**	12.	Norway	13.3

Source: World Investment Report 2001, UNCTAD.

UNCTAD points out that a number of location factors not directly related to economic conditions also influence FDI. Such things as political risk, government policy, international perceptions and the regional "image" can affect FDI differently from other aggregates. Thus, there can be significant variations in national abilities to attract inward FDI, given such factors as economic size or international exposure.

The Inward FDI Index, based on the unweighted average of three ratios reflecting the propensity to attract FDI after adjusting for the relative economic size and strength of a host economy, enables one to see how well countries are doing in attracting investment relative to others. The three ratios take a country's share in world FDI inflows and divide it by its share in each of three global aggregates: GDP, employment and exports. This provides a benchmark of a country's international position as a destination for FDI (see Exhibit 6.8). The index indicates relative performance in attracting FDI; it does not measure the factors that account for such performance.

Higher GDP indicates larger markets, always a magnet for market-seeking FDI; it may also reflect a larger resource base, again a magnet for certain forms of FDI. Employment is very similar, indicating the size of the labour force and potential market size. Higher exports indicate greater openness to international markets and greater competitiveness in trade. Thus, *ceteris paribus*, a country with higher shares of these global aggregates may be expected to have larger shares of FDI inflows.

Countries that receive more FDI than predicted by these aggregates – for whom the index takes a value greater than one – can be presumed to have certain other advantages (for instance, a more conducive regime for international investors or skilled labour, strong

Exhibit 6.8. **The Inward FDI Index, 1988-1990 and 1998-2000**

		FDI Inflow Share Over GDP Share[1]	Employment Share[2]	Exports[3]	Ratio
	1988–1990				
1.	Singapore	12.7	26.5	1.4	13.5
2.	Belg/Lux	3.8	16.8	1.0	7.2
3.	Seychelles	6.7	9.2	2.4	6.1
4.	Hong Kong	5.0	11.8	0.7	5.9
5.	New Zealand	3.9	10.6	2.8	5.8
6.	Lesotho	7.5	0.9	7.9	5.4
7.	Netherlands	3.0	11.3	1.1	5.1
8.	UK	3.0	9.7	2.5	5.1
9.	Australia	2.7	9.4	3.2	5.1
10.	**Spain**	**2.4**	**7.5**	**2.6**	**4.2**
	1998–2000				
1.	Belg/Lux	8.5	40.8	2.6	17.3
2.	Hong Kong	6.3	24.5	1.1	10.6
3.	Ireland	5.1	20.3	1.2	8.9
4.	Sweden	4.4	18.8	2.2	8.5
5.	Netherlands	3.5	13.5	1.3	6.1
6.	Malta	4.5	9.3	1.2	5.0
7.	Lesotho	7.4	0.9	6.2	4.8
8.	Denmark	1.9	9.3	1.2	4.2
9.	Angola	7.7	1.1	2.8	3.9
10.	UK	2.0	7.7	1.7	3.8
11.	Finland	2.0	7.7	1.7	3.8
12.	Azerbaijan	5.6	0.5	4.9	3.6
13.	Singapore	2.2	7.5	0.3	3.3
14.	Argentina	1.3	3.8	3.3	2.8
15.	Seychelles	3.1	4.5	0.9	2.8
16.	Canada	1.8	5.7	1.0	2.8
17.	Bolivia	3.1	4.5	3.9	2.7
18.	Trin & Tob	3.0	3.4	1.5	2.6
19.	Switzerland	1.1	5.7	0.6	2.5
20.	Germany	1.2	5.3	0.9	2.5
21.	Bahrain	2.1	4.7	0.6	2.5
22.	Norway	1.1	5.4	0.7	2.4
23.	US	0.9	4.3	1.8	2.3
24.	Chile	2.4	2.4	2.1	2.3
25.	Mozambique	1.9	0.1	4.2	2.1
26.	Armenia	2.6	0.5	3.1	2.0
27.	Czech Rep	2.7	2.3	1.0	2.0
28.	Brazil	1.2	1.0	3.7	2.0
29.	France	0.8	3.9	0.7	1.8
30.	Nicaragua	2.9	0.3	1.9	1.7
31.	Israel	1.0	3.3	0.6	1.7
32.	**Spain**	**1.0**	**3.1**	**0.8**	**1.6**

(1) The ratio of the economy's share of world FDI inflows to the economy's share of world GDP.
(2) The ratio of the economy's share of world FDI inflows to the economy's share of world employment.
(3) The ratio of the economy's share of world FDI inflows to the economy's share of world exports.
Source: World Investment Report 2001, UNCTAD.

domestic research capabilities or excellent infrastructure). The index, in other words, is a measure of "revealed competitive advantage" in attracting FDI after discounting for size factors and export activity.

Care should be taken in interpreting the index, however. A high value of the index need not always be a good economic sign. It may reflect transitory factors (like large one-off transactions) or it may be the result of a relative decline in a deflator of the index, (eg, in GDP, employment or international competitiveness, to which FDI inflows have not responded in the period considered). Nevertheless, it can provide a starting point for benchmarking the extent to which countries succeed in attracting FDI.

The index covered 112 countries in 1988-1990 and 137 in 1998-2000, with all the values taken as averages for three years to avoid year-by-year variations. The rankings changed significantly over time. Spain slipped from 10th position in 1988-1990 to 32nd in 1998-2000, with its ratio falling from 4.2 to 1.6, one of the steepest declines and suggesting that the country may be reaching maturity with respect to inflows of FDI. Singapore dropped from first position to 13th and Ireland, the "Celtic Tiger", shot from 46th place to third. Singapore's decline reflected the relatively slow inward growth between the two periods, together with a rapid increase (more than doubling) in both GDP and exports. The rise of Ireland, a small economy, was the result of a surge in the FDI share relative to GDP, employment and exports. There were 53 countries with a ratio higher than one, including Spain, and 79 with ratios lower than one. The last group of "underperformers" included advanced economies like Japan and Italy.

Chapter 7

The Banking industry

The Spanish banking industry has undergone profound change over the last decade, and two global players have emerged: Santander Central Hispano (SCH) and Banco Bilbao Vizcaya Argentaria (BBVA). By many yardsticks – profitability, technology, international expansion and even customer satisfaction – Spanish banks are ahead of many of their European peers and not that far behind their US counterparts. What was less than 20 years ago a highly protected, oligopolistic and sluggish banking system is today very competitive and aggressively expansionist. SCH and BBVA, the two big guns, have become the dominant foreign banks in Latin America in less than five years and they have also established cross-border links in Europe that place them at the centre of the pan-European consolidation of the industry when it eventually starts.

