Situación Spain

- The international environment and the euro depreciation support the external sector

- Immigration: crucial for economic growth

- The inflation problem: something more than crude oil

- The spanish economic "miracle": a macro perspective

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Index

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Editorial

The Spanish economy is growing in the first half of the year at rates of above 4%. This strong growth performance is attributable to a series of shocks, both of a demand and supply nature, which have allowed the economy to expand at rates above potential GDP growth since 1997. The transitory nature of these shocks casts doubt on the sustainability of the expansion, however. In 2000, the expansion in exports, in response to a favourable international environment and euro depreciation, is making possible a reduction in the negative contribution of the external sector to output growth. This, in spite of the impetus shown by imports on the back of the continued strength of domestic demand. The faster GDP growth also masks the growing imbalances that are emerging in the Spanish economy. Nonetheless, per capita income is still only 82% of that of the European Union, meaning that a positive growth differential with Europe is required for convergence in real terms. In this context, economic policy decisions need to be geared to securing buoyant growth in Spain's economy and dealing with the bottlenecks that are threatening to stifle activity. The maintenance of an inflation differential with EMU and the rising external deficit are evidence of excess demand in the economy and the existence of rigidities in product and labour markets.

Economic policy should employ a two-handed approach. On the one hand, counter-cyclical fiscal policy is needed to neutralize the expansionary nature of European monetary policy for Spain. On the other hand, a far-reaching programme of reforms is required to make Spanish markets more flexible and dynamic. This liberalization process should take the U.S. product and labour markets as its reference point, as the European markets are excessively rigid and require as radical a programme of reforms as in Spain. This area of economic policy should encompass four policy ingredients: labour market reform, the liberalization of goods and services markets, investment in human and physical capital and guarantees for the sustainability of the welfare state. It is therefore not a matter of implementing corrective measures that affect the short-run performance of economic variables, such as inflation, as such measures have only a limited and short-lived impact, and, in the case of inflation, distort relative prices. Measures need to attack the root of the problem in order to secure price stability in the medium term and lay the basis for sustained and balanced growth.

1. International environment

The setting for Spanish economic activity is one of robust growth in the world economy and an associated strengthening of world trade. In addition, the depreciation of the Euro has led to a gain in competitiveness of EMU against the rest of the world, which has been particularly beneficial for the export sector. The only clouds on the horizon for this year are the increases in the price of oil and other commodities and their repercussion on inflation. The rise in official interest rates in the leading industrial countries, the appreciation of the euro and a number of latent problems in the industrialized economies (the current account balance in the United States, a potentially overvalued stock market and the slow pace of structural reform in Europe) mark the uncertainty about the sustainability of growth in 2001.

Optimism for 2000

Growth in the world economy this year is expected to return to pre-Asian crisis levels. Activity is strengthening in both the developing countries and the industrial economies. For the OECD as a whole, a 0.5-point acceleration in activity should take GDP growth rates up to their highest level since the end of the 1980s.

Several factors are behind these developments. The first of these is the lax stance of monetary conditions, except for the United States after the last hikes to interest rates. The second factor is a less restrictive fiscal policy stance, as is evident in an interruption of the reduction in structural deficits, particularly in EMU, where planned tax cuts could give a pro-cyclical bias to fiscal policy. The third is the moderation shown by wage growth, not only in the United States, where unemployment has fallen to below its structural component, but also in Europe, where, in spite of faster price increases in recent months, wage settlements have been lower than expected at the start of the year. Finally, there is the technological shock linked to the "New Economy", which has lifted potential growth in the United States and generated expectations that the shock will pass into the European economy.

This has provided a positive stimulus to world trade, which, after rising by 5.7% in 1999, could reach near double-digit growth in 2000.

Unlike events in previous expansions, inflation has remained in check. In spite of the increase in the price of oil and other commodities, there seems to have been no pass-through into trend inflation, which has remained virtually stable with only modest rebounds from the low point in 1999. In this sense, inflationary risks appear to be limited, even in areas where, because of greater market rigidity, a bigger pass-through from higher energy prices could a priori be expected. This is the case of EMU, where the rise in oil prices has coincided with a depreciation of the euro. Although these factors have sent inflation to the upper bound of the stringent target set by the ECB, the underlying component is running at 1.3%, that is, at historically low levels. The growing credibility of monetary policies, falling prices in sectors with a high technology component, the development of new distribution channels and wage moderation have contributed to this behaviour.

Doubts for 2001

Against the backdrop of improving growth prospects and subdued inflationary pressures, there are still a

Table 1.1. Growth forecasts				
	1998	1999	2000	2001
OECD	2.3	3.2	3.7	2.9
US	4.3	4.2	4.5	2.8
EMU	2.7	2.4	3.5	2.9
UK	2.2	2.1	2.9	2.3
Japan	-2.8	0.3	0.9	1.4
Developing countries	3.0	3.5	4.9	5.0
Latin America	2.0	0.1	4.0	4.3
Transition countries	-0.6	2.4	2.4	3.0
WORLD	2.4	3.4	4.1	3.7
Source: IMF and BBVA				

Table 1.2. Inflation forecasts				
	1998	1999	2000	2001
OECD	1.6	1.4	2.0	1.8
US	1.6	2.2	2.9	2.2
EMU	1.1	1.2	1.9	1.7
UK	2.7	2.3	2.3	2.5
Japan	0.6	-0.4	-0.2	0.0
Developing countries	10.5	6.7	5.9	4.8
Latin America	10.1	8.5	7.3	6.2
Transition countries	20.8	43.2	19.0	14.0
WORLD	6.1	5.5	4.4	3.5
Source: IMF and BBVA				

number of lingering uncertainties. Chief of these is the uncertainty surrounding the intensity and duration of any slowdown in the U.S. economy. The size of the U.S. current account deficit, which is expected to exceed 4% of GDP in 2000, calls into question the sustainability of current rates of growth. The strength of domestic demand and record low levels of unemployment could lead to a significant increase in interest rates, to levels above those being discounted at present. If this happens, the reaction of the stock markets – stock prices may be somewhat overvalued – and a possible loss of investor confidence in the U.S. economy could bring about a sharp downturn in activity and a sizeable depreciation of the dollar. As opposed to this risk scenario, a monetary policy tightening of interest rates to around 7%, barely half a point higher than at present, should suffice to slow domestic demand growth and bring about a soft landing of the economy.

In Europe, the uncertainties relate to whether activity in the years ahead can sustain a rate of growth similar to that forecast for 2000, as this is largely underpinned by demand factors. The slow pace of structural reform in product and factor markets is holding back recovery in productivity and is maintaining this economy's relative weakness with respect to the United States. Particularly troublesome is the low participation rate, which evidences the need to put in place policies geared to reducing the unemployment rate and increasing labour force participation. In the medium term, the fact that the fiscal consolidation drive has stalled could become a problem, especially as the level reached seems to fall short of what is required to cope with potential changes in the cyclical position of the economy and future challenges linked to demographic trends.

In spite of improving expectations in Japan, the new government must press ahead more forcefully with those reforms already started and push through reforms that eliminate the barriers in product and factor markets. The temptation to introduce new fiscal stimulus plans should be avoided. Conversely, there is a need to embark on a drive to reduce the level of public deficit. Even in the latter case, the slow pace of such processes will hamper the revival in activity anticipated for Japan's economy.

Upward bias in interest rates

Robust economic growth in most OECD countries suggests that the current tightening cycle of interest rates is likely to continue in the coming months. In the context of a soft landing, interest rates in the United States could be close to peaking, and may even fall in 2001. In EMU, meanwhile, monetary policy indicators show that monetary conditions are still relatively expansionary, as a result of which interest rates will probably continue to trend upwards over the next year and a half.

As for long-term interest rates, the volatility linked to the uncertainty surrounding the macroeconomic scenario in the United States will continue to shape developments. However, as this uncertainty unwinds (provided that there is a soft landing), and the debt-to-GDP ratio falls, long-term interest rates should decline.

The decline in long-term interest rates in Europe is expected to be less marked than in the United States, and the differential between the two areas should therefore narrow. This is one of the factors that will work to lift the exchange value of the euro to levels more in line with economic fundamentals; that is, to above one dollar to the euro. However, a lasting appreciation will require a reduction in the productivity differential, not only in the medium term as a result of cyclical developments in the United States but also consistently in the long term as a result of the resolution of Europe's structural problems.

Graph 1.1

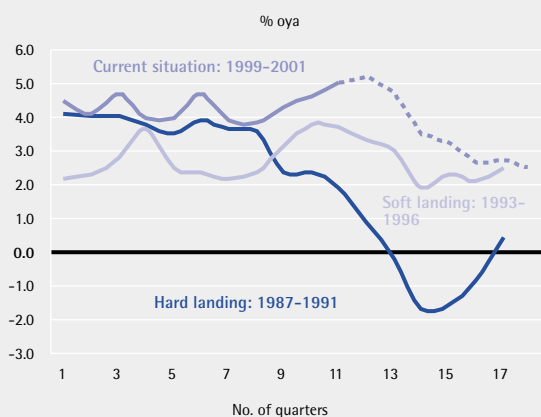**U.S. GDP in different slowdowns**

% oya

Source: Commerce department

Table 1.3. Interest rate forecasts				
	Jun.00*	Sep.00	Dec.00	Jun.01
Official rates				
US	6.50	7.00	7.00	6.75
EMU	4.25	4.25	4.50	4.75
10-year interest rates				
US	6.11	6.50	6.30	5.80
EMU	5.22	5.50	5.40	5.30
Exchange rate				
Dollar–euro	0.94	0.92	1.00	1.04

* Data to June 22.
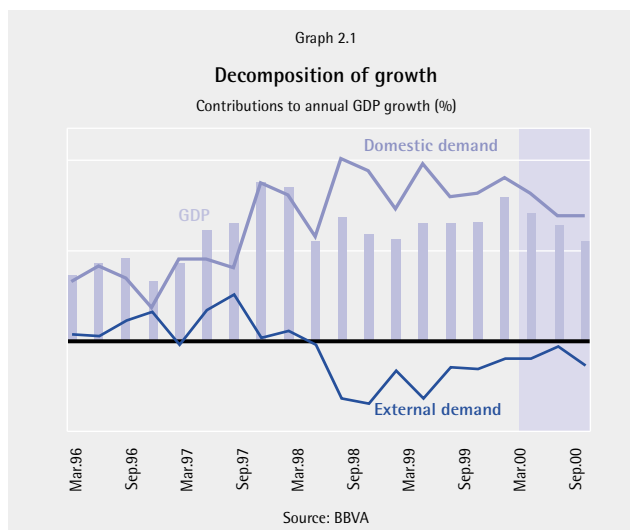
Source: BBVA

2. Real economy

The Spanish economy is in a strong cyclical expansion. Annual rates of growth have remained above 3% since 1997, and high growth rates are expected in 2000 and 2001 (4% and 3.2%, respectively). GDP growth in Spain is thus still one of the strongest in the euro area, though the differential with EMU is expected to narrow in 2000 and 2001[1].

The external sector and loose monetary policy account for Spain's strong economic performance

The revival in exports as a result of improved world economic conditions and gains in competitiveness associated with the depreciation of the euro has been, since the middle of 1999, the main factor contributing to the cyclical upswing. In addition to this external momentum, domestic demand grew at annual rates of 5% in 1998 and 1999 because of a combination of expansionary monetary policy, excessively loose fiscal policy and the positive impact of the decline in commodity prices between early 1997 and 1999, and of wage moderation and expanding employment. As a result, real household disposable income and business expectations have strengthened, which largely translates into increased spending on consumption and investment.

The most negative aspect of this expansion relates to the inability of supply to meet demand growth, with the ensuing acceleration in prices (accentuated by

Graph 2.1

Decomposition of growth
Contributions to annual GDP growth (%)

Domestic demand
GDP
External demand

Mar.96 Sep.96 Mar.97 Sep.97 Mar.98 Sep.98 Mar.99 Sep.99 Mar.00 Sep.00

Source: BBVA

exogenous factors such as higher energy costs and euro depreciation) and a growing current account deficit. That is, a loss of market share for Spanish goods and services with respect to foreign goods and services.

Apart from an interruption in 1995, interest rates fell in Spain from the end of 1992 until the middle of 1999. Real 3-month rates in the first quarter of 2000 stood at 0.6%, 6.7 percentage points lower than the average over 1991-1993, and 3 percentage points below the average over 1994-1998. At the same time, the real effective exchange rate vis-à-vis the OECD in terms of consumer prices saw a cumulative fall (gain in competitiveness) of 17.6% between 1992 and the first quarter of 2000.

