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The morning after

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After three decades of partying, Spain has woken up with a hangover. Curing it will require changes, writes Michael Reid (interviewed [here](#))

AFP



THE past few months have been bittersweet for Spain. In a general election in March the Socialist Party won a clear but not overwhelming victory, giving José Luis Rodríguez Zapatero a second term as prime minister. That seemed to drain some of the partisan poison that had accumulated in the political system over the previous four years. In June Spain shook off its long-standing reputation as the permanent under-achiever of world football, winning the European championship with swift and skilful attacking play. Not only did the performance of its young team (featuring Catalans as well as the usual Madrileños in prominent positions) seem to echo Spain's flowering of creativity in everything from architecture to gastronomy; many commentators saw the footballers' triumph and the public's rapturous response to it as a welcome expression of national unity in a country that seemed to be turning increasingly fissiparous. In July Rafael Nadal, a tennis genius from Mallorca, won the Wimbledon championship. At the moment of victory he scampered across the press-box roof, clutching the national flag, to salute Spain's crown prince and his wife.

But every month since the election the news at home has become gloomier. Investment is slumping. Unemployment in August was 11.3%, a third higher than a year earlier, the biggest jump for 30 years. The economy grew by just 0.1% between the first and the second quarters of this year, the slowest pace since 1993. It is now almost certainly contracting. So sharp was the deterioration that Mr Zapatero (pictured above with Pedro Solbes, his finance minister), who had earlier refused to acknowledge that there was any economic crisis, interrupted his August break to hold an emergency cabinet meeting. "Spaniards went on holiday in party mood and came back to find there was no champagne left, nor even any decent wine," sums up Fernando Fernández, a former IMF official who is now rector of Nebrija University near Madrid.

Great while it lasted

The fiesta had indeed been splendid. Spain has undergone an extraordinary transformation since Francisco Franco died in 1975 and his long dictatorship came to an end. Democracy was swiftly consolidated. A deeply conservative Catholic society has metamorphosed into an almost self-consciously tolerant one. In the 1960s two-fifths of Spaniards still toiled on the land, many of them living in poverty. Now only 5% work in agriculture. Spain has become a vibrant, middle-class urban society.

Social and political change went hand in hand with economic progress. Between 1994 and 2007 the economy grew at an average annual rate of 3.6%. During that period unemployment fell from 24% to 8%, even though

many women joined the labour force and some 5m immigrants arrived—and were absorbed with scarcely any sign of tension. For most of the past decade Spain has been responsible for creating about one in every three new jobs in the euro zone. By 2007 total employment had risen to 20m, from only 12m in 1993. When Spain joined the forerunner of the European Union in 1986 its income per person was only 68% of the club's average; in 2007 its income per person was 90% of that of the 15 EU members before its latest expansion. Living standards are now higher than Italy's.

The improvement in Spaniards' lives is instantly visible. Many elderly people are short, stunted by the hunger they suffered as children in the hard years of fascist autarky after Franco won the civil war of 1936-39. Young Spaniards are strikingly taller than their grandparents, exemplified by Pau Gasol, who measures seven feet (2.13 metres) and was voted the most valuable player when Spain won the latest world basketball championship.

Spain is not just a desirable place to live—though it is that, attracting northern Europeans who have bought second homes in order to enjoy the Spanish combination of sun, good public services and a relaxed way of life. In 2006 it was the world's ninth-largest economy measured at market exchange rates and the twelfth-largest at purchasing-power parity. It is the sixth-biggest net investor abroad.

The economic boom began under Franco, who abandoned autarky in the late 1950s. He turned the management of the economy over to technocrats from Opus Dei, a lay Catholic organisation, who opened it to foreign trade and investment. But a bigger change came in 1986 when Felipe González, a Socialist prime minister, led Spain into Europe. Foreign direct investment flooded in as multinationals set up car and other factories to take advantage of relatively low wages.

