# Macroeconomic policy in the EMU: Can inflation be expansionary? The case of Spain

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## 1. Introduction

During the last decade, the Spanish economy has enjoyed an unparalleled period of sustained growth since mid-seventies. In the European Union (EU-15) only Finland, Ireland and Luxembourg (and Greece since 2001) have registered higher real GDP growth rates. As a direct result of this boom, there has been a pace of strong employment growth, leading unemployment rates to levels that are one third of those registered in early nineties. Actually, the Spanish rate of unemployment, that during the decades of the eighties and the nineties was the highest one among those of developed countries, is quite similar to that of the EU-15.

There is no doubt about the significance of this long phase of economic growth. Thus, the Spanish GDP per capita in PPS has risen from 79.4% of that of EU-15 in 1996 to 91% in 2005; the employment in this period has increased in 6 million jobs (+46.5%), leading to a fall of the rates of unemployment from 22.4% to 9.1% in the first quarter 2006. Actually, since 1994, 27%

of new employment in the EU-15 has been created in Spain and the difference between the rate of unemployment in the EU-15 and Spain has fallen from 9.4 percentage points in 1994 to only 1.4 percentage points in 2005.

The incorporation of Spain to the euro cast some shadows about the capacity of the Spanish economy to generate a process of sustained high growth that could solve the structural problems of the huge figures of unemployment and the gap in terms of the GDP per capita with the rest of partners of the European Monetary Union. It was thought that the entry to the EMU would have a significant impact in the short-run on the inflation rates. The single monetary policy and the structural reforms that should be implemented in the labour market and in certain markets of goods and services would help to slow down the rates of inflation and to reduce the differential of inflation with the other members of the EMU. In this sense, the foreign constraint arisen from the foreign deficit that would come from the higher inflation rates would operate as a powerful stimulus for economic agents to change their decision-making processes when setting the growth of prices and wages.

The process of slowing down the inflationary process could have a significant impact on the economic activity, at least in the short-run until the combination of a lower inflation rates and the consequences of the structural reforms in the goods and services markets and the factors market had developed all their positive consequences on the supply-side and the long-term rate of growth. However, the final outcome has not been the expected one. As we mentioned above, since mid-nineties Spain is enjoying the most stable and sustained phase of economic growth in the last thirty years but the inflationary process has not been cut, an, actually, the current rates of inflation are close to those registered before the entry to the euro.

Our explanation to that unexpected situation is that, though it can seem paradoxical, the euro has involved for Spain the implementation of a expansionary macroeconomic policy, mainly in the case of monetary policy. Actually, as we will see, the current configuration of the Spanish economic policy is quite close to the traditional recommendations of Keynesian economics:

- an expansionary monetary policy that reduces real interest rates to stimulate private investment and consumption,
- a neutral fiscal policy to offset, mainly through the working of built-in stabilizers, the effects of monetary policy and to restrain the aggregate demand,

- a voluntary incomes-wage policy to cut inflationary pressures and to accelerate the employment creation.

How can we talk of a Keynesian-expansionary economic policy when the current configuration of the economic policy in the EMU (as defined by the sum of a monetary policy only focused on price stability ruled by an independent European Central Bank and a tight fiscal policy ruled by the Stability and Growth Pact only worried by reducing fiscal deficits and generating fiscal surpluses) is blamed to be restrictive if not deflationary? In our opinion, the answer must be found, though paradoxically, in the high inflation rates registered in the Spanish economy.

In a provocative way, we could say that inflation is working, in some way, as the engine of the economic growth in Spain. Put in another words, the current economic situation in Spain can be described in terms of a classic Philips curve, where the high rates of inflation come with high levels of economic activity, strong creation of employment and declining rates of unemployment. But, what makes different the current Spanish economic situation from the traditional Philips curve are two elements. The first one is the relation of causality, that would be operating in both ways: the high economic growth is leading to high inflation rates but the high inflation rates is also leading to high rates of economic growth. A symptom of the first interpretation is the higher Spanish economic growth compared to that of the rest of EMU members. The rising aggregate demand would be pushing the aggregate supply, that, besides being relative stable in the short-run, suffers from certain structural weakness that makes that the demand-push leads to both higher prices and a external deficit. In this sense, the inflationary pressures would be the main constraint to the economic growth, and, therefore, the main economic disequilibria of the Spanish economy (Bank of Spain, 2006; Directorate-General for Economic and Financial Affairs, 2005; International Monetary Fund, 2006a; OECD, 2005).

But, as mentioned, the higher inflation rates would be favouring the economic growth through several transmission channels:

- The high inflation rates are reducing the real interest rates, even making them negative, thus fuelling the expenditures in consumption and investment due to a growth in the borrowing.
- The high inflation rates are not leading to a tighter monetary policy, since the stance of the monetary policy in the EMU is not determined by the situation of a single economy

but of the whole area, whose rate of inflation is quite below to that of Spain and closer to the target of the ECB.

- The inflation rates are leading to high gross operating surpluses, mainly in closed sectors, which in turn are fuelling investment, and even consumption via dividends and the wealth effect generated by the rise of stock prices.
- Due to the current wage moderation registered by a non-formal wage policy since 1997, the inflation is reducing the real wages. The negative growth of real wages is specially important for those sectors open to foreign competition, that is manufacturing sector, whose price increases can not be significantly different from those registered in the world markets and that suffer from the pressure of the higher costs of domestic goods and inputs (mainly from those of the services sector closed to foreign competition).

The second difference is the fact that the inflation problem is not generated in the labour market through the pressures exerted by the intense process of employment creation on the wage setting process. Actually, the current phase of economic growth is not coming with rising real wages but with a fall in real wages. It is the rise of corporate profits and the behaviour of the mark-ups the main determinants of the current high inflation rates.

The paper structures as follows. First, we will show the main features of the model of economic growth and economic policy registered in Spain since the beginning of the democracy until mid-nineties. This is a relevant element to understand the different roots of the current economic expansion. As we will see below, during the decade of the eighties and the first half of the nineties, the Spanish economic authorities implemented an orthodox strategy of economic policy, whose main pillars was a tight monetary policy focused on the inflation and a systematic policy of flexibilizing the labour market through the extended use of fixed-term employment contracts. Second, we will focus on the basis of the economic situation and the economic policy since the incorporation of Spain to the EMU. Next, we will pay special attention to the role played by inflation in the current phase of economic growth. Last section summarizes and concludes.

## 2. The economic policy in Spain before the EMU[1]

[1] This section is based on Ferreiro and Serrano (2001a, 2001b and 2004)

Since the beginning of the democracy in Spain in 1977 and until the Spanish incorporation to the EMU, the economic policy has an orthodox stance. This stance is clearly reflected in the vector of instruments and objectives that defined the macroeconomic policy, though several phases can be distinguished along the period.

Since the late seventies, the economic policy was focused on the control of the inflationary process. In late seventies, the economy suffered a serious problem of inflation, with rates having peaked 24.5% in 1977 and reaching 15.7% in 1979. Though, inflation was a generalized process in most developed economies, in Spain it was fuelled by a set of particular determinants: first, a loose monetary policy implemented by the last governments of the dictatorship, that tried to offset the negative impact on Spain, an economy strongly dependent of foreign sources of energy and with a productive structure where the industry most intensive in the consumption of energy dominated in the manufacturing sector, of the increase of oil prices; and, second, a wage-push allowed by the late francoist governments that tried to offset the wage moderation registered in the early seventies at the time that was politically instrumented as a legitimation tool by a political system in decomposition that tried to silence the generalized dissatisfaction generated by political and economic elements.

Until mid-eighties, the incomes policy, that is, wage policy, was the main instrument of the counter-inflationary policy (Ferreiro, 2003; Ferreiro and Serrano, 2004). The implementation of the incomes policy was justified by both political and economic reasons. Incomes policy was an (essential) part of a wider social concertation policy, whose ultimate objective was to help to consolidate the incipient democratic process by generating a climate of (relative) social peace. But, incomes policy had an economic foundation, since voluntary wage moderation had as a direct objective the slow-down of the growth of labour costs. The fall of real unit labour costs was considered as a prerequisite to, first, moderate the inflation rates, and, second, to increase the corporate profits and, subsequently, to stimulate private investments and to re-organize the low competitive productive sector.

Moreover, we can not forget that incomes policy worked as a substitute of the traditional macroeconomic policies, like the monetary and fiscal policies. In the case of the monetary

policy, it could not play a significant role until late-eighties[2], and, besides, wage moderation avoided the implementation of a tighter monetary policy that, through the increase in real interest rates, could have damaged even deeper the private investment. In the case of the fiscal policy, it faced serious problems for an effective implementation, due, first, to the (relative) small size of the public sector and, second, to the need of increasing the social expenditures, among other reasons, to facilitate the implementation of the incomes policy (Ferreiro and Gomez, forthcoming).

This strategy changes with the first Socialist government. A set of elements help to explain the break of the model of economic policy implemented during the first years of democracy. Though paradoxical, one of these elements is the consolidation of the democracy. The election of a government with a majority of seats at the Parliament and the view of the democracy as a fully consolidated process[3] allowed to the political authorities to implement unpopular measures than the previous (minority) administrations did not want or dare to do it, like the tax reforms or an intense manufacturing reconversion process with deep impacts in certain industries and regions.

This new political scene helps also to understand the rising distance between the Socialist administrations and the trade union movement, mainly with the socialist trade union Union General de Trabajadores (UGT). This distance led to a nation-wide strike against the Socialist government in 1988. This situation explains the rejection of the Socialist government to the implementation of an incomes policy agreed with the unions, whose permanence and effectiveness depended on the existence of a political and economic exchange with the involved unions, mainly UGT.

But, behind the change of strategy there also exits a set of economic elements[4]. The first one was the problems to slow down the inflation rates and to keep the process of wage moderation. In this sense, there was the new view according to which the inflationary process was due to an

[2] Until 1985, the monetary policy only focused only on the sterilisation of the monetary effects of the public deficit (Marín and Peñalosa, 1997). The funding of the budget deficit via legal investment ratios, joined to the high bank reserves ratios, obstructed the Banco de España to adopt monetary measures via short-term interventions like, for instance, interbank loans or open market interventions using public debt issues in the hands of commercial banks. We must keep in mind that in 1985 nearly 50% of total assets in the banking system were affected in view of the different legal ratios (Marin and Peñalosa, 1997)

[3] There is a consensus about the view that the process of transition to the democracy ends with the election of the Socialist government in October 1982 and that the democracy is fully consolidated with the entry to the EEC in 1986.

