
CHAPTER I

THE FRENCH AND SPANISH ECONOMIES: A MACROECONOMIC PERSPECTIVE (*)

All the tables and graphs in this work are part of a statistical annex disseminated separately on the Internet at www.bde.es. This chapter includes only those that are most relevant, but retains the same numbering as for the statistical annex. That explains any gaps in the numbering used in this chapter.

(*) The authors of this chapter are Concha Artola and Teresa Sastre (Banco de España) and André Tiomo (Banque de France). The opinions expressed are those of the authors and do not necessarily reflect the views of the Banque de France and Banco de España.

I. INTRODUCTION

This chapter surveys the main macroeconomic features of the French and Spanish economies. It does not attempt to review the extensive macroeconomic background of the two economies. The performance of the French and Spanish economies is compared within the framework of the European economy, i.e. whenever the data are available, the relevant variable is shown for both France and Spain and also for the aggregate of the 12 countries making up the euro area in 1999. This comparison is carried out using data from the main macroeconomic indicators of both countries, including growth, foreign trade, inflation and unemployment. Over the last forty years there have been fundamental changes in both economies, but the change has been more dramatic in Spain, which has been going through a process of catching-up for most of the period. In fact, from 1986 to the early 1990s, Spain benefited strongly from a substantial improvement in the terms of trade and the economic upswing in Europe.

The chapter is organized as follows: section 2 sets out the growth performance of the two economies in the light of the changes that have taken place in the productive structure of the two countries; section 3 focuses on the foreign trade between the two countries over the last ten years; section 4 describes the patterns in saving, investment and financing in both the French and Spanish economies; the labour market in the two countries is presented in section 5; section 6 considers very briefly cost and price developments in the two countries; lastly, an overview of monetary and financial conditions is given in section 7.