The euro effect

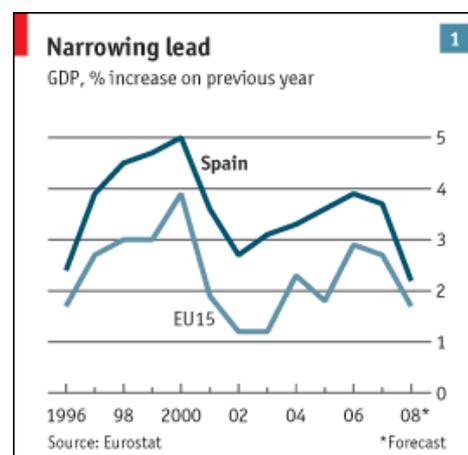
Money from Brussels also poured in. Spain has been the largest single beneficiary of EU regional funds. It has received a total of €186 billion, most of which was wisely spent on improving roads and railways. Under Mr González's successor, José María Aznar of the conservative People's Party (PP), Spain qualified to join the euro at its inception in 1999. Interest rates fell dramatically: the cost of mortgages, for example, came down from 18% to below 5%, unleashing a housing boom.

Yet with a suddenness that has taken officials by surprise, economic boom has turned to bust. When the European Central Bank raised interest rates last year, the housing bubble burst. Higher oil prices also cut disposable income, as well as pushing inflation to a new high of 5.3% in July. And international financial turmoil has caused a credit squeeze at home.

Mr Zapatero points out that so far Spain has fared no worse than several other large European economies, and that the country's financial system is stronger than that of many of its counterparts: to date, no Spanish bank has got into difficulties. In an interview for this special report Mr Zapatero conceded that the economy faces a period of stagnation, but insisted that "once calm returns to the international system, we will return to growth without the Spanish economy having suffered structural damage." The government forecasts that after a year of almost no growth a recovery will start towards the end of 2009.

This strikes many as far too optimistic. Economists and businesspeople complain that the government was slow to respond to the economy's swift descent into recession. One of the country's most experienced bankers reckons that even if the outside world rights itself fairly quickly, recovery will not begin for at least two years. Some are even more pessimistic, arguing that in addition to the liquidity squeeze and the housing bust Spain suffers from an underlying lack of competitiveness. The symptoms are a current-account deficit that topped 10% of GDP in the first half of this year and an inflation rate that has been about one percentage point higher than the average for the euro zone for most of the past decade.

Fixing this will not be easy. When recession struck in the past, as it did in the early 1980s and again in 1993, the key to recovery was devaluation. But with Spain in the euro that option is no longer available. Unless the government rams through structural reforms to make the economy more competitive, the argument goes, adjustment to a harsher economic environment will involve a big rise in unemployment and years of stagnation. Instead of going into a V-shaped recession, with a swift recovery, the economy could be heading for an L-shaped depression.



Spain's prosperity is due partly to good luck, in the form of EU entry. But for most of the past 30 years it has also managed its affairs far better than its southern Mediterranean peers have done. Despite some corruption, particularly in local government, Spanish politics is generally fairly clean. The country's economy is relatively open and flexible—halfway between Britain and the rest of continental Europe. Economic management has been mostly competent and stable: since 1993 Spain has had just two finance ministers (Italy has had four since 2001 alone). Mr Solbes, who has held the job since 2004, had an earlier spell in 1993-96 under Mr González before moving on to become the EU's commissioner for economic and monetary affairs. Under Mr Aznar the incumbent was Rodrigo Rato, who subsequently became the IMF's boss.

Officials reel off other reasons why Spain is now a different and stronger country than it was when recession last struck. For example, in 1993 the government had a budget deficit of 7% of GDP; in 2007 it had a surplus of 2.2% and public debt was just 36.2% of GDP, down from a peak of 68% in 1996 (compared with Italy's figure of 104% in 2007 or Britain's of 44%). Even more importantly, over the past 15 years a clutch of powerful Spanish multinationals has emerged. In 2000 the *Financial Times* list of the world's 500 biggest firms by market capitalisation included only eight from Spain; by 2008 the figure had risen to 14.

A generation of young Spaniards that has grown up knowing nothing but rapid economic growth may now have to contend with unemployment. This will put Spain's political system, as well as its economy, to its most severe test since the early years of its transition to democracy. This special report will weigh the country's strengths and weaknesses and assess its prospects for renewed economic growth. It will argue that Spain can avoid Italy's fate of seemingly remorseless decline. But there are some grounds for concern in politics.

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