To this monetary stimulus must be added the positive effect on households' disposable income of the 1999 income tax (IRPF) reform, which introduced lower withholdings and rates of tax. The effect on household spending that year is estimated to have been more than

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[1] Spanish GDP in 1999 was 1.5 percentage points higher than in EMU as a whole. In 2000 and 2001, the differential seems likely to fall back to 0.5 and 0.3 percentage points, respectively.

Table 2.1.

| GDP ESA-95 (gross data) | 1999 | | | | 2000 | | | | Annual average | | |
% change oya	1Q99	2Q99	3Q99	4Q99	1Q00	2Q00	3Q00	4Q00	1999	2000	2001
Private consumption (¹)	4.4	4.6	5.0	3.9	6.2	4.0	3.5	3.3	4.4	4.2	3.6
Public consumption	7.4	0.0	3.1	-2.8	3.3	2.2	2.1	2.1	1.8	2.4	2.2
Gross fixed capital formation	8.3	12.4	7.4	5.5	7.2	6.6	6.7	7.0	8.3	6.9	4.7
Capital goods	4.4	13.6	9.0	6.5	9.5	7.0	8.0	7.0	8.4	7.8	5.0
Construction	11.0	11.7	6.5	4.9	5.7	6.3	6.0	7.0	8.3	6.3	4.5
Inventories (*)	-1.3	0.2	-0.4	1.6	-0.6	0.4	0.0	0.0	0.1	0.0	0.0
Domestic demand	**4.3**	**5.8**	**4.8**	**4.7**	**5.3**	**4.8**	**4.0**	**4.0**	**4.9**	**4.5**	**3.7**
Exports	5.8	6.1	7.8	14.0	10.9	11.4	11.9	10.4	8.5	11.2	7.7
Imports	9.4	12.9	11.2	16.5	12.6	12.9	12.7	12.1	12.6	12.6	9.0
Net exports (*)	**-1.0**	**-1.9**	**-0.9**	**-0.9**	**-0.6**	**-0.6**	**-0.2**	**-0.8**	**-1.2**	**-0.6**	**-0.6**
GDP at market prices	**3.3**	**3.9**	**3.9**	**3.9**	**4.7**	**4.2**	**3.8**	**3.3**	**3.7**	**4.0**	**3.2**

(*) Contribution to GDP growth; (¹) Includes NPISH

Source: INE and BBVA

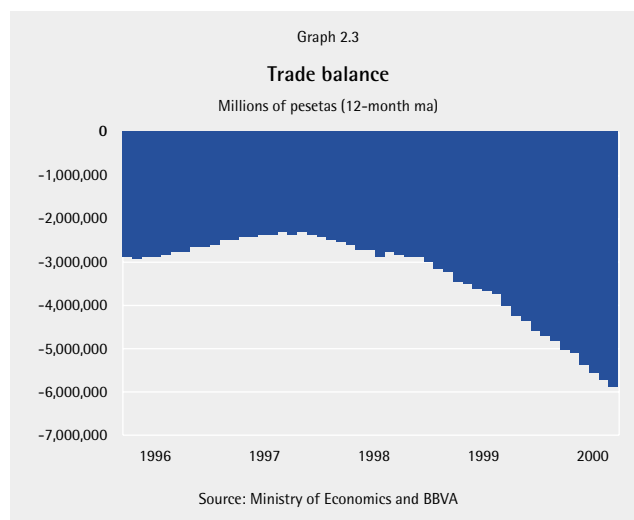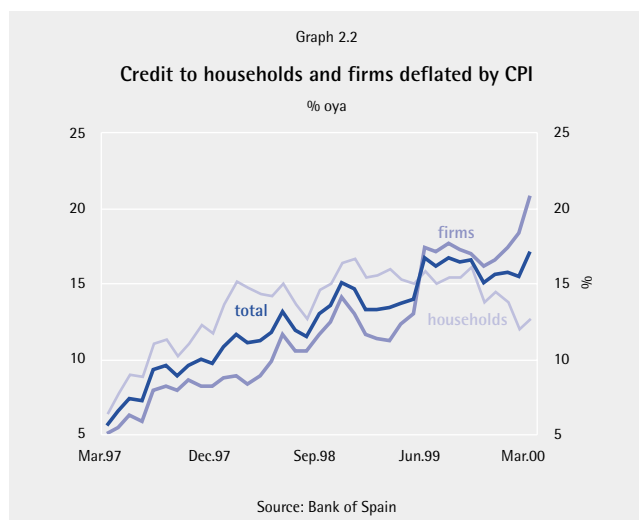0.5 points of growth. In 2000, the positive impact is expected to be 0.2 points.

Growth in final household spending – 4.4% in 1999 – is expected to slow somewhat in the course of 2000, most notably in the second half of the year. This year there will be no additional fiscal stimulus and salaried employee income should register lower growth than in previous years, mainly as a result of weaker growth in real wages (the rate of increase in inflation in 2000 will outstrip that of wages). In addition, the rebound in ECB interest rates, while having a positive impact on income, is feeding through into the cost of credit. Both mortgage and personal loan rates have increased since July of last year, the former to 5.36% in April (49 basis points higher than in December), the latter to 7.96% in April for loans under three years (1.25 points higher than in December). The latest short-term indicators relating to household consumption show a common pattern of slower – though still high – annual rates of growth than in the second half of 1999. Nonetheless, these factors do not seem to be having a significant effect on consumption so far. The strength of consumption in the early part of 2000 is thus attributable to record high levels of consumer confidence, growth in credit to households (stable annual rates of around 15%) and the rise in property prices. Consumption is expected to slow in the second half of the year and through 2001 as a consequence of the above-mentioned factors.

The variables that determine capital goods investment are sending out contradictory signals as to the evolution of this variable. Thus, interest rates will no longer be instrumental in reducing the real cost of capital, but will in fact increase the upward pressure on costs[2]. Conversely,

demand expectations remain strong, both on account of buoyant domestic consumption and strengthening external demand as the exchange rate of the peseta boosts the competitiveness of Spanish firms. These divergent influences are also apparent in the behaviour of various short-term indicators. Apparent investment in capital goods is recording high rates of growth as a result of both the contribution from the industrial production index and faster import growth. It is also showing a different pattern to that of growth of capital goods investment in the Quarterly National Accounts. The qualitative indicators of the Industrial Trends Survey are also sending out an optimistic message, and expectations are at an all-time high in the main branches of industry, especially in those most favoured by the improving external sector. Taking all these factors into account, the slowdown in this variable in 2000 is likely to be very modest, but more marked in the second half of the year. Annual rates of growth in the first half of 2000 above those of the second half of 1999 are not out of the question. For 2001, the moderating effect of slower external growth and of greater financing restrictions on corporate earnings is likely to hold sway.
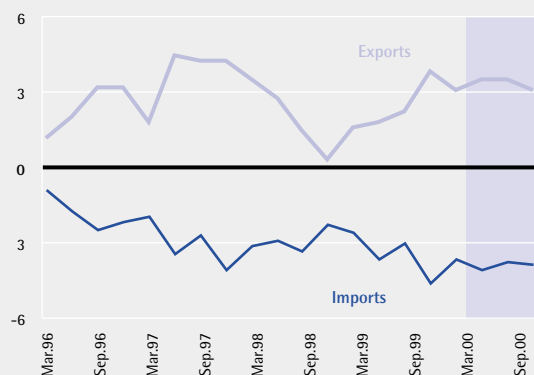
In gross fixed capital formation in construction, the component with the biggest share in investment, the expectations prevailing a few months ago are also being scaled up as a consequence of the recent positive surprises registered by a number of indicators (apparent consumption of cement, official tendering). Nonetheless, this picture must be set against the effect of higher interest rates on house-purchasing capacity in a context of lower growth in households' real disposable income. The moderating effect on activity of weaker housing demand from families is thus likely to be the most important factor. As a result, investment in construction will probably rise by 6.3% in 2000, down 2 percentage

[2] On data from the Bank of Spain's Central Balance Sheet Office for the fourth quarter of 1999, the gross operating surplus of manufacturing firms in the sample fell by 0.6% in 1999.

Graph 2.2

Credit to households and firms deflated by CPI

% oya

Source: Bank of Spain

Graph 2.3

Trade balance

Millions of pesetas (12-month ma)

Source: Ministry of Economics and BBVA

Graph 2.4

External sector

contribution to GDP growth in percentage points

Source: INE and BBVA

points from 1999. In 2001, the slowdown in house building activity is expected to continue, while the ongoing drive to control public spending will limit any positive contribution from public works. The outcome is likely to be a rate of growth of 4.5%.

The expansion in exports is powering industrial activity, though not enough to balance the external sector

The external sector of the Spanish economy, and more specifically the expansion in merchandise exports, is the most important factor behind the generalized improvement in expectations for growth in 2000, and should more than compensate for the slowdown expected in domestic demand.

Growth in merchandise exports at constant prices accelerated by almost 11 percentage points between the early part of 1999 and mid-way through 2000, from 2.7% to 13%. The buoyant export performance is the result of the simultaneous impact of stronger world trade and an
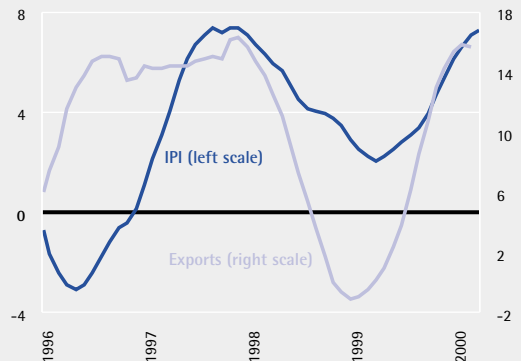
improving competitive position for Spanish firms – the euro depreciated by 23.2% against the dollar between January 1999 and the first quarter of 2000. This very positive external scenario is likely to remain relatively unchanged in the short run, particularly with regard to the behaviour of world demand. The continuing price differential with the other euro area countries, to which Spain sends around 60% of its merchandise exports, will nonetheless lead to a loss of competitiveness, though in 2000 this will be offset by euro depreciation. In 2000, total exports of goods and services are expected to rise by over 11%, which would be consistent with a 3% gain in competitiveness of the Spanish economy vis-à-vis the rest of the world and growth in world trade of 6.5%, 2.5 points more than in 1999. In 2001, the recovery anticipated for the euro and the maintenance of a positive inflation differential between Spain and its euro area competitors will probably give rise to a loss of competitiveness of around 3%. This development, in conjunction with slower growth in world trade, will probably send export growth down by 3.5 percentage points, to 7.7%.

The path of imports will mirror that of GDP and relative prices, the rate of growth slowing in 2000 by almost half a percentage point, from 13.2%[3] to 12.6%. The slight slowdown in this variable will be instrumental in reducing the negative contribution of net trade on GDP in 2000, from 1.4 points in 1999 (BBVA estimate) to 0.6 points.

The expansion in activity because of the influence of the external sector is apparent in industrial activity, notably in the production of intermediate goods, which account
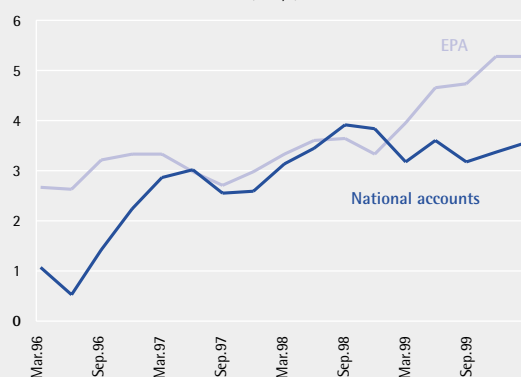
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[3] BBVA estimate taking into account the revision of the initial INE data release for 1999. The relationship between the merchandise trade figures of the Customs Department of the Ministry of Economics and those of INE from the Quarterly National Accounts is discussed in a box in this section.

Graph 2.5

Intermediate goods

% smoothed

Source: INE and BBVA

Graph 2.6

Employment

(% oya)

Source: INE and BBVA

Overseas merchandise trade: INE and Customs divergence

The Department of Customs and Special Taxes of the Ministry of Finance releases monthly data on merchandise trade, disaggregating in terms of the origin and destination of trade flows and type of product, and also distinguishing between value at current prices and constant prices. Merchandise exports and imports are a vitally important part of the macroeconomic picture drawn up by the National Statistics Institute, which uses Customs data as its source of information. Nonetheless, there are differences in the definitions employed by both institutions in the measurement of overseas merchandise trade.

