



Volume 4, Issue 1

12.01.2007

# ECFIN COUNTRY FOCUS

## Highlights in this issue:

Spain's external deficit relative to GDP is at record levels

Structural factors are a prominent reason for this

Implementing measures aiming at fostering productivity growth should be at the top of the political agenda

## The Spanish external deficit: cyclical or structural?

By Alberto Cabrero Bravo and Javier Yaniz Igal\*

### Summary

*In 2005 the current account deficit attained 7½% of GDP, its worst position of the last 25 years, and in 2006 it might reach 8½%. Traditionally, Spain's trade deficit has been partially offset by surpluses in other external balances, particularly service trade, as a result of large net tourism inflows, but since 2005, the current account deficit has been as large as the trade deficit. While cyclical factors, strong domestic and weak foreign demand, and the transitory effect of the increase in oil prices certainly have some bearing on the deterioration of the current account balance, structural factors, linked to persistent competitiveness losses, also play a significant role. In the past, attempts to rebalance external accounts relied on the exchange rate instrument. However, as devaluation is no longer an available option since accession to the monetary union, the focus should be put on rolling out policies designed to enhance productivity growth – in other words, implementing the Lisbon agenda. This remains crucial to recovering lost competitiveness and rebalancing the external accounts.*

### The history of an increasing external deficit

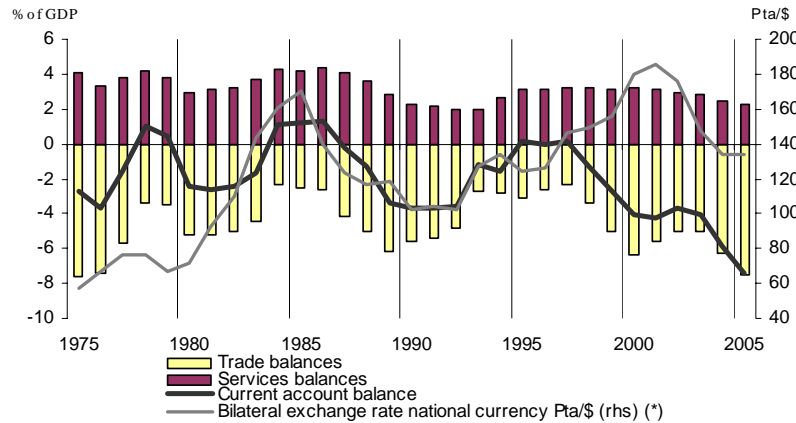
The Spanish current account deficit reached €66 billion or 7½% of GDP in 2005, and might attain 8½% in 2006. It has been widening during the last decade, in parallel with Spain's current long-lasting expansionary phase, in which annual GDP has grown at a rate of 3½% in real terms. Starting from a balanced position in 1997, the current account deteriorated steadily until it reached a deficit of around 4% in 2000. It then remained broadly unchanged until 2003, but resumed its downward path in 2004 (see chart 1).

Historically, it has not been unusual for Spain to run a current account deficit<sup>1</sup>; rather, it is external surpluses that have been the exception. During the previous expansionary phase of the Spanish economy, between 1986 and 1991 (coinciding with the accession to the EU), when real GDP grew by 4% per year, the trade deficit widened, mainly due to the opening of sheltered markets to foreign competition. This, together with a slight contraction of the services balance, resulted in a deterioration of the current account, which moved from a surplus of 1.3% of GDP in 1986 to a deficit of 4% of GDP in 1989. With a view to rebalancing the economy, and also to reducing the two-digit inflation rate, Spain joined the exchange rate mechanism (ERM). However, the credibility gained through accession to the ERM was eroded by the persistently expansionary fiscal policy. The current account deficit remained broadly unchanged at around 4% of GDP.

*The Spanish external deficit is one of the highest in the OECD*

\* Directorate for the Economies of the Member States.

