Current Issues

Global growth centres

Deutsche Bank Research

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Spain 2020 – the success story continues

Spain's economic success over the past years has been most impressive – raising concerns about its sustainability. An analysis of the roots of the success is a prerequisite for assessing the likelihood of an unpleasant correction.

Four fundamental reasons help explain the rise of Spain together with entry into EMU in 1999. They indicate that the need for a correction is much smaller than often assumed:

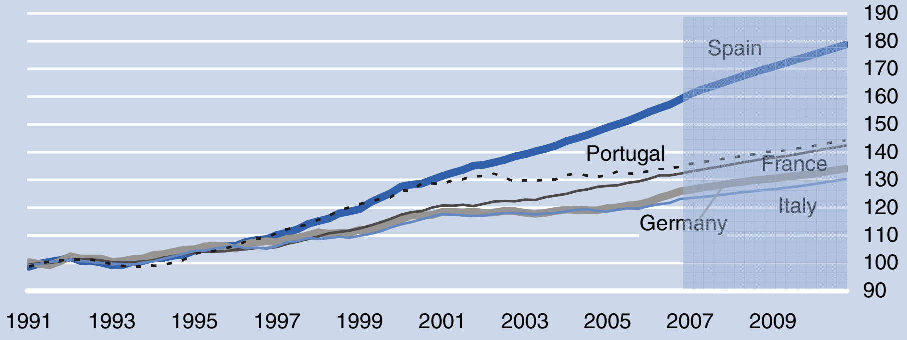
1. **Labour input has been surging** since the mid-1990s because of plunging unemployment, increasing immigration and higher participation rates.
2. **Human capital is increasing rapidly,** with tertiary graduation rates approaching 40%, up from 10% three decades ago.
3. **Openness has risen strongly** as consequence of EU entry and of increased activity abroad by strong Spanish companies. Inward foreign direct investment has also surged.
4. **Innovation is strengthening** from a weak base. It is a top priority of the government and policy measures are clearly pointing in the right direction.

The rise in the capital stock, the housing boom, the current account deficit and the fiscal surplus are mostly consequences of these underlying economic changes.

Given the massive and partly unexpected changes in Spain over the past years it is difficult to produce forecasts for GDP growth until 2020. However, per capita GDP growth is likely to remain above the euro-area average of just below 2% for several more years, allowing Spain to climb past Italy and Germany in the rankings of GDP per capita by 2020.

Spanish economy outperforms its peers

Total real GDP, 1995 = 100



Sources: National Statistical Offices, DBR forecasts from 2007

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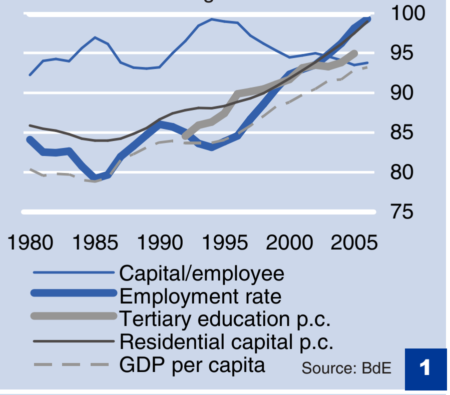
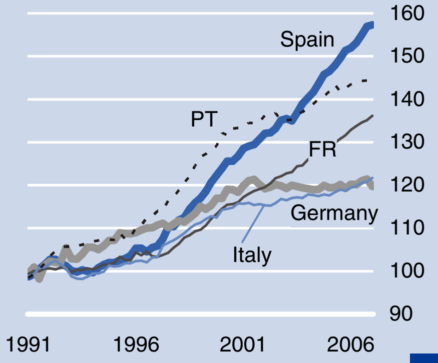
As % of EMU average



Source: BdE 1

Private consumption up

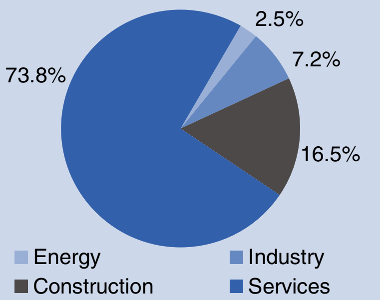
Real consumption, 1995=100



Sources: National Statistical Offices 2

Service sector drives GDP

Contribution to growth in value added between 2000 and 2006 in %

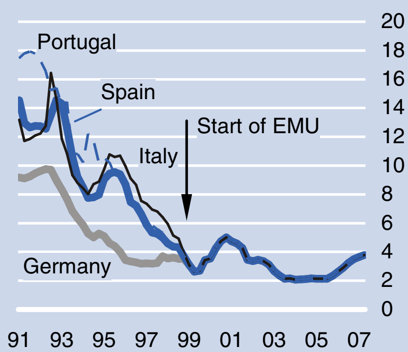


(Agriculture declined)

Sources: IMF, DB Research 3

Convergence of short rates

Short-term interest rates, %



Source: OECD 4

The gains in Spain are for real

The Spanish economy – the ninth-largest in the world with 44.5 million people – is one of the most impressive success stories among rich countries over the past decades. Highlights include:

— Average annual real GDP growth of 3.8% over the ten years to 2006 was well above the EMU average of 2.2%, Germany's 1.5% and even the US's 3.2%.

