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INTEGRATION WITH THE EUROPEAN UNION: THE SPANISH EXPERIENCE

In this paper, we review the Spanish experience following integration with the European Community (now European Union), from its accession on 1 January 1986 to the most recent developments in European integration. We first look at the completion of the customs union of Spain with the EC, as well as the implementation of the Single Market Program, by examining the behaviour of trade flows immediately after integration. A precise analysis of foreign direct investment in the process of integration is also provided, given its particular importance to the Spanish case. Finally, we discuss the main problems associated with the completion of the Economic and Monetary Union, together with some prospects for the Spanish economy.

Keywords: European Union, European integration, Spanish economy

INTRODUCTION

Modern developments of the Spanish economy can be traced back to 1959. Before that year, and following the end of the Spanish Civil War and the beginning of World War II, the Spanish economy was characterized by a strong degree of State interventionism, in the context of a policy of autarky inspired by fascist ideologies. Although the main lines of economic policy were somewhat softened during the 1950s, autarky led to a big crisis at the end of the decade, with the Spanish economy close to complete bankruptcy.

As a response to such a quite dramatic situation, the so called "Stabilization Plan" was implemented in July 1959. Overall, the Plan led to a greater opening and liberalization of the economy, although still limited. However, since the Spanish economy started from very low levels of development, the new policy orientation allowed accomplishing very high growth rates through the 1960s and early 1970s, accompanied by an intense process of modernization of the country. An important feature of that period was the crucial role that, in order to sustain growth without a balance of payments crises (due to the high dependence of the Spanish economy on

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imported raw materials and equipment goods), was played by the revenues coming from tourism into Spain, Spanish emigrants abroad, and foreign direct investment (FDI) inflows.

However, the 1974 oil shock, and the subsequent world-wide economic crisis, affected quite seriously the Spanish economy. In addition, this period coincided with the process of transition to democracy, following General Franco's death in November 1975. All this resulted in several years of low growth and political instability. Later on, after the first democratic general election in forty years held in June 1977, the so called "Moncloa Agreements" led to reinforce the strategy of opening and liberalization of the economy. These "Moncloa Agreements" were the result of a compromise among all the political forces represented in the first democratic Parliament, and took their name from the seat of the Spanish Prime Minister's office, the Moncloa Palace in Madrid, where the pacts were signed in October 1977.

Finally, Spain joined, together with Portugal, the European Community (EC hereafter) on 1 January 1986, which meant the definitive strengthening of that general economic strategy, and opened the door to a period of successful evolution of the Spanish economy which is still in force. Notice that, in what follows, we will make use of the term "European Community", instead of "European Union" (as it was known from November 1993 onwards), since this was its official name at the time of the Spanish membership. Recall that, since 1 January 1986, the EC was composed of twelve member states: France, Belgium, Luxembourg, the Netherlands, Germany, Italy, the United Kingdom, Ireland, Denmark, Greece, Portugal, and Spain; the EC was later extended with three new members: Austria, Finland, and Sweden, on 1 January 1995.

As is well known, it is customary to distinguish several levels of economic integration, with every stage embodying the previous one. These are, from lower to greater: free trade area, where the member countries remove tariffs and quotas on imports on their partner's goods; customs union, where, in addition, member countries apply a common external tariff on goods from outside the area; common market, where, in addition, the free movement of factors of production (labour and capital) is allowed; and economic and monetary union, where, in addition, there are a single currency and a common monetary policy, and major economic policies are coordinated.

From the outset, the EC was designed to be basically a customs union. Therefore, membership into the EC means, first of all, the completion of the customs union with the other member states, by removing any trade barriers among them, and adopting the EC's Common External Tariff (CET). In

addition, the Single European Act, which came into effect on 1 July 1987, envisaged the completion of a Single European Market by 1 January 1993. The Single Market Program was addressed to the removal of all kinds of non-tariff barriers that prevented in fact the existence of a single internal market within the EC. To this end, a legislative programme was developed, aimed at setting the essential requirements for completion of the common internal market, including the removal of physical barriers (i.e., administrative formalities and border controls), technical barriers (i.e., security norms and regulations in production), and fiscal barriers (i.e., harmonization of indirect taxes), as well as the opening of public procurement to foreign producers.

Finally, the Treaty on European Union, which came into effect on 1 November 1993, has meant a new step in the process of European integration. It established a set of convergence criteria (on inflation, interest rates, exchange rates, budget deficit, and public debt) that had to be satisfied by those countries wishing to belong to the European monetary union, the so called Economic and Monetary Union (EMU). As a consequence, on 1 January 1999 the third and final stage of EMU was started, so that a group of European countries (France, Belgium, Luxembourg, the Netherlands, Germany, Italy, Ireland, Portugal, Spain, Austria, and Finland, with Greece joining the following year) adopted a common currency, the euro, and transferred the functions of monetary policy to the newly created European Central Bank (ECB).