The rules of the game changed with Spain's entry into the European Union in 1986 and intensified after the euro's launch in 1999. Customers are no longer "captive"; they invest where they want to and establish their benchmarks at the world level. The single currency has eliminated exchange rate risk throughout the euro zone. All banking products and services now compete directly with one another as there is no longer a domestic currency barrier or national markets. In the case of Spanish banks, the number of competitors has gone from around 380 credit entities on their home turf to close to 8,000 in their enlarged market. Many trends have gathered pace: the advance of deregulation throughout the world, the narrowing of customer spreads, disintermediation (ie, the substitution of banks' credit by investors' direct access to capital markets), the consolidation of a single financial area in the EU, the arrival of non-banking competitors that have invaded specific areas of the finance business, and the possibilities offered by remote channels arising from technological developments. Internet, more than anything else, has eliminated geographical barriers for banks.

The new European banking environment is tougher, but the opportunities are also greater. The conditions that produced a zone sharing a common currency – low inflation and reduced budget deficit and public debt levels – have created a more stable and favourable banking environment and increased consumer confidence, thus lifting the volume of business. This is seen in Spain, for example, in the strong growth in private-sector lending, which increased from 71% to 96% of GDP between 1991 and 2000, owing mainly to mortgages. Spain has the highest proportion of home ownership in Europe and the United States (86%).

The extent to which the Spanish market has become fiercely competitive can be seen in the almost continuous decline in net interest revenue from lending (the difference between interest revenues and interest expenses) as a percentage of average total assets. For all banks the figure was 2.8% in 2001, down from 3.7% in 1991. Net interest revenue, a classic activity, is one of the bulwarks of a bank's income statement. At the same time, stricter lending criteria and upgraded monitoring systems have cut the level of non-performing loans (NPLs). Combined with the high level of NPL coverage, asset quality is very good. The NPLs of the whole banking system (commercial banks and savings banks) are around 1% of total lending (9% in 1993) and NPL coverage is very high. A bursting of Spain's property boom, however, would push up NPLs.

The anti-cyclical loan-loss provisions imposed by the Bank of Spain, an innovative measure introduced in 2000, create a cushion during the upward phases of the economic cycle, which softens the impact of NPLs during periods of lower growth when defaults tend to be higher. The Spanish banks are also well capitalised. The capital adequacy ratio is well above the requirement of the Basel Banking Supervision Committee. The level of Tier 1 capital compares well with other countries (see Exhibit 7.1). Spanish banks are among the most profitable in the world (see Exhibit 7.2).

Exhibit 7.1. **International Comparison of Tier 1 Capital as a % of Assets**

	2001	2000	1999
France	9.47	8.69	7.09
Germany	3.95	3.94	3.77
Italy	6.54	6.73	7.15
Spain	**7.33**	**6.75**	**7.26**
UK	13.32	11.52	9.15
US	9.27	8.82	8.87

Source: The Banker.

Exhibit 7.2. **International Comparison of Pre-Tax Profits as a % of Capital**

	2001	2000	1999
France	16.80	13.77	11.88
Germany	11.28	13.22	13.78
Italy	15.16	18.51	14.00
Spain	**17.32**	**17.99**	**19.67**
UK	18.18	26.13	22.74
US	20.14	20.41	23.12

Source: The Banker.

Exhibit 7.3. **Top Banks by Market Capitalisation***

Citigroup	US	206,912
Bank of America Corp	US	109,446
HSBC Holdings	UK	106,701
Wells Fargo & Co	US	85,018
Royal Bank of Scotland	UK	77,428
JP Morgan Chase & Co	US	65,702
UBS	Switzerland	62,546
Lloyds TSB Group	UK	54,579
Barclays Bank	UK	53,772
Wachovia Corp	US	50,942
Bank One Corp	US	44,858
Mitsubishi-Tokyo	Japan	41,632
HBOS	UK	40,921
Deutsche Bank	German	39,730
Credit Suisse Group	Switzerland	38,822
SCH	**Spain**	**37,167**
Fifth Third Bancorp	US	37,107
BBVA	**Spain**	**35,339**
FleetBoston Financial	US	34,527

(*) At June 14, 2002 ($ million).
Source: Datastream.

Exhibit 7.4. **Top Five Commercial and Savings Banks by Tier 1 Capital Strength[1]**

	Strength Tier 1 Capital (US$ mn)	Size Assets (US$ mn)	Soundness Capital Assets Ratio (%)	Return on Assets (%)	Cost/Income Ratio (%)	BIS Capital Ratio (%)	NPL to Total Loans (%)
SCH	15,209	315,623	4.82	1.18	62.09	12.76	2.17
BBVA	13,106	272,535	4.81	1.18	58.07	12.60	1.71
La Caixa	5,801	77,296	7.51	1.19	69.98	13.40	0.60
Cajamadrid	3,322	58,759	5.65	1.05	55.01	12.49	0.81
Banco Popular	2,432	32,956	7.38	2.28	40.59	11.33	0.80

(1) Figures for 2001.
Source: The Banker.

The merger process has been intense in Spain. The three largest commercial banking groups – SCH, BBVA and Banco Popular – account for two-thirds of the total deposits of the commercial banks, up from 45% in 1997 and 35% in 1990. The commercial banks have 42% of deposits and the mutual savings banks 58%. The latter sector is more fragmented (see separate section). Size is a pre-requisite for those banks wishing to be supra-regional or global players like SCH and BBVA, as it creates the capacity needed to compete in specific business areas, such as fund management, generates the economies of scale for reducing costs, and releases the funds required for investment in technology. SCH and BBVA are the result of the merger of six banks over a number of years. SCH was the first bank merger in the euro zone after the introduction of the single currency in 1999, a move which sparked the start of a fresh wave of consolidation in European banking.

SCH and BBVA are among the top 20 in the world by stock market capitalization and SCH is the second-largest in the Euro zone (see Exhibit 7.3). Forty-four of Spain's commercial and savings banks made it into the top 1,000 banks in the world in 2001 drawn up by The Banker magazine on the basis of Tier 1 capital strength (see Exhibit 7.4).

Although the merger process among Spain's big commercial banks has been strong (it has yet to happen among medium-sized banks and, for legal reasons, among savings banks), the branch network is still among the densest. At the end of 2001, Spain had 38,676 branches (commercial and savings banks and credit unions). This worked out at 1,063 people per branch, compared with around 12,000 in the US, 5,000 in the UK and 2,000 in Italy. The more people a bank can serve through each branch, the more productive it is, although service quality may not be the best. Branches typically make up about half of a bank's total costs. Although Spain

is over-banked on the basis of this yardstick, the branch size is smaller than the EU average. The commercial banks have substantially cut the number of their branches (from 17,636 in 1993 to 14,756 in 2001) while the mutual savings banks, freed in 1989 from restrictions that barred them from opening branches throughout Spain, increased their number over the same period from 14,485 to 19,829. The mergers among the big banks created cost-cutting opportunities in retail banking owing to the very large overlap of branch networks.

Spanish banks are technologically very advanced: the proportion of automatic teller machines (ATMs) and point-of-sale terminals (POSs) per one million inhabitants is the highest in Europe (990 in 2000, compared with an EU average of 686).