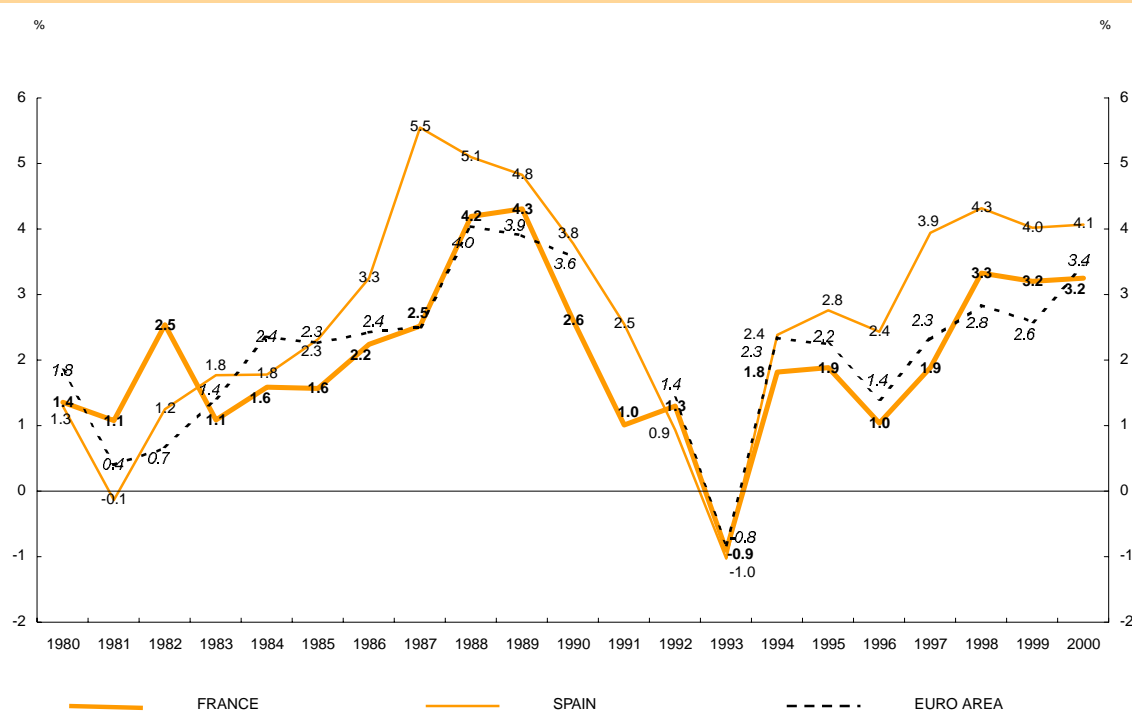
2. GROWTH AND STRUCTURAL CHANGES

Since its accession to the European Union in 1986, the Spanish economy has experienced a significant growth, outpacing most of the European countries. This section analyses this positive growth differential in the light of the changes that have taken place in the Spanish and French productive structure.

Growth performance in Spain, France and the euro area during the last two decades is shown in graph I.1 where the common trends along all the period can be analysed. For the whole period, Spain has maintained a positive growth differential with the euro area, while the French economy closely followed the European pattern. While the 1992-1993 recession was deeper in Spain, the recovery from 1994 was very strong in relative terms; in the subsequent years the gap between the growth rate in Spain and its European partners widened up to 2000, when the gap substantially narrowed (1).

(1) The growth differential with the euro area was 1.5 p.p. between 1997 and 1999 and 0.6 p.p. in 2000.

REAL GDP GROWTH



Source: OECD ADB database.

Table I.1 presents the changes in the productive structure in Spain and France over the last twenty years. The main trend in the two countries is the move towards a service society, and the continuing decline in the importance of agriculture and industry. When measured in nominal terms, the increased in the weight of the service sector was the same size in both countries (around 10 p.p.). However during the nineties the advances towards a service society went further in Spain than in France (between 1990 and 1997 the share of service activities in total VA rose 5 p.p. in Spain and 3 p.p. in France). The increasing participation of the services sector in the generation of value added is much weaker when measured in real terms (less than 5 p.p. in both Spain and France), reflecting faster price increases in the service sector than in goods production. This «dual inflation» phenomenon reflects the large non-tradable component of services as well as a lower level of domestic competition than in other activities, and in particular in manufacturing.