**Chart 1: External accounts and exchange rate**



Source: AMECO, and Banco de España

(\*) Since 1999 estimated using the exchange rate \$/€ and the irrevocable exchange rate: Pta/€ = 166.386 "

*The trade balance is behind the deterioration of the current account*

But external imbalances have not arisen only during activity expansions; they have also coexisted with periods of sluggish economic growth such as the period 1992-1994. Exchange rate devaluations have been the usual policy tool used to rebalance the economy. Specifically, after the ERM crisis in the autumn of 1992, Spain experienced a sudden slowdown of economic activity, with GDP falling in real terms by 1% in 1993, while the current account deficit rose to around 4% of GDP. The recession in Spain was stronger than in other European countries due to the external and fiscal imbalances that had cumulated in the preceding expansionary phase. The currency was devalued several times and, as a result, the current account deficit was reduced significantly, to around 2%, in 1994. However, at the end of 1994, in order to fulfil the convergence criteria for adoption of the euro, a new monetary policy strategy based on a strong anti-inflationary commitment was implemented. The peseta exchange rate in terms of the ECU was situated on the lower side of the band of parities, so that the peseta/euro irreversible exchange rate was fixed below the value corresponding to the central parity (see Malo de Molina, 2003; and Bulir and Smidkova, 2005).

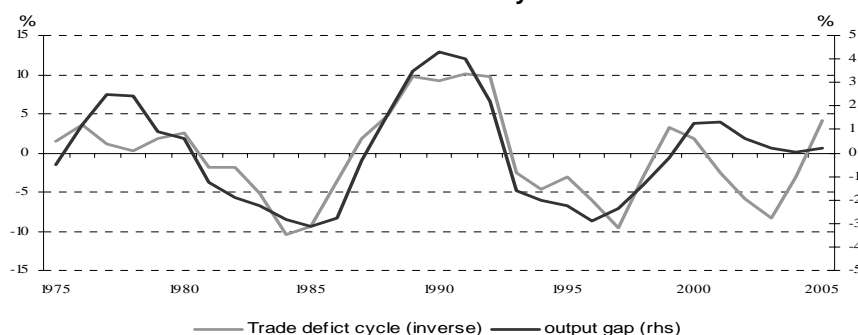
Spain's current account record can be compared with other "catching-up" European economies that have also experienced a strong expansionary phase of economic activity, such as Portugal. After enjoying a period of strong growth between 1995 and 1999, Portuguese net exports declined, as they did in Spain in similar quantitative terms. Yet the Portuguese economy was running a twin (external/fiscal) deficit, which closely compares with the current position of the Spanish public accounts. However, Ireland, another catching-up economy in the 1990s, has shown completely different behaviour in its external sector as the strong and sustained economic growth has been accompanied by a persistent two-figure net export surplus.

All the sub-balances of the Spanish current account have deteriorated since the mid-1990s. Surpluses in the balance of services are shrinking, due in particular to reduced tourism inflows, while deficits in the balance of primary incomes and current transfers (migrants' transfers) are increasing. However, it is the deterioration in the trade balance that explains the bulk of the external deficit. The following sections, therefore, concentrate on trade accounts and examine export and import developments.

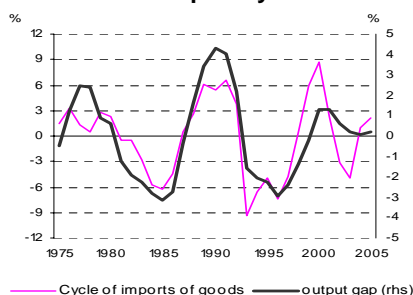
### ***The trade deficit at present: a closer look***

According to European Commission (2006a), the Spanish trade deficit is the result of three different types of factors. Firstly there are *cyclical factors*, reflecting strong and sustained growth in Spain coupled with sluggish economic activity in Spain's main trade partner, the euro area. Secondly there is a *transitory factor*, the increase in the energy bill, which may be having a direct and substantial impact on nominal imports. Finally, *structural factors* associated with persistent inflation differentials between Spain and the euro area, together with low productivity growth, seem to be another reason for the deterioration in competitiveness and could explain why growth of exports has always been below that of imports, especially since 1998.