[4] We can not forget the example of the negative consequences of the expansionary policy implemented by the French Socialist governments in 1981-82.

excessive wage growth fuelled by an ineffective institutional model of the labour market (inefficient structure of the collective bargaining, wage bargaining based on an imitation effect, excessive wage rigidity and excessive rigidity in the labour hiring).

Moreover, it is in the mid eighties when the problem of unemployment is more severe. The destruction of jobs generated by the economic crises of late seventies and early nineties and by the intense manufacturing reconversion process implemented since 1983 is joined to a mass incorporation of new population (youngster but, mainly, women) to the labour market and to a significant return of emigrants from Western Europe. Though since 1985 employment is rising, this creation of employment is not enough to offset the employment destroyed in the past (from 1977q1 to 1984q4, more than 1,260,000 salaried jobs were lost) and to employ the new active population. The outcome was a huge increase in the figures of unemployed and in the rates of unemployment: from 1977 to 1985 the figure of unemployment rose from 690,000 to 3 million people, and the rate of unemployment rose from 5.2% to 21.5%.

With the objective of curbing the inflationary process, the monetary policy will get a tight stance. Once solved the constraints to the discretionary management of the monetary policy, monetary policy will get a key status in the strategy of monetary policy, with the result of the increase in real interest rates. In this sense, the previous practices of monetary and privileged funding of the public deficit was considered as incompatible with the new strategy of monetary policy, and an orthodox funding of public deficits was implemented. The outcome was the increase in the debt burden and the rise in the size of public deficits, what made necessary the implementation of measures to reduce fiscal imbalances by cutting public expenditures.

Furthermore, the problem of mass unemployment began to be explained by the presumed existence of rigidities in the labour market, mainly in the fields of hiring and firing. This view put the emphasis in the need of flexibilizing the labour market, acting on the ways of hiring-firing. Thus, in 1984 the first labour market was passed allowing the hiring of workers with fixed-term employment contract regardless the permanent of temporary nature of their jobs. The kind of flexibilization adopted was an external-numerical flexibilization in the margin, because it only affected to those workers with temporary employment contracts, leaving unaffected those incumbent permanent workers and leaving unaffected the constraints that prevented a more intense internal-functional flexibilization. Thus, from 1987q2 to 1990q4 permanent salaried

employment fell in 247,000 workers but temporary salaried employment rose in 1,796,000 workers, and the share of temporary salaried workers rose from 15.3% to 31.3%

Therefore, since mid-eighties a new strategy of economic policy was implemented, whose main features were a tight monetary policy, a fiscal policy focused on the control and reduction of public deficits and the flexibilization of the labour markets through a set of measures and reforms that affected to the firing costs, the unrestricted use of fixed-term employment contracts and the cuts in the unemployment protection scheme approved in 1991-92.

In this strategy, the entry of Spain in the European Monetary System in 1989 made even more intense the tight stance of the monetary policy. Though the inflation rate was only 4.8% in 1988, it reached 6.8% in 1989. The entry of the peseta in the EMS involved that the exchange rate became the main instrument of the counter-inflationary policy. Joined to the gains in terms of credibility from a policy of currency stability, the Bank of Spain opted by keeping a overvalued exchange rate, what was reached thanks to the high nominal and real interest rates[5]. The currency stability joined to the high real interest rates led to a huge capital inflow that increased substantially the loanable funds supply. The higher capital supply, joined to the economic acceleration of the late eighties and the positive expectations led, despite the high interest rates, to an increase of private investments. Thus, gross fixed capital formation rose from 17.7% GDP in 1984 to 25.4% GDP in 1990.

Despite the good macroeconomic outcomes (the GDP grew form 1985 to 1990 at an average rate of 4.5%, employment grew in 1,950,000 people and the rate of unemployment fell from 21.5% to 16.2%), however, the bases of the model of growth were quite weak. The model was clearly unsustainable. Firstly, the growth was based on an investment based on the high margins of profits (thanks to the low wage costs) and on a certain investment bubble, and on a consumption fuelled by the higher levels of employment, but where all the employment created was temporary, and, consequently, highly pro-cyclical, as the early nineties crisis shown. Moreover, the growth came with an acceleration of inflation (reaching 6.8% in 1989 and 6.7% in 1990) and with a competitiveness problem generated by the inflation gap and the overvalued exchange rate of the peseta (the current account moved from a surplus of 4.9%GDP in 1984 to a deficit of 6.9% in 1992).

[5] This strategy generated a vicious circle: high interest rates leading to huge capital inflows leading to higher interest rates to sterilize the monetary-inflationary impact of these inflows.

The crisis of the years 1991-93 showed the weaknesses of the model of growth and the failure of the orthodox strategy implemented of economic policy. The most dramatic outcome was the huge destruction of jobs: from 1991q3 to 1994q1 885,000 salaried jobs were destroyed, the 71.5% of them being permanent jobs. The share of temporary employment kept rising, reaching 35.2% in 1995q3.

The crisis of the EMS, allowed the monetary policy to adopt a looser stance, leading to a significant fall of interest rates: thus, for instance, the average real interest rate of mortgages fell from 11.6% in April 1993 to only 5.8% in March 1995. Fiscal policy also adopted a looser stance: public deficit rose from 4.2% GDP in 1990 to 6.6% in 1995, due exclusively to an increase in the public expenditures, that rose form 42.6% GDP to 45%GDP.

Despite the loose stance of monetary and fiscal policy, the Spanish economy remained nearly stagnated: GDP grew at rates of 2.7% in 1995 and 2.4% in 1994. Behind this bad outcome was the poor performance of private consumption that despite the creation of employment, remained unchanged[6]. Both public authorities and social agents agreed that behind the poor performance of private consumption, was the excessive rate of temporary workers, that was increasing the precautionary motive saving. Hence, the need to reform the labour market reducing the huge figures of temporary employment, since it was generating both micro and macroeconomic problems that made difficult the necessary employment creation to reduce the huge rates of unemployment (24.1% in 1994) and to ensure a sustained process of economic growth in the long-term. With that aim, in 1994 a new labour market reform was passed with the explicit objective of reducing the shares of temporary workers, trying to recover the principle of causality, that is, setting more stringent conditions to the use of fixed-term contracts, and to modify the pattern of flexibility, promoting the internal flexibilization of staffs instead of the external-numerical flexibilization provided by the use of temporary workers.

However, the 1994 reform was a failure. Though it did promote the permanent hiring of workers, it also increased the problem of the labour rotation of them, since it led to a dramatic fall of the length of the fixed-term employment contracts (actually the rate of temporary workers was above 39% in the private sector since 1994q2 to 1996q4). Moreover, social agents, both employers

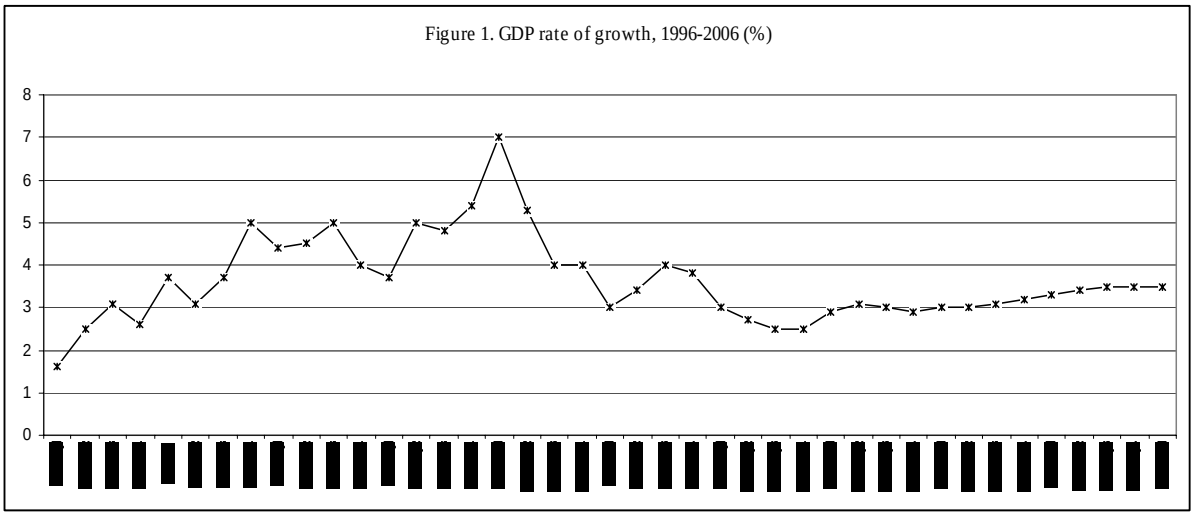
[6] From 1993 to 1995, real GDP grew at rates of -1.2%, 2.3% and 2.7, but private consumption grew at lower rates: -2.2%, 0.9% and 1.7%, respectively

associations and the main trade unions did not move to the collective bargaining agreements the necessary measures to promote the internal flexibility of staffs.