In this regard, the compilation of overseas trade statistics by the Ministry of Economics and Finance adheres to the norms of the European Union[1], whereas the INE follows the methodology established in the European System of Accounts 1995 (ESA 95)[2]. The most significant difference is whether or not the cost of insurance and freight between the seller and buyer country is added to the value of merchandise imports. According to the ESA 95, exports and imports are valued on an f.o.b. basis at the territorial limit of the exporting country, meaning that the cost of these factors would not be included in shipment from the exporting country to the border of the importing country, but is instead considered as an import of services[3]. However, Customs defines the statistical value of imports as "...the value of goods at the place and time in which they enter the statistical territory of the importing member state"[4]. That is, it includes the cost of insurance and transport to the border of the importing country. Quantitatively, the difference in the valuation of imports is relatively small, and as far as the analysis of the domestic economic scene is concerned, it neither alters the cyclical trend of the variable in constant prices nor in current prices.

When the INE released its first GDP estimate for the fourth quarter of 1999 on February 23, the December 1999 data on overseas merchandise trade compiled by Customs were still unavailable (they were released on March 8), and so an estimate had to be used. On the figures released by the Ministry of Finance, the overseas merchandise trade numbers for the fourth quarter of 1999 were much worse in trade deficit terms than the estimates produced by the INE. As shown in the table below, INE estimates of merchandise exports for the fourth quarter of 1999 were 2.5% higher than the Customs data, a much larger divergence than normal. The import differential at constant prices estimated for the fourth quarter of 1999 was 8.8%, more than four percentage points above the usual differences in level in recent quarters.

With the publication of the Quarterly National Accounts (QNA) for the first quarter of 2000 on June 21, the 4Q99 differentials have fallen, to 1.4% and 4.8%, much more in line with earlier ones. On the basis of the first-quarter QNA data, the INE has revised down the 4Q99 gross data for merchandise exports and revised up the data for merchandise imports. As a result of this new estimate, the positive contribution in gross data terms of the external sector in the fourth quarter of 1999, initially estimated at 0.6 percentage points, has swung to a negative contribution of 0.9 points (domestic demand in this quarter was also revised up). As the INE has left the annual figures unchanged, there have been adjustments in the first three quarters of 1999 to compensate for the change in the fourth-quarter data. In view of the above, a revision of the figures for 1999 growth in September is not out of the question. While this would probably leave GDP growth unchanged at 3.7%, it would likely estimate a faster pace of domestic demand growth than the current estimate (4.9%) and a more negative contribution to growth from the external sector (1.2%).

[1] Regulations 3330/91 of the EU Council, 3046/92 of the Commission, 1172/95 of the Council and 840/96 of the Commission.
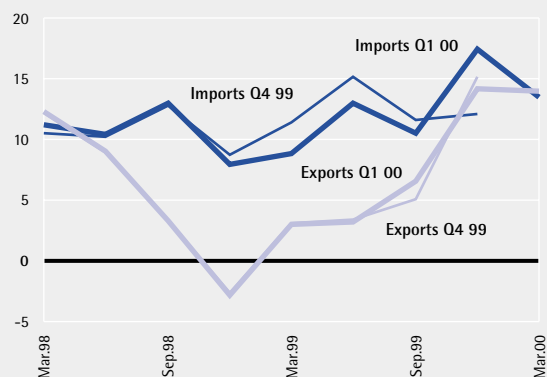[2] EU Council Regulation 2223/96.
[3] The ESA 79 did include these costs as added value in merchandise imports.
[4] Article 9, section 1 of EU Council Regulation 840/96.

Merchandise trade in National Accounts terms
(1995 constant pesetas, gross data, % oya)

Source: INE and BBVA

Differences in level between INE and Customs in % 1995 pesetas

	Exports (INE 4Q99)	Exports (INE 1Q00)	Imports (INE 4Q99)	Imports (INE 1Q00)
Mar-98	0.9	1.0	-4.2	-4.0
Jun-98	1.2	1.2	-4.4	-4.2
Sep-98	1.4	1.4	-4.3	-4.4
Dec-98	0.9	0.8	-4.6	-4.9
Mar-99	1.4	1.4	-3.8	-5.7
Jun-99	1.4	1.3	-4.5	-6.2
Sep-99	0.7	2.1	-4.2	-5.2
Dec-99	2.5	1.4	-8.8	-4.8
Mar-00	—	2.2	—	-5.0

Source: INE, MH and BBVA

Immigration: crucial for economic growth

The population projections produced by different institutions (EU, UN, World Bank and INE) all indicate that the demographic problem derived from population ageing and the associated drop in available labour will be one of the key challenges of the 21st century for Europe, in general, and for Spain, in particular. On UN projections, (Replacement Migration; March 2000), Spain's population will have shrunk by more than 9 million by 2050, and the working age population by close to 12 million. In such a scenario, the dependency ratio (the population aged 65 or over as a percentage of the working age population) would be well above 50%, a long way from its current 24.5% level. The INE projections, produced using the 1991 Census, confirm that the total population will begin to fall from 2010 onwards and the working age population as of 2005. Thus, in 2020, the last year in the time frame of the INE projections, the dependency ratio will have risen to 31%. Population ageing and the decline in the potentially active population would render the welfare state in its current form unsustainable – around 60% of social expenditure is financed from social security contributions.

In addition, the decline in population, in so far as it negatively affects potential growth, reduces individuals' per capita income in the long run. The tables below depict different scenarios for immigration and growth, and hence for job creation[1]. It can be seen that the unemployment rate is above 5% in 2020 in only two of the twelve scenarios. In the rest of the scenarios considered, and notably in all the scenarios under the current intake of 30,000 immigrants, the shortage of labour imposes restrictions on job creation and hence holds back growth. A successful solution to the population dynamics problem in the Spanish economy involves changing demographic developments, in such a way that Spain's population pyramid can be restored to a position of balance.

Changing the structure of the population pyramid will require a higher fertility rate or an increase in migratory flows given that the other key demographic variable, life expectancy, should continue to rise. Even if measures are taken to bring the Spanish birth rate, currently the lowest in the world at 1.2 births per woman, up to the replacement level of 2.1 births per woman, their impact would not be immediate (the birth rate has not been at this level since 1980). More than a decade would be needed for it to make a substantial impact on the structure of the population. In addition, the shortage of labour in the medium term for demographic reasons is already showing up in a number of sectors (agriculture, construction and the hotel and catering sector) as a consequence of the low geographical and functional mobility in Spain in spite of the high rate of unemployment (15% in the first quarter of 2000) and the present restrictive immigration policy. Immigration is thus the only measure within reach for dealing with the labour shortage that is holding back job creation and weakening the growth prospects of the Spanish economy. In addition, immigrants tend to fill jobs that national workers reject (for instance, seasonal jobs in agriculture) or for which they lack the necessary skills (new technologies). In Spain, the foreign population only accounts for 1% of the total population, compared with 6% in France and 8% in Germany. An efficient immigration policy is needed to raise society's awareness of this. Such a policy should increase the number of work permits, enhance the coordination of labour supply and demand and reduce illegal immigration. This would facilitate the integration of immigrants into both the labour market and society.

Nonetheless, although immigration would help to mitigate the problem of population decline, it will not resolve it unless a very large intake of immigrants is permitted (5 million initially), which would not be politically and socially viable anyway. On INE population projections, holding the dependency ratio at its current levels would require average migratory flows of around 300,000 per year (the annual quota of work permits is 30,000, compared with approximately 95,000 applications in 1999). These flows are so high (10 times the current quota) that they are unlikely to come about in the short run. Given the scale of the problem and the pressing need for a solution, political parties and social agents should come together to formulate measures aimed at fomenting both the birth rate and immigration. These measures should be supplemented with others designed to delay the age of retirement, promote training among the unemployed and workers close to retirement and raise the flexibility of the labour market. Such measures would, in turn, reduce the wage pressures arising from the imbalances in labour supply and demand.

[1] All the scenarios assume that: i) the participation rates by age group gradually draw closer to the prevailing rates in the United States; and ii) GDP growth is 50% productivity growth and 50% employment growth.

Unemployment rates under alternative immigration and economic growth scenarios

	Average GDP growth				Average GDP growth		
INE Immigration 35,000	2.0%	2.5%	3.0%	BBVA Inmigration 120,000	2.0%	2.5%	3.0%
2005	13.1	12.0	10.9	**2005**	15.0	13.9	12.8
2010	10.1	7.9	5.6	**2010**	13.6	11.4	9.2
2020	0.2	*	*	**2020**	7.4	2.7	*
	Average GDP growth				Average GDP growth		
BBVA Immigration 90,000	2.0%	2.5%	3.0%	BBVA Inmigration 150,000	2.0%	2.5%	3.0%
2005	14.3	13.2	12.2	**2005**	15.6	14.6	13.5
2010	12.4	10.2	8.0	**2010**	14.8	12.6	10.5
2020	5.0	0.1	*	**2020**	9.6	5.1	0.3

Note: * denotes a negative unemployment rate. Source: BBVA

for almost 50% of industrial output and merchandise exports. A growth rate of close to 6.4% in the IPI of intermediate goods is probable in 2000, more than double that of the previous year. The overall IPI is expected to see growth of close to 4.5% in 2000, with faster increases in the early part of the year as a consequence of the external environment.

Employment is rising in Spain, but not at the levels suggested by the EPA labour survey

The latest results of the EPA labour survey put the annual rate of employment growth at around 5%, very close to the all-time high registered in 1989. However, this rate of growth masks the survey changes introduced (see Box: The EPA loses time homogeneity), which entail an upward bias in the level of employment in the first quarter of 2000 amounting to 77,500 payrolls, or 0.5% of the total[4].

The sharp upturn in employment and the reduction in unemployment in Spain are the result of a combination of four factors. The first of these is a sustained rate of economic growth of above 3%, with current rates close to 4%. The second is the increased share of part-time employment, which has risen from 4% in 1989 to close to 9% in the first quarter of 2000. Thirdly, new forms of permanent hiring for certain groups and incentives for social security contributions are being used. As a result of both these elements, part of the employment recorded in Social Security registers after 1997 is not "new" employment, but rather underground economy jobs that have surfaced. Finally, smaller increases in the population entering the labour market (due to lower numbers of young people and longer training periods) and the steady fall in the age at which workers are leaving the labour market

(early retirements) have both further contributed to the decline in the unemployment rate as a percentage of the labour force. These factors are joined by the changes to the way in which the EPA labour survey is conducted, as a result of which the Spanish labour market data have become spectacular, but a poor reflection of reality.

Moreover, the data on social security registrations, the EPA labour survey and the Quarterly National Accounts all paint a different employment picture for Spain. A combined analysis of all the variables suggests that the number of full-time equivalent jobs in Spain is growing at rates of 3.5%, though the trend is downwards. A rate of growth in this variable of 3.3% is probable in 2000, which would be consistent with GDP growth of 4% and an apparent labour productivity of 0.7%.

The labour force grew by 1% in 1999, in line with the slight downwards trend in the total population aged 16 or older. We expect the traditional pro-cyclical effect of economic growth to strengthen in 2000, reflecting a decline in early retirements and larger numbers of women entering the labour market. Accordingly, the unemployment rate in terms of EPA is likely to fall to 14.2%, down 1.7 percentage points from 1999.

Graph 2.7

Labour force

Contribution to growth by age group
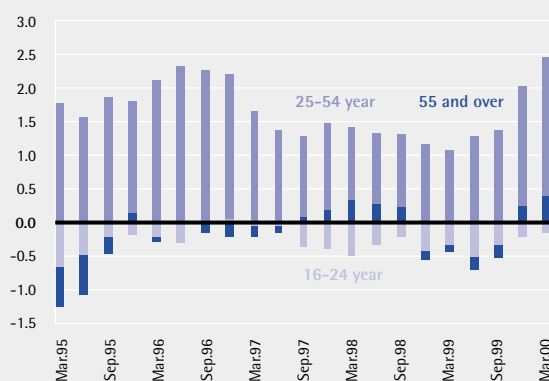
Source: INE and BBVA

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[4] The possible existence of an upward statistical bias in the 1999 data must be borne in mind. The sample period and, correspondingly, the number of census sections interviewed were expanded in the first quarter of 1999. Other changes included the increased use of telephone interviews, which, while not changing the definitions of the main variables, did change the question relating to some categories of people in employment.