Expansion in Latin America

The expansion of Spanish banks in Latin America is one of the most striking elements of the globalization of banks in recent years. This move has been much more intense than in the rest of the developed world. The consolidated external assets of the Spanish banking system with emerging markets rose sixteenfold between 1985 and 2001 to $187.8 billion, compared with a threefold rise for other BIS reporting countries. In well under a decade Santander Central Hispano and Banco Bilbao Vizcaya Argentaria have become the region's leading financial franchises. The two banks have jointly invested $25 billion in Latin America, including Puerto Rico, and between them in 2001 accounted for 21.7% of the region's deposits, 41.5% of funds in private pension schemes and 12.9% of mutual funds (see Exhibits 7.5 and Exhibit 7.6). SCH, the biggest banking group in Latin America, and BBVA, the leader in management of private pension funds, now employ far more

Exhibit 7.5. **Investments of Santander Central Hispano and Banco Bilbao Vizcaya Argentaria in Latin America**

Santander Central Hispano

Country	Main Banks	% Share	Investment US$ mn
Argentina	Banco Río de la Plata[1]	80.32	2,154
Brazil	Banespa	97.83	
	Banco Santander Brasil	95.78	7,157
	Banco Santander Meridional	96.91	
Chile	Banco Santiago[2, 3]	43.50	1,537
	Banco Santander Chile[3]	89.42	
Colombia	Banco Santander Colombia	63.11	421
México	Banca Serfin	98.85	2,661
	Banco Santander Mexicano	98.85	
Puerto Rico	Banco Santander Puerto Rico	86.74	198
Venezuela	Banco de Venezuela[4]	98.80	761
	Banco Caracas[4]	91.88	
Other	Banco Santander Central Hispano - Perú	100.00	
	Banco Santander Uruguay	100.00	
	Banco de Santa Cruz (Bolivia)	95.93	
	Banco de Asunción (Paraguay)	98.09	829
Total[6]			15,718

Banco Bilbao Vizcaya Argentaria

Argentina	BBVA Francés	68.17	1,523
Brazil	BBVA Brasil	99.99	930
Colombia	BBVA Ganadero	95.35	1,119
Chile	Banco BHIF	62.90	864
Mexico	BBVA Bancomer	52.00	3,700
Venezuela	BBVA Provincial	54.95	564
Other	BBVA Panamá	98.76	
	BBVA Paraguay	99.99	
	BBVA Continental (Peru)	40.66	
	BBVA Puerto Rico (Holding)	100.00	
	BBVA Uruguay[5]	39.12	752
Total[6]			9,452

(1) A further 18.54% was acquired in January 2002 for €373 million.
(2) A further 35.45% acquired in April 2002 for $670 million.
(3) To be merged, pending authorization.
(4) Merged in May 2002.
(5) The stake rose to 100% in May 2002 with an additional investment of $55 million.
(6) Accumulated gross investment in banks, pension fund companies and other subsidiaries.
Source: SCH, BBVA, UBS Warburg.

Exhibit 7.6. **Market Shares in Latin America of Santander Central Hispano and Banco Bilbao Vizcaya Argentaria[1]**

Santander Central Hispano

Country	Loans (%)	Deposits (%)	Ranking	Pension Funds[2]	Ranking	Mutual Funds[2]	Ranking
Argentina	8.3	7.9	3	23.4	1	13.0	2
Bolivia	13.5	16.2	1	-	-	-	-
Brazil	4.6	4.6	4	-	-	4.5	6
Chile	27.6	26.1	1	11.0	5	24.8	1
Colombia	2.8	3.3	6	12.7	5	6.1	6
Mexico	10.4	14.1	3	9.0	4	12.4	3
Paraguay	3.8	4.5	5	-	-	-	-
Peru	9.1	5.6	4	28.1	2	20.1	3
Puerto Rico	15.2	15.4	2	-	-	21.8	3
Uruguay	8.4	5.8	5	18.2	4	16.3	4
Venezuela	16.2	16.6	1	-	-	9.3	4
Total Latam	**10.5**	**10.4**	**2**	**13.9**	**3**	**8.2**	**3**

Banco Bilbao Vizcaya Argentaria

Argentina	6.2	8.5	2	20.1	2	13.2	1
Bolivia	-	-	-	50.9	1	-	-
Brazil	1.4	1.3	9	-	-	0.8	11
Chile	5.7	5.3	6	31.8	1	4.9	9
Colombia	6.8	7.1	3	46.1	1	10.0	2
Ecuador	-	-	-	71.6	1	-	-
El Salvador	-	-	-	49.0	2	-	-
Mexico	26.2	28.1	1	21.8	1	19.1	2
Panama	6.3	5.0	5	40.0	1	-	-
Peru	15.3	20.2	2	25.2	3	25.5	2
Venezuela	16.7	16.2	1	-	-	33.3	1
Total Latam	**8.7**	**11.3**	**1**	**27.6**	**1**	**4.7**	**5**

(1) Figures for 2001. (2) Market share by assets.
Source: Santander Central Hispano and Banco Bilbao Vizcaya Argentaria.

Exhibit 7.7. **M3/GDP, 2001(%)***

US	78
Euro zone	80
Spain	**96**
Latam	46

(*) Excluding Peru and Venezuela.
Source: European Central Bank, US Federal Reserve, Latin American central banks, IMF.

people in the region than they do in Spain. Latin America generated 38% of SCH's net attributable income in 2001 and 18.8% of BBVA's.

The push into a region that for three centuries was mostly under the Spanish crown came at a time when the two banks were financially very strong, the Spanish market was very mature and globalization and the euro meant that size was needed to play the game[1]. The banks had to learn to invest abroad and Latin America was just the opportunity to grow and progress along the learning curve. The region offered good opportunities for banks with a certain critical mass seeking increased size and competitiveness, entry into expanding markets, global utilization of resources and organizational and technological capacities, and appropriate risk diversification based on the corresponding rate of return. The Latin American market's underdevelopment, attractive margins, high potential rates of return and improved supervisory and regulatory systems in an environment of liberalization opened up the kind of business opportunities that had existed in Spain 20 years before the expansion abroad. For example, the customer spread in Mexico in early 2002 of eight percentage points (the difference between the lending and deposit rates) was similar to that in Spain in the late 1980s.

Latin America has a very underdeveloped financial sector, as measured by the size of the sector in terms of the ratio of M3 to GDP and banking penetration (see Exhibit 7.7). M3 is the broadest measurement of money supply and includes time deposits, savings and

[1] This section draws on *The Spanish Banks' Strategy in Latin America* by C. Hernansanz and M. Sebastián (BBVA Working Paper 3/00).