— As a result, GDP per capita rapidly narrowed the gap to the EMU average (chart 1).

— Private consumption – the ultimate goal of economic activity – rose almost 4% annually over the same period, compared to 2.0% in the euro area and Germany's 1.0% (chart 2).

— The unemployment rate plunged from 19.5% in 1994 to 8.0% in mid-2007 using the harmonized definition.

— Spain evolved from an emigration country to an immigration country. Two million Spaniards moved to other European countries between 1960 and 1975 but more than two million foreigners moved to Spain between 2002 and 2006.

— Public debt fell from 70% of GDP in 1996 to below 40% at the end of 2006.

The service sector is the driver of economic success

While the construction sector dominates most reports about the Spanish economy, the service sector really is behind the economy's success. Services accounted for 67% of value added in 2006 and for three quarters of the rise in value added between 2000 and 2006 (see figure 3). The construction sector (comprising residential, public and commercial construction) contributed 16.5% to the volume increase – large by international standards, but not the main driver of the economy. Real estate services contributed significantly to the rise in service sector value added – not surprisingly as the higher housing capital stock allows more consumption. Overall real value added in services rose 19% between 2000 and 2005, with particular support from financial intermediation (+50%), health (+23%).

The four ingredients of Spain's success

The roots of the Spanish success reach deep, well beyond transfers from the EU budget (net 1% of GDP, see chart 27 on page 11) and interest rate convergence ahead of EMU (see chart 4). Italy and Portugal only experienced a short-lived boost from EMU because they did not add sufficient domestic support. Real interest rates in Spain are low today partly because of the country's convergence process with strong GDP growth and higher inflation.

The following pages will outline the four drivers of Spain's economic success: Surging labour input, improving human capital, more openness and an improving innovation system. Later it will be argued that the booming housing sector, the external deficits and the fiscal surplus should be seen as a consequence of these underlying changes in the economy.

Outlook: Success story continues – more moderately

Deutsche Bank Research's *Formel-G* model presented in early 2005 predicted that the Spanish economy would grow by 2.8% annually between 2006 and 2020. Overall, this forecast still looks good, but with a larger contribution from population growth than previously anticipated. From 4% growth in 2006/07, annual rates are nevertheless likely to moderate to a good 2% by 2020. As a result, Spain is set to overtake Italy in terms of per capita GDP in the next few years and by 2020 it may well overtake Germany as well.

1st ingredient: Rising labour input

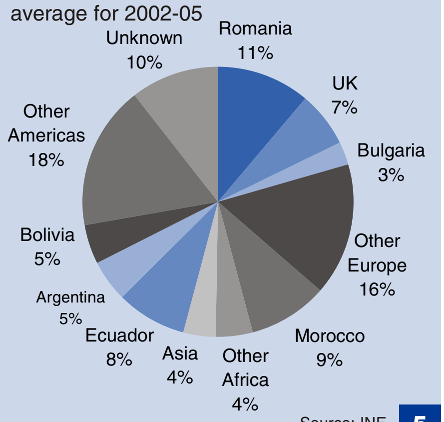
Population projection for 2050 has doubled

The most striking, unexpected and probably underappreciated aspect of Spain's economic success is the rapid rise in labour input fuelled from at least three sources: immigration, falling unemployment and rising participation rates. The changes are so massive that some databases and forecasters are struggling to keep up with them. This means that not all the available data convey the same message or are equally reliable. The current national population projection for 2050 of 53 million people is almost twice as high as the UN projection of 1996, now assuming immigration of 280,000 annually in 2010-20 (half the pace of 2002-05).

Immigration of 1.3% of the population per year

Immigration of foreigners

By country/continent of origin (%), average for 2002-05



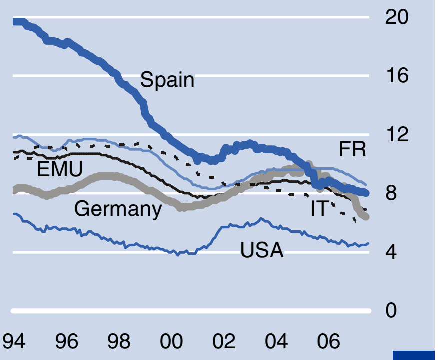
Source: INE 5

Net immigration of foreigners averaged 550,000 per year during 2002-05, equivalent to 1.3% of the population. During these years, Spain accounted for 36% of all net immigration in the EMU. The immigrants are not just retirees from England or Germany. Rather, they come from a wide array of countries such as Romania (11% of all immigrants during 2002-05, see chart 5), Morocco (9%) or Ecuador (8%). More than one-third came from Latin America. With the exception of Romania, these are countries with high fertility rates well in excess of two children per woman, which ensures a large pool of possible immigrants in the future. The law of 2000 on the rights and freedoms of foreigners effectively made Spain an immigration country. And the early 2005 drive to legalise migrants sent a strong signal abroad: You are welcome in Spain! Together with Ireland and the UK, Spain was one of the few countries granting full mobility to workers from new EU member countries in 2004. And finally, Spain seems to be an increasingly attractive place to live: since the mid-1990s almost all the variables associated with happiness – and happiness itself – have risen in Spain.[1]