The EPA labour survey loses time homogeneity

The aim of the EPA labour survey is to classify the population in terms of its relationship with activity (employment and unemployment). The universe of the survey is the set of all Spanish households, the most representative sections of the population Census (3,484 since 1Q99) being selected from the roughly 30,000 from the total. This sample is fixed, and only a sixth of the households interviewed in each section are replaced each quarter.

When a new Census becomes available, the National Statistic Institute (INE) revises the sample so that it continues to give an accurate representation of the structure of the population. The probability of each census section being chosen for the EPA is re-estimated. Those sections whose probability stays the same or increases relative to the previous sample enter the new sample, and those that have a lower probability drop out (probability increases with the number of households in the section)[1]. Sample re-adjustment means that it is impossible to undertake a homogeneous analysis of the behaviour of these variables over time. Representativeness and homogeneity are goals that are only attainable together if parallel surveys using the old and new samples are undertaken, thus disentangling the effect of census change from that of the behaviour of the variables itself. This was done in 1Q00, as the sample re-adjustment only affected 4.1% of the sections (143, or some 2,600 interviews), but it seems that this will not be the case in future[2].

The labour force participation rate is higher with the new sample than with the unadjusted one (51% and 50.7%, respectively), as, in the universe of the Spanish population at January 1, 1998 (from which the new sample is taken), the group aged 25-54 has a bigger share than in the 1991 Census on which the old sample is based[3]. At present, it is impossible to quantify this increase because the age structure of the total population is not yet available under the two EPA samples. An approximation can be gained from the estimate produced by INE in 1995, which calculated the age structure in 3Q95 on the basis of two sub-samples of roughly equal size that were obtained using the old and new sections. The result was that 39.61% of the population taken from the "new" sections (1991 Census) was aged between 25-54, whereas this figure dropped to 38.38% in the population of the "old" sections (1981 Census).

The table below displays the most noteworthy differences in the main EPA variables. Thus, the sample change increases the active population by 0.52%, most notably in the group aged 25-54 (0.86%) and in services (0.82%). Biases of virtually the same size are found in the employed population, meaning that unemployment has been only slightly affected by the sample change (0.03 percentage points). Another notable difference is the increase in salaried employees with permanent contracts (0.90%) and the decline in those with fixed-term contracts (0.18%).

Nonetheless, these changes in the levels of variables also lead to bias in growth rates. 77,500 of the quarterly increase of 171,500 payrolls seen in 1Q00 are the result of sample re-adjustment. Thus, after the census change, the annual rate of job growth is 5.25%, overstating the increase in employment by 0.6 percentage points, as the homogeneous sample shows an annual rate of job creation of 4.68%[4]. For a correct analysis of the annual rates of variation in the EPA in the coming quarters, the parallel survey for the old sections would have to be maintained, and this seems unlikely to happen. As a result, it will be impossible to analyze the behaviour of the variables, including, among others, the rate of job creation and productivity, and to evaluate the impact of economic policy on the labour market. Without a parallel EPA using the old sample or an "official" link for the series, the data will be prone to controversy and speculation.

[1] The last change of this kind took place between 1Q95 and 2Q96, during which time the sample resulting from the 1991 Census was gradually incorporated (85% different from the previous one).
[2] The INE intends to update the sample every two years using the information provided by the Permanent Census.
[3] The representation (number of houses, population) of newly urbanized urban sections has increased and that of "old" sections (as a rule urban centres) has decreased.
[4] Also playing a part was the positive impact on employment from Easter, which in 1999 fell in the first quarter of the year and in 2000 in the second quarter.

EPA 1Q00, selected differences

'000s and %	updated sample	% oya	unadjusted sample	% oya	% of levels	Absolute differences of rates
TOTAL ACTIVE POP.	16,723.1	2.8	16,637.1	2.3	0.5	0.5
Aged 25-54	12,477.0	3.7	12,370.3	2.8	0.9	0.9
Other ages	4,246.1	0.3	4,266.8	0.8	-0.5	-0.5
Services	9,736.6	5.2	9,657.3	4.3	0.8	0.9
Other activities	6,986.5	-0.3	6,979.8	-0.4	0.1	0.1
TOTAL EMPLOYED POP.	14,213.0	5.3	14,135.5	4.7	0.5	0.6
Men	8,937.6	3.8	8,896.9	3.3	0.5	0.5
Women	5,275.4	7.8	5,238.6	7.0	0.7	0.8
Aged 25-54	10,835.7	5.9	10,741.2	5.0	0.9	0.9
Other ages	3,377.3	3.3	3,394.3	3.8	-0.5	-0.5
Services	8,841.1	6.0	8,768.9	5.2	0.8	0.9
Other activities	5,371.9	4.0	5,366.6	3.9	0.1	0.1
Permanent employees	7,681.5	8.5	7,613.0	7.6	0.9	1.0
Fixed-term employees	3,563.3	4.1	3,569.6	4.3	-0.2	-0.2
Per memoriam						
Population aged 16+	32,785.6	0.4	32,785.6	0.4	0.0	0.0
Participation rate (%)	51.0	2.4	50.7	1.8	0.5	0.5
Employment rate (%)	43.4	4.8	43.1	4.2	0.5	0.6
Unemployment rate (%)	15.0	-11.6	15.0	-11.4	-0.2	-0.2

Source: INE and BBVA

Effect of sample updating on EPA employment

Change qoq ('000s) % change oya
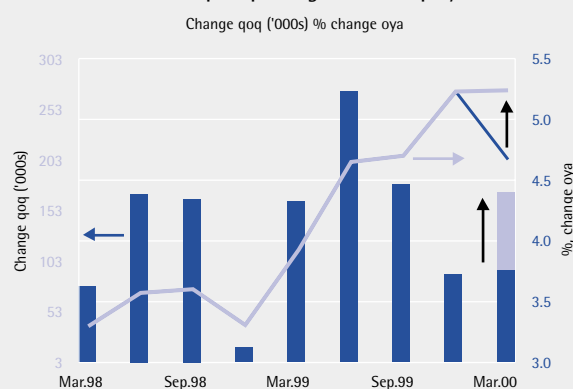
Note: the number of sections was increased from 3,216 to 3,484 in Q199 when the interview period was extended from 12 to 13 weeks.

Source: INE and BBVA

3. Prices and wages

Inflation concerns: not only oil and the euro are pushing up prices

The current inflation environment of the Spanish economy, measured as the rate of increase in CPI inflation, is giving cause for concern, both on account of the level of inflation (as well as the differential with other EMU countries) and the fact that the upward pressure on prices from a number of the factors that have generated this situation (demand pressure, rising non-energy costs, weak competition in goods and services markets) is unlikely to slacken in the short run.

The annual increase in inflation in May was 3.1%, the highest rate since December 1996, and 1.3 percentage points more than in February 1999 when the price of oil first began to turn upwards. However, the rise in fuel prices[1] cannot be held responsible for all of this increase, nor can the prospective decline in the price of oil and/or the appreciation of the euro be expected to provide a solution to the inflation problem confronting the Spanish economy. The rebound in inflation is centred in the least volatile and largest of the CPI components as a consequence of the inflationary pass-through of higher costs in a context in which relatively rigid supply is unable to fully meet demand.

In the light of these elements, we expect an annual rate of inflation at end-2000 of 2.9%, somewhat lower than
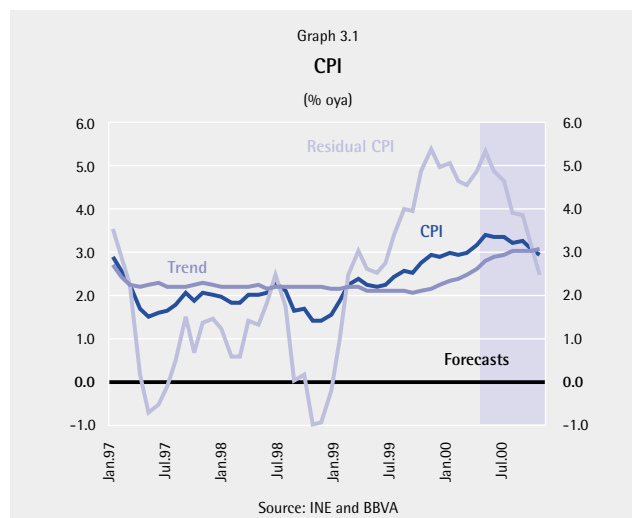
in May, but with a more unfavourable composition than at present. This is because the more stable components of the index (BBVA Trend CPI[2]) are expected to remain on the rising course initiated in October 1999, while the improvement (largely expected in the final quarter of the year) would be the result of favourable basis effects in oil prices.

The upside risks to these forecasts are associated with the energy components, though these could partly be compensated for by the behaviour of a number of food products. Here, it is worth highlighting the significant fall in prices in the heading for cooking oils and fats due to the decline in olive oil prices resulting from strong harvest expectations and the lack of a government

Graph 3.1

CPI

(% oya)

Source: INE and BBVA

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[1] The behaviour of the price of unleaded petrol, the relationship between retail prices and the world market price and its impact on CPI are analyzed in a box in this section.

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[2] This index strips out the most unstable components from overall CPI, which tend to bias estimations of inflationary pressures. In this case, fresh food, tobacco, cooking oils and fats, tourism services, telecommunications and education are removed. BBVA Trend CPI includes 75.8% of goods and services in the CPI.

Table 3.1. CPI. Data and forecasts

|	Overall CPI			Core			Residual CPI			Trend CPI		
	1999 oya	2000 monthly	oya	1999 oya	2000 monthly	oya	1999 oya	2000 monthly	oya	1999 oya	2000 monthly	oya
January	1.5	0.3	2.9	2.2	0.3	2.3	-0.2	0.0	4.9	2.1	0.4	2.2
February	1.8	0.1	3.0	2.3	0.2	2.2	1.0	-0.3	5.0	2.1	0.3	2.3
March	2.2	0.4	2.9	2.5	0.3	2.2	2.4	0.8	4.6	2.2	0.3	2.4
April	2.4	0.4	3.0	2.5	0.3	2.2	3.0	0.8	4.5	2.2	0.3	2.4
May	2.2	0.2	3.1	2.5	0.2	2.3	2.6	0.0	4.8	2.1	0.2	2.6
June	2.2	0.3	3.4	2.5	0.3	2.4	2.5	0.3	5.3	2.1	0.2	2.8
July	2.2	0.4	3.4	2.5	0.4	2.5	2.7	1.0	4.8	2.1	0.2	2.9
August	2.4	0.4	3.4	2.4	0.3	2.6	3.4	1.2	4.6	2.1	0.2	2.9
September	2.5	0.1	3.3	2.3	0.1	2.6	4.0	-0.5	3.9	2.1	0.2	3.0
October	2.5	0.0	3.3	2.3	0.0	2.6	3.9	-0.7	3.8	2.0	0.2	3.0
November	2.7	0.0	3.1	2.3	0.1	2.7	4.8	-0.7	3.2	2.1	0.2	3.0
December	2.9	0.3	2.9	2.4	0.2	2.7	5.4	0.7	2.5	2.1	0.2	3.1
Average-00	2.3	—	3.1	2.4	—	2.4	3.0	—	4.3	2.1	—	2.7
Average-01	—	—	2.7	—	—	2.9	—	—	1.5	—	—	3.1
December-01	—	—	2.8	—	—	3.0	—	—	1.9	—	—	3.1

Source: INE and BBVA

price-control mechanism. As for the upside risks, it should be noted that the scenarios assumed for the price of Brent crude oil and the euro may be regarded as being somewhat optimistic. Our end-year forecasts are based on a world market price for Brent of close to $24 a barrel and an appreciation of the euro exchange rate to $1/euro. A scenario of higher energy costs, whether via Brent or the exchange rate, would prompt an upward revision of our forecast for CPI inflation in December 2000. If the price of a barrel of Brent were only to fall to $28, inflation in December 2000 would probably be 2-3 tenths of a point higher than initially estimated.

Upside risks from wages and demand pressure

In this context, there are a number of risks to the current price scenario, such as the pass-through of factory-gate price pressures and the onset of an upward spiral in wages and consumer prices. The annual increase in producer prices is still trending upwards, though not only because of higher oil prices. While PPI inflation will probably be slower at end-2000 than at present (4.4% year-on-year in December 2000, compared with 5.7% in April), this will be the result of favourable basis effects in energy prices. Nonetheless, the rate of increase of producer prices for manufactured goods (the index that affects CPI inflation most directly) is speeding up, and reached a rate of 1.4% in April, 4 tenths of a point higher than end-1999 levels. The outlook for this component in the coming months is for faster price increases as a consequence of cost pressures (non-oil commodities and wages) in a context of continuing strong demand for such goods.

