Spain in the Globalization Process

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This paper is in two parts. In Part I, I present the history of the successful Trade Integration of the Spanish Economy. In Part II, I explain the Financial and Monetary aspects of the insertion of the Spanish Economy in the World Economy, with special emphasis in the Spanish accession to the Euro.

I. Trade Integration

Spain is a clear case of economic success. This has been frequently attributed to the benefits from its membership into the European Union and the Euro, but to a large extent it all began a long time ago, in the late 50s, when Spain began to take advantage of all the benefits of commercial and financial integration that today we sometimes call the process of globalization.

The key year was 1959 in which it was implemented an orthodox Stabilization and Reform Plan under the auspices of the IMF. Before that year, and for more than two decades, the successive General Franco’s governments had developed an economic policy based on autarchy and import substitution. These autarchic policies were a failure, with inflation problems and with a stagnant economy, in which the level of per capita income that had prevailed in 1935 was not achieved until 1952, with foreign trade staying at one third of the level registered in 1931.

The situation deteriorated dramatically in 1959, when Spain was practically bankrupt and could not make any payment in foreign currency, even for the most necessary food imports.

Following De la Dehesa (1991) the growth of the Spanish economy in recent history has been largely made possible through four major episodes of trade and economic liberalization, that set the productive forces of the Spanish economy free from regulation and intervention and exposed domestic production to foreign competition.

These four episodes were the 1959-1966 episode initiated with the 1959 stabilization plan; the 1970-1975 episode that started with the 1970 Spain-EEC preferential agreement; the 1977-1980 episode that originated with the beginning of political democracy in Spain; and, finally, the 1986 to the present episode that was born with Spain’s accession to the EU.


The Stabilization Plan approved in July 1959 contained very important decisions regarding the external sector of the Spanish economy. First, a devaluation was accomplished, setting the exchange rate at 60 pesetas per US Dollar. Second, a system of uniform exchange rates was introduced, and practices giving rise to multiple exchange rates were abolished.

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1 For a very concise and complete history of Spain’s Economic Development from 1939 to 1992, see Spitaller and Galy (1992).

2 Even the fees to join the World bank and the IMF in 1959 had to be paid through a loan obtained by Spain from the Manufacturers Hanover Trust, a bank in New York. See De la Dehesa (1991).
Moreover, Spain agreed to liberalize very rapidly at least 50 percent of its imports with convertible currency countries, a new tariff structure became effective on June 1960 and a new foreign investment law was passed, providing more facilities and incentives to attract foreign capital.

The openness of the Spanish economy went up from 15.0% in 1959 to 20.2% in 1966, by more than five points.

The Second Liberalization Episode, 1970-1975

On June 29, 1970, and after very difficult negotiations with the EEC, Spain finally signed a preferential agreement with the EEC that became effective on October 1. In the meantime, around 1966 the expansionary cycle that started in 1960 began to lose momentum, inflation was rising and Spain had again balance of payments deficits (in spite of important surpluses in services) that forced the government to implement a new economic program in November 1967 that included a devaluation of the peseta by 16.7 percent.

The EEC agreement included the easing of quantitative restrictions (to have in 1976 only 5 percent of Spanish imports from the EEC under quota restrictions) and the reduction of tariffs, in such a way that at least 60 per cent of Spanish imports from the EEC were affected by tariff cuts. From the side of the EEC, a substantial tariff reduction of 60% for Spain’s industrial exports was agreed.

The openness index went up from 27.4% in 1970 to 30.8% in 1975 (an increase of 3.4 points).

The Third Liberalization Episode, 1977-1980

Again, the main measures adopted during this third episode were further tariff cuts and further easing of the quantitative restrictions system, while two international commitments helped to foster trade liberalization. On June 1979, Spain signed a trade agreement with the EFTA, the European Free Trade Association and, on the other front, on July 1980 after the end of the Tokyo Round of the GATT negotiations, the government approved a new tariff reductions that were to be extended to the GATT members.