## 3. The Spanish economic policy since the incorporation to EMU

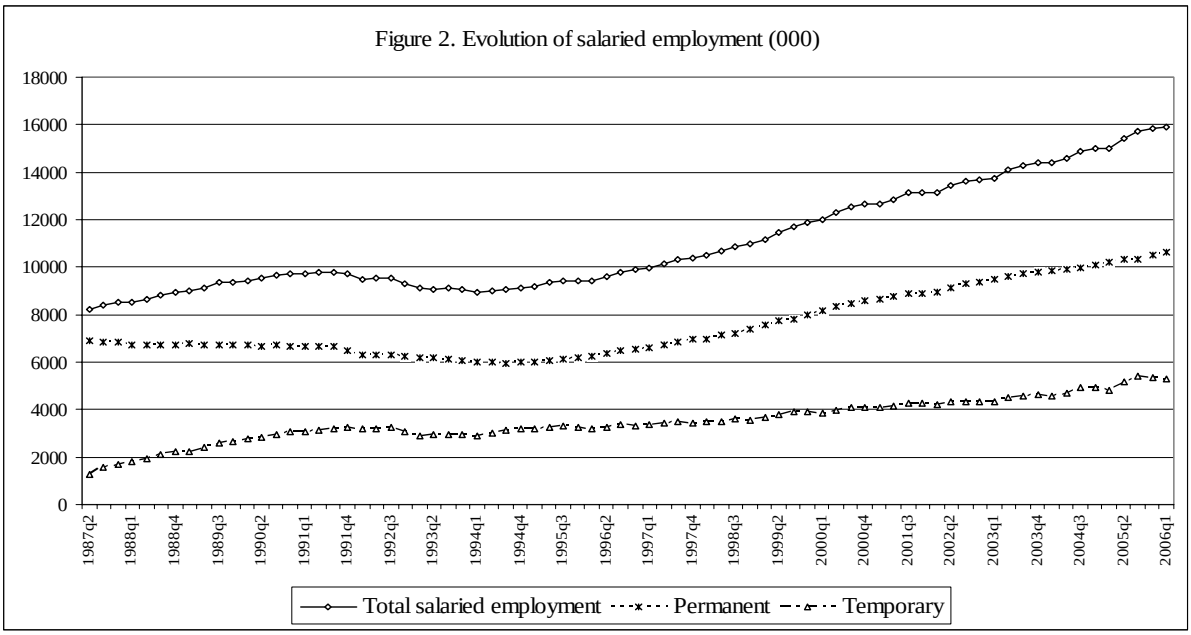
Despite this bad starting point, since 1997 the Spanish economy has enjoyed an unparallel stage of economic growth. Figure 1 shows the evolution of the GDP, since 1997 Spain has permanently grown at rates above 3%, and though since the year 2000 the pace of growth has slowed, it is still registering rates of 3.5% in the last year.

Figure 1. GDP rate of growth, 1996-2006 (%)




Source: Instituto Nacional de Estadística

The economic boom has led to a significant employment creation. Since 1997q1 to 2006q1, more than 5,900,000 salaried jobs have been created in Spain. As figure 2 shows, this process has not only affected to temporary employment (+1,960,000 workers) but also, and this one key difference with previous phases of economic growth, to permanent employment (+4 million workers).




Source: Instituto Nacional de Estadística

This prolonged expansion has led to a dramatic fall in the rate of unemployment, reaching a figure of 10% for the unemployment rate in 2006q1, a rate not registered since 1980 (figure 3). But what is even more significant, is the fact that the employment creation process has not only allowed to reduce the unemployment rates but also to increase the activity rate of the Spanish labour market, rising from 51.4% in 1997q1 to 58% in 2006q1. In absolute figures, that process means that during the last nine years the active population has risen in Spain in 4,657,000 workers (+28%)

Figure 3. Employment and unemployment in Spain


Source: Instituto Nacional de Estadística

The elements that have contributed most to the economic expansion have clearly been the household consumption and the investments (table 1). In the case of the evolution of the investments, two different phases can be clearly distinguished. From 1997 until 2001, the most dynamic element was the investment if capital goods, but since that date until the last semester of 2004, the growth of that kind of expenditures remained quite low. It was the construction sector, where investment in dwellings played a key role, the engine of the growth of the Spanish economy, at least until last year when productive investment started a new period of remarkable acceleration.

Table 1. Annual variation rate of GDP

| | 1996q1 | 1996q2 | 1996q3 | 1996q4 | 1997q1 | 1997q2 | 1997q3 | 1997q4 | 1998q1 | 1998q2 | 1998q3 | 1998q4 | 1999q1 | 1999q2 | 1999q3 | 1999q4 | 2000q1 | 2000q2 | 2000q3 | 2000q4 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Gross domestic product | 1.6 | 2.5 | 3.1 | 2.6 | 3.7 | 3.1 | 3.7 | 5.0 | 4.4 | 4.5 | 5.0 | 4.0 | 3.7 | 5.0 | 4.8 | 5.4 | 7.0 | 5.3 | 4.0 | 4.0 |
| National final consumption expenditure. Total | 2.8 | 2.3 | 1.6 | 1.6 | 0.7 | 2.0 | 4.9 | 4.5 | 5.1 | 4.4 | 3.7 | 5.0 | 4.7 | 5.3 | 4.9 | 5.1 | 6.2 | 5.5 | 4.8 | 3.6 |
| National final consumption expenditure: general government | 0.7 | 1.4 | 1.6 | 1.4 | 2.4 | 2.3 | 2.4 | 2.9 | 2.8 | 3.4 | 3.8 | 4.0 | 3.7 | 3.7 | 4.0 | 4.5 | 5.8 | 5.0 | 6.9 | 3.5 |
| National final consumption expenditure: households and NPISH | 3.4 | 2.6 | 1.6 | 1.7 | 0.2 | 1.9 | 5.7 | 5.0 | 5.8 | 4.7 | 3.6 | 5.3 | 4.9 | 5.8 | 5.2 | 5.3 | 6.3 | 5.7 | 4.2 | 3.7 |
| Gross capital formation. Total | -0.8 | 3.2 | 4.0 | 2.8 | 15.1 | 4.7 | -7.1 | 6.9 | 2.1 | 9.3 | 25.0 | 13.5 | 6.3 | 14.5 | 11.9 | 11.4 | 11.9 | 4.3 | 3.9 | 4.7 |
| Gross fixed capital formation. Total | 2.7 | 1.8 | 3.5 | 2.4 | 2.9 | 4.3 | 5.2 | 7.7 | 10.2 | 10.4 | 12.0 | 12.6 | 11.2 | 12.1 | 10.0 | 8.7 | 7.3 | 5.7 | 6.4 | 7.1 |
| Gross fixed capital formation in capital good. Total | 10.1 | 10.5 | 11.1 | 8.4 | 7.2 | 9.8 | 11.1 | 15.8 | 19.6 | 17.2 | 17.2 | 16.3 | 12.1 | 12.9 | 11.0 | 7.6 | 8.5 | 6.4 | 5.9 | 7.5 |
| Gross fixed capital formation in construction. Total | -2.1 | -3.5 | -1.2 | -1.1 | 0.8 | 1.6 | 2.4 | 3.4 | 5.2 | 6.8 | 8.6 | 10.5 | 10.3 | 10.3 | 9.0 | 8.7 | 6.0 | 5.3 | 6.1 | 6.4 |
| Gross fixed capital formation in construction. Dwellings | 14.5 | 13.2 | 12.9 | 9.0 | 4.8 | 1.3 | 0.5 | 2.4 | 5.8 | 10.8 | 13.7 | 13.2 | 11.9 | 10.4 | 10.4 | 12.9 | 12.6 | 12.2 | 9.5 | 7.4 |
| Gross fixed capital formation in construction. Other constructions | -10.6 | -12.3 | -9.2 | -7.1 | -1.8 | 1.9 | 3.7 | 4.2 | 4.7 | 4.1 | 5.2 | 8.6 | 9.2 | 10.3 | 8.0 | 5.7 | 1.0 | 0.0 | 3.5 | 5.6 |
| Variation in stocks | -152.3 | 417.2 | 19.6 | 42.4 | -1,016.5 | 30.5 | -321.3 | -53.6 | -75.0 | -45.2 | -133.7 | 163.1 | -201.1 | 246.6 | 88.1 | 200.2 | -200.6 | -38.5 | -55.8 | -56.1 |
| Exportation of goods and services. Total | 6.4 | 8.8 | 14.4 | 11.8 | 8.6 | 16.8 | 18.6 | 15.4 | 16.9 | 9.9 | 3.2 | 3.5 | 7.3 | 5.3 | 7.6 | 9.6 | 11.6 | 12.4 | 8.8 | 8.4 |
| Importation of goods and services | 8.0 | 9.0 | 10.0 | 9.2 | 9.4 | 14.7 | 12.3 | 16.2 | 16.8 | 14.2 | 14.7 | 13.9 | 12.1 | 14.1 | 14.3 | 14.0 | 13.4 | 11.8 | 10.6 | 7.7 |