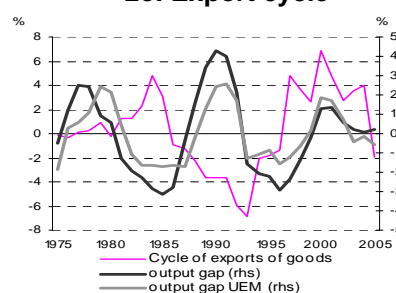
**Chart 2: Trade cycle in Spain**  
**2a: Trade deficit cycle**



**2b: Import cycle**



**2c: Export cycle**



Source: AMECO and own calculations

Note: Trade cycle and output gap estimated using HP filter (lambda=100)

Although most analysts agree with this taxonomy of factors, the balance of opinion is less clear-cut about the relative importance of each one. The research department of the BBVA bank considers that all three factors have contributed broadly equally since 1995 (BBVA, 2006). The IMF, however, presents more ambiguous results. On the one hand, the staff report for the 2006 Article IV consultation for Spain argues that between 1980 and 2005 structural factors have had a relatively slightly higher impact on the external sector (37%) than other factors. On the other hand, Allard et al. (2005) conclude that cyclical factors might have been slightly underestimated.

However, other evidence would suggest that structural factors might be the most significant of the three. Chart 2a indicates that, while the correlation between the output gap and the cyclical part of the trade deficit seems quite strong until 2000, it becomes weaker thereafter. In other words, although sluggish growth in Spain's main trade partners and strong domestic demand can largely explain the insufficient net export growth until 2000, these cyclical factors are not sufficient to explain the size of the current trade deficit over the last five years.

*Both cyclical and structural factors seem to be behind insufficient export growth*

Interestingly, while the cycle of imports have to a certain extent followed the Spanish business cycle (see chart 2b), the cyclical component of exports seems to be independent of not only the Spanish but also the EMU cycle which, according to Cabrero et al. (2003), is relatively closely synchronised with the Spanish cycle (see chart 2c). It is, rather, factors of a more structural nature which explain export developments.

### **Sustainability of external deficits and competitiveness**

As shown above, it is exports, which largely explains the divergence between the trade deficit and the output gap. The question then arises whether low export growth can coexist in the long term with high GDP growth. To answer this question, Thirwall (1994) present a relationship between GDP growth and the equilibrium in the external sector on the basis of the dynamic equilibrium between exports (x) and imports (m) and the exports' and imports' demand functions:

$$(1) \quad p^x + x = p^m + m$$

$$(2) \quad x = \varepsilon_{x,p} (p-p^*) + \varepsilon_{x,y} y^* \quad \text{and} \quad m = \varepsilon_{m,p} (p^*-p) + \varepsilon_{m,y} y$$

where  $p^x$  and  $p^m$  represent export and import price changes respectively, and  $x$  and  $y$  real export and import growth. Additionally  $\varepsilon_{x,p}$ ,  $\varepsilon_{x,y}$ ,  $\varepsilon_{m,p}$ ,  $\varepsilon_{m,y}$  are price and income elasticities of exports and imports respectively. The combination of (1) and (2) leads to:

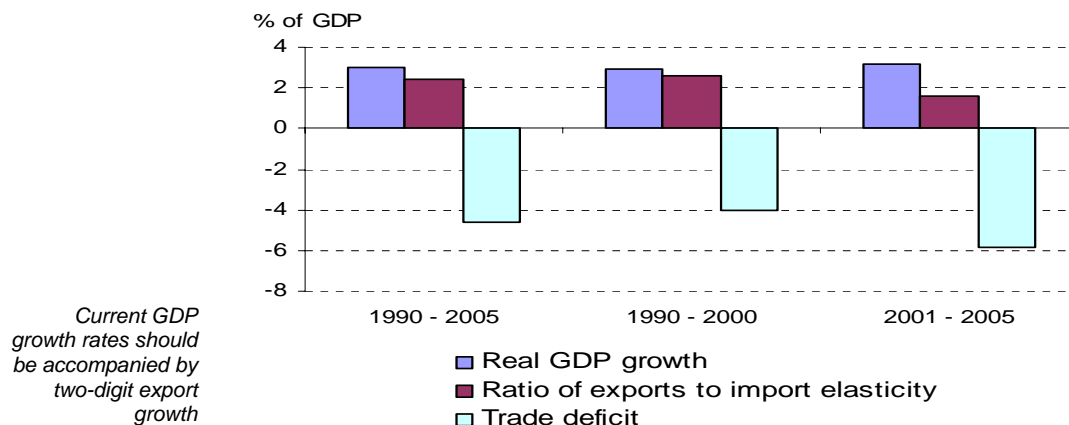
$$(3) \quad y = [x + (1 + \varepsilon_{m,p}) (p^*-p)] / \varepsilon_{m,y}$$

Assuming that relative prices, measured using a common currency, do not significantly change in the long run, the so-called Thirwall condition becomes:

$$(4) \quad y = x / \varepsilon_{m,y}$$

which gives the real GDP growth rate compatible in the long run with balanced trade accounts. Given the income elasticity of imports, (4) can be interpreted as the maximum potential GDP growth compatible with a given export growth rate, or, equivalently, as the necessary export growth to sustain a given GDP growth rate, so as to keep the external accounts in balance. In the particular case of Spain, where the income elasticity of imports seems to be fairly stable at around 3, maintaining GDP growth at close to potential, which is currently estimated at around 3½%, would require an average export increase of around 10% per year in the long run.

**Chart 3: GDP growth and ratio of export growth to import elasticity**



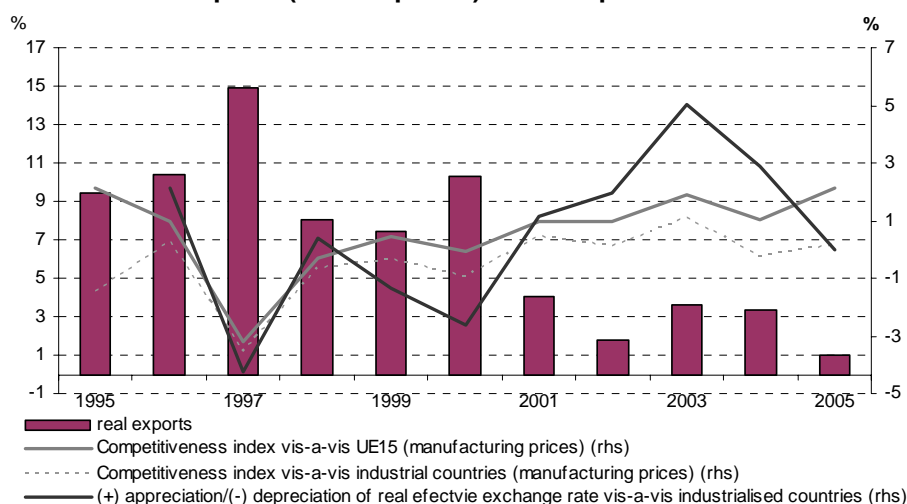
Source: AMECO and Banco de España

Note: Import income historical elasticity has been calculated the average of the ratio between import growth vs GDP growth

Chart 3 shows that, between 1990 and 2005, an average GDP growth of 3% per year coexisted with an average export growth of around 8%, not quite enough to avoid persistent trade deficits. According to the Thirwall condition, the GDP growth rate compatible with such export growth and a balanced trade sector would have been around 2½%. Moreover, since 2000, with similar GDP growth, the growth rate of exports has fallen dramatically, to slightly below 4%, which explains the worsening of the trade deficit. The Thirwall condition now points to a GDP growth rate below 2% as the rate compatible with such conditions.