The purpose of this paper is to review the Spanish experience following integration with the EC, from its accession on 1 January 1986 to the most recent developments in European integration. In this way, our period of analysis covers the completion of the customs union of Spain with the EC, as well as the implementation of the Single Market Program (since both developments were experienced simultaneously in the Spanish case), to the prospects related to the operation of EMU, stressing the problems related to the adjustment process to this new economic environment.

The paper is structured as follows. In Section 1, we examine the behaviour of trade flows immediately after integration, analyzing both the overall evolution of imports and exports and the performance by large groups of sectors of its most important component, trade in manufactures. In Section 3, we provide a detailed analysis of FDI in the process of integration, given its particular importance to the Spanish case. In Section 3, we discuss the main problems associated with the completion of EMU, together with some prospects for the Spanish economy. The main conclusions are summarized in the final section.

1. FROM CUSTOMS UNION TO THE SINGLE MARKET: THE EFFECTS OF TRADE LIBERALIZATION

According to economic theory, the formation of a customs union can lead to changes in the allocation of resources, both across sectors and regions. Also, the incorporation of imperfect competition issues into the theory of international trade in the 1980s, has allowed contemplating additional insights to the analysis of economic integration, such as interaction among firms, the extent of market power, the location decision of firms, and the like. A survey of the main questions related to the theory and empirical evidence of economic integration can be found in Baldwin and Venables (1995).

The effects of trade liberalization in Spain during the 1960s and 1970s were examined in De la Dehesa, Ruiz and Torres (1991), where three episodes were identified: 1959-66, 1970-75, and 1977-80. In this section, we are going to analyze the main effects of the next episode, 1986-90, that is, the period that starts with the Spanish integration into the EC. In addition, we will also provide a further examination of the period 1991-94, that is, the following years where the customs union with the EC was completed, and the Single European Market was already enforced. A large part of the analysis in this section comes from Bajo-Rubio and Torres (2001), where a more detailed discussion of the different issues can be found.

The period beginning in 1986 witnessed the deepest trade liberalization process experienced by the Spanish economy. In particular, all the trade regimes were fully liberalized, border adjustment taxes were replaced by a value-added tax system, and Spanish tariffs progressively approached those of the EC, which implied the adoption of the CET (lower on average than the previously existing Spanish tariffs) on imports from third countries, and the removal of all tariffs on imports from the remaining EC member countries. In addition, all these provisions had to be extended to those countries (EFTA, Mediterranean countries, and Lomé Convention) having signed preferential trade agreements with the EC, as well as to the countries benefiting from the Generalized System of Preferences. Specifically, the removal of tariffs between the EC and Spain for all the industrial products and the moving of Spanish tariffs towards the CET were made along a transitory period of seven years, according to the following calendar:

Date	% reduction	Accumulated %reduction
1 March 1986	10.0	10.0
1 January 1987	12.5	22.5
1 January 1988	15.0	37.5
1 January 1989	15.0	52.5
1 January 1990	12.5	65.0
1 January 1991	12.5	77.5
1 January 1992	12.5	90.0
1 January 1993	10.0	100.0

As a background to the analysis, we present in Table 1 several indicators of macroeconomic performance for the two periods examined here. In general, it can be said that, whereas the period 1986-90 was characterized by a protracted economic expansion above the European average, the period 1991-94 was one of a slower growth across the EC, which was even more acute in the case of Spain.

Table 1
Main economic indicators 1986-90 and 1991-94, Spain and EC-12
(average annual figures)

	1986-90		1991-94	
	Spain	EC-12	Spain	EC-12
Gross Domestic Product (at constant prices, % change)	4.5	3.2	1.0	1.2
Gross fixed capital formation (at constant prices, % change)	11.7	5.9	-3.4	-1.7
Inflation (GDP deflator, % change)	7.4	4.9	5.4	4.0
Employment (% change)	3.1	1.3	-1.4	-0.7
Unemployment rate (% of civilian labour force)	18.8	9.6	19.7	9.9
Current balance (% of GDP)	-1.3	0.4	-2.6	0.1
Long-term interest rate (%)	12.9	9.5	11.1	9.1

Source: Eurostat

The process of trade liberalization resulting from Spanish membership into the EC started in March 1986 with a favourable balance of payments position. Weak domestic demand during the previous few years and the

depreciation of the real exchange rate brought about a small increase in imports and a considerable growth in exports. All this, combined with a favourable record in the services account, was reflected in a steady improvement of the current account balance, which moved from a deficit of 2.5% of GDP in 1980 to a surplus of 1.7% in late 1985.

On the basis of these initial conditions, Spanish integration with the EC resulted in a rapid and substantial increase in the volume of imports, a slower growth of exports, a concentration of trade on EC member states, and a dramatic deterioration in the Spanish trade balance. On the other hand, a growing trade deficit, combined with smaller surpluses in services, brought the current account into deficit from 1987 onwards; in 1990 the deficit amounted to 3.4% of GDP. But the favourable performance of capital flows allowed a steady surplus in the basic balance and a steady accumulation of foreign currency reserves, and this, in turn, generated a continuous pressure for an appreciation of the peseta. Finally, the trade performance from 1991 to 1994 was significantly different to that during the initial years of integration with the EC, since exports surged and outpaced the growth in imports, which experienced a strong deceleration. As a result, the trade deficit experienced a substantial improvement. In Table 2 we present the main trade figures for both periods.