Exhibit 7.8. **Banking Penetration**

	Pop over 18 with Current Account (%)	Customers per Branch ('000)
Spain	**95**	**1**
Argentina	35	8
Brazil	48	19
Chile	50	8
Mexico	35	13
Peru	37	27

Source: BBVA.

money market funds held by institutions. The percentage of the population that has a bank account in Spain is double that of Latin America. The reason for this may be the small number of branches, as the number of customers per branch is in some cases 27 times higher in Latin American countries than in Spain (see Exhibit 7.8). Unlike in Europe, therefore, there is considerable potential for the expansion of branch networks.

Latin America was also the ideal place for Spanish banks because of a shared language and cultural affinities. This furnishes several advantages. It makes it possible to sell the same products, using common marketing techniques. For example, deposits linked to lotteries have been as successful in Latin America as in Spain. The use of the same language facilitates the transfer of know-how, the installation of the same IT platforms and is conductive to the exchange of employees between the parent bank and its subsidiaries, thereby accelerating integration and the diffusion of the business culture.

The macroeconomic situation in Latin America today is also similar to that of Spain during the 1980s and early 1990s, so that the managers of the banks have a wealth of experience from which to draw lessons for their operations in the region (see Exhibit 7.9).

The banks' foray into Latin America coincided with the surge in foreign direct investment by Spanish companies in the region, but the banks' strategy is not one of tracking these firms into the region. However, the fact that they are customers of the banks is an added benefit. The bulk of the investment is concentrated in telecommunications and energy and has been made by a handful of companies (see Chapter 5).

Exhibit 7.9. **Macroeconomic Situation in Spain and Latin America (%)**

	Spain	Latam
	Avg. 80-95	Avg. 96-01
Inflation	**7.9**	10.4
Currency depreciation	**5.0**	12.1
GDP growth	**2.5**	2.6
Maximum growth	**5.6**	5.5
Minimum growth	**-1.2**	0.0

Source: BBVA Research Department.

Lastly, one should not forget that, by becoming much bigger, the banks are in a stronger position to protect themselves from takeovers on their home ground and play a bigger role in the drawing up of the future European banking map. As brands, SCH and BBVA now have an internationally recognized value. The banks have been able to buy market share in Latin America much more cheaply than in mature European markets. BBVA's Research Department roughly calculated, on the basis of the stock market capitalisation of each country's biggest banks and their share of deposits at the end of 1999, that a 1% share of the German deposit market in 1999 cost $2.2 billion if this was attained by purchasing shares in the major listed banks. The same share would have represented an outlay of $196 million in Argentina or $205 million in Mexico.

Banks no longer need a large physical presence to do business outside their home countries, due to the technological advances. The fact that the Spanish banks decided to acquire large networks shows that their strategy is to replicate the universal banking model that has proven successful in Spain. Cross-selling, a particular skill of SCH and BBVA, is easier when you have critical mass. There is also considerable room for cost savings at the banks acquired. This can be achieved through downsizing, the use of much more sophisticated technology and better management techniques. The efficiency ratio (cost/income) of SCH in Latin America, for example, improved from 61.4% in 1998 to 49.5% between 1999 and 2001. Over the same period the improvement in Spain was from 59.3% to 48.8%.

By establishing themselves in other countries, the Spanish banks are able to influence the market much more directly and set the pace. For example, SCH doubled its market share of the credit card market in Mexico from 7% to 14.5% between September 2001 and March 2002

with its innovative Light card offered by Banca Serfin, which it acquired in 2000. The card provided no points, air miles or insurance but an interest rate far below that offered by the main rivals. This was an unprecedented product for Mexico, only 20% of whose 100 million population have a bank account and only one-quarter of these hold credit cards[2]. Cheeky commercials showed an attractive young actress looking out from behind the card, deliberately made transparent, and comparing it with other cards that had become millstones in people's pockets, so laden down were they with high interest rates and unusable perks. The TV commercials were backed by 2,000 telemarketers across the country and 350 stalls in shopping malls and department stores. The product provoked a quick response from the competition: BBVA Bancomer, 48% owned by BBVA and one of the two market leaders, offered its customers the chance to switch their outstanding credit card balances into an account that would charge them only 25% interest and Banamex, acquired by Citigroup of the US in 2001, also matched the offer.

SCH's move was reminiscent of when, in 1989, Banco Santander put an end to the cosy oligopoly of Spain's then seven big banks. Although the banks' chairmen met for lunch once a month, Santander surprised them all one day by starting to pay interest on its current accounts. This triggered a "deposits war" similar to the battle for supremacy now taking place between the two big banks in Latin America.

Latin America is a volatile region – economically as well as politically – with coups, devaluations and guerrilla wars, but less so than in the not too distant past. Most countries are now democracies to varying degrees. The sharp fall in inflation and interest rates has created a

[2] See *Taking Credit for Transparency* by John Authers (*Financial Times* May 28, 2002).

more stable business environment and the control by sophisticated and solvent US and European banks of large parts of the region's banking systems means there is less likelihood of repeating the mistakes of the past that led to repeated lending booms and busts[3].

Nonetheless, there are still risks as Argentina's crisis painfully highlighted. Argentina massively devalued the peso in 2002 and defaulted on its $155 billion of public-sector foreign debt, the largest such default in history. The impact on SCH and BBVA was considerable: SCH's net attributable income grew 10% in 2001, compared with increases of 25% in 1999 and 2000, and BBVA's rose 6%, well below the compound annual growth rate of 24% that was promised when BBVA was created in 1999. The respective growth rates for the first quarter of 2002 compared with a year earlier were 0.3% (+9.6% excluding Argentina) and 6%.

Both banks put Argentina into quarantine, ringfencing the troubled operations. First they wrote off all their very large investment in the country and then they adopted an equity accounting presentation which isolated Argentina below the operating income line. This prudent approach – after more than a year of calculated gambling by the banks that the peso-dollar peg would ultimately withstand the crisis – began to assume the worst possible scenario. SCH set aside a general provision (€1.29 billion), which slightly exceeded the entire book value of its investments in Argentina at end-March 2002. In addition, as a result of the devaluation of the Argentine peso, its equity was reduced by €778 million to reflect the loss in value of its stake in Banco Rio. The respective figures for BBVA were €1.28 billion and €437 million. Fitch

[3] See the section on Latin American banking in *Spanish Banks: Cost-Cutting and Focus Drive Superior Earnings Growth* (Bernstein Research, October 2001).

Ratings noted on May 29, 2002 that "despite the impact of the Argentina crisis, high provisioning and goodwill amortizations, SCH's performance ratios are better than the average for its European peers". The same could be said of BBVA.

Thanks to an appropriate and prudent provisioning policy, these banks were able to weather the Argentine storm. Although this meant reduced earnings, these still continued to outgrow those of most of the major international banks. But the Spanish banks faced a difficult decision of whether to inject more capital into their Argentine subsidiaries. Because of the size of their operations, these banks were in a much more complex position than Canada's Scotiabank, which decided to pull out of its small operation, and France's Crédit Agricole, which stopped injecting fresh capital into the three rural banks it controlled and put them in the hands of the state-owned Banco de la Nación. The Bank of Spain does not want the subsidiaries to become a drain on the parent bank.