| | 2001q1 | 2001q2 | 2001q3 | 2001q4 | 2002q1 | 2002q2 | 2002q3 | 2002q4 | 2003q1 | 2003q2 | 2003q3 | 2003q4 | 2004q1 | 2004q2 | 2004q3 | 2004q4 | 2005q1 | 2005q2 | 2005q3 | 2005q4 | 2006q1 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Gross domestic product | 3.0 | 3.4 | 4.0 | 3.8 | 3.0 | 2.7 | 2.5 | 2.5 | 2.9 | 3.1 | 3.0 | 2.9 | 3.0 | 3.0 | 3.1 | 3.2 | 3.3 | 3.4 | 3.5 | 3.5 | 3.5 |
| National final consumption expenditure. Total | 3.7 | 3.4 | 2.9 | 3.5 | 2.9 | 2.8 | 3.5 | 3.7 | 3.1 | 2.6 | 3.2 | 3.4 | 3.8 | 5.1 | 5.1 | 5.0 | 4.7 | 4.4 | 4.3 | 4.2 | 4.1 |
| National final consumption expenditure: general government | 3.4 | 4.8 | 2.1 | 5.5 | 3.4 | 4.3 | 5.0 | 5.3 | 5.5 | 4.4 | 4.5 | 4.8 | 5.5 | 6.0 | 6.5 | 6.0 | 5.2 | 4.0 | 4.2 | 4.6 | 4.7 |
| National final consumption expenditure: households and NPISH | 3.8 | 3.0 | 3.2 | 3.0 | 2.8 | 2.4 | 3.1 | 3.2 | 2.4 | 2.0 | 2.8 | 3.0 | 3.3 | 4.8 | 4.7 | 4.7 | 4.6 | 4.6 | 4.3 | 4.0 | 3.9 |
| Gross capital formation. Total | 6.3 | 6.1 | 3.2 | 1.5 | 2.0 | 2.1 | 3.7 | 6.0 | 6.1 | 6.1 | 5.2 | 4.4 | 4.4 | 4.1 | 5.1 | 5.7 | 6.8 | 7.2 | 7.2 | 6.5 | 6.3 |
| Gross fixed capital formation. Total | 6.8 | 6.4 | 3.5 | 1.7 | 2.2 | 2.2 | 3.5 | 5.5 | 6.1 | 6.0 | 5.3 | 4.8 | 4.1 | 4.1 | 5.3 | 5.8 | 7.0 | 7.6 | 7.3 | 6.8 | 6.2 |
| Gross fixed capital formation in capital good. Total | 4.0 | 2.6 | 0.2 | -6.2 | -4.3 | -6.5 | -3.4 | 2.7 | 3.6 | 3.7 | 2.1 | 0.7 | -0.7 | 0.9 | 6.2 | 8.4 | 9.8 | 10.4 | 8.9 | 9.1 | 8.3 |
| Gross fixed capital formation in construction. Total | 8.8 | 9.0 | 4.7 | 4.9 | 4.4 | 6.0 | 7.2 | 7.3 | 6.9 | 6.4 | 6.0 | 6.0 | 6.0 | 5.5 | 5.3 | 5.2 | 6.0 | 6.2 | 6.3 | 5.6 | 5.8 |
| Gross fixed capital formation in construction. Dwellings | 8.6 | 7.4 | 5.2 | 2.8 | 0.4 | 5.9 | 7.5 | 14.1 | 14.1 | 9.0 | 7.8 | 7.1 | 5.7 | 7.4 | 6.2 | 4.6 | 5.9 | 5.9 | 7.0 | 5.1 | 7.4 |
| Gross fixed capital formation in construction. Other constructions | 9.0 | 10.4 | 4.2 | 6.7 | 7.9 | 6.1 | 6.9 | 1.8 | 0.9 | 4.1 | 4.3 | 4.9 | 6.3 | 3.7 | 4.4 | 5.9 | 6.2 | 6.5 | 5.6 | 6.1 | 4.1 |
| Variation in stocks | -16.3 | -13.9 | -12.0 | -11.0 | -8.0 | -1.0 | 15.9 | 41.4 | 5.0 | 11.2 | 0.2 | -19.5 | 24.5 | 0.8 | -7.5 | -7.5 | -7.7 | -16.6 | -0.4 | -18.4 | 9.7 |
| Exportation of goods and services. Total | 5.9 | 3.2 | 5.2 | 1.9 | -0.9 | 1.8 | 1.6 | 4.6 | 4.6 | 3.6 | 4.1 | 2.2 | 4.0 | 3.0 | 3.7 | 2.7 | -1.4 | 1.3 | 2.1 | 1.9 | 9.1 |
| Importation of goods and services | 10.4 | 5.3 | 1.6 | -0.4 | -1.4 | 1.9 | 5.0 | 10.3 | 7.8 | 4.8 | 6.4 | 5.1 | 7.4 | 9.6 | 10.5 | 9.7 | 6.2 | 7.9 | 7.8 | 6.6 | 12.4 |

Source: INE

Table 2. Composition of GDP (current prices)

| | 1996q1 | 1996q2 | 1996q3 | 1996q4 | 1997q1 | 1997q2 | 1997q3 | 1997q4 | 1998q1 | 1998q2 | 1998q3 | 1998q4 | 1999q1 | 1999q2 | 1999q3 | 1999q4 | 2000q1 | 2000q2 | 2000q3 | 2000q4 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| National final consumption expenditure | 78.8 | 77.8 | 77.0 | 77.4 | 76.4 | 76.9 | 77.9 | 77.0 | 76.8 | 76.4 | 76.5 | 77.3 | 76.9 | 76.4 | 76.7 | 76.9 | 76.9 | 76.9 | 77.2 | 76.5 |
| National final consumption expenditure: households | 63.5 | 62.7 | 62.1 | 62.7 | 61.9 | 62.5 | 63.7 | 63.0 | 62.9 | 62.4 | 62.6 | 63.4 | 63.1 | 62.8 | 62.9 | 63.3 | 63.0 | 63.2 | 63.2 | 63.0 |
| National final consumption expenditure: general government | 18.1 | 18.0 | 18.0 | 17.9 | 17.6 | 17.6 | 17.5 | 17.3 | 17.3 | 17.4 | 17.3 | 17.3 | 17.3 | 17.2 | 17.1 | 17.1 | 17.2 | 17.1 | 17.6 | 16.9 |
| Gross capital formation | 21.1 | 21.9 | 22.4 | 21.5 | 23.1 | 22.5 | 20.7 | 22.1 | 23.1 | 23.5 | 23.7 | 23.6 | 23.8 | 25.6 | 25.6 | 25.5 | 26.3 | 26.1 | 26.2 | 26.4 |
| Gross fixed capital formation | 21.4 | 21.2 | 21.5 | 21.5 | 21.5 | 21.8 | 22.0 | 22.0 | 22.5 | 22.6 | 23.2 | 23.8 | 23.8 | 24.4 | 24.8 | 25.2 | 25.8 | 25.7 | 25.8 | 26.0 |
| Gross fixed capital formation. Dwellings | 4.7 | 4.7 | 4.8 | 4.8 | 4.8 | 4.7 | 4.7 | 4.7 | 4.8 | 4.9 | 5.1 | 5.2 | 5.3 | 5.4 | 5.6 | 5.7 | 5.9 | 6.1 | 6.2 | 6.3 |
| Gross fixed capital formation. Other construction | 7.1 | 6.9 | 6.9 | 6.8 | 6.8 | 6.8 | 6.9 | 6.7 | 6.7 | 6.6 | 6.8 | 7.0 | 7.0 | 7.1 | 7.1 | 7.1 | 6.9 | 7.0 | 7.3 | 7.5 |
| Variation in stocks | -0.3 | 0.7 | 0.9 | 0.0 | 1.6 | 0.7 | -1.3 | 0.1 | 0.6 | 1.0 | 0.4 | -0.3 | 0.1 | 1.2 | 0.7 | 0.3 | 0.5 | 0.5 | 0.4 | 0.4 |
| Exportation of goods and services | 23.0 | 23.0 | 23.7 | 24.8 | 24.3 | 26.2 | 27.5 | 27.2 | 26.9 | 27.1 | 26.5 | 26.1 | 26.5 | 26.2 | 26.7 | 27.2 | 28.0 | 29.1 | 29.1 | 29.8 |
| Importation of goods and services | 22.8 | 22.8 | 23.1 | 23.8 | 23.8 | 25.6 | 26.0 | 26.3 | 26.8 | 27.1 | 26.8 | 27.0 | 27.2 | 28.2 | 29.0 | 29.7 | 31.3 | 32.1 | 32.5 | 32.7 |

| | 2001q1 | 2001q2 | 2001q3 | 2001q4 | 2002q1 | 2002q2 | 2002q3 | 2002q4 | 2003q1 | 2003q2 | 2003q3 | 2003q4 | 2004q1 | 2004q2 | 2004q3 | 2004q4 | 2005q1 | 2005q2 | 2005q3 | 2005q4 | 2006q1 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| National final consumption expenditure | 77.2 | 76.4 | 75.6 | 75.3 | 75.7 | 75.4 | 75.2 | 75.5 | 75.5 | 74.2 | 74.5 | 74.9 | 75.2 | 75.4 | 75.6 | 75.7 | 75.5 | 75.5 | 75.4 | 75.7 | 75.8 |
| National final consumption expenditure: households | 63.4 | 62.6 | 61.9 | 61.3 | 61.9 | 61.0 | 60.8 | 60.8 | 61.1 | 59.8 | 59.9 | 59.9 | 60.4 | 60.1 | 60.3 | 60.3 | 60.3 | 59.7 | 60.1 | 60.1 | 59.8 |
| National final consumption expenditure: general government | 17.1 | 17.2 | 17.0 | 17.1 | 16.8 | 17.3 | 17.3 | 17.4 | 17.2 | 17.4 | 17.4 | 17.6 | 17.6 | 17.8 | 17.9 | 17.9 | 17.7 | 17.8 | 17.7 | 18.0 | 17.8 |
| Gross capital formation | 26.9 | 26.6 | 26.3 | 25.6 | 26.5 | 26.6 | 26.6 | 26.8 | 27.3 | 27.6 | 27.4 | 27.4 | 27.8 | 28.2 | 28.4 | 28.7 | 29.3 | 29.8 | 29.8 | 29.9 | 30.5 |
| Gross fixed capital formation | 26.5 | 26.2 | 25.9 | 25.3 | 26.1 | 26.2 | 26.2 | 26.3 | 27.0 | 27.3 | 27.0 | 27.1 | 27.4 | 27.9 | 28.0 | 28.3 | 28.9 | 29.5 | 29.5 | 29.6 | 30.1 |
| Gross fixed capital formation. Dwellings | 6.4 | 6.5 | 6.5 | 6.4 | 6.4 | 6.9 | 7.1 | 7.4 | 7.4 | 7.7 | 7.7 | 8.0 | 7.9 | 8.4 | 8.3 | 8.6 | 8.5 | 8.9 | 8.8 | 9.0 | 9.1 |
| Gross fixed capital formation. Other construction | 7.3 | 7.5 | 7.4 | 7.6 | 7.6 | 7.8 | 7.7 | 7.6 | 7.6 | 7.9 | 7.8 | 7.7 | 7.7 | 8.0 | 7.9 | 8.1 | 8.1 | 8.4 | 8.3 | 8.4 | 8.3 |
| Variation in stocks | 0.4 | 0.4 | 0.4 | 0.4 | 0.3 | 0.4 | 0.4 | 0.5 | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 | 0.3 | 0.4 | 0.3 | 0.3 | 0.3 | 0.4 |
| Exportation of goods and services | 29.2 | 28.9 | 28.5 | 27.7 | 27.3 | 27.5 | 27.2 | 27.2 | 26.6 | 26.5 | 26.3 | 26.0 | 25.8 | 26.0 | 26.1 | 25.7 | 24.7 | 25.3 | 26.0 | 25.4 | 26.1 |
| Importation of goods and services | 33.2 | 31.9 | 30.3 | 28.6 | 29.5 | 29.5 | 29.0 | 29.4 | 29.5 | 28.4 | 28.3 | 28.3 | 28.8 | 29.6 | 30.1 | 30.2 | 29.6 | 30.6 | 31.2 | 31.0 | 32.3 |

Source: INE

As a direct consequence of this model of growth, the weight of the domestic consumption in the GDP has fallen, reaching percentages below 60%. We must stress that this falling consumption takes place during a process of intense employment creation (not only of temporary employment but also, and mainly, of permanent employment) and reduction of unemployment, of intense growth of population mainly due to the massive inflows of immigrants, and where several cuts in direct taxes have been passed. All these elements should have led to an increase of consumption in terms of the percentage of GDP. As we will see later, behind this paradox we will find the negative growth of real wages that has led to a redistribution of national income against compensation of employees.