Production specialisation differs in the two countries. As table I.1 shows, relative to Spain, France appears to be specialised in financial services, real estate and business services, and in other service activities (which include, *inter alia*, education, health and personal services). That said, the productive structures of these two economies have become more similar the last two decades.

3. FOREIGN TRADE

Joining the European Union has been beneficial for France and Spain's trade with the rest of the world. Most industrial sectors found themselves largely unprotected after customs tariffs were scrapped and trade barriers came down. Consequently, the two countries' economies opened up further. In the case of Spain, for example, exports rose from 17.1% of GDP in 1991,

TABLE I.1

CHANGES IN THE STRUCTURE OF VALUE ADDED

VA Structure at current prices	SPAIN			FRANCE		
	1980	1990	1997	1980	1990	1997
Agriculture	7.4	5.4	4.5	4.6	3.7	3.1
Industry	28.6	24.6	22.2	28.0	22.7	21.0
Construction	8.2	8.7	7.1	6.6	5.7	4.7
Total Services	55.8	61.2	66.2	60.8	68.0	71.2
Wholesale, retail, hotels, transport	24.5	24.8	27.0	18.5	20.0	18.9
Financial intermediation, real estate	15.9	17.8	18.9	23.0	27.0	28.9
Other service activities	15.3	18.7	20.3	19.3	21.0	23.4
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0

VA Structure at 1995 prices	SPAIN			FRANCE		
	1980	1990	1997	1980	1990	1997
Agriculture	5.4	4.8	5.1	3.6	3.2	3.4
Industry	26.3	22.8	22.5	23.1	20.8	21.4
Construction	7.8	8.4	7.2	6.8	5.9	4.6
Total Services	60.6	64.0	65.2	66.5	70.1	70.6
Wholesale, retail, hotels, transport	28.1	25.8	26.7	18.4	19.6	19.3
Financial intermediation, real estate	17.5	19.1	18.3	25.9	28.6	28.1
Other service activities	15.0	19.1	20.2	22.2	21.9	23.2
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0

Sources: OECD ANA database and INE (Spanish Statistical Institute).

to 27.5% in 1999, while imports increased from 20.3% to 28.8% over the same period. In France, there was also an opening trend; exports rose from 21.5% of GDP in 1991 to 25.9% in 1999 and imports from 22% to 23.7% of GDP in the same period (see table I.2.A). At the end of the nineties, the Spanish economy was more opened than the French one.