Argentina has also served to emphasise that Latin America is not a monolithic market. Each country has unique features and opportunities and each economy is increasingly viewed by investors on the basis of its own merits. While Argentina went down the tubes, Mexico ended 2001 with an investment grade rating from Moody's to join Chile, the most developed market. Mexico contributed €583 million to SCH's net attributable income and €397 million to BBVA's. Brazil, the biggest challenge for both banks, has also proved to be fertile ground so far. Analysts gave SCH a beating for buying a stake in Banespa in 2000 because they said the original bid price was too much (almost three times the bid offered by the next-highest bidder). The overall purchase price for almost complete control of the bank was 2.2 times its book value. Banespa generated €474 million of net attributable income in 2001, which represented a

return on investment of 9% in dollar terms in its first full year. But it is still too early to say who was right. The jury is still out on the Latin American venture.

Europe

Far from concentrating on Latin America to the exclusion of Europe, Spanish banks, and not just the big two, have also built up cross-border stakes. In 2001 Santander Central Hispano owned 8% of Royal Bank of Scotland, the UK's second-largest retail bank, 5.4% of Italy's San Paolo IMI and it was becoming increasingly active in consumer financing after acquiring Germany's AKB. Banco Bilbao Vizcaya Argentaria had 3.7% of Crédit Lyonnais, the privatised French bank, and 14.8% of Italy's Banca Nationale del Lavoro. Both banks also have a significant presence in Portugal, particularly SCH (see Chapter 5).

Savings Banks

Spain's 47 mutual savings banks are a force to be reckoned with. They have close to 60% of deposits and two-fifths of loans. Two of them, the Barcelona-based La Caixa and the Madrid-based Caja Madrid, are among the five largest financial institutions in the country and have moved on from their humble origins as locally-based quasi-charitable entities to become financial service groups on a par with commercial banks. La Caixa, for example, has a significant stake in Deutsche Bank.

Based more on the German than the British model, they do not have share capital and are governed by general assemblies which are dominated by local politicians from Spain's 17

autonomous regions. They have an unfair advantage over the commercial banks as they are allowed to buy other banks, and several have done so, but they are themselves protected from takeover. Under a proposed new law they would be allowed, for the first time, to raise capital from private investors through an instrument called a participating stake, which does not grant investors any voting rights. The move stops short of privatization.

Direct Banking

Direct banking (telephone and Internet) have a small, but growing, market share in Spain (2.8% in March 2002, almost double that of a year earlier) and are capturing an increasingly large portion of new deposits.

The banks have adopted varying approaches to the Internet challenge: considering the Internet as a new channel in addition to branches and telephone banking or creating specific banks to compete solely on the Internet. In 2000 Santander Central Hispano acquired Patagon.com, Latin America's largest financial Internet portal, and merged it with its Open Bank, the leading online bank in Spain, to create Patagon Internet Bank, one of the world's largest global financial Internet sites. Having said that it would "sweep the board," SCH scaled back the business to stem the losses. SCH made a one-time €700 million charge, including €616 million of goodwill write-offs, on the sale of its Patagon America unit in 2002 to the Internet bank's former owner Wenceslao Casares and co–founder Guillermo Kirchner. SCH acquired the 11.4% of Patagon Euro from Casares before selling Patagon America and is now concentrating on Europe.

Bankinter, which has long been at the forefront of technological innovation and moved into Internet banking in 1996, has been much more successful. More than one-third of the bank's transactions are completed online, the highest proportion in the world outside standalone Internet banks. Bankinter, the fifth-largest commercial bank after SCH, BBVA, Banco Popular and Banesto, was also the first bank to offer a free e-mail service in Europe. Freeserve, the UK Internet service provider, followed in its footsteps.

Foreign Banks

Foreign banks as a whole in Spain have rarely cornered more than 10% of loans or deposits since they began to move into the country after 1978 and acquire networks from ailing banks hit by the 1977-85 banking crisis. Barclays, for example, bought the 33 branches of Banco de Valladolid. As a result, most foreign banks have concentrated on corporate rather than retail business because of the high cost of creating their own networks needed to obtain deposits more cheaply than on the interbank market, and the most successful have been those that have managed to carve out a niche for themselves.

The recent arrival of online banking makes it less costly for foreign banks to compete with the extensive networks of the Spanish banks. ING Direct has been particularly successful in this area.

Chapter 8

Equity and Debt Markets

The internationalization of the Spanish economy is clearly seen in the growing volume of foreign investment in the *Bolsa de Madrid* (Madrid Stock Exchange), Europe's fourth-largest market after London, Euronext (France, Belgium and the Netherlands) and Deutsche Börse. Gross investment (ie, purchases) in the Bolsa represents around one-half of total trading, and in 2001 the volume was 25 times higher than ten years earlier. At the same time, popular capitalism has taken root among Spanish investors. A massive programme of privatizations reduced the public sector's share of the Bolsa's market capitalization from almost 17% in 1992 to practically zero in 2002, while the proportion held by individual investors today stands at more than 30%, the highest in Europe (see Exhibit 8.1). Spaniards are also increasingly investing outside their own country, particularly via the Spanish multinationals that operate in Latin America.

The Bolsa's capitalization of shares, spurred by privatizations, flotations and numerous public offerings, rose from 21.7% of GDP in 1990 to 81% in 2001, higher than Germany and Italy (see Exhibit 8.2). Turnover as a percentage of market capitalization (84%) was the highest among the markets covered by Morgan Stanley Capital International in 2001.

The Bolsa has proven its capacity to confront the competitive challenges raised by new technologies and the globalization of international finance. Its electronic trading system, known as SIBE, is used in several countries (Greece, Venezuela, El Salvador, Uruguay), and its Visual Trader, a latest-generation technological platform for direct access to markets and international order routing networks, is of interest to several European and Latin American markets.
In response to the creation of the Euro zone, the holding company Bolsas y Mercados Españoles was formed in 2002 to integrate all of Spain's equity, fixed-income, futures and options markets and the clearing and settlement systems. The integrated Spanish market is one of the most

Exhibit 8.1. **Participation of Individual Investors in the Capitalization of European Stock Markets (%)[1]**

Madrid	30.5	London	16.0	Oslo	7.7
Milan	25.2	Frankfurt	15.6	Paris	7.5
Warsaw	20.2	Stockholm	13.1	Helsinki	7.3

(1) 2000 figures.
Source: European Federation of Stock Exchanges.

Exhibit 8.2. **Stock Market Capitalization (% of GDP)[1]**

	1990	2000
France	25.9	111.8
Germany	21.0	67.8
Italy	13.5	71.5
Portugal	13.0	57.8
Spain	**21.7**	**90.3**
UK	85.9	182.2
US	53.2	153.5

Source: World Bank Development Indicators 2002.