In spite of the increases registered, services price inflation has benefited from the favourable behaviour
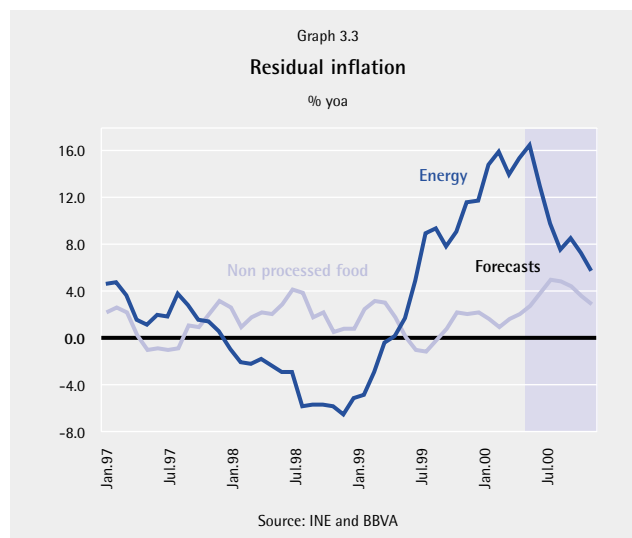
of telecommunications prices and a number of regulated prices (education). Stripping out these groups of products (and the tourism services heading because of its high variability) to get the *services trend CPI* shows that price increases have quickened pace. Faster price increases are the result of the low level of competition in service sectors (culture, bars and restaurants, commercial distribution, medicine, household services, house rents) compared with manufactured goods and rising demand for these products.

The high share of wages in the cost of services provision means that any risk of wage pressures is felt particularly strongly in this CPI component. In addition, the reference point for wage bargaining is overall CPI, which thus increases the danger of a wages-prices spiral. The latest collective bargaining data show that average wage settlements in the first four months of the year stood at 2.8%, practically the same as in 1999. Wage

Graph 3.3
Residual inflation
% yoa

Source: INE and BBVA

Graph 3.2
Trend inflation
% oya

Source: INE and BBVA

Graph 3.4
Wage indicators
% oya cumulative

Source: INE, Ministry of Labour and BBVA
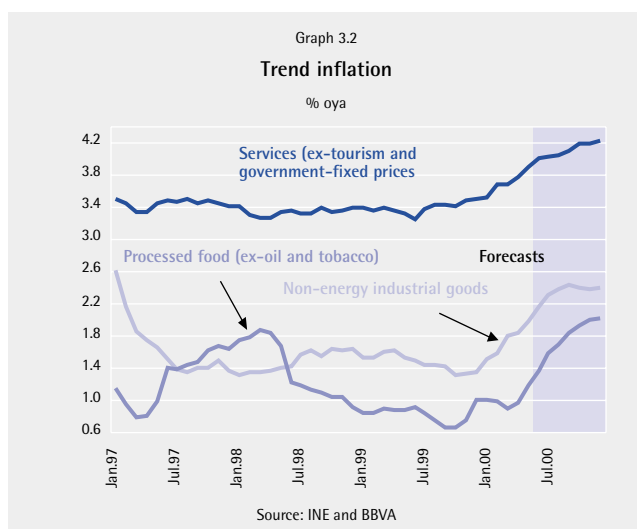
Are the recent increases in the price of petrol justified? Is there room for further increases?

The recent increases in fuel prices (petrol rose six times and diesel three times in May) and the scale of the rise since the beginning of the year (20 pesetas in super, 15 pesetas in unleaded petrol and 6 pesetas in diesel) have revived the debate about the lack of competition in the hydrocarbon sector. The concentration of 75% of the retail distribution market in only three operators and almost simultaneous increases in retail prices have drawn criticism from many circles and led to pressure being put on the government for an immediate: i) reduction in fuel taxes; ii) restoration of the policy of regulated maximum prices that was in force until 1998; and iii) introduction of measures to lower the transportation fees charged by CLH. However: i) bearing in mind that special taxes on fuels in Spain are among the lowest in the European Union, it is difficult to justify a cut in taxes, especially as this would run counter to the introduction of an environmental tax, and also because special taxes suffer least from tax evasion; ii) a policy of maximum prices would allow petrol companies to raise final prices even more (see graph); and iii) the cost of transporting a litre of petrol through the CLH oil pipelines in 1999 was 1.18 pesetas, barely 3% of the pre-tax sales price of unleaded petrol.

If the increase in fuel prices is indeed attributable to a lack of competition in the sector, instead of remedying the problem, the above measures would only serve to mask it, distorting the adjustment of relative prices. However, the debate on the role of competition in the determination of fuel prices conceals the impact derived from the behaviour of other factors that affect their final price (raw materials, exchange rate, distribution costs and retail margins – fixed between seven and eight pesetas for unleaded petrol).

Recent developments in these variables suggest that fuel prices would have increased regardless of the level of competition in the Spanish market. The price of oil in dollars has risen by 22% a barrel since the start of the year and the world market price of petrol is up by an average of 56.7% (in the Rotterdam and Geneva markets). In addition, the euro has depreciated (9.2% since the first week of January 2000), pushing up the cost of oil in domestic currency terms by 34.4% since the start of the year. The bulk of the increase was seen from the third week in April onwards (the world market price in pesetas of both oil and petrol has since risen by around 30%) after the transitory impact on oil prices of the agreement reached by the major oil-producing countries in Vienna in March had worn off. Nonetheless, it is important to assess whether these factors (higher Brent crude oil prices and euro depreciation) justify an increase in prices on the scale seen (12.1%, including taxes, between January 1 and May 27[1]), or whether the large petrol companies are taking advantage of their dominant market position to increase profits. If the increases are justified, and the effects of developments in Brent crude oil and the euro have yet to filter through completely, further increases in the price of petrol would be justified (and hence inflation would be affected).
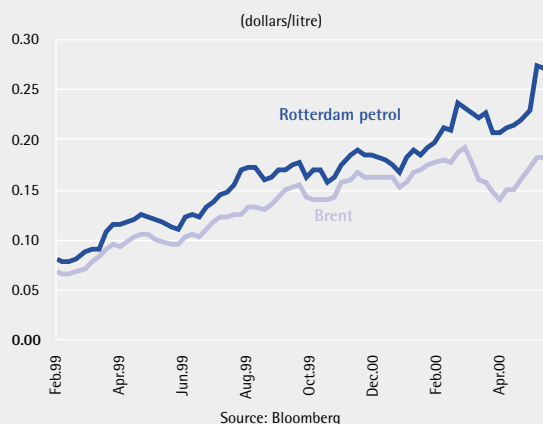
The increase in the world market price of petrol imposes higher costs on Spanish petrol companies. The oil industry comprises three stages, namely, extraction, refining and distribution, and companies do not necessarily operate in all three. In order to assess the behaviour of final prices, therefore, the benchmark price should be the world market price for petrol – the final product of refining activity – as companies can choose between distributing their own petrol or buying it on the world market (companies may even engage solely in distribution). Hence the importance of the world market price of petrol, as this price determines an operator's profit margin in the sale of petrol to the domestic market.

[1] The retail price of unleaded petrol is approximated by the data provided by REPSOL, the only operator to release weekly and historical data.

Unleaded petrol: maximum and retail prices (including taxes)

(Pesetas)

Source: Repsol and BBVA
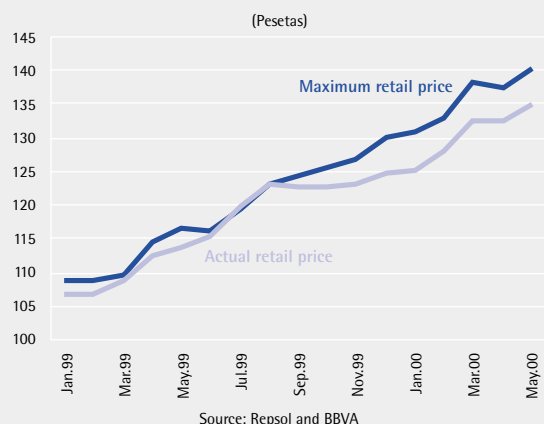
World market price of oil and unleaded petrol (excluding taxes)

(dollars/litre)

Source: Bloomberg

The world market price of petrol in pesetas has risen by 72.6% since the first week of 2000 (30.7% since the middle of April). Against this backdrop, an increase in the pre-tax price of fuels was inevitable unless petrol companies accepted considerably lower profit margins. As a result, the pre-tax price in pesetas of unleaded petrol has risen by 28.5% since the beginning of the year. However, whereas the euro has made a smaller contribution to the rise in petrol prices since mid-April onwards, the contribution of the world market price has continued to increase. The behaviour of the variables that have a bearing on the price of petrol therefore justifies the direction of the latest price movements, which, as the above data show, have yet to feed through completely into final prices.

In this context, the pertinent question is whether there is room for further increases. To answer this, we compare the behaviour of the price of unleaded petrol with its world market price (which does not include distribution costs). Given that petrol distribution costs in Spain represent a very small and fixed percentage (1.18 pesetas a litre) of the final price and that the commission charged by petrol stations is pre-established in the supply contracts (at around 7-8 pesetas), the evolution of retail prices should change in line with the cost of buying petrol on the world market. The graph below shows that the differential between bringing petrol to the domestic market and the cost of buying on the international market ("margins") has fallen considerably in recent weeks. The reason for this contraction is that whereas the price in pesetas of petrol on the international markets has risen by 30.7% since the middle of April, the price in Spain has only risen by 11.5%. The differential is seen to have narrowed even further if, instead of looking at the price rise of the past few weeks, we consider the cumulative increase since last summer: 95.2% and 39.6%, respectively.
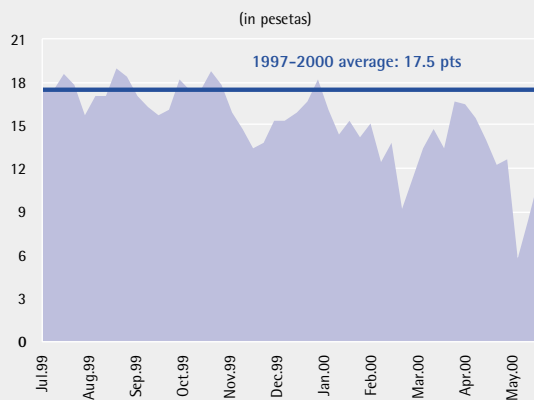
Between August 1999 and the early part of 2000, Spanish petrol companies were under pressure not to pass on the increases in the world market price of petrol to retail prices so as not to endanger compliance with the inflation target. The final price of unleaded petrol trended in line with the price marked by the old price-setting system up to August 1999 (see first graph). From then onwards, it has been considerably lower. The differential between the final price in Spain and the world market price of petrol averaged 9.5 pesetas in May, well below the average of 17.5 pesetas registered since 1997. If the price of crude oil remains at its current levels, a recovery in margins would therefore be enough to bring about further price increases.

How does the new petrol price scenario affect inflation?

The increase in fuel prices in May (around 2.7% on average on the month), and virtually stable average prices at around this level for the rest of the year, have prompted an upward revision of inflation forecasts for 2000. We have thus raised our inflation projection for this year to 3.1%, from the 2.7% previously predicted, mainly as a consequence of a 0.6-point contribution to inflation from the fuel CPI heading (0.8 points on average in the first four months of the year, and 0.4 points in the June-December period), instead of the 0.4 points initially forecast for the whole of the year.

There are nonetheless upside risks to this revision should crude oil prices be more negative than in our baseline scenario (Brent crude oil is expected to fall to $24 a barrel by end-2000), and the euro fail to strengthen (we assume an exchange rate of $1 to the euro by end-2000), or if petrol companies adopt a more aggressive pass-through of raw material costs to final prices than the one underlying the inflation forecast.

The debate on the increase in fuel prices thus needs to distinguish between two different aspects. On the one hand, there is clearly a need for a greater degree of competition in the sector. Yet, on the other hand, the recent increases in the price of petrol should not be put down to the degree of competition. In reality, they reflect the world market behaviour of oil and petrol, the impact of which has only partially fed through into final prices and with a time lag.