The table I.2.B shows the bilateral trade between the two countries. The most notable fact is that France is Spain's most important trading partner. A constant level of 13% of Spanish goods exports went to France in all the years analysed, while imports of French goods grew by almost two percentage points from 1991 to 1999, to 15.1%. From the viewpoint of France, trade with Spain almost doubled between 1991 and 1999; exports rose from 3.9% in 1991 to 7% in 1999, and imports from 3.2% to 6.3% in the same period. The bilateral trade balance has remained constantly positive for France, while in Spain it has been negative in every year. However, between 1994 and 1996 the Spanish deficit fell significantly owing to the successive devaluations of the peseta.

4. SAVING, INVESTMENT AND FINANCING

The French and Spanish economies have displayed rather similar patterns of national saving and investment. The slowdown in economic activity during the period 1992-94 was mainly reflected in a decrease of gross national capital formation and of gross saving in relation to GDP (see graph I.2). As a result, the negative net lending to the rest of the world, characteristic of the early nineties, turned positive in 1993 in France, and in 1995 in Spain. In both countries the reduced domestic saving was mainly due to a lower level of general government gross saving (graph I.3) in accordance with the cyclical position. During the second half of the nineties, the net financing needs of the general government were progressively reduced in both coun-

TABLE I.2

FOREIGN TRADE IN FRANCE AND SPAIN

A. Exports and Imports as % of GDP									
	1991	1992	1993	1994	1995	1996	1997	1998	1999
Spain									
Exports / GDP	17.1	17.6	19.4	22.3	22.6	23.9	26.7	27.2	27.5
Imports / GDP	20.3	20.4	20.0	22.1	22.8	23.4	25.7	27.2	28.8
France									
Exports / GDP	21.5	21.5	20.7	21.5	22.5	23.1	25.5	26.1	25.9
Imports / GDP	22.0	20.9	19.2	20.2	21.1	21.4	22.5	23.5	23.7
B. Bilateral goods trade between Spain and France (%)									
	1991	1992	1993	1994	1995	1996	1997	1998	1999
Spain									
Exports of goods to France/ Total Spanish exports	13.2	12.8	12.0	13.7	14.2	14.1	12.7	13.3	13.0
Imports of goods from France/ Total Spanish imports	13.2	13.4	13.7	15.0	14.8	14.3	14.8	15.1	15.1
France									
Exports of goods to Spain/ Total French exports	3.9	4.2	4.4	5.3	5.5	5.9	5.9	6.4	7.0
Imports of goods from Spain/ Total French imports	3.2	3.5	4.0	5.1	5.6	6.0	6.0	6.3	6.3
Bilateral goods trade balance (%) (as % of Spanish GDP/ French GDP)	-4.1/1.3	-4.8/1.6	-4/1.3	-2.8/1	-1.5/0.6	-2/0.8	-4.1/1.6	-4.9/2	-7.9/3.3

Sources: Balance of Payments of Banque de France and Banco de España, INSEE and INE (French and Spanish Statistical Institutes) and Customs Statistics.