Unemployment has plunged to 8%, participation rates have risen

Unemployment plunged

Harmonised rate in %



Source: Eurostat, BLS 6

The harmonised unemployment rate plunged from 19.5% in 1994 to 8% in mid-2007 as chart 6 illustrates. The upside is getting thinner as Spain's unemployment is now only one percentage point above the euro area average. Emulating best-practice countries such as Denmark and the Netherlands with their sub-4% rates must be the goal for the coming decade.[2]

Spain is also integrating more and more women into the labour market. From 31.7% in 1995 the employment rate of women had risen by more than 20 percentage points by 2006. At 53% there is still some upside potential compared to the EU-15 average of 58% and the Scandinavian levels above 70%. Similarly, the employment rate of 55 to 64-year olds rose from 32.7% in 1994 to 43.1% in 2005, bringing it in line with the EU-15 average, but still below best-practice levels of around 70%. All in all, employment rose by 7.3

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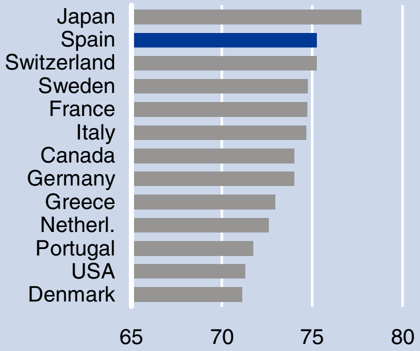
[1] See Bergheim (2007). The happy variety of capitalism. Deutsche Bank Research, Current Issues.

[2] The BdE's April 2007 Quarterly Bulletin featured a box on the Danish labour market.

High longevity

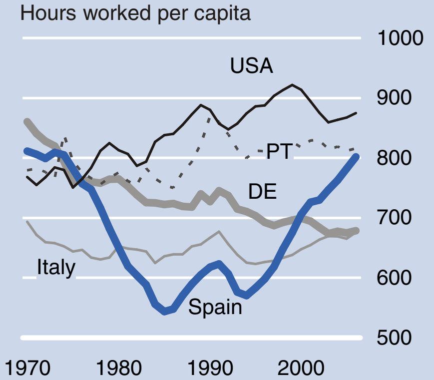
Healthy life expectancy at birth in years, females, 2002



Source: WHO World Health Statistics 2006 **7**

Surge in hours worked

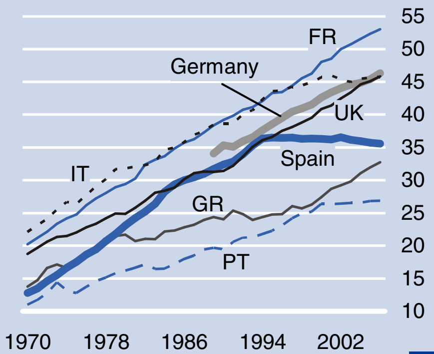
Hours worked per capita



Sources: GGDC, DB Research calculations **8**

Labour productivity flat

GDP per hour worked in PPP USD



Source: GGDC **9**

million or a stunning 60% between 1993 and 2006, accounting for more than 40% of all the new jobs in the euro area over that period.

A series of reforms is behind those successes. It began with the 1984 deregulation of fixed-term contracts that led to a boom in fixed-term employment and was partly counterbalanced in the 1994, 1997 and 2001 reforms in order to boost permanent employment. The 1994 reform eased dismissal rules and the 2002 reform tightened the eligibility criteria for unemployment benefits. Most recently, the 2006 reform was a further attempt to boost permanent employment contracts – with rather limited success so far.

Improvements in health and rising life expectancy are further factors to consider. Spanish healthy life expectancy is already one of the highest in Europe and well ahead of that in Portugal (or the US). Chart 7 shows that newborn Spanish girls can expect to live 75.3 years in good health. This means that Spaniards will have to work longer in life – but also that they are healthy enough to do so.

Surging labour input dampened productivity growth

Taking all this together, the total number of hours worked in Spain surged by 50% between 1994 and 2006, accounting for 60% of the total rise in the euro area. Hours worked per capita (the natural counterpart to GDP per capita) surged by 40% (see figure 8) during the same period, while it fell slightly in Germany and France.

One of the consequences of integrating more and more people into the labour market was to dampen the rise in productivity. Previously unemployed people have below-average skills, so their entering employment is a drag on average productivity. This goes a long way towards explaining why hourly labour productivity stagnated over the past decade. Productivity even declined in the booming construction sector and in the hotel and restaurant sector. Once unemployment stabilises (and maybe immigration slows), productivity will begin to rise more quickly again driven by improving human capital and a rising stock of physical capital.