How has influenced the economic policy in this process of sustained expansion?. To give an answer we must focus in the role played by the labour market policy and the macroeconomic policy. First, we will focus on the first element, which in turn, leads us to pay special attention to the reforms of the labour market passed since 1997, whose aim was to reduce the high rates of temporary employment, and to the implicit wages policy existing since that year.

In 1997, with the implicit support from the new conservative administration of the Partido Popular, the main trade unions (Comisiones Obreras, CCOO, and Unión General de Trabajadores, UGT) signed two interconfederal agreements that, with the monetary policy adopted by the European Central Bank (ECB) since the implementation of the euro, are the cornerstones of the current economic policy in Spain.

The ultimate aim of the first agreement the Interconfederal Agreement on the Employment Stability (AIEE) was to complete the return to the principle of causation in the field of permanent-temporary labour hiring. The objective of the AIEE was the reduction of the share of temporary workers, a percentage that all the social agents considered as excessive and, this is the most important, at the root of the problems of competitiveness and growth suffered by the Spanish economy. The AIEE creates a new modality of permanent employment contract, initially directed to specific groups of workers, mainly unemployed ones and youngsters, with lower firing costs than the

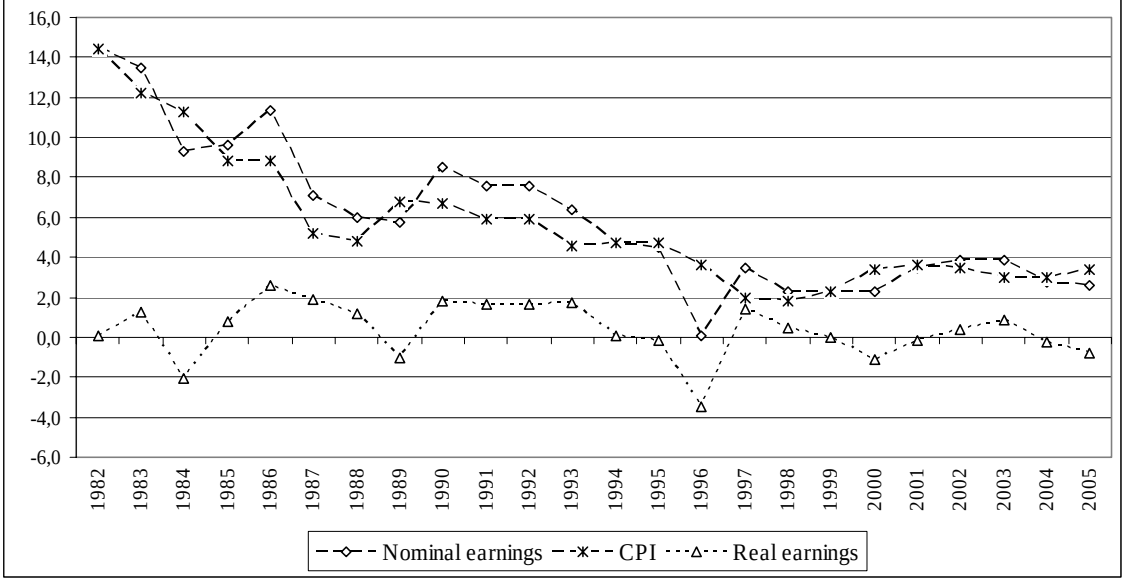
ordinary permanent contract. This new permanent contract helps to understand the rise in permanent employment contract since 1997 (Ferreiro and Gómez, 2006).

The AIEE had a validity of only four years. The lack of consensus between employers and trade unions, led the Conservative administration to unilaterally approve a new reform of the labour market, whose main content was the maintenance of the new permanent employment contract and the increase in the range of groups of workers that could sign this contract. In this sense, only a couple of months ago, the new Socialist administration has approved a new labour market reform agreed with the employers associations and the unions UGT and CC.OO on the bases of this two previous reforms, always with the new permanent employment contract at the centre of the reform. This new reform allows the possibility of using in the future the new permanent contract and tries to foster the conversion of fixed-term employment contracts into permanent ones by concentrating the public grants only in the hiring of workers with permanent contracts and in the conversion of temporary workers into permanent workers (though in the latter case, the grants only will given for those conversions made during 2006). The objective of this new reform was the fall in the percentage of temporary workers and to try to slow down the acceleration in the hiring of temporary workers that had being taken place since 2005 (Ferreiro, Gómez and Serrano, 2006).

But even more significant in terms of its macroeconomic consequences is the existence since 1997 of the Interconfederal Agreement on Collective Bargaining (AINC). The AINC has two main objectives: first, the use of collective bargaining as a key tool to change the current pattern of numerical-external flexibilization of the staffs for a internal-functional flexibility, and second, to reach an agreed wage moderation, thus making the successive new and extended AINCs an implicit wage policy. The AINCs involve a double trade-off: the first one, between the reduction of temporary employment and the fostering of permanent hiring and the internal (functional and geographical) flexibility; the second one, between wage moderation and the creation of permanent employment. In this sense, the AINCs have an explicit twofold micro and macroeconomic objectives: the microeconomic objective is the change in the pattern of competitiveness of the Spanish firms, changing the current dominant one (based on low wage costs and an intense use of temporary workers) to a new one (based on high productivity, innovation and R&D activities and an intense use of permanent workers).

The macroeconomic objectives are to reach a sustained path of high rates of economic growth, to increase the investment and the activities related to the innovation of firms and to reach non-inflationary environment, what involves the implicit acceptance of the inflation target of 2% of the CPI. In this sense, the guideline adopted since 1997 in the subsequent AINCs has been the need to bargain real wages below the increases of productivity, what involves the acceptance of negative real unit labour costs. Actually, as figure 4 shows, the current policy of voluntary wage moderation has involved the acceptance of a freeze of real wages in Spain

Figure 4. Annual rates of growth of nominal and real earnings (%)




Source: Instituto Nacional de Estadística

However, both the reforms of the labour market and that implicit wages policy can not explain alone the permanence of the high rates of economic growth. At most, they could help to understand the evolution of the figures of permanent and temporary employment or the evolution of total employment and of the unemployment rates. In a context of a fall or real earnings, investment can only expand in case of a pull of exports and a substitution of (relatively more expensive) imports by (relatively cheaper) domestic production. However, as we have seen in table 1 and 2, the contribution of current account to the economic activity has been negative, due to the huge deficit in the current account (slightly above 7%GDP). Therefore, we must pay special attention to the role played by the macroeconomic policy.

Table 3. Public expenditures and resources (%GDP)

| | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|---|---|---|---|
| Current expenditures | 42.2 | 41.7 | 39.7 | 42.4 | 38.5 | 38.7 | 38.3 | 38.8 | 38.2 |
| Current resources | 39.0 | 39.1 | 38.4 | 41.4 | 38.0 | 38.4 | 38.3 | 38.7 | 39.3 |
| Overall balance | -3.2 | -2.7 | -1.3 | -1.0 | -0.5 | -0.3 | 0.0 | -0.2 | 1.1 |

Source: Banco de España

Table 3 shows the basic elements of the Spanish fiscal policy. It is clear that the fiscal policy stance has not been an expansionary one, but tight. Since 1997, Spanish authorities have carried out an intense process of fiscal consolidation: the public deficit of the year 1997 (3.2% GDP), has turned into a surplus of 1.1%GDP in 2005. This surplus has been reached with a dramatic fall in public expenditures of 4 percentage points of the GDP. This fiscal consolidation has led to a fall in the weight of public debt from 65.3% GDP in 1997 to 43.2% GDP in 2005.

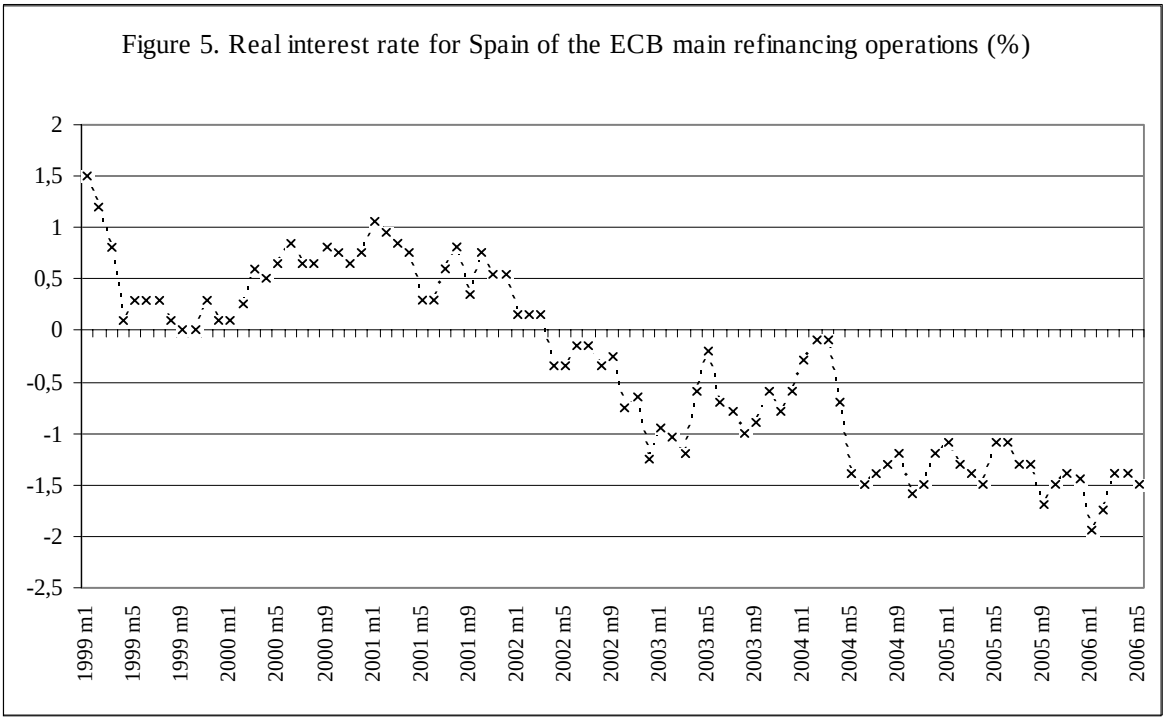
It could be argued that through the working of non-Keynesian effects, the Spanish fiscal policy could have generated the bases for the current sustained expansion. However, since 2001, the fiscal consolidation has been driven by a rise of public revenues and not by falling expenditures, something that is contradictory with the postulates of the defenders of the existence of non-Keynesian effects.