The openness of the economy went up from 30.9% in 1977 to 33.8% in 1980 (a further increase of almost 3 points).

The Fourth Liberalization Episode, Spain’s Accession to the EEC in 1986

Accession to the EEC on January 1, 1986 initiated Spain’s most important liberalization episode since 1959. Tariffs have been reduced to zero for goods coming from European Union countries and the common external tariff was fully adopted for goods coming from the rest of the world. Besides, the integration of the Spanish Peseta into the European Monetary System in 1989 and the accession to the Euro in 1999, for reasons that will be presented later, have all contributed to Spain being one of the most open countries presently in the world.
The openness ratio went up from 37.5% in 1986 to the present 56% in 1999 (an important increase of almost 20 points in only 13 years!)

After all this process of Commercial Integration and Globalization of the Spanish economy, Spain is nowadays the 15th exporter and the 14th importer of the world. It imports mainly from the EU (72% of all imports), Asia (12%) and the Western Hemisphere (9%). Exports go also mainly to the European Union (also 72% of all exports), but also to Asia (8%), Latin America (5%) and the USA (4%).

As, quite correctly, Eduardo Aninat, Deputy Managing Director of the IMF, has recently remarked in Aninat (2001), Spain is a star performer. Spain is the second country, only after Japan (that multiplied its income per capita by 9 times) to increase its income per capita by more in the last 50 years (Spain has multiplied its income per capita by a factor of five, to reach the present 16000-17000 dollars).

The contention of this paper is that a great part of this increase has been dued to the huge increase in the openness of the spanish economy. The openness ratio of the Spanish economy starting from 1959 has been presented above and it can be seen, for the last three decades, in Table 1.

<table>
<thead>
<tr>
<th>Year</th>
<th>Openness</th>
<th>GDP (1995=100)</th>
<th>Wages (1995=100)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1971</td>
<td>28,0%</td>
<td>51,5</td>
<td>3,8</td>
</tr>
<tr>
<td>1975</td>
<td>31,0%</td>
<td>63,7</td>
<td>8,6</td>
</tr>
<tr>
<td>1980</td>
<td>33,8%</td>
<td>69,6</td>
<td>26,8</td>
</tr>
<tr>
<td>1986</td>
<td>37,5%</td>
<td>77,5</td>
<td>55,0</td>
</tr>
<tr>
<td>1994</td>
<td>44,5%</td>
<td>97,4</td>
<td>95,4</td>
</tr>
<tr>
<td>1999</td>
<td>55,8%</td>
<td>114,2</td>
<td>115,5</td>
</tr>
</tbody>
</table>


Much has been written, recently, in connection with the effects and consequences of Globalization. In particular, a lot of attention has been paid to the effects of Globalization regarding the convergence between rich and poor countries and the distribution of income among and within countries.
According to work recently done by Dollar and Kraay (2001) and Bhalla (2002), as well as others, productivity, wages, and incomes in poor countries seem to be catching up with those obtained by individuals in the rich world. Spain is a clear case that confirms all the above: The growth of its per capita income has been impressive, and, regarding wages, as it can be seen in Table 1, also its growth has been quite remarkable, from a low level of 3.8 in 1971 to the present level of 115.5 in 1999.3

II. Financial and Monetary Integration: The Euro, a Global Money for Spain

Spain has reached nowadays the highest degree of financial and monetary integration within the project of European unification. Spain doesn’t have anymore a local currency. It has now a global currency: the Euro.

But it wasn’t easy to reach the Euro. Let’s see the Maastricht Convergence Criteria that Spain had to fulfill in 1998 to belong and launch the Euro in 1999.

- Price Stability: The annual inflation rate couldn’t exceed by more than 1.5 percentage points that of, at most, the three best performing Member States.
- Interest rate convergence: The 10 year government bond yield could not exceed by more than 2 percentage points that of, at most, the three most price-stable Member States.
- Two conditions for Sustainability of the Government Financial Position:
  a) The Fiscal Deficit to GDP ratio couldn’t exceed 3%
  b) The Public Debt to GDP ratio couldn’t exceed 60%, unless diminishing and approaching 60%
- Exchange Rate Stability: Observance of normal Exchange Rate Mechanism fluctuation margins for at least two years, without devaluation.