Inflationary pressures remain modest

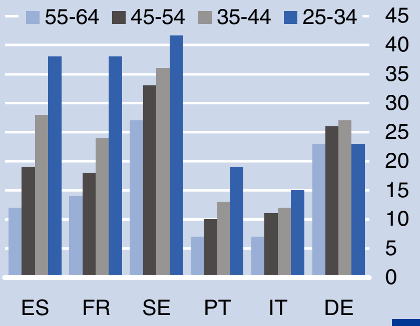
Over the past years, the rapid increase in labour supply – driven by immigration and labour market reforms – has kept wage growth moderate (just above 3%), unit labour cost gains (at around 2 ½%) only slightly above rates consistent with the ECB's inflation objective, and HICP inflation at 2.5% in mid-2007. This indicates that inflationary pressures remain modest and adjustment needs are therefore limited.

Outlook: Slower growth in labour input is likely

Over the coming decade, the rate of increase in labour input is likely to slow especially because employment and unemployment rates are reaching internationally comparable levels. Whether immigration continues at the pace of the past years is impossible to predict.

Young are better educated

Tertiary education attainment by age group as %, 2004



Source: OECD **10**

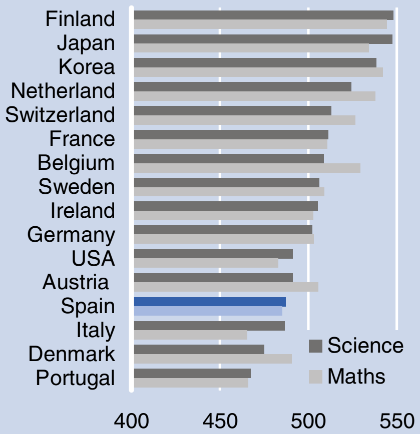
Milestones of the Spanish education system

1970	General Education Act
1975	End of Franco regime
1978	Right to education guaranteed by the Constitution
1983	University Reform Act (LRU)
1990	Act on the General Organisation of the Education System (LOGSE)
2001	University Act (LOU)
2006	Organic Education Act (LOE)

Source: Ministerio de Educacion **11**

Poor PISA results

2003, ranked according to science results



Source: OECD **12**

2nd ingredient: Improving human capital

The second ingredient in Spain's successes over the past years is the rapid improvement in the quality of its workforce, i.e. its human capital. The average years of education of Spain's working age population (the best measure for the overall stock of human capital) surged from 7.3 years in 1990 to 10.6 years in 2004 – the fastest increase of any OECD country. Chart 1 on page 3 already showed that the share of Spaniards with tertiary education rose from 85% of the EMU average in the early 1990s to 95% by 2005.

Major improvement in the education level

And the changes are not over yet: 38% of young Spaniards complete tertiary education, twice the share among 45 to 54-year olds as chart 10 illustrates. The young people entering the labour force will therefore continue to be much better educated than those leaving it, enabling the average level of education to rise further. Chart 10 shows that France has seen a similar boom in higher education, while Italy and especially Germany have not.

Spanish politicians laid the foundation for this rapid rise in human capital before the end of the Franco dictatorship in 1975. The general education law of 1970 was aimed at providing an education for all Spaniards between the age of 6 and 14. The new constitution of 1978 even included the right to education. The 1983 reform of universities introduced economic and academic autonomy for universities, while the 1990 general law on the education system raised the age limit for compulsory education from 14 to 16 years. The university law of 2001 continued this process with a focus on improving the quality of education and research. The most recent reform is the 2006 Organic Education Act.

Much needs to be done

Chart 12 shows that Spain's PISA results are below the OECD average (although in line with the level predicted by the education level of the parents). Lifelong learning is also very low. These weaknesses have been recognised and are being addressed.

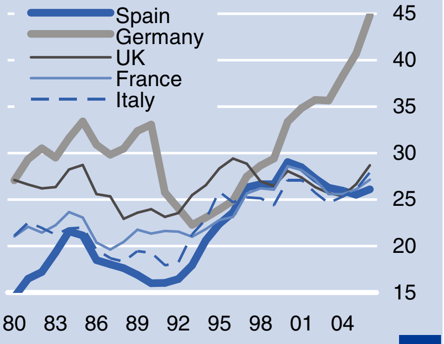
Further improving human capital is the third pillar of the "National Reform Program" published in late 2005 and partly implemented via the Organic Education Act (LOE) of 2006. The reform programme sets targets for the whole spectrum of education ranging from nurseries to tertiary education and then right through to continuing education. One important objective is to cut the share of secondary level dropouts by half from a very high 30% in 2004 to 15% in 2010. Another objective is to more than double the participation in continuing education from 5.2% in 2004 to 12.5% in 2010.

Outlook: Further gains in human capital will come

With enough money available in public coffers and the clear political will to further improve education, rising human capital will continue to underpin the trend growth rate of Spanish GDP.