It is in this situation when we must turn to the role played by the monetary policy. In the EMU there is a single monetary policy ruled by the ECB, a monetary policy that has been often blamed as one of the main reasons of the stagnation of the European economies. However, though such a statement might be true for the whole EMU countries, it is not necessarily true all of them, like, for instance Spain, and the main reasons is not other than the higher inflation rates of Spain, that have made the ECB monetary policy an expansionary one for Spain. In other words, the inflation process in Spain has worked as an engine of the current expansion.

The inflationary process is fuelling the current expansion process through several transmission channels:

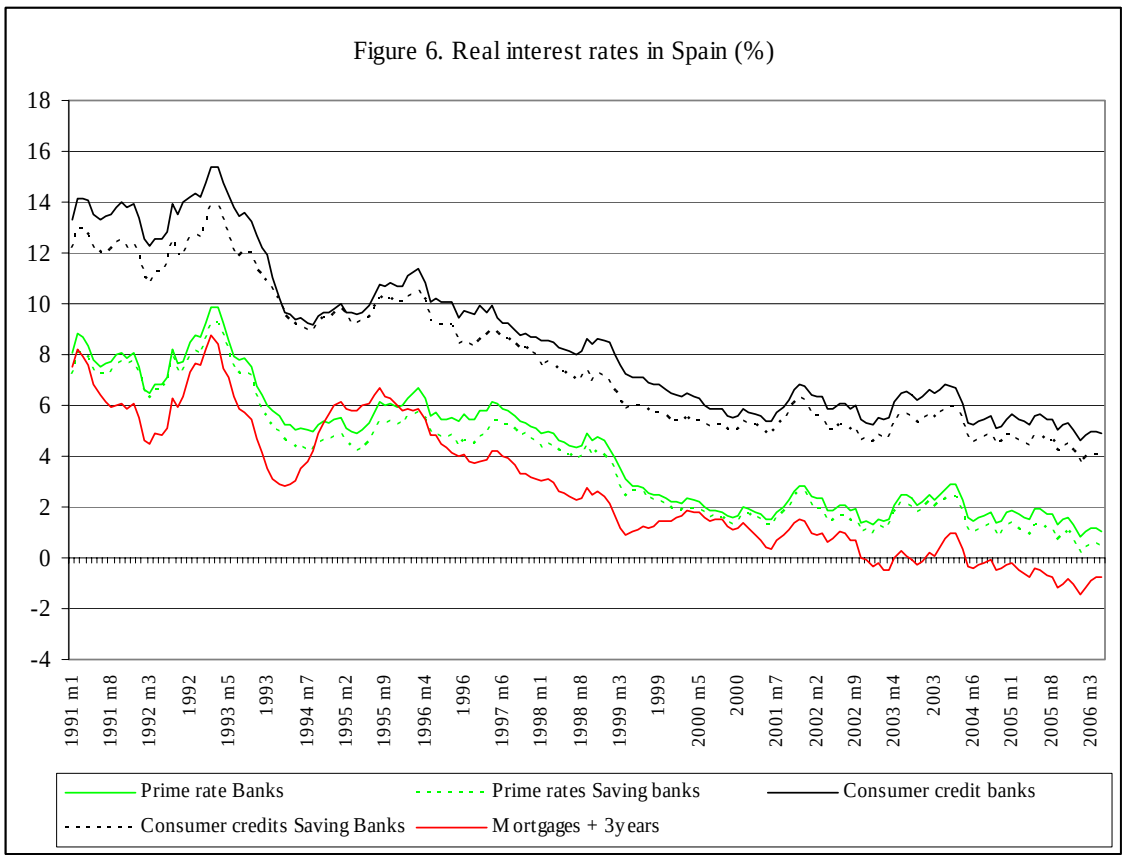
i) The higher than the EMU average inflation rate has made the monetary policy of the ECB to adopt for Spain an expansionary stance. As table 5 shows, since 2002 the monetary stance of the ECB has been clearly expansionary for Spain. In the last years the real interest rates have turned into negative ones. If we subtract to the nominal interest rate of the ECB main refinancing operations the Spanish CPI, the ECB monetary policy has led to a big fall of real interest rates in Spain. In January 2006, it meant a real interest rate of -1.95%.

Figure 5. Real interest rate for Spain of the ECB main refinancing operations (%)




Source: Banco de España and Instituto Nacional de Estadística

This fall in the ECB real interest rates have moved to the interest rates that banks and saving banks apply to their operations with their clients. Figure 6 shows the evolution of the main operations of the banking system in Spain. Real interest rates in mortgages are negative since 2004 and the real interest rates in the lending to business (proxied by the prime rate) is currently 1% in the case of banks and 0.5% in the case of saving banks,




Source: Banco de España and Instituto Nacional de Estadística

Low real interest rates, joined to the higher employment, have generated a significant increase in household borrowing, most of them devoted to the dwelling acquisition, with the result that the ratio outstanding liabilities/gross disposable income has increased from 65.2% in 1998 to 120.4% in 2005.

ii) Due to the existence of a single monetary policy, the surge of the inflation rates has not automatically lead to a tighter monetary policy, as would be the case with a domestic monetary policy, since the single monetary policy is determined by the evolution of the average inflation rate for the EMU members. This operative limitation of the monetary policy can not be offset with a tighter stance of the fiscal policy. First, because, from an orthodox perspective, a tighter fiscal policy based on increases of tax pressure is not recommended, and, second, because the low weight of public expenditures in Spain makes difficult to generate higher fiscal surpluses through discretionary cuts in public expenditures[7].

[7] As it is even accepted by the own Spanish authorities (see IMF, 2006b)

In this sense, the budgetary prospects included the Stability Programme Update for the period 2005-08[8] show a fall in the net lending of the general government from the 1% GDP in 2005 to 0.6%GDP in 2008. Total revenues are expected to fall from 39.4% GDP to 38.9% GDP and total expenditures will move from 38.4%GDP to 38.3% GDP. Actually, excluded interest payments, primary expenditures are expected to rise from 36.6% GDP to 36.9%.

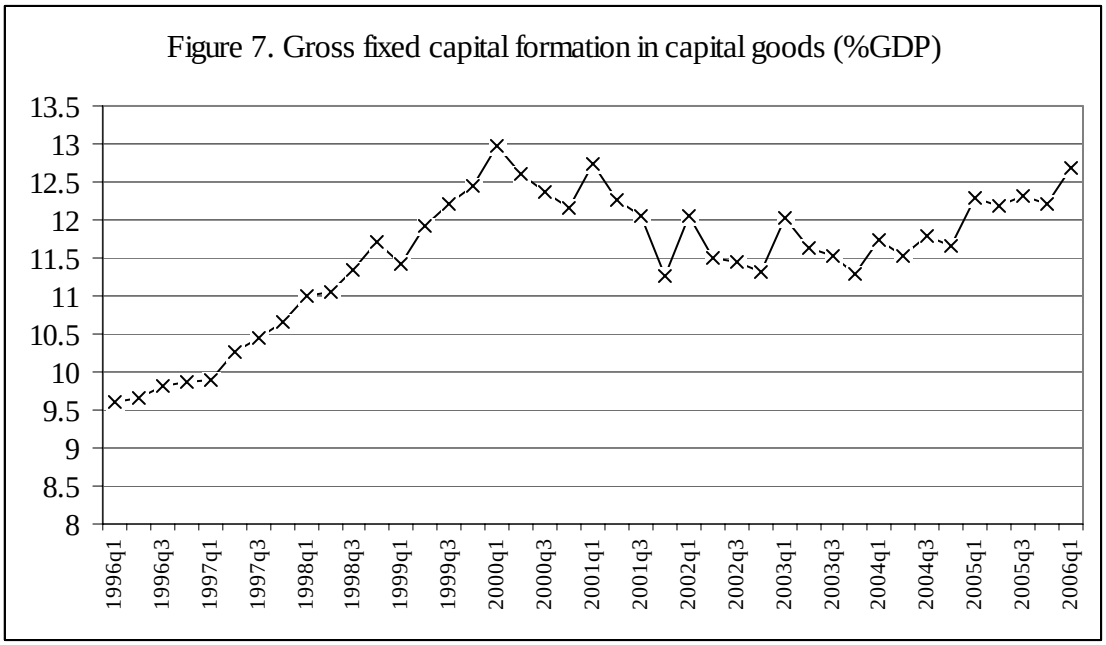
One of the reasons that explain the problems to implement a tighter fiscal policy in Spain is, precisely, the past tight stance of fiscal policy. From 1995 to 2005, the net lending of general government fell from -6.6% GDP to -0.1%[9]: This fiscal consolidation has been reached with an increase of total resources of 1.6%GDP, and a fall in total expenditure of 4.9%GDP, out of which, 3.1%GDP corresponds to the fall in interest payments and1.2%GDP to the fall in capital expenditure (Directorate-General for Economic and Financial Affairs, 2005). As a consequence of this fiscal adjustment, in 2005 the ratio public expenditures/GDP for Spain (38.2%GDP) is 9.3 p.p. lower than for EMU-economies, 9 p.p. lower than that for EU-25 and 9.2. p.p. lower than in the case of EU-15. Actually only 5 EU members (Ireland, Estonia, Latvia, Lithuania and Slovakia) have lower public expenditures than Spain (Directorate-General for Economic and Financial Affairs, 2006).

iii) Another channel of transmission of the inflation to the economic growth is its impact on the housing wealth and stock gains that are fuelling household consumption and borrowing. According to the data from the National Accounts, the nominal labour incomes of Spanish households have risen 48.3% from 1998 to 2005[10], but the distributed income of corporations rose at a rate of 95.7%, the outstanding long-term securities other than shares increased in 91.6%, the value of quoted shares owned by households rose at 57.7%, the unquoted shares increased in 48.8% and the insurance technical reserves increased in 118.4%.