Differential between retail price (excluding taxes) and world market price of unleaded petrol

(in pesetas)

1997–2000 average: 17.5 pts

Source: Bloomberg and Repsol

| Impact of inflation			
	1999	2000	
		Current	Previous
Inflation	2.3	3.1	2.7
Average fuel price	113.2	131.4	123.4
Impact from fuel (p.p.)	0.2	0.6	0.4
Source: INE, Repsol and BBVA			

agreements in April show an average pay award of 3%, however, a reflection no doubt of a worsening of agents' expectations for inflation in the course of 2000. If this prospect is realized, the negative inflation surprise seen in the past few years could change sign in 2000 and fuel an upward price spiral in Spain.

In this sense, in an EMU setting, the price outlook for the monetary area, rather than that for the Spanish "regional" economy, should be considered as the benchmark for wage bargaining, particularly as competitiveness versus the other EMU members depends entirely on the inflation differential. Spanish competitiveness can be decomposed into two parts, that of Spain with EMU and that of EMU with the rest of the

world. In 1999 and 2000, the inflation differential is leading to a loss of competitiveness of the Spanish economy within EMU, which is being offset by the gain in competitiveness of EMU vis-à-vis the rest of the world due to the depreciation of the euro. However, the euro is expected to appreciate towards the end of the year and in 2001, which would lead to a loss of competitiveness of EMU with the rest of the world. This scenario is particularly alarming in that Spain would lose competitiveness on two fronts, internally within EMU and versus the rest of the world. This risk further underscores the need for increased flexibility in product and factor markets so that the Spanish economy can grow at faster rates without inflationary pressures emerging.
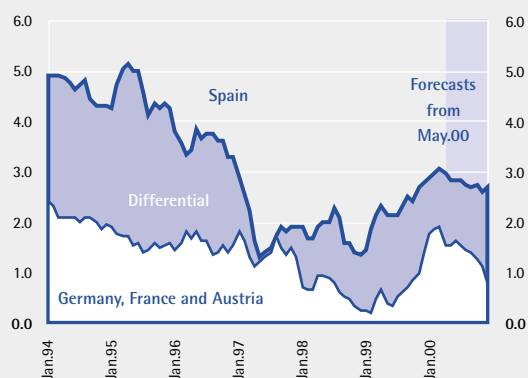
Graph 3.5

Competitiveness (REER)

(1980 = 100)
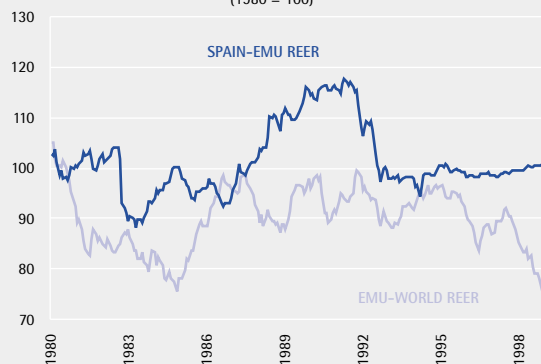
Note: A rise in the index implies a loss of competitiveness

Source: Bank of Spain and BBVA

Graph 3.6

HICP differential for Spain with Germany, France and Austria

Source: Eurostat and BBVA

4. The Public Sector

The strong economic performance is facilitating compliance with the State Budget

During the first four months of 2000, there was a central government budget surplus of 42.3 billion pesetas in cash balance terms, compared with a deficit of 41.2 billion in the same period of the previous year. However, this figure can clearly be put down to a drop in interest payments in the early part of the year, as the primary surplus has shrank by 10% (192.7 billion pesetas) since January.

Non-financial revenue rose by 2.5% over this period. Indirect taxes made a significant contribution, both VAT revenue (up by 15.9%), which received a boost from the rise in petrol prices, and special taxes – there was a 20.4% increase in revenue from the Specific Means of Transport tax (car registration) as a result of higher vehicle sales in the first quarter of the year. The strength of economic activity should allow effective end-year revenue from these taxes to come in above budget.

Direct taxes are recording weaker-than-expected growth (0.3%), reflecting the effect of the changes in personal income tax (not applied until February, 1999). Revenue figures are still not final, however, as tax collection has yet to start.

Non-financial spending rose by 1.3%, instead of the 2.1% increase budgeted. It is worth noting the behaviour of spending on goods and services, which is well above budget, and on wages and salaries, which shows a fall of 6% due to the transfer of responsibility for education to some autonomous regions. To date, the expenditure headings that are considerably lower are public investment and financial spending (down by 14%), the latter as a result of the phasing of debt interest payments. When interest payments are excluded, current expenditure rose at a rate of 8.2% in the first four months of the year, instead of 4.7% as budgeted.

Overall, non-financial spending could be somewhat higher than budgeted, though higher revenue means that compliance with the budget should be comfortably assured. The strong cash balance performance may make it possible, as in previous years, to undertake debt exchange operations, possibly up to a maximum value of 150 billion pesetas.

Reflecting the revenue performance, the central government has secured a financing capacity of 742.1 billion pesetas in the first four months of the year, in contrast to a borrowing requirement of 153.6 billion pesetas in the same period of 1999. These figures are not directly comparable, however, as funds deposited in the Bank of Spain have been used in 2000, whereas in 1999 these funds were increased. After correcting for this effect, borrowing would have fallen by only 219 billion pesetas.

The sustained strong performance of the economy, which is conducive to revenue overshooting, has made it possible to attain a surplus in National Accounts terms equivalent to 1.1% of GDP in the four months to April. This has enabled the government to revise down its general government deficit target to 0.4% of GDP, instead of 0.8% as forecast. An even more ambitious target should have been set, however, and the reduction secured through spending cuts, rather than simply through higher cyclical receipts.
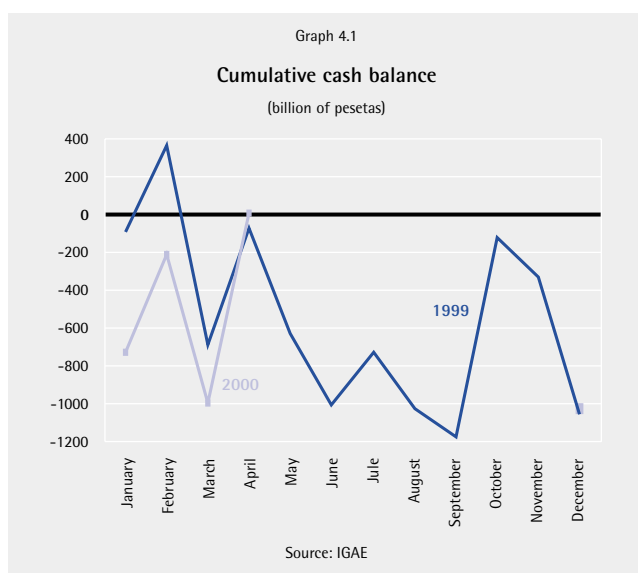

Graph 4.1

Cumulative cash balance

(billion of pesetas)

Source: IGAE

Table 4.1. Budget outturn to April and State Budget target

(% oya)

% oya	To April	2000 Budget/ 1999 outturn
Direct taxes	0.3	2.4
Income tax	0.6	1.0
Corporate tax	-3.8	5.1
Indirect taxes	13.6	7.6
VAT	15.9	10.6
Special taxes	7.6	2.5
Total non-financial revenue	**2.5**	**2.1**
Wages and salaries	-6.0	-3.1
Goods and services	-0.8	-22.0
Interest payments	-14.0	-11.7
Current transfers	12.1	7.9
Total current operations	**1.5**	**1.7**
Investment	-8.0	5.7
Capital transfers	14.0	-0.4
Total capital operations	**-0.1**	**2.5**
Total non-financial expenditure	**1.3**	**1.8**
Source: IGAE, MH and BBVA		

The Spanish economic "miracle": a macro perspective

Manuel Balmaseda[1] , Miguel Sebastian[1] and Patry Tello[1]

1. Introduction

The rapid growth registered by Spain's economy in the second half of the 1990s has prompted a number of analysts to rather hastily claim that, like the United States, Spain is benefiting from a technological shock, and that this should ensure that the current expansion continues without inflationary pressures emerging.

This technological shock, which lies at the root of the "New Economy", is increasing total factor productivity, and hence potential GDP growth. However, a first analysis of the factors contributing to the current cyclical expansion of the Spanish economy suggests that rather than the result of a technological shock, the expansion is the consequence of a combination of transitory shocks, and that, as these unwind, the current pace of economic activity could slow.

This paper is set out as follows. First of all, we review the key features of the current economic expansion. Secondly, we identify the shocks that are affecting the Spanish economy and determine the dominant ones in the current expansion. And finally, we map out what the priorities of economic policy should be.

2. The current economic expansion: key features

In the past twenty years, Spain's economy has experienced four economic expansions (see Graph 1)[2]: 1976-1977, 1981-1983, 1987-1991 and 1995-1999[3]. In order to identify the key features of the current cyclical upswing, we must examine the intensity of growth and the cyclical alignment with other areas, the pattern of growth (domestic demand versus net external demand) and the size of the disequilibria accumulated (inflation, external deficit and fiscal deficit).

Given that the degree of openness of the Spanish

economy was very low until Spain entered the EEC in 1986, it is only meaningful to compare the last two economic expansions.

Table 1 compares the performance of the main economic variables during both periods. The data reveal that the current economic expansion: i) is weaker and longer-lasting than the previous one; ii) exhibits a lower degree of synchronization with the EMU cycle (the
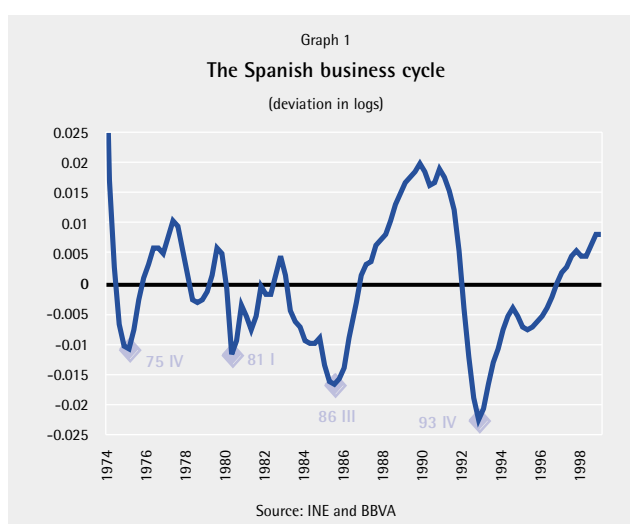

Graph 1

The Spanish business cycle

(deviation in logs)

Source: INE and BBVA

Table 1. Main macroeconomic data

(% oya)	1995–1999	1987–1991
GDP growth	3.2	4.3
Growth differential with EMU	1.0	0.6
Alignment with EMU (correlation)	0.2	0.8
Domestic demand	3.5	6.1
Net trade [1]	–0.3	–1.9
Inflation (CPI)	2.9	5.9
Inflation differential (3-best EMU)	1.9	4.2
Real wages	–0.2	2.0
Employment (National Accounts)	2.5	3.2
Productivity	0.7	1.1
(% of GDP)		
Trade balance	–4.1	–6.2
Current account balance [2]	0.8	–2.1
Public deficit	–3.7	–3.9
Public debt	66	43

[1] Contribution to GDP. [2] Includes capital transfers.

Source: INE, Ministry of Economics, Customs, Eurostat and BBVA.

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[1] BBVA Research Department.
[2] An economic expansion begins in the next quarter after the one in which the business cycle, obtained by applying the Hodrick-Prescott filter to GDP, reaches a low point and ends when it begins to fall.
[3] Although the current economic expansion actually started in 1994, it is taken to start in 1995 in order not to distort the comparison between different periods of expansion. The reason is that after the deep recession in 1992-1993, the starting point of the current expansion is much lower than in the previous one: GDP grew by 3.2% in 1996, measured by the ESA 79, and fell by 1.2% in 1993. The information available for economic indicators up to May 2000 suggests that the expansion will continue during this year.

correlation coefficients are 0.2 and 0.8, respectively); iii) is characterized by more moderate growth in domestic demand (consumption and investment) and a smaller external drag (largely because of stronger momentum in exports); iv) shows a moderate rate of increase in prices, though there is still a positive inflation differential with EMU; v) is without wage pressures as a result of lower "wage aggressiveness"; vi) continues to register very modest productivity growth; and vii) exhibits a smaller external imbalance. Macroeconomic imbalances, though smaller, therefore continue to exist.