Exhibit 8.3. **Capitalization of Companies[1]**

	€ mn	% of Total
Telefónica	41,316	8.9
SCH	38,338	8.2
BBVA	36,593	7.9
Telefónica Moviles	25,464	5.5
Endesa	15,574	3.3

(1) June 30, 2002.
Source: Bolsa de Madrid.

diversified in Europe and its size and single voice will enable it to play a leading role in drawing up the new European securities market map. In 1999 the Bolsa launched Latibex, the only euro market for Latin American shares and fixed-income securities, marking an unprecedented step towards the integration of European and Latin American capital markets (see separate section).

The Spanish market has been one of the strongest performers over the past ten years, though, like other markets, it was in the doldrums between 2000 and 2002. One reason was the bursting of the dot.com bubble in Spain. The lacklustre performance was also due to the "tango effect" of Argentina's crisis, as the Spanish companies with interests in Latin America account for around three-quarters of the Bolsa's total trading volume. The companies were affected because a significant proportion of their assets and profits are tied up in Latin America (see Chapter 5). This exposure is the main feature that sets the Spanish market apart.

The total net consolidated income of the companies that comprise the IBEX-35 index, the 35 most liquid shares, declined 3% in 2001, marking the first fall since 1993, when the Spanish economy was in recession.

According to Morgan Stanley Capital International, the compound annual growth including reinvestment of gross dividends of the Bolsa was 18.3% between 1991 and 2001, compared with 13.1% for New York, 11.2% for London, 13.9% for Paris and 10.6% for Hong Kong. Some of the flotations have been spectacularly successful. For example, Amancio Ortega, the founder of the international chain of Zara stores, and several relatives made nearly €2.7 billion in 2001 when they sold a 26% stake in Inditex, the family-owned textile and fashion retail business.

Exhibit 8.4. **Most Traded Shares[1]**

	€ mn	% of Total
Telefónica	56,259	23.6
SCH	38.384	16.1
BBVA	38,230	16.0
Repsol YPF	17,467	7.3
Endesa	13,173	5.5

(1) First half of 2002.
Source: Bolsa de Madrid.

Despite the steady rise in the number of listed companies, the market is still dominated by a handful of big players. Five companies accounted for 34% of total market capitalization at June 30, 2002 and 68% of the trading volume in the first six months of the year (see Exhibits 8.3 and 8.4). Telefónica alone generated 24% of the turnover. This company and Banco Bilbao Vizcaya Argentaria (BBVA), Endesa, Repsol YPF and Santander Central Hispano (SCH) form part of the Euro Stoxx 50. The big companies are also listed abroad (see Exhibit 8.5).

El Nuevo Mercado

A market for high-growth stocks was launched in 2000. *El Nuevo Mercado*, modelled on European New Markets for growth companies, fills a gap on the Spanish stock exchange, where rules requiring companies to include detailed profit forecasts in their offering documents had kept away companies with a focus on the new economy.

The companies on the this market are: Abengoa, Amadeus, Amper, Befesa, Indra, Radiotrónica, Terra, TPI, Sogecable and Zeltia. None of them were start-ups; they already traded on the main market. Regulators decided to build the market around established stocks in order to give it volume and credibility.

Latibex

Latibex, the euro market for blue chip Latin American shares and fixed-income securities – the only one of its kind in the world – was launched in Madrid at the end of 1999. It enables European investors to trade in Latin American stocks using a single electronic

Exhibit 8.5. **Spanish Companies Listed on International Stock Markets**

Nasdaq	New York	London	Tokyo	Frankfurt	Buenos Aires	S. de Chile	Sao Paulo
Terra Networks	BBVA	BBVA	Telefónica	Terra Networks	BBVA	BBVA	Telefónica
	SCH	SCH		BBVA	Repsol-YPF	SCH	
	Endesa	Telefónica		SCH	Telefónica	Endesa	
	Repsol-YPF			Endesa		Telefónica	
				Iberdrola			
				Repsol-YPF			
				Telefónica			
				Mapfre			

Note: There are other companies not listed here, but their trading volumes are low.
Source: Bolsa de Madrid.

trading and settlement platform in euros and ensures internationally recognized standards of transparency and security. For Latin American companies, Latibex provides direct access to euro funding. For both sides, there is no exchange rate risk.

The companies whose shares are traded on Latibex include Banco Bradesco, Latin America's third-largest bank by assets, Electrobras, Vale do Río Doce, Aracruz Celulose, Suzano, Copel and Globo Cabo from Brazil; Enérsis (Chile), Telmex, América Móvil and BBVA Bancomer (Mexico); BBVA Banco Francés and Banco Río de la Plata (Argentina); Volcán (Peru), Santander Bancorp (Puerto Rico). Electrobras (electricity) and Telmex (telecommunications) are two of Latin America's largest companies. Latibex's market capitalization in June 2002 was more than €90,000 million, 17% of that of Madrid and the third-largest Latin American market on the basis of this yardstick after Sao Paulo and Mexico City.

Until the arrival of Latibex, investing in Latin America involved operations in a number of different countries, legal environments, exchange-rate regimes and settlement systems. In short, a labyrinth requiring considerable knowledge before beginning to operate in these markets. Latibex cuts all this out.

The trading system is Spain's SIBE. Shares are registered through book entries in the Clearing and Settlement Service and are settled within three working days, the same as on the Madrid market (see Exhibit 8.6).

Latibex offers the capacity to trade during the same hours as those of European markets. This means that investors are able to trade for 10 to 12 consecutive hours, covering sessions in

Exhibit 8.6. **Main Features of Latibex**

- Market authorized by the Spanish government.
- Trading and settlement platform in Europe for leading Latam companies.
- Currency: euro
- Trading: SIBE electronic system.
- Settlement: D+3 through book entries.
- Brokers: all members of the Spanish market and members of authorised Latam markets.
- Index: FTSE Latibex All Share, drawn up in conjunction with the FTSE, the company responsible for the indices of the *Financial Times*.
- Transparent information: listed companies provide the market with the same information as they supply to their markets of origin.

Source: Bolsa de Madrid.

Europe and then in Latin America. Investors not only have the possibility of finding a counterparty with greater ease in their normal working hours but also have the chance to evaluate their portfolios on the basis of price formation in a system similar to their own without having to wait for markets to open in Latin America. As the European and Latin American trading sessions overlap during several hours, this also provides an opportunity for arbitrage between the two.

Futures and Options

MEFF trades and clears futures and options on bonds, interest rates, the IBEX-35 index of the most traded shares and futures and options on certain stocks. MEFF is a member of the GLOBEX® Alliance with the Chicago Mercantile Exchange, the Paris Bourse, the Singapore Exchange Derivatives Trading, Brazil's Bolsa de Mercadorias & Futuros and the Montreal Exchange. Although the systems of member exchanges are separate, the technology used allows investors to trade across the systems as if they were a single platform.