In the context of a rapidly expanding domestic demand, trade liberalization and appreciating real exchange rates, merchandise imports experienced a big surge from 1986 on, with an annual average growth in volume of 17.5% between 1986 and 1990. This big increase in imports affected all categories of goods, especially non-energy goods, and particularly manufactured products and capital goods. Combined with this, Spanish integration with the EC resulted in a significant concentration of trade flows on European markets; thus, imports from the EC moved from 36.8% of the 1985 total to 59.5% in 1990. In turn, during 1991-94 imports increased on average by 7% in real terms, less than half the rate of the preceding period, and the deceleration was higher in imports from the EC as well as in manufactured products. The geographical concentration of import flows stabilized over these years: while the share of imports from the EC in total imports increased by about 23 percentage points from 1985 to 1990, it only rose by less than 2 percentage points from 1991 to 1994.

Table 2
Foreign trade during the periods 1986-90 and 1991-94
(average annual rates of growth)

	Imports					
	Total		EC		Non-EC	
	1986-90	1991-94	1986-90	1991-94	1986-90	1991-94
Total	12.5	8.8	23.7	9.8	3.8	7.6
Energy	-6.2	2.3	1.3	1.5	-6.7	2.5
Non-energy	19.6	9.7	24.7	10.0	12.7	9.3
Primary sector	8.3	13.6	18.7	20.1	2.0	22.6
Semimanufactures	21.3	11.5	23.7	11.9	15.8	11.0
Manufactures	25.9	7.6	27.6	7.0	22.9	10.0
Capital goods	24.5	6.7	25.5	7.0	23.5	6.7
Consumer goods	34.8	10.5	38.5	7.3	32.0	19.0
	Exports					
	Total		EC		Non-EC	
	1986-90	1991-94	1986-90	1991-94	1986-90	1991-94
Total	7.0	15.1	12.9	14.9	-1.6	16.0
Energy	-2.9	-3.6	-9.6	5.9	4.2	1.5
Non-energy	7.9	15.8	14.7	15.1	-2.1	17.7
Primary sector	6.0	16.6	10.6	18.2	-2.0	24.4
Semimanufactures	5.2	15.7	15.5	16.1	-3.8	17.0
Manufactures	10.2	15.9	16.2	13.8	-1.1	23.0
Capital goods	13.1	16.9	17.9	14.4	1.7	25.7
Consumer goods	3.6	13.0	11.6	13.3	-5.2	19.0

Source: Bajo-Rubio and Torres (2001)

It could be of interest trying to explain the performance of non-energy imports during the initial years of Spanish membership into the EC, from the evolution of their main potential determinants, i.e., domestic demand and competitiveness, together with the impact of trade liberalization. Using the import elasticities estimated in Sebastián (1991) (1.76 and -0.68 for domestic demand and relative prices, respectively), and given a cumulative growth in domestic demand of 24.4% and a loss in competitiveness of 32.4%, these two variables taken together would have accounted for 64.9% of the total cumulative growth of 150.5% (in real terms) of non-energy imports between 1985 and 1990. The percentage not explained by the import function (that is, the remaining 85.6%) is customarily attributed to the effects of trade liberalization. In other words, 57% of the recorded increase in non-energy imports in the period 1985-90 may be explained by the liberalization process, independently of the evolution of its structural determinants.

Regarding exports, they recorded a sharp fall in 1986 which was followed by a rapid recovery in 1987 and sustained growth from that year on. The fall in 1986 could be partly attributed to exports brought forward during the last quarter of 1985, anticipating the elimination of the existing export tax rebate system (which involved a significant amount of subsidy), following the introduction of a new system based on the taxation of value added in January 1986; and, more importantly, to the appreciation of the real exchange rate and the evolution of foreign demand. However, after 1987, a drastic change occurred in the evolution of exports, which recorded an annual average increase of 8.1% in real terms between 1987 and 1990. In 1987, it was exports of agricultural produce and foodstuffs that experienced a remarkable upturn; after 1989, manufacturing exports, and in particular capital goods, were those leading the process. On the contrary, the volume of exports doubled its growth rate on average from 5.7% during 1986-90 to 12.4% from 1991 to 1994; the upsurge in exports was particularly significant in the case of exports to non-EC countries.

Turning to the distribution of exports by geographical areas, the greater dynamism of exports to the EC relative to those to the rest of the world should be noticed, being reflected in a substantial increase in the share of total exports going to EC countries, which rose from 52.3% in 1985 to 69.3% in 1990. These figures, however, remained basically unchanged from 1991 to 1994.