Let’s talk a little bit about the rationale of these convergence criteria. The rationale for interest rate convergence and inflation convergence is the same. If two countries want to have the same currency, or for that purpose if any country wants to use another one’s currency, they will have to have, logically, the same interest rates. Taking into account that (nominal) interest rates decompose into real interest rates and inflation rates, it follows that inflation rates have also to be approximately equal.

The rationale for the two criteria for sustainability of the government financial position lies in the pressure that high fiscal deficits pose on interest rates driving them upwards in one country when the others would be maintaining interest rate convergence. On the other hand, one country running big fiscal deficits would behave also in a "free rider" way in the sense that that would tend to produce a current account deficit in the balance of payments of the whole region vis-a-vis the rest of the world, putting pressure on the exchange rate of the common currency, the euro, against i.e. the dollar, forcing an eventual depreciation of the euro that could impede the objective of price stability.

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3 Other important factors might be responsible for the economic success of Spain: In particular, its geographical position in Europe. For more, along these lines, see Dornbusch (2000) and Aguado (2001).
4 This is, by the way, the same constraint that applies for countries in Eastern Europe willing to euro-ise, or for countries in Latin America willing to dollarize.
The rationale, finally, for lower Public Debt to GDP ratios lie in the fact that the bigger the Public Debt of any country the bigger the interest payments that will put pressure on the deficit.

One may question why the Maastricht Criteria were set at 3 and 60 per cent and not at other figures, but in any case, if the objective of price stability was to be achieved, those figures would have to be set at low levels.\(^5\)

The rationale for the fifth criterium regarding exchange rate stability lies, finally, in the wish to avoid late devaluations by member countries that would benefit from competitive devaluations hurting other countries in the European Union.

Spain made great efforts in the 90s to achieve the needed convergence on inflation. Following the joining of the Spanish Peseta of the European Monetary System in 1989, Spain’s Monetary Policy was tight in the 90s and, together with the contractionary fiscal policy of the late 90s, the inflation target was achieved in 1998.

What are the pros and cons of the Euro for a country like Spain?

The first and obvious benefit is that of avoiding currency and severe balance of payments crisis, like the one of 1992. Without the domestic currency, the possibility of a devaluation has disappeared and sudden capital outflows motivated by fear of devaluations are ruled out.

Another clear advantage has been that of aligning Spanish inflation and interest rates with those in the rest of countries of the Eurozone, particularly with Germany, an anchor of the previous European Monetary System and of the present Euro system. In the following table, it can be seen the important process of convergence in inflation and interest rates.

What are the pros and cons of the Euro for a country like Spain?

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</thead>
<tbody>
<tr>
<td>Interest Rates(*)</td>
<td>15.96</td>
<td>13.37</td>
<td>14.68</td>
<td>11.04</td>
<td>5.36</td>
</tr>
<tr>
<td>Inflation(**)</td>
<td>31.9</td>
<td>56.8</td>
<td>77.7</td>
<td>100.0</td>
<td>113.8</td>
</tr>
</tbody>
</table>

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</thead>
<tbody>
<tr>
<td>Interest Rates(*)</td>
<td>8.50</td>
<td>6.87</td>
<td>8.88</td>
<td>6.50</td>
<td>5.24</td>
</tr>
<tr>
<td>Inflation(**)</td>
<td>66.2</td>
<td>80.1</td>
<td>85.7</td>
<td>100.0</td>
<td>107.0</td>
</tr>
</tbody>
</table>

(*): Government Bond Yields
(**): Consumer Price Index (1995 = 100)


\(^5\) For a very clear view of the problems posed by the financing of Budget Deficits, see Ball and Mankiw (1996).