Therefore, sustaining the current potential growth requires export growth to be significantly enhanced. Within EMU, competitiveness can only be improved by containing price and wage inflation, fostering productivity growth and increasing the innovative content of domestic products. Chart 4 shows the gradual deterioration in the competitive position of the Spanish economy vis-à-vis its main trade partners, in which the persistent inflation differential with the euro area (around 1 pp) comes hand in hand with disappointing productivity growth rates (½ pp per year, compared to more than 1% in the euro area).

**Chart 4: Total exports (at 2000 prices) and competitiveness indices**



Source: AMECO and Banco de España

Note: Appreciation (+)/ depreciation (-) of competitiveness indices

*The trade specialisation consists mainly of medium technology goods*

According to European Commission (2005a), current price competitiveness losses in Spain are particularly significant, given the high export price elasticities. A high price elasticity of exports is the consequence of a particular pattern of trade specialisation. Spanish exports of manufactures concentrate on products with a low degree of technological sophistication and limited degree of product differentiation, in which price competition is intense. Spanish exports of manufactures show a high degree of specialisation in “mature” activities for which international demand is less vigorous, namely medium-high technology goods (around half of Spanish manufacturing exports) and low technology products (around 20%)<sup>2</sup>. Overall, Spain’s degree of specialisation in high-tech exports, which is an indicator of competitiveness improvement, remains well below that of the euro area<sup>3</sup>. Indeed Spain has maintained the ratio of exports of high technology products as a share of total exports practically unchanged at around 6% during the last 15 years, while it increased in the euro area from 16% in the period 1990-1998 to 19% in 1999-2004. It is worth mentioning that, during the same period, Ireland almost doubled the entire EU-15 high-tech export share, and indeed it is well known that technology uptake is one of the main factors behind the Irish success story.

### **The implementation of appropriate policies**

The current worsening of the external sector reflects a deterioration of Spain’s competitive position, which is preventing it from taking full advantage of recent growth in international economic activity (European Commission, 2006a). Furthermore, the growing external deficit mirrors increasing investment in the housing sector, which, in general terms, contributes less than investment in technology and equipment to potential growth. Before Spain joined EMU, exchange rate devaluations allowed it to recover lost price competitiveness: as mentioned above, Spain has devalued at crucial moments in order to boost exports, cool down imports and, as a result, rebalance external accounts. However, since the adoption of the euro this is no longer possible. The question therefore arises of the importance of an external deficit within a monetary union. The governor of the Spanish Central Bank stated: *“in a monetary union, external imbalances are not a disease in themselves but rather a symptom of another disease”*. (Banco de España, 2006). In the Spanish case, as we have shown, the disease is the deterioration of competitiveness.

Although an appropriate policy would take into account the dual nature of the problem, cyclical and structural, the emphasis should be on decisively implementing policies aiming at tackling the structural problems of the Spanish economy. A restrictive fiscal policy of course helps cool down domestic demand pressures, which, in turn, would decelerate import growth. Whilst the budget has been in balance for the past several years, special factors that have boosted tax elasticities may have temporarily improved fiscal revenues. Specifically, European Commission (2006b) shows that part of the revenues stemming from VAT accruing from the present housing boom might be of a cyclical nature. But policies aiming to tackle structural factors behind inflation, enhance

productivity growth and foster innovation also need to be vigorously implemented in order to reverse the structural deterioration of the external accounts. This could be done, for example, by fostering competition in certain sectors such as utilities and services, and by stimulating R&D investment and a more productive investment pattern.

Furthermore, as shown in European Commission (2005), a sustainable improvement of the Spanish competitive position requires a radical shift by moving away from the current price-based model to a specialisation pattern based on product differentiation underpinned by higher productivity growth. Now that Spanish society has reached a broad consensus on the need to maintain stability-oriented macroeconomic policies, the productivity goal must be brought to the top of the economic policy agenda in order to effect the necessary structural changes. The Lisbon strategy is the framework within which to achieve this rebalancing of the external sector, as it puts the emphasis on tackling structural factors. According to European Commission (2006c), the awareness of the need for structural reforms has already been shown in the Spanish National Reform Programme – but it is the determined implementation of the announced measures that will be key in tackling the competitiveness bottlenecks of the Spanish economy.