As in the case of imports, the initial performance of exports during this period can be tried to be explained on the basis of its main potential determinants, in this case foreign demand and competitiveness. Using the export elasticities estimated in Sebastián (1991) (1.70 and -1.71 for foreign demand and relative prices, respectively), and given a cumulative growth of trade in the industrialized countries of 38.4% and a loss of competitiveness relative to the rest of the world of 27.2%, these two variables would together explain 32.4% of the 30% total cumulative growth in real terms recorded by exports between 1985 and 1990. This procedure therefore does not reveal any significant impact of the liberalization process on the growth of exports in real terms during the period 1985-90.

So far we have examined the impact of liberalization on aggregate trade flows. Next, we will analyze the behaviour of foreign trade in manufacturing at the industry level, where manufacturing sectors have been classified according to their demand dynamism; that is, strong, average, and weak demand sectors. The relevant information is presented in Table 3.

Table 3

Indicators of trade performance, Spanish manufacturing industry (1985-90)

	Total		EC		Non-EC	
	$\Delta 85-90$	$\Delta 90-93$	$\Delta 85-90$	$\Delta 90-93$	$\Delta 85-90$	$\Delta 90-93$
Imports/Apparent consumption						
Strong demand	16.9	11.3	5.7	-3.8	-1.1	-2.7
Average demand	10.8	9.4	1.4	2.5	1.5	1.0
Weak demand	6.4	5.7	0.7	3.9	1.5	2.4
Total	10.6	8.6	2.0	2.3	1.5	0.9
Exports/Production						
Strong demand	6.0	8.3	-2.4	3.7	0.7	3.1
Average demand	3.1	5.1	-2.1	4.6	3.1	1.5
Weak demand	-4.9	2.1	-6.9	6.4	2.5	3.8
Total	0.5	4.5	-4.1	5.5	3.0	2.6
Revealed comparative advantage						
Strong demand	-17.5	-5.6	-33.2	14.0	8.7	22.9
Average demand	-30.4	-23.9	-42.0	7.2	7.0	8.3
Weak demand	-38.7	-25.4	-45.5	8.6	6.9	9.7
Total	-30.4	-18.4	-45.5	10.0	7.5	15.2

Source: Bajo-Rubio and Torres (2001)

Between 1985 and 1990, the sectoral performance of imports in real terms showed a relatively higher growth in average demand sectors, which increased their share in total imports, whereas the share of high and weak demand sectors fell; a trend that can also be observed for the imports from the EC. As a result, and given the considerable positive differential observed between import growth rates and domestic demand, import penetration (defined as the proportion of imports in apparent consumption) increased by a little more than ten percentage points during the period (from 16% in 1985 to 26.6% in 1990); more than 80% of this increase can be attributed to imports from the EC, although non-EC imports also increased. On the other hand, between 1990 and 1994, the structure of real imports did not experience a significant transformation when considering total trade. However, the figures for EC and non-EC trade reveal a slightly different pattern in both areas, since imports from strong and average demand activities were the most dynamic in trade with the EC, while for non-EC trade imports from weak and average demand sectors recorded a major expansion. Except for the strong demand activities, import penetration ratios increased during that period.

The effects of economic integration can be further assessed by means of the classical concepts of trade creation and trade diversion introduced by Viner (1950), so that its favourable or unfavourable impact in terms of welfare will

depend on the relative intensity of either phenomenon. Following Truman (1975), the effects of trade creation and diversion can be analyzed in terms of the evolution of the structure of apparent consumption: there will be trade creation if the share of EC imports in apparent consumption increases after liberalization, and trade diversion if import penetration ratios from the rest of the world decrease; while, if the share of national production in apparent consumption falls, there will be net trade creation. As can be seen from Table 3, at the aggregate level, there was no trade diversion in manufacturing products, at the same time that considerable trade was created with the EC. In addition, the integration of Spain with the EC would have generated a remarkable net trade creation effect, since the cumulative increase of national production, 17.9%, was substantially lower than that of apparent consumption at 34.5%. When applying Truman's method to the period 1991-93, we observe that the net trade creation effect that we identified for the previous period has now disappeared, since manufacturing production increased above domestic demand; however, the increase in import penetration ratios indicates that trade creation in manufacturing products with the EC continued (although in a smaller amount than in the period 1986-90), at the same time that the result of no trade diversion still holds (see Table 3).

Regarding exports, between 1985 and 1990 the pattern of specialization emphasized the high and average demand sectors, while the rather poor results obtained in the weak demand sectors resulted in a decline by more than 11 percentage points in total exports. The asymmetry in export performance is very clear in the distinction between EC and non-EC countries: while exports to the EC recorded positive growth rates in all groups, especially those of high and average demand, exports to non-EC countries declined; thus, the concentration on EC markets of manufacturing exports substantially increased. In turn, between 1990 and 1993 exports from strong demand activities experienced the highest growth rates, raising their share in total manufacturing (now at above 25% of total exports); this pattern was common to both EC and non-EC trade, though more pronounced for the latter. As a result of the higher dynamism of exports as compared to production, there was a generalized growth in export-output ratios during this period.