Nominal exports up in 1990s

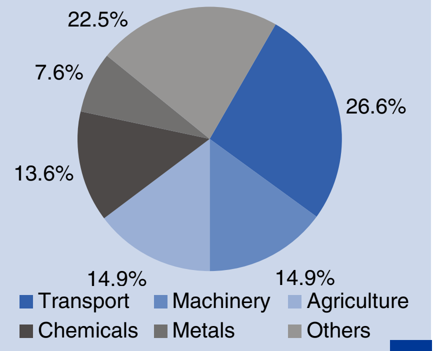
as a percentage of GDP



Source: IMF, national statistical offices 13

Diversified export structure

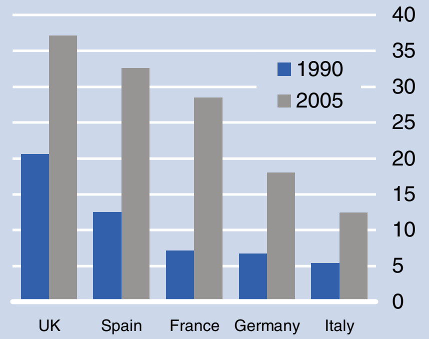
Exports by products, 2004 in %



Source: INE 14

Inward FDI stocks jump

As a percentage of GDP



Source: UNCTAD, World Investment Report 2006 15

3rd ingredient: More openness and deregulation

The third ingredient in Spain's economic success is its rapid opening to the rest of the world – first to the EU, then to Latin America and now increasingly to Asia – complementing and adding to the migration flows outlined above. In general, increasing exchange with foreigners allows countries to specialize and to apply ideas and technology from abroad, thus accelerating learning.

In the early 1980s Spain was still a very closed economy. The accession to the EU in 1986 triggered a wave of trade liberalisation: the lifting of all import duties on products from EU and EFTA countries and the harmonising of import tariffs on products from outside the EU at the lower EU level. The Single European Market in 1993 led to the lifting of all quotas for other EU member states. As a result the share of exports in nominal GDP doubled from 15% in 1980 to nearly 30% by 2000 as chart 13 shows. From 2000 it fell slightly in line with developments in other large European economies except Germany because wage restraint in Germany and the strong euro dampened exports of other EMU countries.

Spain's exports are well diversified across products, with transport equipment (27%) and machinery (15%) the largest groups as chart 14 illustrates. Three-quarters of Spain's exports go to European countries, 4.4% to the USA, 6.7% to Asia and 4% to Africa.

The opening of Spain was not confined to trade. The stock of foreign direct investment in Spain surged from 12% of GDP to 33% between 1990 and 2005 (chart 15) – only France registered a more rapid gain. This activity of foreigners implies greater competitive pressure and more new technologies for Spain. And Spanish companies – especially in banking, telecommunications and construction – are also increasingly active abroad: The stock of Spanish direct investment abroad jumped from a mere 3% of GDP in 1990 to 34% in 2005.

Openness goes hand in hand with deregulation

Open borders also require a business-friendly climate at home in order not to alienate entrepreneurs. Openness should therefore go hand in hand with deregulation and an improving institutional framework. The World Bank's Doing Business project saw Spain only in 39th place overall in 2006 partly because of the length of time needed to start a business and the complicated tax code.

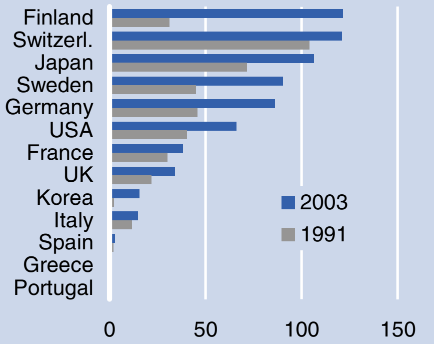
Spain has recognised this weakness and pillar 5 of the national reform program of 2005 is about "more competition, better regulation, effectiveness of the public administration and competitiveness." The bill concerning the creation of a new National Competition Commission is already being debated in parliament. A new agency for assessing public policies is being set up to ensure evidence-based policy. Other measures include the opening-up of freight transport to private rail operators.

Outlook: Spain is going to open up further

Spanish companies are increasingly active abroad, the government is explicitly supporting these activities (new treaties this July with Mexico and Panama) and the growing stock of foreigners in Spain is providing more and more links on a global scale. The productivity-enhancing opening of the Spanish economy is thus set to continue. The challenge of handling the adjustment pressures on the domestic economy (labour market) remains.

Weak patent activity

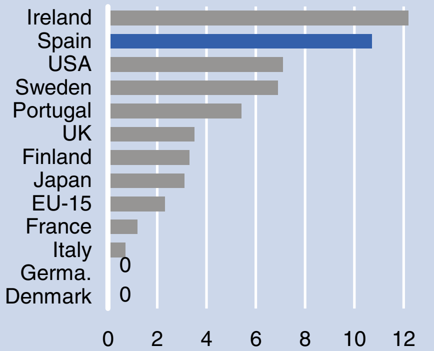
Triadic patents per million population



Source: OECD Compendium of Patents Statistics **16**

Government R&D spending

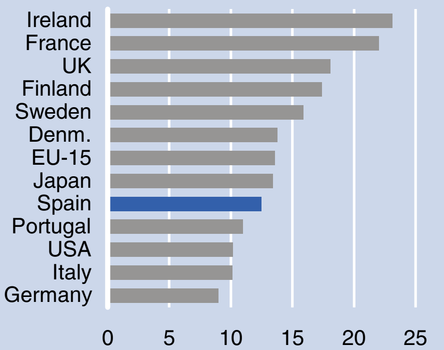
Annual percentage growth 2000-05



Source: Eurostat **17**

New S&E graduates

As share of 20-29 year olds, 2004



Source: Innometrics **18**

4th ingredient: Improving innovation

While Spain's innovation system has not yet reached the standard of the global or European leaders, it is quickly gaining ground. Weakness in innovation is not a major problem for a catch-up economy focused on adaptation. But as Spain moves ahead, it is crucial for it to strengthen innovation – and that is what seems to be under way. By 2020 Spain's innovation system is likely to differ significantly from today's.