[8] Available at the website of the Spanish Ministry of Economy and Finance (http://serviciosweb.meh.es/APPS/DGPE/ingles.aspx).
[9] The more recent estimations above mention estimate the overall balance of general government in a surplus of 1%GDP in 2005.
[10] In that period the number of salaried workers increased in 44.4%.

iv) Surely the most important channel is the impact of inflation of investment. The huge increase in dwellings prices[11] and the low interest rates have made that construction becomes one of the main engines of the Spanish economy, as we saw in tables 1 and 2. Though in many occasions, it is argued that the Spanish model of growth is excessively dependant of the construction sector, the investment in capital goods is also quite dynamic. Figure 7 shows the evolution of the ratio gross fixed capital formation/GDP. In the first quarter of 2006, the ratio has reached 12.7%, 4.1 percentage points higher than in the first quarter 1996. This ratio rose dramatically since 1996 until 1999, and it fell until 2003, starting to rise again since then.

Figure 7. Gross fixed capital formation in capital goods (%GDP)

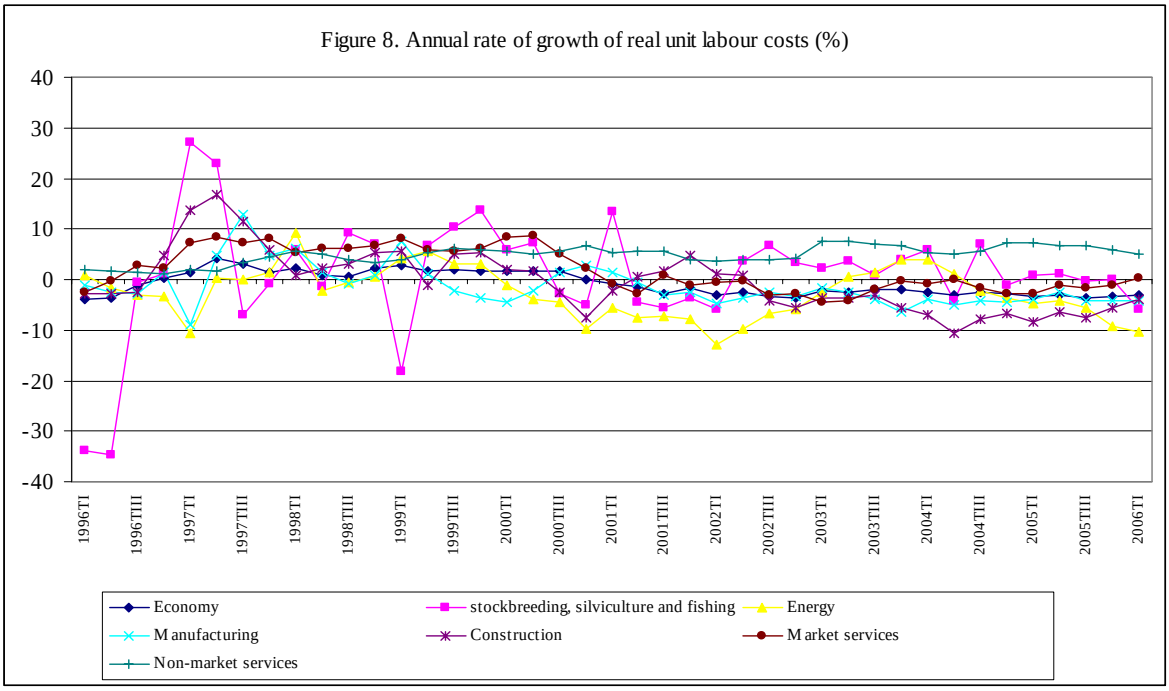



Source: Instituto Nacional de Estadística

Not surprisingly, this cycle of the investment in capital goods is parallel to the evolution of real interest rates, as we could saw in figure 6. If we focus on the prime rates, these interest rates followed a declining trend until 2001, when they remained nearly constant until 2004, when they began again a new declining trend. Therefore, inflation would have boosted investment through the impact on real interest rates.

But inflation has also fuelled investment via the impact on real wages and real unit labour costs and the rising mark-ups that have increased corporate profits.

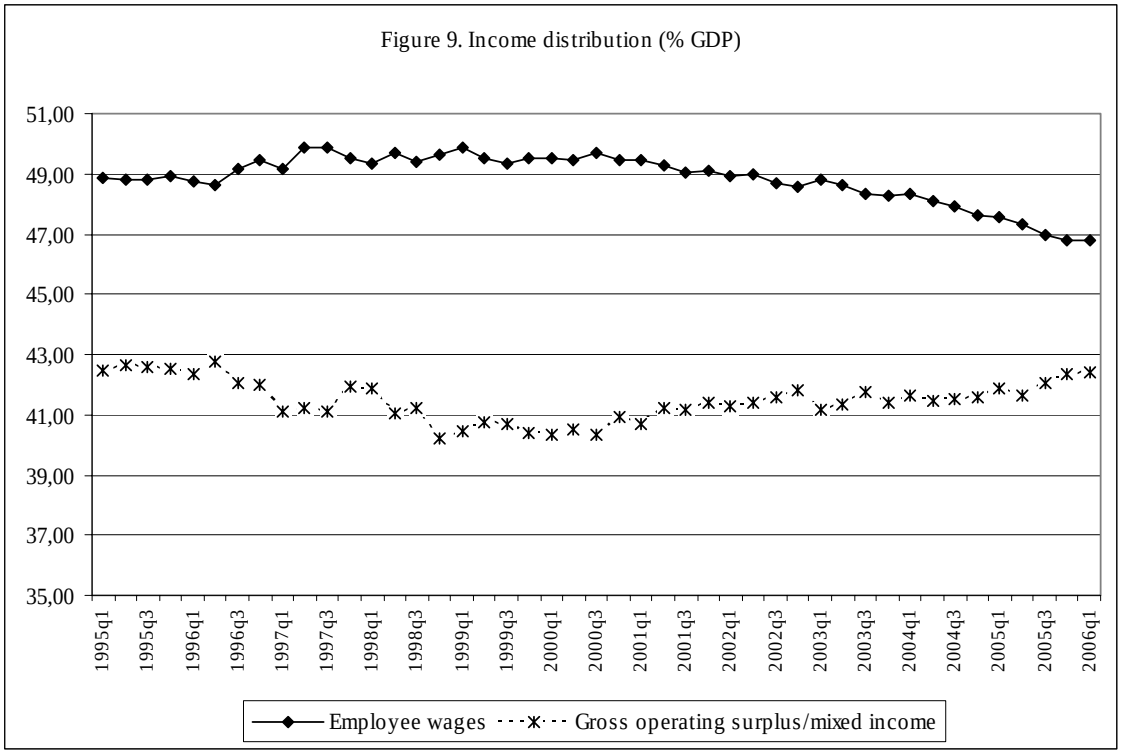
[11] Real housing prices rose around 200% between 1995 and 2004 (International Monetary Fund, 2006c).




Source: Instituto Nacional de Estadística

The wage moderation registered since 1997[12] joined to the acceleration of the inflation rates have led to a significant fall of real unit labour cots since 2001. The declining real ULC have led to a redistribution of the income against labour incomes, as figure 9 shows, a fall that, this being remarkable, is taking place during a period of intense employment creation and with a higher rate of salaried employment.

[12] We must remember that, according to the subsequent AINCA, the guideline for collective bargaining is that (nominal) wages must be bargained with the reference of the inflation target (currently 2%) plus a part of the productivity gains.




Source: Instituto Nacional de Economía

Declining real unit labour costs have led to a fall in the ratio compensation of employees/value of production and a rise in the rates of profits. The table 4 shows for most sectors a clear pattern of rising rates of profits and declining share of wages in the value of production

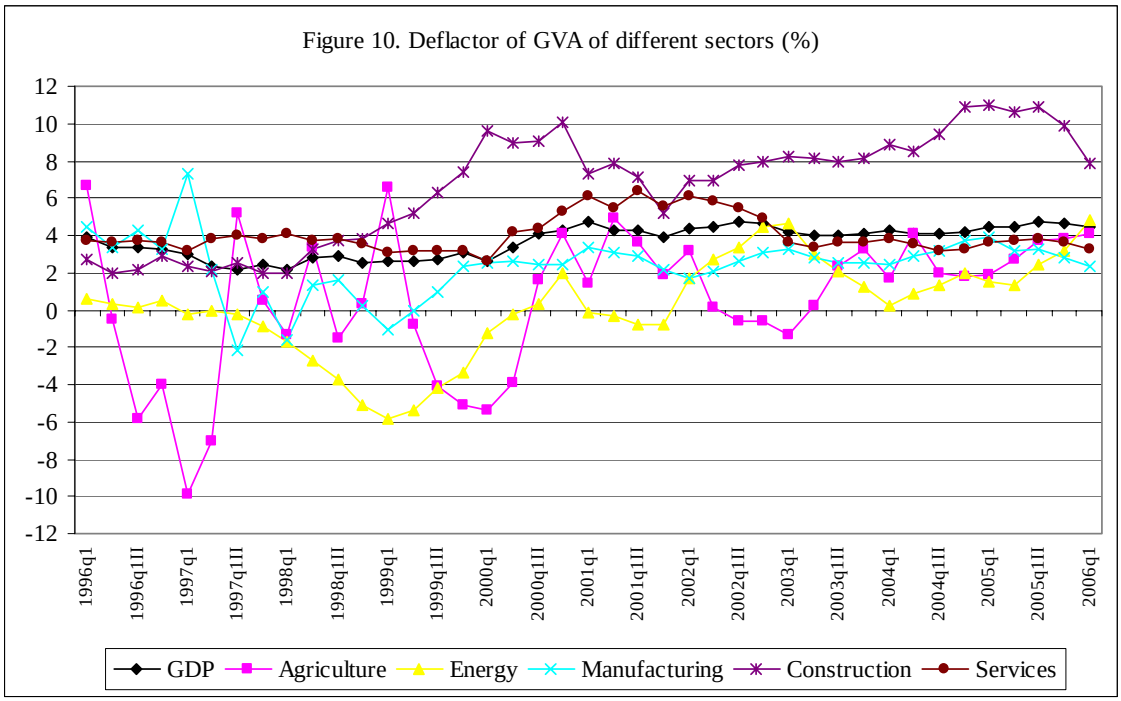
Table 4. Share of wages and profits in the value of production (%)