Finally, Table 3 also shows the change in the indices of revealed comparative advantage (RCA) between 1985-90 and 1991-93 for total trade, trade with the EC, and trade with the rest of the world. As can be seen, during the first period the RCA indices experienced a rapid and general fall that was greater in weak demand activities, and less so in average and strong demand sectors. The picture is similar when we look at trade with the EC and with the rest of the world,

though the decline of the RCA indices was less steep for the EC and steeper for the rest of the world than for total trade. In turn, during the second period the RCA indices experienced a general improvement for all groups of activities and for both EC and non-EC trade (though they remained negative in almost all cases). This improvement was particularly remarkable for strong demand sectors and non-EC trade.

Another interesting issue would be the analysis of the degree of intra-industry specialization that may have occurred during this period, since this would have influenced the ease with which the process of adjustment entailed by trade liberalization could be completed. It has been conventional for an empirical analysis on intra-industry trade to associate its development with experiments in economic integration. In fact, when the EC customs union was established in the 1960s, intra-industry, rather than inter-industry, specialization in differentiated products prevailed. As a result, no substantial changes in the production structure emerged, which tended to ease the adjustment within the member states (Balassa 1966).

In this regard, the results from the Grubel-Lloyd indices of intra-industry trade elaborated in the Spanish Ministry of Commerce and Tourism for a set of representative sectors, showed remarkably high values that increased in almost all cases between 1981 and 1994 (the main exception being equipment goods' sectors), and were generally higher for trade with the EC. The adjusted overall index went up from 48.2% in 1981-85, to 62.2% in 1986-90 and 64.7% in 1991-94 for total trade; and from 56.7% in 1981-85, to 65.9% in 1986-90 and 67.1% in 1991-94 for EC trade.

The important role played by intra-industry trade in the Spanish case would then lead us to presume a relatively easy adjustment in response to the integration with the EC, as usually assessed in the literature. However, and more recently, attention has been also addressed to the extent of vertical (i.e., quality-based), as opposed to horizontal (i.e., particular attributes-based), intra-industry trade (see, e.g., Greenaway, Hine and Milner 1995). In that respect, Gordo and Martín (1996) have identified the share of vertical intra-industry trade in total for the Spanish case, following Greenaway, Hine and Milner's method. They showed that its share would have been higher than that of horizontal intra-industry trade, increasing between 1985 and 1992 and then decreasing until 1994. Since a higher share of vertical intra-industry trade would lead to a more painful adjustment following trade liberalization, Gordo and Martín's results would point to somewhat less optimistic conclusions on the role of intra-industry specialization in minimizing adjustment costs in the case of Spanish integration with the EC.

On the other hand, as is well known, intra-industry trade is traditionally associated with a series of factors related to the theory of industrial organization, in particular economies of scale and product differentiation. So, for instance, in Bajo-Rubio (1990), manufacturing exports from large Spanish firms were found to be positively related to the level of scale economies, and negatively to advertising-type product differentiation. Overall, the progressive loss of competitiveness of Spanish industry in labour- and resource-intensive products, with the consequent change in the pattern of Spanish trade towards that of other industrialized countries, would point to a greater relevance of models based on considerations of imperfect competition, which incorporate industrial organization variables (mainly scale economies and product differentiation) when explaining the patterns of Spanish foreign trade (see Krugman 1995 for a survey of this kind of models).

2. THE ROLE OF FOREIGN DIRECT INVESTMENT IN THE PROCESS OF INTEGRATION

The crucial role played by FDI has been a distinctive feature of the Spanish economy since the beginning of industrialization. Prior to integration with the EC, there was already considerable FDI from the EC or elsewhere, but Spanish integration with the EC was accompanied by a remarkable expansion in FDI flows, combined with significant changes in their sectoral and geographical composition.

Table 4 shows the main trends in FDI since the early 1960s. According to the balance of payments figures, gross FDI went up from an average of 0.5% of GDP in the 1960s and 1970s, to 0.7% in the early 1980s, 1.7% in 1986-90, and 2.1% in 1991-94. Its contribution to capital formation was also very important, since the share of FDI in total fixed investment (excluding construction) grew from an average of 5.6% in the 1960s and 1970s to 9% in the early 1980s, 16.8% in 1986-90, and 29.5% in 1991-94. In aggregate terms, manufacturing was traditionally the main target for FDI, although its share in total fell to an average 45.9% during the period 1986-90, due basically to the enormous increase of FDI in real estate, finance and insurance. This trend, however, was partially reverted during the period 1991-94, when the percentage of FDI in manufacturing reached 51% of the total. The geographical origin of FDI also experienced considerable variations, so that the EC's share grew steadily, reaching an average of 54% and 61.7% during the periods 1986-90 and 1991-94, respectively, while the US share fell to 4.7% and 6.4% during that time. Also

Noteworthy was the increase in FDI performed by foreign firms already established in Spain, which accounted for more than 20% over the whole period.