The weakness of innovation is severe

To date, Spain's innovation system has indeed been quite weak. The roots of this weakness can be traced back to the banning of books in the 16th century, to the civil war (1936-39) and the autocratic regime until 1975. The 2006 Summary Innovation Index (SII) by the European Commission puts Spain behind Italy and the Czech Republic with a particular weakness in entrepreneurship and life-long learning. Spanish patent applications are just one-tenth of the EU-15 average, as chart 16 shows.

Major changes are underway – and underappreciated

The weaknesses are well-known in Spain and the government is starting to act on them. Between 1995 and 2005 total R&D spending rose from 0.8% of GDP to 1.1% and the government plans to raise spending to 2% of GDP (equal to today's EU-15 average; the Lisbon objective is 3%) by 2010 as one objective in its INGENIO 2010 programme.[3] Between 2000 and 2005, R&D spending by the government rose 11% annually. This was already one of the highest in the EU-15 as chart 17 illustrates, but the 2006 and 2007 budget laws each provide for 30% gains.

The crucial next step is to broaden these increases to the private sector. The INGENIO 2010 programme aims to raise the private sector share in R&D investment from 48% in 2004 to 55% in 2010 (today's EU-15 average; Lisbon objective is 66%). Tax incentives are the main government tool in Spain: according to the OECD, Spain has the highest rate of tax subsidy per unit of R&D spending across the OECD at 45%. The relevant law was only passed in 1995 and modified in 2002/03, showing again that the changes in Spain are recent but substantial.

Other promising initiatives include the 2006 changes in the Universities Act that makes it easier for public-sector researchers to start a company. Furthermore, the Broadband Penetration Plan as part of the "Avanz@" plan has the goal of achieving broadband coverage for most of the population by 2010.

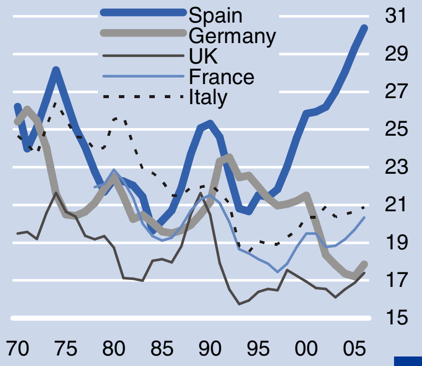
Spain's scientists are the youngest in the EU: 38% are aged between 25 and 34 years, compared to just 16% in Germany. Almost 13% of 20-29 year olds graduate in science and engineering – not leading in Europe, but ahead of the USA and Germany (chart 18).

Outlook: Rapid catch-up as well

Spain is likely to narrow the large gap it currently has relative to the EU in terms of innovation. The current fiscal surplus provides the financial means and the sharp increase in tertiary graduation rates provides the brains for more innovation in the future. The challenge is to broaden innovation to the private sector.

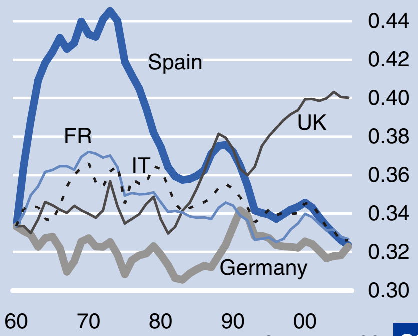
[3] Pillar Four in the government's National Reform Program of 2005.

Investment surges
Fixed investment as % of nominal GDP



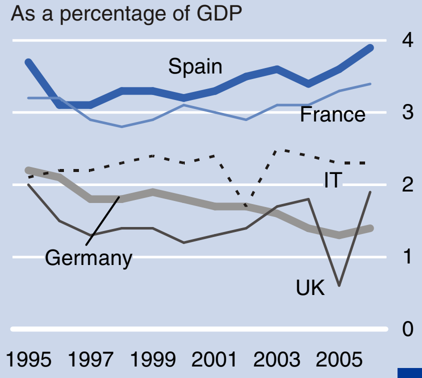
Source: OECD 19

Capital productivity drops
Ratio of real GDP and net capital stock



Source: AMECO 20

Government fixed capital formation
As a percentage of GDP



Source: Eurostat 21

Capital stock rising quickly

After discussing the four fundamental ingredients in Spain's economic success, the following two sections will focus on some of the consequences of these changes. As labour input is rising rapidly, as Spaniards get better and better educated and as productivity rises because of more openness and deregulation, the incentives for a rising capital stock are improving year by year. In addition, real interest rates are supportive for Spain as the ECB sets nominal rates partly based on the low-inflation situation in Germany.