The combination of macroeconomic policies applied in both expansions was inappropriate. During the 1987-1991 economic expansion, fiscal policy was pro-cyclical, and so monetary policy needed to be very restrictive to correct the disequilibria that were accumulating. The outcome was a particularly deep recession. In contrast to what occurred then, the present monetary policy of the ECB is proving too expansionary for the Spanish economy, which is at a more advanced stage of the cycle than EMU. Fiscal policy is not restrictive enough to offset this situation, meaning that the policy-mix is excessively loose for the economy. Indeed, the fiscal deficit is on average only two tenths of a point below the level reached in the previous economic upturn, though it rose in 1987-1991 and fell in 1995-1999, and public debt is 22.5 percentage points higher in terms of GDP.

### 3. What is behind the Spanish economic miracle?

This look at the key features of the current economic expansion reveals significant differences with respect to other expansions. The more moderate and longer-lasting nature of the current cyclical upswing, together with the slower rate of increase of prices, seems to support the idea that, in addition to demand factors, supply-side

factors may be working to increase potential GDP growth. Is Spain benefiting from a technological shock similar to the one that is increasing productivity in the United States? In other words, what are the support variables for growth in Spain?.

The Spanish economy has been exposed to both demand and supply shocks over the past decade. Identifying these shocks will enable us to ascertain which of them are driving economic growth. As regards demand shocks, two positive shocks are discernible – a monetary one and a more recent fiscal shock – the combination of which have brought about a policy-mix that is very expansionary for Spain.

The gradual reduction in real interest rates as a result of interest-rate convergence in the economies that would form EMU (from 7.1% in 1993 to 0.6% on average in 1999), and the steady depreciation of the peseta, initially because of devaluations within the EMS and later Euro weakness against the dollar (in 1999, the REER was 16.1% below its average value in 1992), have paved the way for a significant decline in the Monetary Restriction Index (MRI)[4] since 1993. Indeed, the levels reached in 1999 were the lowest in the past twenty years. The MRI is expected to continue to fall in 2000, as the rebound expected in real interest rates (too small for Spain[5]) will likely be more than offset by the average depreciation of the Euro against the dollar (around 10%). The Spanish economy is therefore underpinned by a substantial positive monetary shock. In addition, the significant process of fiscal consolidation undertaken in 1996 and 1997 has stalled in the past few years. After advancing from a primary deficit equivalent to 0.9% of GDP in 1995 to a surplus of 1.6% of GDP in 1997[6], there has since only been an improvement of 0.1 of a point (1.7% of GDP in 1999). The 1999 reform of personal income tax (IRPF), which has led to a substantial increase in households' disposable income, shows that fiscal policy has not been

Graph 2
**Monetary Restriction Index**
(1990=100)

Source: BBVA
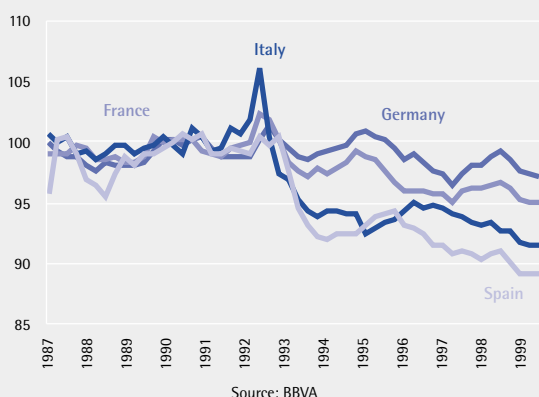
[4] The Monetary Restriction Index (MRI) is calculated as a weighted average of the real effective exchange rate (REER), according to the degree of openness of the Spanish economy, and the real interest rate.
[5] The ECB interest rate at the middle of June was 4.25%, whereas a modified Taylor rule was suggesting a recommended interest rate for Spain of above 6%.
[6] These estimates are based on the first deficit data in terms of the ESA 95 released by the European Commission.
[7] The policy-mix is the result of the combination of demand policies applied at any given time: monetary policy (MP) and fiscal policy (FP). FP is considered to be expansionary when the structural deficit exceeds that required for compliance with the Stability and Growth Pact (1.5% of GDP in the case of Spain) in the event of a recession. In the same way, MP is considered to be expansionary when the actual real interest rate is less than 2.5% (the real equilibrium interest rate of the Spanish economy is around this value). These limits make it possible to divide the graph into four quadrants: i) I restrictive MP and FP; ii) II restrictive MP and expansionary FP; iii) III expansionary MP and restrictive FP; and iv) IV expansionary MP and FP. Each year appears in the quadrant that reflects the policy stance instrumented.
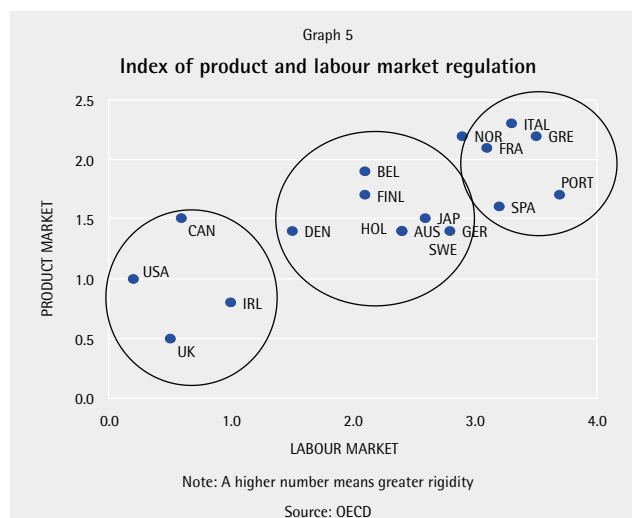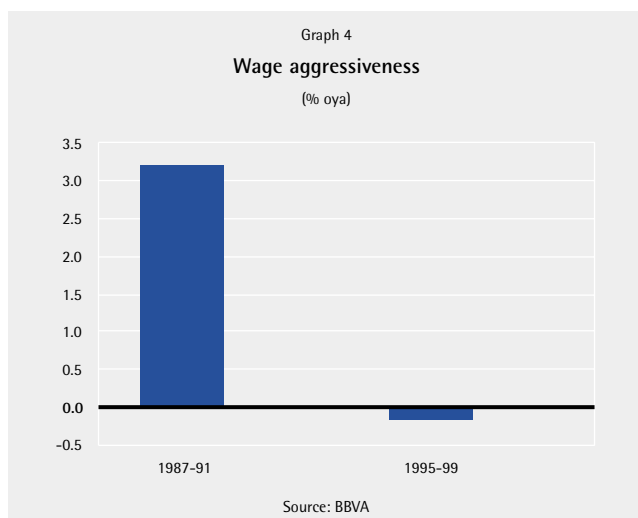
Graph 3
Policy-mix

Source: BBVA
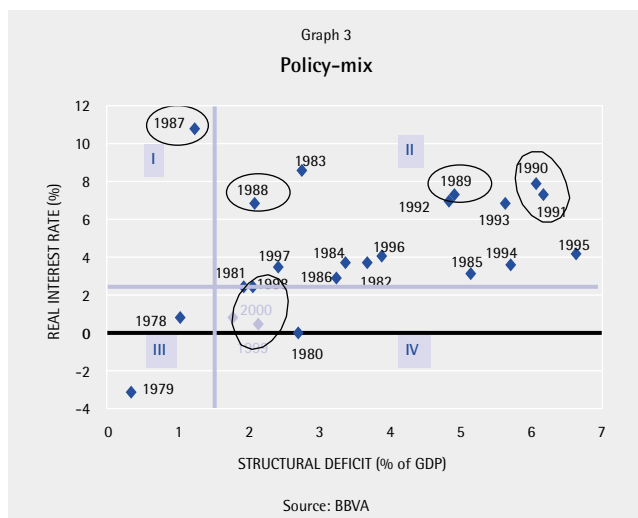
restrictive enough (counter-cyclical) to counterbalance the expansionary monetary policy stance[7]. As shown in Graph 3, the policy-mix in recent years is not orthodox (expansionary monetary and fiscal policy).

Turning to supply shocks, we shall make a distinction between "permanent" shocks, which affect potential GDP growth, and "transitory" shocks, with no such effect. The two transitory shocks that can be identified are the favourable behaviour of commodity prices (imported deflation) and wage moderation. Commodity prices, measured in terms of the CRB index, registered a fall of 6.4% on average over the period 1995-1999. In fact, the price of oil and a number of other commodities (base metals and agricultural products) only began to turn upwards in the latter part of 1999. Unlike events in the previous economic expansion, wages have not been a factor exerting pressure on costs, and hence on firms' competitiveness. Wage moderation has enabled the positive real wage-productivity gap to continue in spite of only meagre

gains in productivity. Modest wage growth reflects a change of attitude in the behaviour of trade unions. In support of this claim, we have defined wage "aggressiveness" as the increase in real wages not attributable to inflation "surprises" (the difference each year between the inflation forecast contained in the State Budget and actual inflation); that is, the part of wage growth that is attributable to workers' wage demands above (high aggressiveness) or below (low aggressiveness) actual inflation. The behaviour of the "wage-aggressiveness" element has differed markedly in the last two expansions (see Graph 4). Thus, whereas real wage growth in the first expansion is entirely accounted for by "wage aggressiveness", in the 1995-1999 period, real wages would have fallen further had it not been for positive inflation "surprises" (actual inflation was lower than forecast). The past few years have thus been marked not only by wage moderation, but also by a lower "wage aggressiveness". In 1999, however, something of a resurgence in this element was evident, which offset the negative impact of an inflation surprise and made room for a small gain in purchasing power. One of the key shocks in the current economic expansion therefore seems to be wearing off.

As regards the permanent supply shocks, we will look at two possible shocks, one linked to structural reforms, the other associated with technological progress. The product and labour markets are markedly rigid in Spain. In addition, the difficulties encountered in maintaining the welfare state given prospective demographic developments mean that wide-ranging structural reforms must be put in place. The reform programme undertaken to date falls short of what is required to ensure that the Spanish economy maintains its strong performance. Measures have affected both the goods and services markets (telecommunications-

Graph 4
Wage aggressiveness
(% oya)

Source: BBVA

Graph 5
Index of product and labour market regulation

Note: A higher number means greater rigidity

Source: OECD

1997, the power sector-1997, gas-1996 and fuel-1996/ 1998) and the labour market (1994 and 1997), as well as the sustainability of the welfare state (the Toledo Pact-1995, the Law on the Consolidation and Rationalization of the Social Security System-1997 and Savings tax-1999). Graph 5 shows that the degree of liberalization is very low in most European countries, especially in the countries of Southern Europe.

Turning to the technological shock, this shows up first in an increase in investment – required for the introduction and diffusion of the new technologies – and subsequently in higher productivity as a result of enhanced productive processes (changes in the way firms are organized, the appearance of new products, the increased share of qualified human capital) and a more efficient functioning of the labour market (a decline in the rate of structural unemployment). A comparison of the behaviour of investment in Spain and in the United States, where a technological shock does seem to be having a beneficial impact, shows that investment growth in Spain is not only slower than in the United States, but also weaker than in the previous economic expansion. With investment growth weak in a context of low real interest rates and buoyant private consumption, it seems unlikely that investment is at the level required for a shift in the productive process to take place.

The behaviour of productivity, in turn, has also been widely differing in Spain and the United States. Productivity growth in Spain also seems to lend no support to the hypothesis of a technological shock. Indeed, productivity has been growing more slowly in the current economic expansion than in the 1987-1991 period. Conversely, in the United States productivity gains are outstripping those of previous

years. The Spanish economy can therefore not be said to be benefiting from a technological shock.

From the foregoing analysis, it can be concluded that in recent years Spanish economic growth has benefited from a combination of transitory supply shocks (falling commodity prices and wage moderation) and demand shocks (an expansionary policy-mix). However, there is no evidence that a technological or permanent supply shock is taking place.

Another way to determine whether the fluctuations in Spain's economy are the result of permanent technological shocks or of transitory supply and demand shocks is to decompose the variations in GDP using a structural vector autoregression (VAR) such as that of Blanchard and Quah (1989)[8]. The identification criterion used to decompose the fluctuations consists in imposing the restriction that transitory shocks have no long-run impact on output.