Table 4

Foreign direct investment in Spain. General evolution

	Average annual value ¹	% of GDP	% of Gross Fixed Capital Formation ²	% of FDI in manufacturing	% from the EC	% from the US
1961-65	3.8	0.4	3.2	54.6	25.8	32.4
1966-70	12.7	0.6	6.5	73.5	35.0	32.8
1971-75	22.7	0.5	6.1	79.3	37.1	37.4
1976-80	55.6	0.5	6.4	71.0	42.3	25.8
1981-85	151.7	0.7	9.0	62.0	42.5	16.5
1986-90	704.1	1.7	16.8	45.9	54.0	4.7
1991-94	1249.0	2.1	29.5	51.1	61.7	6.4

¹ gross inflows according to balance of payment figures, in billion pesetas

² excluding construction

Source: National Accounts and Balance of Payments

In any case, a clear conclusion comes out from these figures: the FDI has played a very important role in the development of the Spanish economy, even increasing since Spanish integration with the EC.

What have been the main macroeconomic factors behind this evolution of FDI? An econometric analysis on the subject was presented in Bajo-Rubio and Sosvilla-Rivero (1994) for the period 1964-89. There, a long-term relationship was found between, on the one hand, gross total FDI inflows in real terms and, on the other, the level of real GDP, the rate of inflation, the level of trade barriers, the lagged foreign capital stock, and, only in the short-run, the real effective exchange rate. A significant effect (in both cases negative) was also found for the user cost of capital and unit labour costs in the long-run relationships for manufacturing and non-manufacturing FDI, respectively; while a dummy variable that proxied integration with the EC proved significant only in the equation for FDI from the EC.

This evidence would suggest that the size of the Spanish market and its growth potential would have been the most important explanatory factors behind the significant growth in FDI experienced by Spain during the last decades. Spain, no doubt, represented a relatively large market within the EC, especially when compared with other less developed member states such as Portugal or Greece, and the Single European Market programme could have been considered as a permanent increase in the size of the market. On the other hand,

maintaining basic macroeconomic equilibria, to the extent they affect the economy's growth potential, should also have been a necessary condition for a favourable environment concerning the attraction of FDI.

On the other hand, we failed to detect a significant influence of labour costs on FDI, except for the case of non-manufacturing activities. In this regard, it has been noted (see e.g., Porter 1986) that multinational firms, when choosing a country in which to invest, tend to value less and less the availability of natural resources and cheap, unqualified labour; on the contrary, they would prefer other factors like the availability of skilled scientific and technical staff, advanced infrastructure, and so on. All this would be in line with the experience of last years, so that most FDI inflows have gone to the countries from which FDI comes from, i.e., the industrialized countries; see Graham and Krugman (1993). Hence, it would seem that, in general, FDI oriented towards the Spanish market would have been interested not as much in a labour force still relatively cheap, as in an expanding domestic market and acceptably well qualified personnel.

We examine now the sectoral structure of FDI in manufacturing. As shown in Bajo-Rubio and López-Pueyo (1996), during the period 1986-90 FDI was basically addressed to average and strong demand activities, with shares on total FDI in manufacturing of 49.1% and 33.2%, respectively. The preference of foreign investors for strong demand activities would reveal itself even greater when FDI figures were expressed as a percentage of sales, being the average ratios FDI-sales 4.1%, 2.1%, and 1.1% for strong, average and weak demand sectors, respectively (compared to an average ratio of 2.1% for total manufacturing industry). In turn, for the years 1991 through 1993, a greater share of the weak demand activities was observed, although the overall ranking of groups according to their importance as recipients of FDI (i.e., average, strong, and weak demand sectors) did not change. On the other hand, when FDI was measured in terms of industry sales, the average ratio reached a value of 3.8% for total manufacturing industry (as compared to 2.1% for 1986-1990), being again higher for strong demand activities (6.7%), followed by those of average and weak demand (3.3% and 3.1%, respectively).

Some econometric evidence about the relationship between FDI (measured as a percentage of sales) and several manufacturing industry indicators, using panel data for the period 1986-92, can be found in Bajo-Rubio and López-Pueyo (2002). In general terms, the results stressed the important role which, regarding the sectoral allocation of FDI, would be played by factors such as better labour skills, the extent of product differentiation (especially technological differentiation, as opposed to that based on advertising), or a higher productivity. Also, a higher FDI share was found in those industries characterized by lower

scale economies at the plant level, higher export and import propensities, and a faster growth of domestic demand. Again, no significant relationship was obtained for unit labour costs, which would cast some additional doubts on the role of cost differences as the main factor behind the allocation of FDI. Finally, higher FDI inflows were found to be associated with a depreciated exchange rate and an expected appreciation. Summarizing, these results would agree with the greater importance given more recently to knowledge-based assets, rather than to physical capital assets, as the key element giving rise to FDI (Markusen, 1995), so that FDI would be a crucial channel for the diffusion across borders of ideas and technologies.