Asset Management

Asset management in Spain, the sixth-largest savings market in Europe, is growing at a fast pace, driven by low bank deposit rates, investor-friendly changes in tax laws and a more sophisticated investor culture[1].

[1] See the section on Spain by William Chislett in the *2001 European Fund Industry Directory* (Lipper).

The tax treatment of financial assets has been overhauled and standardized to a large extent; returns on most instruments (excluding mutual funds and equities) are taxed as income from capital, irrespective of the taxable event. As a result, the choice of savings instrument has become less tax-driven and more performance-driven. Long-term investment in mutual funds, the main vehicle for the growth of managed savings, has been encouraged by taxing all capital gains at 20% if the investment period is more than two years. If it is less than this, the gains are considered as part of taxable income and taxed at the marginal rate. As of 2003 investors will be allowed to switch between fund management companies without paying capital gains tax until the end of the life of their investments, instead of whenever they change funds.

The financial assets of households stood at €1,180 billion in 2001 (182% of GDP). Their structure has changed considerably (see Exhibit 8.7). The most notable change has been the shift from traditional bank deposits into shares and mutual funds, pension funds and life insurance, which account for around 60% of total financial assets of households, a higher proportion than that of many other developed countries, including France, Italy and Germany. This figure is forecast to reach 66% by 2010. Mutual and pension funds under management stood at €221.6 billion at the end of 2001 (34% of GDP), and the number of unit holders was 7.4 million in mutual funds and 5.8 million in pension funds.

The asset management sector is highly concentrated, with the top ten mutual fund groups capturing 74% of domestic industry assets as of December 2001. The market is dominated by the big banks, SCH and BBVA, which together controlled 46% of mutual funds and 35% of pension funds at the end of 2001. A number of foreign investment banks are gaining ground.

Exhibit 8.7. **Structure of Financial Assets of Spanish Households (% of total)**

	1994	2001
Notes	7.4	3.5
Sight deposits	6.2	5.5
Time deposits	40.0	28.7
Short-term securities	0.9	0.2
Bonds	1.9	1.2
Shares	17.4	31.8
Mutual funds	10.5	11.9
Pension funds and insurance	9.8	13.8
Others	5.8	3.1

Source: Bank of Spain.

Public Debt

Spanish public debt entered the "First Division" among international markets at the end of 2001 when the rating agency Moody's upgraded the Kingdom of Spain's euro- and foreign-currency-denominated bonds from Aa2 to the maximum Aaa (See Exhibit 1.5). Spreads against major issuers improved significantly. The Kingdom of Spain's issues have a split rating. While Moody's considers them Aaa, Standard and Poor's and Fitch IBCA continued with their ratings of AA+.

Fiscal consolidation, culminating with a balanced general government account in 2001 for the first time in more than 25 years, has brought a significant reduction in gross issuance needs (€64.4 billion in 2001, half the equivalent figure for 1997). Debt costs have declined substantially: the average cost at issuance fell from just over 10% in 1995 to 4.5% in 2001. This represents substantial savings for the government.

The share of the public debt portfolio in non–resident hands rose from 28.2% in 1995 to 45.3% in 2001. The Spanish market, the fourth largest in the EU in terms of issues in circulation, is very liquid and efficient. The Treasury launched its first 15-year eurodenominated bond in March 2002.

A proposed new law, expected to be enacted in 2002 would overhaul the Spanish financial system. The reforms include measures and the creation of instruments to enhance the efficiency of financial service providers so that Spanish firms are not at a disadvantage to their European counterparts. They also add protection for service users, particularly

putting online business on the same legal footing as face-to-face, and steps to facilitate the financing of small and medium-sized companies. The specific measures include the merger of securities clearing and settlement systems, paving the way for Spain's participation in future European platforms.

Appendix

Structural Indicators of the Spanish Economy Compared with the EU Average

General Economic Background

	EU-15[1]	Spain[1]
a. GDP		
• GDP per capita 2001 in purchasing power standard (PPS)	100	83.6
• Real GDP growth rate at constant prices (base year 1995)	1.5%	2.1%
b. Labour productivity		
• GDP per person employed	100	91.8
• GDP in PPS per hour worked	100	82.0
c. Employment growth		
• Total employment growth	1.2%	2.5%
d. Inflation rate		
• Annual percentage change in harmonized index of consumer prices (HICP) (annual average)	2.3%	2.8%
e. Unit labour cost growth		
• Growth rate of the ratio: compensation per employee in current prices divided by GDP per total employment in current prices	0.5%	-0.2%
f. Public balance		
• General government net borrowing (-)/net lending (+) as % of GDP	0.6	0
g. General government debt		
• General government consolidated gross debt as percentage of GDP	63.0	57.2

Employment

a. Employment rate (employed persons aged 16-64 as % of total population aged 15-64)		
• Total employment rate	64.0	56.3
• Female employment rate	54.9	41.9
• Male employment rate	73.0	70.9
b. Employment rate of older workers (employed persons aged 55-64 as % of total population aged 55-64)	38.6	38.9
c. Gender pay gap (average gross hourly earnings of females as % of average gross hourly earnings of males)	84.0***	86.0***
d. Tax rate on low-wage earners (total income tax on gross wage earnings plus employees and employer social security contributions)	37.8	33.3
e. Life-long learning (% of population, aged 25-64, participating in education and training)	8.4	4.7
f. Unemployment rate (% of working population)		
• Total unemployment rate	7.4	10.6
• Female unemployment rate	8.7	15.5
• Male unemployment rate	6.4	7.5

Innovation and Research

		EU-15[1]	Spain[1]
a.	Spending on human resources (total public expenditure on education as % of GDP)	5.1*	4.4
b.	R&D expenditure (% of GDP)	1.9*	0.9*
c.	Level of Internet access		
	• Percentage of citizens who have Internet access at home	37.7	24.7
	• Percentage of enterprises who have Internet access (web)	89.0	92.0
d.	Patents (number of patent applications to the European Patent Office per million inhabitants)	152,668*	22,115
e.	Information and Communication Technology expenditure (% of GDP)	4.1*	1.9*

Economic Reform

a.	Relative price levels and price convergence		
	• Relative price levels of private final consumption including indirect taxes	100*	83
b.	Prices in network industries		
	• Price level in telecommunications, local call (in euros)	0.41	0.28
	• Price level in telecommunications, national call (in euros)	1.15	1.60
	• Price level in telecommunications, call to the US (in euros)	2.65	4.25
	• Price level in electricity, industrial users (in euros per kWh)	0.0633	0.055
	• Price level in electricity, households (in euros per kWh)	0.103	0.085
	• Price level in gas markets, industrial users, (in euros per Giga-Joule)	6.12	4.72
	• Price level in gas markets, households, (in euros per Giga-Joule)	8.7	10.86
c.	Market structure in the network industries		
	• Market share of the largest generator in electricity	NA	44.7%**
	• Market share of the incumbent in the fixed telecommunications markets – local	NA	94%*
	• Market share of the incumbent in the fixed telecommunications markets – long distance	NA	86%*
	• Market share of the incumbent in the fixed telecommunications markets – international	NA	86%*
	• Market share of the incumbent in the mobile telecommunications markets	NA	56%
d.	Public procurement (value of which is openly advertised as a % of GDP)	2.41*	3.25
e.	Capital raised on stock markets (% of GDP)	4.5*	21.9
f.	Business investment (gross capital formation by the private sector as a % of GDP)	18.3*	22.1