| | 2000 | | 2001 | | 2002 | | 2003 | | 2004 | |
|---|---|---|---|---|---|---|---|---|---|---|
| | profits | wages | profits | wages | profits | wages | profits | wages | profits | wages |
| Extractive industries and petroleum | 4,9 | 5,6 | 3,5 | 5,5 | 4,2 | 6,3 | 4,0 | 6,3 | 5,6 | 5,6 |
| Food, beverages and tobacco | 2,8 | 11,8 | 4,7 | 11,2 | 3,3 | 11,2 | 3,7 | 11,4 | 4,4 | 11,1 |
| Manufacture of textiles, wearing apparel, leather and footwear | 3,0 | 19,8 | 2,4 | 21,0 | 0,2 | 21,0 | 2,1 | 21,3 | 2,5 | 21,2 |
| Wood and cork | 3,9 | 17,8 | 1,8 | 19,2 | 1,2 | 18,8 | 2,2 | 19,2 | 3,1 | 19,1 |
| Paper, publishing, graphic arts and reproduction of recorded media | 5,1 | 19,8 | 5,4 | 19,9 | 3,8 | 19,8 | 4,0 | 20,4 | 5,9 | 20,4 |
| Chemical industry | 4,6 | 13,5 | 4,1 | 13,9 | 4,3 | 13,4 | 3,5 | 13,8 | 4,2 | 13,4 |
| Rubber and plastic products | 3,4 | 19,8 | 3,1 | 19,8 | 3,5 | 19,1 | 1,8 | 20,4 | 3,7 | 19,6 |
| Various non-metallic ore products | 7,3 | 18,7 | 7,6 | 18,1 | 6,2 | 17,9 | 4,6 | 18,6 | 7,3 | 17,8 |
| Metallurgy and manufacture of metallic products | 5,0 | 19,5 | 4,0 | 20,7 | 3,8 | 20,2 | 3,6 | 20,9 | 5,2 | 18,9 |
| Machinery and mechanical equipment | 4,4 | 22,4 | 3,9 | 22,9 | 3,9 | 22,6 | 3,5 | 23,3 | 4,5 | 22,2 |
| Electrical, electronic and optical material and equipment | 4,0 | 17,1 | 2,8 | 18,0 | 1,7 | 18,8 | 3,5 | 18,8 | 3,3 | 17,7 |
| Transport equipment | 1,7 | 11,2 | 1,0 | 12,1 | 0,5 | 12,5 | 1,4 | 11,9 | 1,5 | 11,7 |
| Various manufacturing industries | 3,7 | 22,6 | 3,7 | 22,9 | 0,3 | 23,6 | 2,6 | 24,1 | 4,1 | 22,7 |
| Energy and water | 11,1 | 8,2 | 9,7 | 8,2 | 17,5 | 7,4 | 12,2 | 7,9 | 11,3 | 7,2 |
| Construction | 14,6 | 27,6 | 13,5 | 23,9 | 13,1 | 20,3 | 13,3 | 19,5 | n.a. | n.a. |
| Wholesale and retail trade; repairs | 26,5 | 32,4 | 25,8 | 31,3 | 24,8 | 32,7 | 25,3 | 33,0 | 25,4 | 33,1 |
| Hotels and restaurants | 18,5 | 25,8 | 17,5 | 26,4 | 17,3 | 27,1 | 16,5 | 27,4 | 15,6 | 28,0 |
| Transport, storage and communication | 27,9 | 26,8 | 28,8 | 27,0 | 30,8 | 26,6 | 31,7 | 27,0 | 31,6 | 26,5 |
| Financial intermediation | 25,9 | 36,5 | 29,7 | 34,5 | 31,2 | 33,2 | 31,1 | 32,7 | 31,0 | 31,8 |
| Real estate, renting and business activities | 31,5 | 26,3 | 32,7 | 27,3 | 30,1 | 30,2 | 29,5 | 30,6 | 31,3 | 28,2 |

Notes:
For industry sector the value of production is equal to total operating income
Wages are equivalent to personal expenses.
For industry sectors, profits are equal to profits and loss for the year. For construction and services sectors profits are equal to gross operating surplus
Source: Instituto Nacional de Estadística

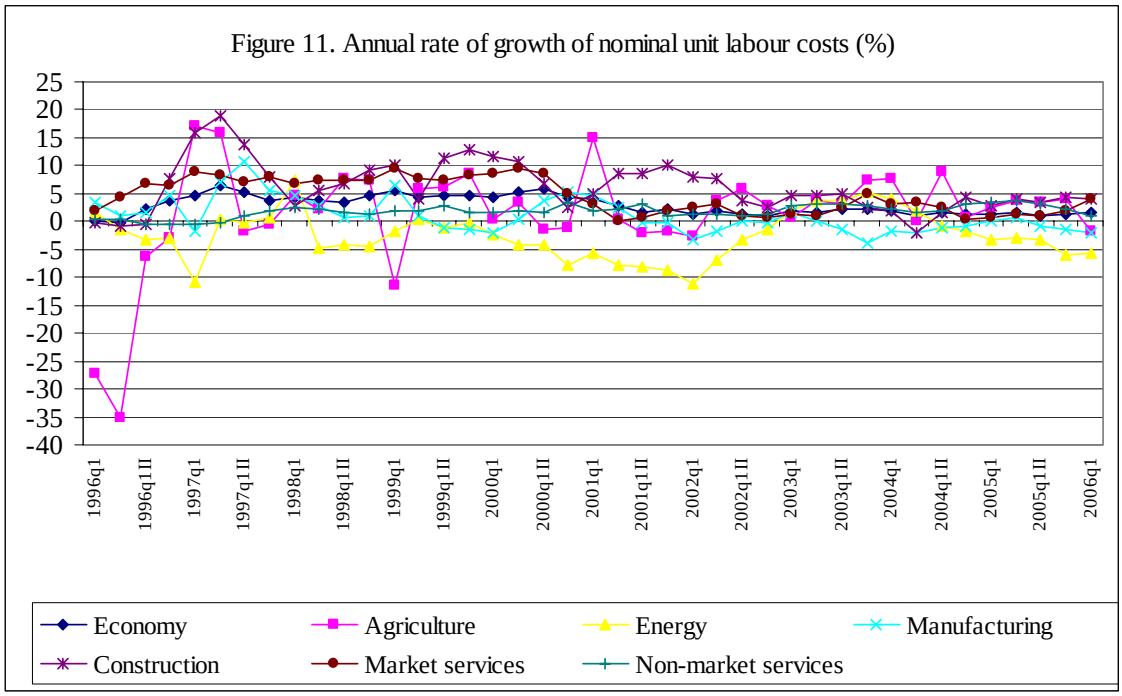
Nonetheless, the inflationary process is not a generalized process. As figure 10 shows, the Spanish inflation has its roots in the services and in the construction sectors. On the contrary, manufacturing prices have a more stable behaviour, with prices rising at rates below 3%. This is one of the more relevant features of the Spanish inflation: it is generated in the closed sectors of the economy.

Figure 10. Deflactor of GVA of different sectors (%)




Source: Instituto Nacional de Economía

Though it could be thought that wage growth could be behind the inflationary process, however, as we mentioned above, the wage growth, at best, can only explain a minor part of the inflation in Spain. Figure 11 shows the evolution of nominal ULC in Spain. Since 2002 nominal ULC has been rising at rates below 2%. Excluded the agriculture sector, due to its volatility, only in services and construction sectors nominal ULC have been rising above 2%. It is these sectors where we find the main determinants of the Spanish inflation: the nominal wage increases and the low growth of productivity in these sectors (an element that is directly related to the nature of some of these sector highly intensive in labour, like trade, hotels and restaurants), and, mainly, the rising mark-ups and rates of profits, an element favoured by the low level of competition existing in many sectors (as it the case of telecommunications, distribution, etc.) and the fact that many services sectors are non-tradable and, therefore, closed to foreign competition.




Source: Instituto Nacional de Estadística

## Conclusions

The current expansion of the Spanish economy is a good proof of the validity of the Keynesian economic recipes. The positive performance in terms of GDP growth and employment creation can be explained by a policy mix consisting in: an expansionary monetary policy, a neutral-slightly tight fiscal policy and a voluntary wages policy. Low, even negative, real interest rates are fuelling consumption and investment. The high economic growth is generating a significant surplus in the public accounts, what, in turn, is partially slowing down the economic growth through the operation of built-in stabilizers. Finally, the voluntary wage moderation operating since 1997 is contributing to accelerate the employment creation process and, consequently, to reduce the unemployment rates.

However, this Keynesian-expansionary macroeconomic policy is not working in a discretionary way. It is the high inflation rates the element that is making expansive a (monetary) policy initially designed as restrictive or, at best, neutral policy.

In our opinion, the Spanish economic situation, therefore, offers to the EMU three important lessons. The first one is that inflation can actually grease the wheels of the economic activity. Higher inflation rates, above the target of the 2%, can lead to higher rates of economic growth. This higher economic growth can be sustainable, since the main constraint that can come from the higher inflation rates, the loss of competitiveness and the problems in the balance of payment, is less significant in the case of a monetary union, mainly if the bulk of the trade flows are with the rest of members of the monetary union.

The second one is that a discretionary monetary policy can lead to higher rates of economic growth. The expansionary monetary policy does not necessarily lead to rising inflation rates if that monetary policy comes with a neutral fiscal policy that generates fiscal surpluses through built-in stabilizers and with a wage policy that avoids higher wage claims that could generate a wage-price spiral.

The third lesson is that the inflationary process is not only the result of an 'inefficient' or 'rigid' labour market that generates excessive wage growth. The Spanish case illustrates the importance of two elements: first, the price-setting process and the behaviour of mark-ups and, second, the structural features of working of some markets closed to foreign and domestic competition. The traditional recipes like the fall of wages and the tight monetary policy, in as much they do not act against the true causes of inflation, will not correct the problem. Falling wages, as the current situation shows, could simply lead to higher profits leaving unaffected the level and growth of prices. In the case of monetary policy, if we could think of a domestic monetary policy, higher interest rates could only lead to an adjustment in the level of employment, as a tool to keep stable the rates of profits, and/or to lower level of activity.

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