3. BEYOND THE SINGLE MARKET: ECONOMIC AND MONETARY UNION

The attempts of achieving a monetary union in the EC can be traced back to 1970 with the Werner Report. Judged to be too ambitious at the time, it led however to a first attempt of limiting the fluctuations of the European currencies, through an arrangement termed the “Snake”. After being abandoned in practice following the first oil crisis, the objectives of the “Snake” were retrieved, in a more ambitious way, with the launching of the European Monetary System (EMS) in March 1979. The strengthening of the EMS by the second half of the 1980s, together with the full liberalization of the capital movements contemplated in the Single European Act, led to reinforce the objective of achieving a monetary union in the EU. The ultimate reason was that, with full capital mobility, and a fixed exchange rate (or rather an adjustable peg, as in the EMS), national monetary policies could not be set independently (Wyplosz, 1997). To that end, in 1988 a Committee headed by Jacques Delors, then the President of the European Commission, was established in order to define the objectives and stages in the road to the monetary union.

Following the recommendations of the Delors Committee, the basis for the project of EMU were incorporated into the Treaty on European Union (the Maastricht Treaty) signed in February 1992, and a calendar of three stages towards monetary union was approved. The Treaty established a set of convergence criteria (on inflation, interest rates, exchange rates, budget deficit, and public debt) that had to be satisfied by those countries wishing to participate in EMU. In this way, since 1 January 1999, the EC countries (with the exceptions of the United Kingdom, Denmark, and Sweden) share a common

monetary policy instrumented by the ECB, as well as a common currency, the euro, introduced physically at the beginning of 2002.

Notice that when a country abolishes its national currency to adopt a currency common to other countries, this means the disappearance of both the exchange rate and an independent monetary policy as instruments of its stabilization policy. What would be the reasons that might lead a particular country to abandon its own currency, and to replace it by another one, assumed to be out of its control? The economic literature has provided several answers to this question; a wide review of the topic can be found in De Grauwe (2003). According to the "theory of optimum currency areas", a country might find it not too costly to join an economic area sharing a common currency, provided that several criteria are fulfilled; in particular, a high degree of factor mobility within the area, a high degree of opening of the economies forming the area, a high degree of productive diversification within the area, and the similarity of the inflation rates. More recently, the so called "credibility argument" has been very frequently used, i.e., the higher credibility of anti-inflation policy that, for a traditionally high-inflation country, would mean forming a monetary union with a low-inflation country; the best known version of this argument is due to Giavazzi and Pagano (1988).

From an empirical point of view, the degree of symmetry of shocks affecting the member countries of a monetary union becomes a crucial question regarding the desirability of monetary integration. The reason is that, if shocks were mainly asymmetric (i.e., those requiring a different optimal policy response in each member country), the costs of forming a monetary union would be potentially higher than if the shocks were symmetric.

Many empirical studies appeared in the years previous to EMU, aimed at analyzing the kind of shocks affecting the EC economies, which was further compared with the case of the US states, taken as an example of a monetary union working for a long time. One of the most influential was that of Bayoumi and Eichengreen (1993), who found that (i) supply shocks (unlike demand shocks) would be greater in the EU, would be less correlated across regions, and adjustment to them would be slower compared to the US; and (ii) there would appear in the EC a "core" (Germany, Belgium, the Netherlands, France and Denmark) and a "periphery" (the UK, Ireland, Italy, Spain, Portugal and Greece), so that supply shocks would be smaller and more correlated across regions within the "core". Overall, these results tended to support the idea that the EC countries would not be particularly qualified to form a monetary union; and, if this would happen, it would be more advisable for the "core" than for the "periphery".

However, the above conclusions were later qualified in the study of Bayoumi and Prasad (1997), who used data for the whole economy, and not only for the manufacturing sector as in Bayoumi and Eichengreen (1993). According to these authors, the relative importance of shocks would be very similar in the EC and the US, given the relatively higher importance of asymmetric shocks in the tradable goods (i.e., manufacturing) sectors in the EC case, and in the non-tradable goods (i.e., services and construction) sectors for the US.

Nonetheless, EMU can be considered as an economic response to the previous situation, already evident since the beginning of the 1990s: once capital flows were fully liberalized, in a context of quasi-fixed exchange rates, the Bundesbank, Germany's central bank, was setting monetary policy for the EC as a whole. Therefore, the other countries, realizing that they had lost control of their domestic monetary policies, would have concluded that creating an EU-wide institution to manage the European monetary policy would be the only way to regain some influence over monetary policy (Wyplosz, 1997). In addition, as noticed by Frankel and Rose (1997), the greater integration associated with the EMU would tend to reinforce the symmetry of shocks affecting the member countries, so making the EMU more desirable once in operation. In any case, due to the loss of the exchange rate among EMU members as well as national monetary policies, the role of other instruments of stabilization policy, in particular fiscal policy, acquires a renewed importance for the EMU member countries.