## References

- Allard, C., M. Catalan, L. Everaert and S. Sgharry (2005), "Explaining differences in External Sector Performance Among Large Euro Area Countries", IMF, Country Report N° 05/401.
- BBVA (2006), "El déficit Exterior de la Economía Española", Situación España, marzo 2006, p. 8 – 11. Servicio de Estudios – Banco Bilbao Vizcaya Argentaria (BBVA).
- Bulir, A., K. Smidkova (2005), "Exchange rates in the new accession countries: What have we learnt from the forerunners?", IMF Working paper, WP/05/27.
- Banco de España (2006), "La Economía española y su Financiación en el marco de la UE", *Discurso del Gobernador en Foro ABC, Madrid 18 de octubre de 2005*. Banco de España.
- Cabrero, A., C. Chulía and A. Millaruelo (2003), "An Assessment of Macroeconomic Divergences in the euro area", Documentos ocasionales, Banco de España No. 0304.
- European Commission Directorate-General for Economic and Financial Affairs (2005), "Country Study: Spain in EMU: a virtuous long-lasting cycle?", Occasional Papers No. 14.
- European Commission, Directorate-General for Economic and Financial Affairs (2006a), "The EU economy 2006 review - Adjustment dynamics in the euro area- Experiences and challenges". REP.56908-EN, available from:  
[http://ec.europa.eu/economy\\_finance/publications/european\\_economy/2006/the\\_eu\\_economy\\_review2006\\_en.htm](http://ec.europa.eu/economy_finance/publications/european_economy/2006/the_eu_economy_review2006_en.htm)
- European Commission, Directorate-General for Economic and Financial Affairs (2006b), "December 2005 Update of the stability programme of Spain (2005-2008) - An Assessment", ECFIN/50381", available from:  
[http://ec.europa.eu/economy\\_finance/about/activities/sqp/country/commwd/es/com\\_es20052006.pdf](http://ec.europa.eu/economy_finance/about/activities/sqp/country/commwd/es/com_es20052006.pdf)
- European Commission (2006c), Communication from the Commission to the Spring European Council – Time to move up a gear – Part II to COM(2006), available from:  
[http://eur-lex.europa.eu/LexUriServ/site/en/com/2006/com2006\\_0030en01.pdf](http://eur-lex.europa.eu/LexUriServ/site/en/com/2006/com2006_0030en01.pdf)
- IMF (2006), "Spain: 2006 Article IV Consultation - Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Spain. IMF. Country Report 06/211.
- Malo de Molina, J.L. (2003), "Una Visión Macroeconómica de los Veinticinco años de Vigencia de la Constitución Española", Documento Ocasional No. 0307. Servicio de Estudios. Banco de España.
- Thirwall A.P., (1979), The balance of payments constraint as an explanation of international growth rate differences, Banca Nazionale del Lavoro quarterly Review, 128.

<sup>1</sup> Current account deficits have led to a sustained deficit of the current primary incomes balance. Therefore, GNP is persistently lower than GDP.

<sup>2</sup> Medium-high technology sectors include the automotive sector, machinery and equipment sector, chemical industry and electrical and electronic activities. Low technological sectors include activities such as textiles, clothing and footwear, processed and unprocessed food, and wood and paper.

<sup>3</sup> High-tech production includes, for instance, ICT.

The *ECFIN Country Focus* provides concise analysis of a policy-relevant economic question for one or more of the EU Member States. It appears fortnightly.

**Chief Editor:** Marco Buti, Deputy Director General, Economic and Financial Affairs

**Coordinating Committee:** Heinz Jansen, Stephanie Riso

**Layout:** Vittorio Gargaro, Johannes Kattevilder

**E-mail:** [ECFIN-CountryFocus@ec.europa.eu](mailto:ECFIN-CountryFocus@ec.europa.eu)

**Website:** [http://ec.europa.eu/economy\\_finance/publications/countryfocus\\_en.htm](http://ec.europa.eu/economy_finance/publications/countryfocus_en.htm)