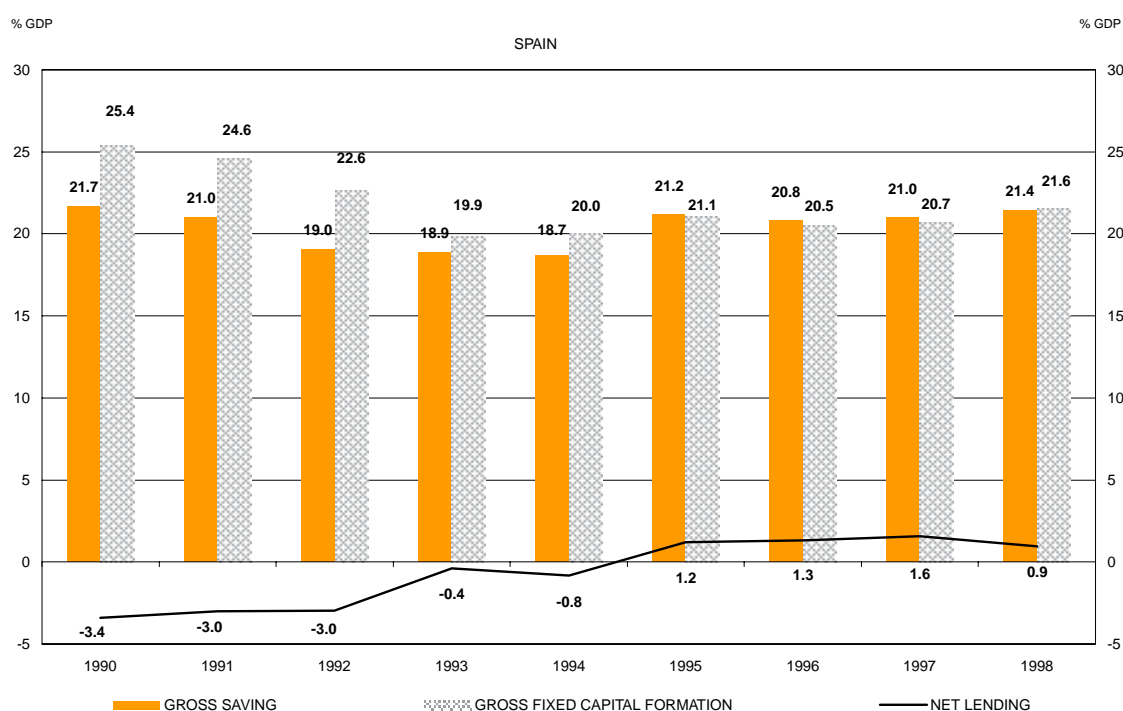
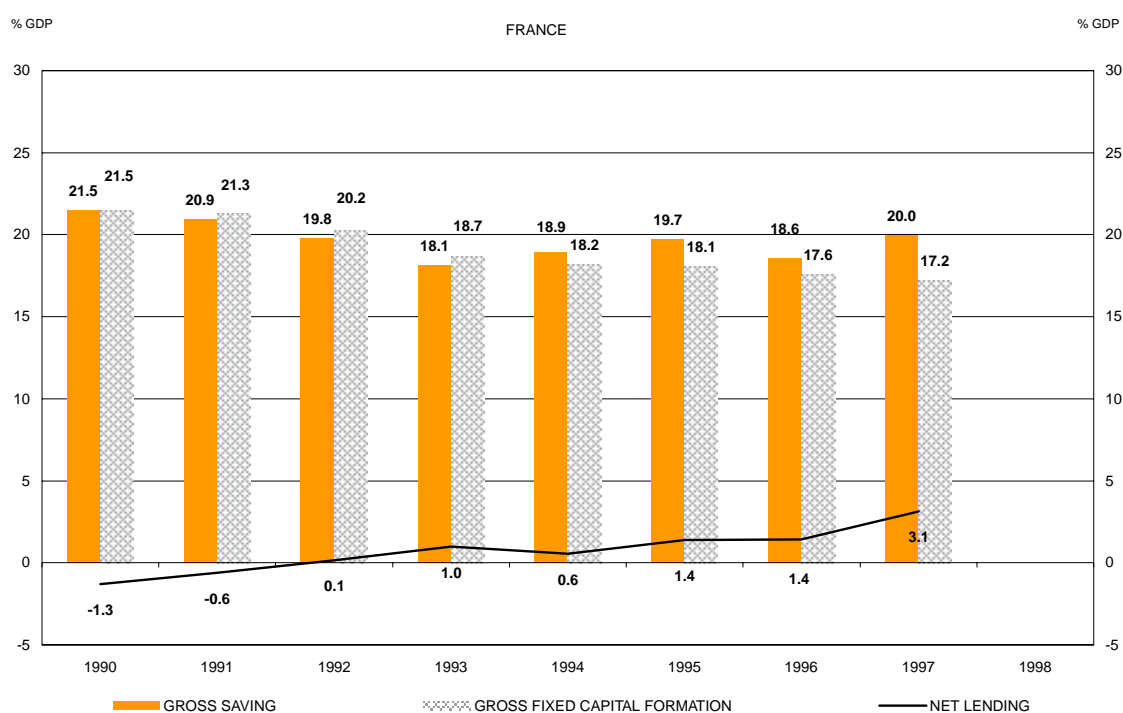
tries, in the context of fulfilment of the Maastricht criteria for public finances. This enabled gross national saving to increase, making room for higher levels of gross fixed capital formation by Spanish firms, while net lending to the rest of the world remained positive. In the case of France the increase in gross national saving pushed up net lending to the foreign sector. The reduction in the net financing needs of general government also led to a decline in public indebtedness during the second half of the nineties. Thus, the ratio of debt to GDP, which was 66.6% in Spain and 59.3% in France in 1997, was reduced to 60.4% and 57.6%, respectively, at the end of 2000.