Even though EMU is a phenomenon recent enough to draw any sound conclusions on its effects on the economies of the member countries, we will now examine a relevant implication for the Spanish economy: the evolution of inflation. The Spanish economy has historically suffered inflation rates quite above the European average, which led to fears on its capability to fulfil the convergence criterion on inflation set in the Maastricht Treaty (i.e., the inflation rate should not be more than 1.5% higher than the average of the three lowest inflation rates in the group of candidate countries). However, Spain was able to reduce its inflation on time to satisfy this as well as the rest of convergence criteria, and so to participate in EMU from the start.

Part of the explanation as regards inflation could have been in how monetary policy was implemented in the years before EMU. In a recent paper, Díaz-Roldán and Montero-Soler (2004a) estimated a Taylor-type rule for the monetary policy of the Bank of Spain, during the period 1989:3-1998:4, i.e., the period that begins with the peseta joining the exchange rate mechanism of the EMS, and finishes in the last quarter before EMU; in other words, the last period of an independent monetary policy set by the Bank of Spain. As the main result, they

found that the Spanish monetary authorities would have been strongly concerned about inflation along that period. In particular, the response coefficient of the interest rate to the inflation rate was estimated at 2.3, well above that postulated in the original Taylor rule (1.5), as well as those estimated in similar exercises for other countries. Overall, this result could support the idea that the convergence towards the German (i.e., stricter) monetary policy implied by the EMS discipline, would have allowed the Bank of Spain to significantly reduce the inflation rate and so satisfy the convergence criterion on inflation.

However, after the adoption of the ECB's monetary policy in January 1999, Spanish inflation has risen, again standing since then as one of the highest in the EMU. Could the monetary policy of the ECB lie behind these developments? To this end, we show in Table 5 the forecast of the nominal interest rate (proxied by the interbank money market rate) for 1999:1 to 2000:4, from the monetary policy rule estimated in Díaz-Roldán and Montero-Soler (2004a), together with the observed values. As can be seen, the forecasted values lie systematically above the observed ones along all the period. In other words, the figures in Table 5 would indicate that the Spanish monetary authorities would have been in the past more concerned with inflation than the ECB now, so that, in the case that the Bank of Spain would have set the Spanish monetary policy after January 1999, this would have been more contractionary than that of the ECB. This, in turn, poses a challenge to the Spanish authorities, which should look for other alternative policy measures to control inflation, in face of the loss of competitiveness suffered by the Spanish economy after the start of EMU; a loss of competitiveness, indeed, that now cannot be compensated with a nominal depreciation of the peseta.

Table 5

Nominal interest rate. Observed and forecasted values

Quarter	Observed	Forecast
1999:1	3.07	3.42
1999:2	2.61	3.36
1999:3	2.68	3.46
1999:4	3.40	3.66
2000:1	3.52	4.53
2000:2	4.26	4.85
2000:3	4.73	5.61
2000:4	4.75	6.33

Source: Díaz-Roldán and Montero-Soler (2004b)

CONCLUSIONS

We have examined along this paper the Spanish experience following integration with the EC, covering the completion of the customs union, the implementation of the Single Market, and the start of EMU. In general, Spanish membership into the EC has implied a significant step forward in the process of opening up the economy which has involved substantial economic effects. These years have meant an important transformation of the Spanish economy, which now will have to face some new developments, such as the consolidation of EMU and, especially, the enlargement of the EC to Central and Eastern European countries (CEECs).

The fifth enlargement of the EC, which took place in May 2004, will have some special features compared to the previous ones: up to 10 countries (the Czech Republic, Slovakia, Slovenia, Hungary, Poland, Estonia, Latvia, Lithuania, Cyprus, and Malta), with levels of *per capita* income well below the EC's average, and most of them recently transitioning from a system of centralized planning towards a market economy. The enlargement will have important implications both from an institutional and economic point of view, with large opportunities but also risks, for the incumbents and also for the former members of the EC.

The new members, no doubt, will have to face huge challenges, such as an increased international competition and the need to adopt the EC regulations (on environment, social protection, competition policy, and so on), to add to the transition process still in force to a market economy. And, even though the overall effects should be considered to be favourable in the long run, important problems concerning the distribution of those effects across economic sectors and regions, as well as the adjustment costs to the new situation, are going necessarily to appear.

But the challenges will be substantial for the former members of the EC, too. And this would be particularly important for a country like Spain, relatively poor in an EC with 15 member states, but much less so in an EC of 25. So, for instance, the last ten years have contemplated an approaching of the pattern of comparative advantage of the CEECs to that of Spain; and this would be related with the behaviour of multinational firms, which are increasingly investing in the CEECs, not only to satisfy their domestic markets, but also to export to the EC (Blanes-Cristóbal, 2003). Also, competition over the total amount and distribution of the EC's Structural Funds, so important for the development of

many Spanish regions, will greatly increase, so that Spain (the highest recipient of the EC's regional funds before the enlargement) should expect a strong reduction in the amount of funds received (Martín et al., 2002).

To conclude, the fifth enlargement of the EC will pose a significant challenge to the Spanish economy, which will become, by a purely statistical device, a relatively rich country within the enlarged EC. The opportunities and the risks will be large for all the countries involved, and overcoming them will be crucial for the future of Europe.

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