The Spanish investment boom began in the late 1990s as the share of fixed investment surged from 21% in 1994 to almost 31% by 2006, an unusually high and unsustainable rate (chart 19). As a result, the real net capital stock expanded by almost 4 ½% annually between 1999 and 2006 – in excess of the 3.7% average annual rise in real GDP over the same period. In general the capital stock tends to rise in line with the rise in GDP over long periods of time, thereby keeping the ratio between the two constant (Kaldor ratio). In order to assess whether an unusual situation has emerged in Spain, chart 20 provides an international comparison: Spanish capital productivity (real GDP per unit of capital stock) has indeed fallen rapidly since the early 1970s – but it is now just in line with that of Germany, France and Italy.

In addition, the capital stock per employee has not changed much, as shown by chart 1 on page 3. Between 1995 and 2006 it rose less quickly than in the euro area mostly because of the massive rise in employment. Using this metric the investment boom appears far from excessive.

Public investment on the rise as well

Another significant difference between Spain and its European peers is the investment activity of the government. Given the favourable budget situation, the Spanish government had increased its fixed investment spending from 3.1% of GDP in 1996 to 3.9% ten years later as shown in chart 21 – during a period when transfers from the EU held steady and the German ratio fell from 2.1% to 1.6%. The focus is on infrastructure investments such as high speed railways or universities. The resulting increase in the capital stock will allow higher flows of GDP in the future.

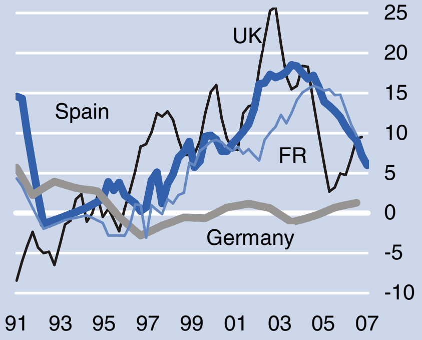
Outlook: Moderation likely

Fixed investment has been high in the past years, especially in residential construction (see below). And the capital stock has been rising more quickly than GDP – a situation that will not continue forever. Therefore, the investment ratio will come down sooner or later and the growth rate of the capital stock will fall to the growth rate of GDP or even below. However, strong fundamentals indicate that a major adjustment crisis does not appear necessary or likely.

Consequences: Housing boom, external deficit and fiscal surplus

House prices in Europe

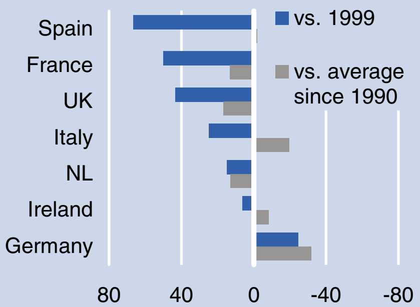
% change yoy



Sources: Nationwide, INSEE; MVIV, BulwienGesa **22**

Housing affordability down sharply since 1999

Change in affordability index in % 2006, positive values imply lower affordabillity



Sources: BIS, ECB, Nationwide, INSEE, NVM, SCB, MVIV, OFHEO, TSB, BulwienGesa, DB Research **23**

Housing vulnerability

Overall risk rank, 2006

1. New Zealand
2. Denmark
3. UK
4. Norway
5. Sweden
6. Australia
7. Finland
8. France
9. Ireland
10. USA
11. **Spain**
12. Canada
13. Netherlands
14. Italy
15. Germany
16. Japan

Source: FitchRatings **24**

The housing boom and the external deficits feature prominently in most analyses of the Spanish economy. In our view, they are – just like the fiscal surplus and above-average inflation – consequences of Spain's economic strength. They are more symptoms of past and current strength than causes of future economic weakness.

Housing boom: The tailwind is fading

Spain's housing sector is experiencing a boom of exceptional proportions: House prices rose by almost 200% over the past decade; construction investment has risen by 6 ½% per year since 1998; there are 800,000 completions every year, more than in Germany France and Italy combined; the share of residential investment in GDP reached 8.1% in 2006, up from 5.1% in 1994 and well ahead of Germany's 5 ½%.

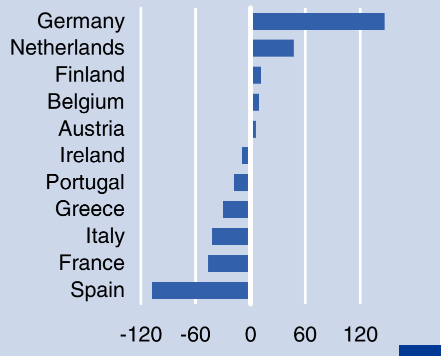
However, there are several factors that explain most of this boom, some of which have been mentioned above. (1) Net immigration of half a million people every year came unexpectedly and led to a doubling of the population expected in 2050 in just a decade. (2) Spain's baby-boomers are younger than elsewhere and are now in the household-forming age. (3) The average household size has been large in Spain and is now also converging to the EMU average. (4) Per capita incomes rose rapidly because of higher employment rates and rising human capital. (5) Over the past 10 years, nominal GDP doubled. (6) Interest rates fell sharply because of EMU entry and are now being kept low by Germany's low inflation. (7) Financial innovation allowed higher leverage of households. (8) Spaniards still spend a much smaller share of consumption on housing than Germans (including imputed rents). Several of these reasons are one-offs and most will not last forever. However, rising human capital will produce solid income gains for several more years.