\(^6\) At an overvalued fixed exchange rate of 65 pesetas per Deutsche Mark, that helped since the beginning to reduce inflationary pressures in Spain.
So, although Spain’s country risk could still be a little bit higher than in other Eurozone countries (a mere 0.12% in 2000), the elimination of currency risks has been crucial for the lowering of interest rates and the consequent boost in investment and growth.

From a fiscal point of view, this lowering of interest rates has been very beneficial for the Spanish budget, as the cost of servicing the public debt has decreased as a consequence of lower interest rates. The whole effort made by the Spanish economy on the fiscal front is shown in the following table, were again the data from Germany are presented only for comparative purposes:

<table>
<thead>
<tr>
<th></th>
<th>Spain</th>
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</thead>
<tbody>
<tr>
<td>Fiscal Deficit(*)</td>
<td>-4.0%</td>
<td>-6.0%</td>
<td>-4.3%</td>
<td>-7.1%</td>
<td>-0.3%</td>
</tr>
<tr>
<td>Debt/GDP(**)</td>
<td>14.0%</td>
<td>40.0%</td>
<td>44.8%</td>
<td>64.2%</td>
<td>60.6%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Germany</th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Fiscal Deficit(*)</td>
<td>-2.0%</td>
<td>-1.0%</td>
<td>-2.1%</td>
<td>-3.3%</td>
<td>+1.3%</td>
</tr>
<tr>
<td>Debt/GDP(**)</td>
<td>16.0%</td>
<td>22.0%</td>
<td>43.8%</td>
<td>58.3%</td>
<td>60.2%</td>
</tr>
</tbody>
</table>

(*) Maastricht Limit = 3%

(**) Maastricht Limit = 60%


Another advantage, not too much highlighted in the literature, has to do with the elimination of the sometimes called "original sin" of emerging and peripheric countries, the problem faced when it is difficult to finance high current account deficits as occurred to Spain in 1992 when confronted with a deficit of more than 3%, and Spain had to devalue finally the peseta up to 85 pesetas per Deutsche Mark. Nowadays, with the Euro, Spain has been able to finance very easily deficits of almost the same magnitude (In 2000, Spain again was approaching an external deficit of near 3% that was, this time, very easily financed).

In addition to promoting financial integration, greater price stability and lower interest rates, Spanish accession to the Euro has contributed even more to the trade integration of Spain with the countries of the Eurozone. The argument is that Spain could achieve even more significant savings in transaction costs that could lead to further increases in trade and investment between countries of the European Union, that are already integrated in a substantial degree.

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7 It could be said that a great part of the investment boom and economic growth that occurred in Spain in the last 4-6 years was due to the large decreases in interest rates. Another factor to be mentioned has been the important moderation of wage increases.

8 Bergsten (1999) presents interestingly the case of USA-Canadian trade where the volume of trade among Canadian provinces is more than 20 times that of their trade with US States despite ten years of a free trade area and the geographic proximity, common language and culture of the two countries.
Regarding the costs of the Euro, Spain has certainly lost its own monetary policy and the exchange rate as economic policy tools. The literature on asymmetric shocks highlights the problems that could appear when Spain faces a particular shock, without being able to use its own monetary policy. This problem has to be, nevertheless, balanced by the great advantages of interest rate and inflation convergence mentioned before, and one must never forget the possibility of using fiscal policy to counteract any specific shock, as well as the existence in the European Union of special funds (Cohesion Funds and Structural Funds) that have been so beneficial in the process of real convergence of Spain with the rest of the Eurozone.

On the other hand, regarding the exchange rate tool, many times we see that devaluations may rapidly lead to more inflation that can undo the positive initial effects of the devaluation on competitiveness for the devaluing country. It is probably the case for Spain that in the future the only way by which the Spanish economy will gain competitiveness will be either through price and wage contention or through increases in productivity.

Let’s, finally, mention that the challenge of the Spanish economy, as well as the challenge of the European economy, via a vis the USA, with the Euro competing with the Dollar as a global currency, will surely be, in the future, the evolution of productivity along both sides of the Atlantic.
References