Social Cohesion

	EU-15[1]	Spain[1]
a. Distribution of income (S80/S20 ratio)	5.4***	6.8***
b. Risk of poverty rate before and after social transfers		
• Risk of poverty rate (= % share of population below the cut-off threshold) before social transfers	6***	25***
• Risk of poverty rate (= % share of population below the cut-off threshold) after social transfers	18***	19***
c. Persistence risk of poverty	11***	10***
d. Regional cohesion (coefficient of variation of unemployment across regions, NUTS 2 level, within countries	63.8*	41.3*
e. Early school-leavers not in further education or training (share of the population aged 18-24 with only lower secondary education and not in education or training)	19.3	28.3
f. Long-term unemployment rate (total long-term unemployed, over 12 months, as a % of total active population aged 15-64)	3.9	5.1
g. Jobless households (% of people in households with no member in employment among all people living in households with at least one person belonging to the labour force)	4.0	4.6

Environment

a. Total greenhouse gases emissions (1990=100)	96**	124**
b. Energy intensity of the economy (gross inland consumption of energy divided by GDP)	199.1**	227**
c. Volume of transport (index of passenger transport volume relative to GDP). 1995=1000	98.4**	107.8**
d. Modal split of transport		
• % share of car transport in total passenger transport	80.8**	78.3**
• % share of air transport in total passenger transport	3.0	3.9
e. Urban air quality		
• Ozone exposure above limit values (average number of days for urban stations)	31**	25**
• Particulate (PM10) exposure above limit values (average number of days in urban areas)	40**	84**
f. Share of renewable energy (% contribution of electricity from renewable sources to total electricity contribution)	14.0**	12.8**

(1) 2001 real figures or estimates, except where indicated. For fuller information and definitions of the concepts, see the Eurostat website (www.europa.eu.int/comm/eurostat/).
** 2000. ** 1999. *** 1998.*
Source: Eurostat at June 17, 2002.

Main Indicators of the Spanish Economy

	1998	1999	2000	2001
Demand and Output at Constant Prices (a):				
Private consumption	4.5	4.7	4.0	2.7
Government consumption	3.7	4.2	4.0	3.1
Gross capital formation	10.3	9.0	5.0	2.9
Exports of goods and services	8.2	7.6	9.6	3.4
Imports of goods and services	13.3	12.8	9.8	3.7
GDP	4.3	4.1	4.1	2.8
Employment, Wages, Costs and Prices (a):				
Total employment	3.8	3.7	3.1	2.4
Compensation per employee	2.7	2.7	3.4	4.3
Unit labour costs	4.2	4.0	3.8	1.9
Consumer price index (12-month % change)	1.4	2.9	4.0	2.7
Consumer price differential with the euro area (HICP) (b)	0.6	1.1	1.2	1.0
Savings, Investment and Financial Balance (c):				
Resident sector: saving (d)	23.7	23.4	23.1	23.6
General government (d)	0.8	2.4	2.9	3.4
Resident sectors: investment	23.2	24.5	25.6	25.5
General government (d)	3.3	3.5	3.3	3.5
Resident sectors: domestic net lending (+) or net borrowing (-)	0.5	-1.1	-2.5	-1.9
General government	-2.6	-1.1	-0.3	0.0
Gross general government debt	64.5	63.1	60.4	57.8
Monetary and Financial Indicators (e):				
10-year government bond yield	4.8	4.7	5.5	5.1
Synthetic bank lending rate	5.9	4.9	5.9	5.8
Madrid Stock Exchange General Index (December 1985=100)	817.7	894.4	994.8	853.4
Real effective exchange rate vis-à-vis developed countries (f)	99.9	99.2	97.3	99.3
Real effective exchange rate vis-à-vis euro area (f)	100.1	100.0	100.0	100.0

(a) Rates of change.
(b) Differentials calculated using the Eurostat series with information to December 2001, before methodological changes were introduced.
(c) Levels as a percentage of GDP. The saving and investment figures for 2001 are estimates of the Bank of Spain.
(d) Includes net capital transfers received.
(e) Average annual levels for interest rates and exchange rates and rates of change for financial assets and liabilities.
(f) 1999 H1 = 100, measured with unit labour costs.
Sources: National Statistics Office, National Audit Office and Bank of Spain.

Websites of Key Spanish Institutions

Spanish Government Portal	www.administracion.es

Ministries

• Justice	www.mju.es
• Economy and Finance	www.meh.es
• Secretary of State of Trade and Tourism	www.mcx.es
• Presidency	www.la-moncloa.es
• Agriculture and Fisheries	www.maypa.es
• Foreign Affairs	www.mae.es
• Defence	www.mde.es
• Education	www.mec.es
• Development	www.mfom.es
• Interior	www.mir.es
• Environment	www.mma.es
• Health and Consumption	www.msc.es
• Work and Social Affairs	www.mtas.es
• Science and Technology	www.min.es

Regional Governments

Andalusia	www.caan.es
Basque Country	www.euskadi.net
Catalonia	www.gencat.es
Galicia	www.xunta.es
Madrid	www.comadrid.es
Valencia	www.gva.es

Others

Bank of Spain	www.bde.es
National Statistics Office (INE)	www.ine.es
Institute of Tourism Studies	www.iet.tourspain.es
Institute of Fiscal Studies	www.ief.es
Institute of Foreign Trade (ICEX)	www.icex.es
National Institute of Consumption	www.consumo-inc.es
Tax Agency	www.aeat.es
Centre of Sociological Investigations (CIS)	www.cis.sociol.es
Official State Bulletin	www.boe.es
National Employment Institute (INEM)	www.inem.es
Madrid Stock Exchange	www.bolsamadrid.es
Latibex, the euro market for Latin American securities	www.latibex.com

The Real Instituto Elcano
de Estudios Internacionales y Estratégicos

The Real Instituto Elcano de Estudios Internacionales y Estratégicos is a foundation, independent of both the government and the companies which largely finance it. Its task is to study the interests of Spain and Spaniards in international society and to place the fruit of its labours at the disposal of all Spaniards. In this sense, the Institute defines itself as an institution which is non-partisan, but not neutral, and develops a strategic and global perspective, with a clearly forward-looking approach. The Institute uses multidisciplinary academic methods and techniques which serve both public and private viewpoints and generate political and social proposals which are at the same time practical and applicable.

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