The VAR model was estimated using quarterly GDP growth data and the unemployment rate (EPA labour survey) for the period 1978:1-1999:4[9]. The results are shown in Graph 8. This graph portrays the cumulative variations in GDP since 1980, distinguishing between variations attributable to transitory shocks (supply and demand) and those deriving from a permanent supply shock (technological shock). The expansion at the end of the 1980s got under way with a combination of

[8] See Blanchard, O. and D. Quah (1989): "The dynamics effects of aggregate demand and supply disturbances", *American Economic Review*, vol. 79, No. 4, pp. 655-673.
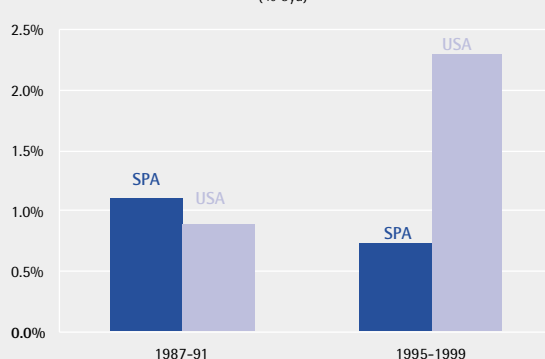[9] Various trends were included in order to capture the non-stationarity of the unemployment rate.

Graph 6
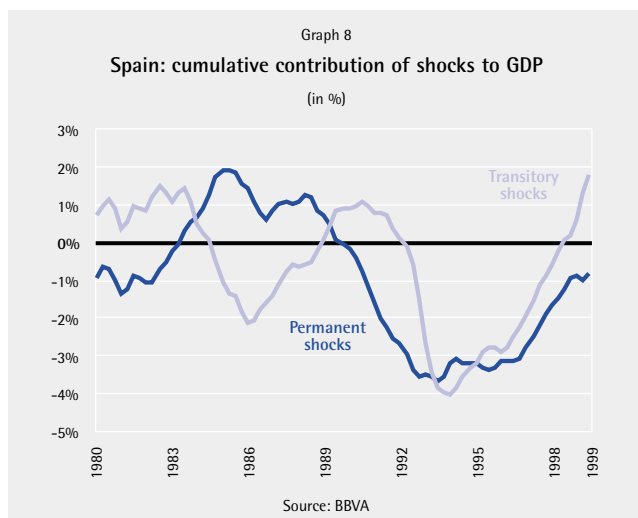**Investment growth in Spain and the United States**
(% oya)
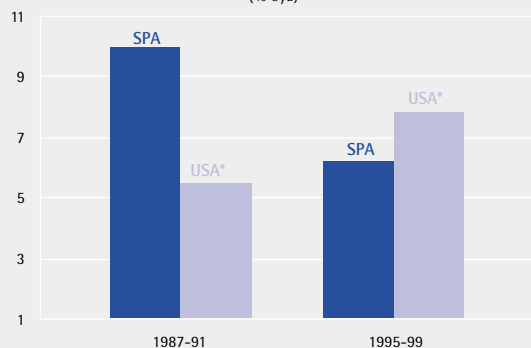
Note: US data refer to US expansion
Source: INE, Bank of Spain and OECD

Graph 7
Productivity growth in Spain and the United States
(% oya)

Source: INE, Bank of Spain and U.S. Labour Department

Graph 8

Spain: cumulative contribution of shocks to GDP

(in %)

Source: BBVA

positive transitory demand and supply shocks (the decline in oil prices in 1986) and positive permanent shocks (EEC entry). Nonetheless, as the cycle matured, the transitory shocks strengthened and the permanent shocks unwound. Likewise, it can be seen that the economic downturn at the start of the 1990s was first the result of a permanent supply shock and subsequently, more intensely, of a decline in demand. In the current economic expansion, it is the transitory disturbances that account for the strength of output growth, as, in spite of having risen over the past three years, the cumulative contribution of the permanent shocks is still slightly negative. As noted above, the modest gain in productivity is a clear sign that the Spanish economy is not benefiting from a technological shock. Meanwhile, the continued inflation differential with EMU and growing trade and current account deficits are two signs of excess aggregate demand.

Graph 9

United States: cumulative contribution of shocks to GDP

(in %)

Source: BBVA
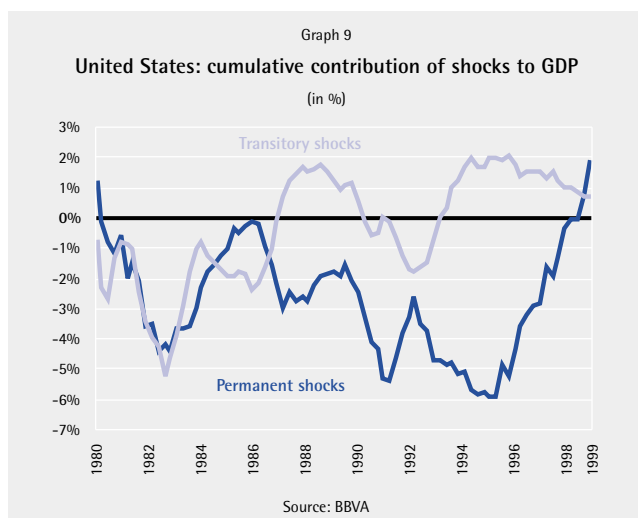
Using the same VAR methodology to analyze the fluctuations in the U.S. economy shows that transitory shocks were dominant in the early stages of the current economic expansion. Nonetheless, since 1996, the technological shock has been providing a very positive stimulus to growth, and it is this shock that is shaping the current cyclical expansion. As a result, it cannot be concluded that the Spanish and U.S. economies are in comparable situations.

Having analyzed the various shocks that have affected the Spanish economy, establishing that the current expansion is the result of transitory shocks, we can attempt to draw up a ranking of these shocks in terms of their contribution to the fluctuations in the economy. Table 2 displays the results of this exercise. The keys to the current economic expansion prove to be the expansionary policy-mix and wage moderation, followed by the favourable commodity shock and, finally, permanent supply shocks, notably the technological shock (the new economy). The recent development of these factors suggests that only one of them, the policy-mix, is likely to remain as a clear growth engine in 2000. In contrast, the upturn in commodity prices confirms that their contribution to growth will no longer be positive. As for the other shocks considered, the increase in "wage aggressiveness" in the course of 1999 and the slow pace of reform (liberalization of product and labour markets), along with the investments needed to capitalize on the benefits of the new economy, suggest that they will not be the engines of growth. However, given that the technological shock unfolding

Table 2. Ranking by contribution to growth		
	1995–1999	**2000**
Demand shocks		
Policy-mix	1–2	+
Supply shocks		
"Transitory"		
Wages	1–2	?
Commodities	3	–
"Permanent"		
Structural reforms	4	+ ?
"New economy"	5	+ ?

Source: INE, Ministry of Economics, Eurostat and BBVA.

in the United States will eventually pass into the European economy, the size of the impact on long-run growth will depend upon the economy's capacity to embrace the new technologies.

4. Economic policy options

The current economic expansion is dominated by transitory demand and supply shocks, not by an increase in potential growth due to technological change. This casts doubt on the duration of the current expansion. Consequently, economic policy should give priority to a two-pronged approach: i) macroeconomic policies aimed at assuring a stable, sustainable rate of growth in order to be able to respond to demographic challenges (immigration policy and reform of the state pension system); and ii) microeconomic policies geared to attaining a more efficient functioning of the goods and services and labour markets (structural reforms and investment in R+D and human capital), thereby providing scope for higher productivity growth.

With regard to macroeconomic policies, the expansionary nature of monetary policy needs to be counterbalanced by counter-cyclical fiscal policy. This would require the attainment of a fiscal surplus in 2000 in order to bring the structural deficit down to around the equivalent of 1% of GDP from its current level of close to 2%.

As regards microeconomic policies, if full advantage is to be taken from the new technologies, there is a need for, on the one hand, significant investment (modernization of computer systems, business start-ups) and an adequate supply of human capital (higher immigration and reform of the education system), and, on the other, greater market flexibility (liberalization, promotion of venture capital).

5. Conclusions

The Spanish economy has benefited in recent years from a combination of positive transitory shocks. This casts doubt over, first, the sustainability of the current economic expansion, and, second, whether the measures needed to benefit from the new technological shock driving the U.S. economy are being taken.

Spain now has a unique opportunity to push through structural reforms to boost economic activity and raise potential growth. The adoption of economic policies aimed at adapting the Spanish economy's productive structure (physical and human capital) to the new era should be the primary goal in the current parliament's agenda.

Table: Spain: main economic indicators

(% change oya, unless otherwise stated)

	1999	2000	March	April	May	Latest figure	One year ago	Trend
Industrial production (calendar-adjusted)	2.6	5.8	7.6	4.9		4.9	0.9	-
Business confidence index (net balance)	-2.1	2.3	6.3	2.0		2.0	-3.0	-
CU (3)	79.9	80.5	80.5			80.5	79.3	-
Electricity consumption (4)	5.8	7.9	7.6	7.6	6.1	6.1	6.3	=
Cement consumption	11.7	9.5	13.1	-5.4	13.5	13.5	18.0	-
Car sales	18.1	7.3	-0.5	10.0	3.5	3.5	24.1	-
Consumer confidence index (2)	7.8	9.4	11.0	10.0	8.0	8.0	6.0	=
CPI (overal)	2.3	3.0	2.9	3.0	3.1	3.1	2.2	+
Producer prices	0.7	5.3	5.7	5.7		5.7	-0.8	+
Wages pacts (5)	2.7	2.8	2.8	2.8		2.8	2.7	+
Liquid financial assets (households and NPISH)	3.6	3.6	1.4	2.8		2.8	-0.1	-
Domestic private sector credit	19.0	19.8	20.3	21.5		21.5	16.5	+
Social security registrations	5.5	5.3	5.6	5.4	5.0	5.0	5.7	-
Registered unemployment (6)	-237.9	-126.7	-128.6	-129.1	-117.9	-117.9	-253.0	-
Unemployment rate (3)	15.8	15.0	15.0			15.0	17.0	-
Employment (quarterly) (3)(6)	612.6	709.6	709.6			709.6	511.8	-
Current account balance (7)	-12,042.5	-3,473.3	-2,134.5			-2,134.5	-465.0	-
Trade balance (7)	-27,547.0	-7,452.2	-2,863.5			-2,863.5	-1968.0	-
Cash balance (8)	-1,057.3	42.3	-1000.1	42.3		42.3	-41.2	+

(1) Available to date. (2) Balance of responses in %. (3) Quarterly data (for quarter ending in month specified.
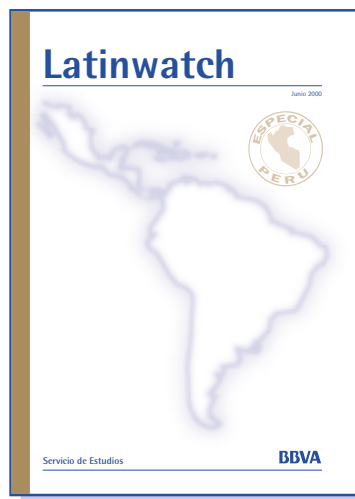(4) Corrected for basis effects and temperature. (5) Cummulative over the period. (6) Annual change in '000s. (7) Balance in millions of euros.
(8) Cummulative over the period, billions of pesetas.

International Context: Summary of Forecasts

Real GDP (%)

	1998	1999	2000	2001
US	4.3	4.2	4.5	2.8
EMU	2.8	2.4	3.5	2.9
Japan	-2.8	0.3	0.9	1.4

Consumer prices (%, end year)

	1998	1999	2000	2001
US	1.6	2.2	2.9	2.2
EMU	0.8	1.1	1.9	1.6
Japan	0.8	-0.3	-0.6	-0.1

Fiscal balance (% GDP)

	1998	1999	2000	2001
US	0.8	1.4	1.8	1.9
EMU	-2.0	-1.2	-0.9	-0.8
Japan	-4.6	-9.0	-8.9	-7.9

Current account balance (% GDP)

	1998	1999	2000	2001
US	-2.5	-3.8	-4.0	-4.1
EMU	1.2	0.5	0.4	0.6
Japan	3.2	2.5	2.6	2.6

Official interest rate (%)

	June	Sep-00	Dec-00	Jun-01
US	6.50	7.00	7.00	6.75
EMU	4.25	4.25	4.50	4.75
Japan	0.50	0.50	0.75	0.75

Exchange rate (vs $)

	June	Sep-00	Dec-00	Jun-01
US				
EMU	0.96	0.92	1.00	1.04
Japan	107	110	108	105

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