Whether this boom will end in tears can only be assessed by looking at ratios that give a sense of overheating. Most of these ratios are issuing warning signals but are not worlds apart from what other countries in Europe are experiencing. For example, chart 1 showed that the residential capital stock per capita relative to the EMU average rose in step with the employment rate and income per capita. The Spanish affordability ratio has risen sharply since 1999 as prices and then interest rates rose, but it is still lower than in the mid-90s (chart 23). Around 95% of Spanish mortgages are on floating interest rates, which is hurting in an environment of rising rates. Affordability declined further in early 2007 as the new legislation aimed at boosting the rental market (just 10% of all housing) reduced tax deductibility of mortgage payments. Combining these and other measures, FitchRatings ranked Spain 11th out of 16 countries in its July 2007 report on vulnerabilities to housing markets. If Spain's economy continues to grow at solid rates – this note argued why this is likely – incomes may justify the current construction activity. And if it does not: the Banco d'Espana requires banks to maintain comparatively high risk provisions, so there seems to be a lot of cushion against bad loans.

Nevertheless, the tailwind from construction is fading: as chart 22 shows, price increases moderated to single-digit rates in early 2007 as houses became less affordable. This is partly a consequence of

Current accounts in EMU

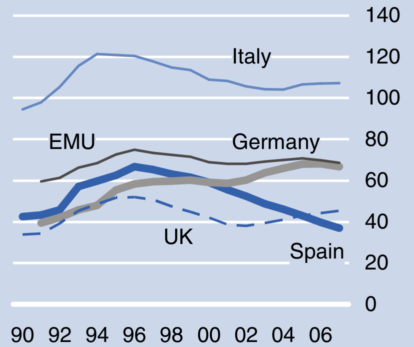
Balance in billion USD, 2006



Source: IMF 25

Public debt down 30%-points

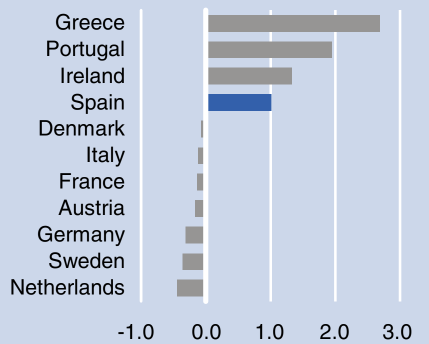
Gross public debt (Maastricht), % GDP



Source: OECD 26

Net flows from the EU

Operating budgetary balances in % of GDP, 2000-05 average



Source: European Commission 27

ECB rate increases since year-end 2005. Construction investment is set to slow over the coming years, dampening overall GDP growth.

Current account deficit – it takes two to tango

The third consequence of Spain's economic strength – especially in conjunction with weak domestic demand in the euro area's largest economy – is a rising current account deficit. Spain's final domestic demand grew by an average annual rate of 4.8% between 1998 and 2006 for reasons explained above, while Germany's grew by just 0.9%. As a result, Spain's current account moved from balance in 1997 to a deficit of almost 9% of GDP in 2006, while Germany's moved from a small deficit to a surplus of 5% of its GDP (chart 25). For the euro area overall, the current account is roughly in balance.

Generally, one can argue that current account balances within a monetary union (just as within a country) are nothing to worry about because an adjustment via the nominal exchange is not possible and interest rates don't have to rise to protect the currency, as was the case in Scandinavia in the early 1990s. Foreigners are financing part of Spain's economic success. In addition, the Spanish deficit does not go towards financing a fiscal deficit but to private investment. And one can argue that the deficit is a sign of economic strength (unlike Italy's) with Spain's rising profit ratio in national income as supporting evidence. Finally, the deficit is likely to shrink once Germany's domestic demand strengthens again as wage inflation picks up. Certainly, Spanish products have become more expensive relative to German products over the past decade. But overall we see little reason to lose sleep over the size of the Spanish deficit.

Fiscal surpluses – prepared for the future

The unexpected inflow of relatively young workers, the massive decline in unemployment and the rise in incomes boosted the government's tax revenue and reduced spending. Earlier this note outlined that the good fiscal situation did not stem from cuts to investment into the future: government R&D spending is rising rapidly and government fixed investment reached almost 4% of GDP in 2006. But overall the government has not increased its command over income: between 1996 and 2006, general government expenditure dropped from 43.2% of GDP to 38.5%, well below the EU-15 average of 47.3%.

Spain posted a fiscal surplus of 1.8% of GDP last year – in contrast to the deficits of 2.5% in France or 4.4% in Italy. Rising surpluses and strong nominal GDP growth allowed Spain's debt-to-GDP ratio to plunge by almost 30 percentage points between 1996 and 2006 to just 39.9% – way below the EMU average of 68.9% as figure 26 shows. This gives Spain plenty of room to keep spending for the future. The net inflow from the EU worth 1.0% of GDP annually during 2000-05 was helpful in this context (chart 27), but domestic drivers clearly dominated, as confirmed by the fact that both government investment spending and the surplus rose.

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