When focussing on the sectoral breakdown of saving and investment (see graph I.3), there appear to be three main differences between France and Spain. Firstly, in the context of the catching-up process of the Spanish economy with respect to the main EU countries, gross fixed capital formation was generally higher in Spain during the nineties, as a proportion of GDP. Secondly, this higher level is attributable to investment by non-financial firms and general government, since households' capital formation remained at a lower level in Spain than in France during this period. Lastly, while gross national saving showed a similar pattern and similar levels in both countries, there were differences in its sectoral breakdown. On one hand, household saving was higher, as a proportion of GDP, in France than in Spain. On the other hand, Spanish non-financial firms significantly increased their saving from 1994, in an attempt to reduce their dependence on borrowed funds, while French firms maintained their saving fairly stable.

Graph I.4 looks at investment from a broader perspective, showing the evolution of its main components. From 1986 the private investment rate in Spain has been continuously above the French rate, the difference being particularly high since 1996, period when the average private non-residential investment rate was 14.3% of GDP in Spain as compared to 11.4% in France. The total investment rate in the two economies, which was very similar up to the mid-eighties, has diverged during the last fifteen years due to the speeding up of the investment

GRAPH I.2

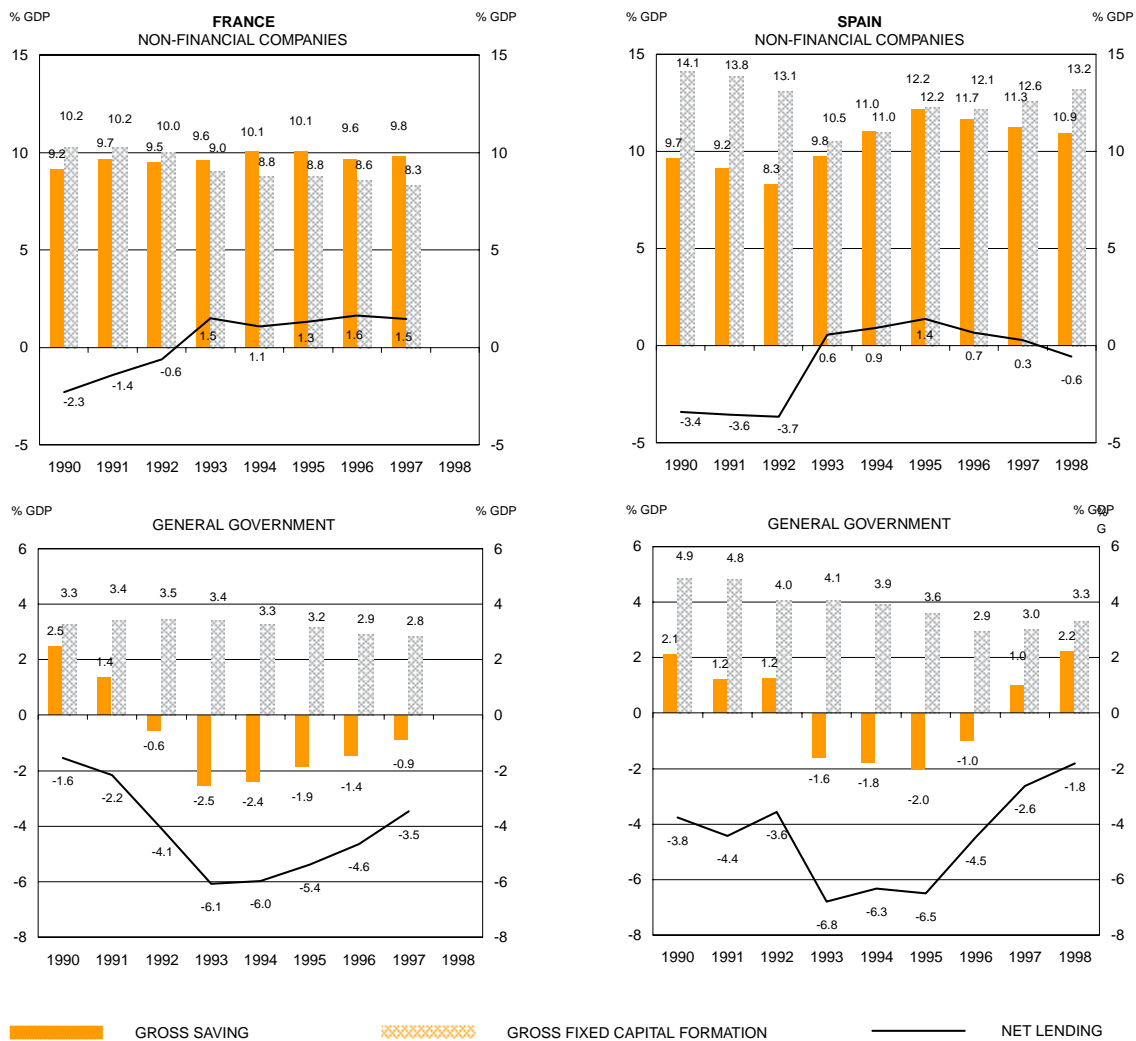
SAVING, INVESTMENT AND FINANCING TOTAL ECONOMY



Source: OECD.

process in Spain. This development is partly explained by the relative dynamism of private non-residential investment, but also by the fast growth in government investment. As seen in table I.3 and graph I.4, the government investment rate was very low in Spain, relative to both France

SAVING, INVESTMENT AND FINANCING BY ECONOMIC SECTORS



Source: OECD.

and the euro area, and followed a downward trend until 1980. From 1982, public investment surged, peaking in 1990-1991 when it reached 4.8% of GDP in real terms (2). The recent slowdown in Government investment, observed both in France and Spain since 1996, is related to the drive to reduce fiscal imbalances, in order to meet the requirements established in Maastricht to participate in Stage Three of EMU.

5. THE LABOUR MARKET

In 1970, employment in Spain as a percentage of the working-age population was about the same as in the euro area and only three percentage points lower than in France (table I.4). As seen in the statistical annex (graph I.6), until the mid-eighties this ratio de-

(2) The fast growth in the 1990-1991 period is associated with the events which took place in 1992; the Universal Exposition in Seville and the Olympics Games in Barcelona

TABLE I.3

INVESTMENT RATE (GROSS CAPITAL FORMATION AS A % OF GDP. VOLUME)

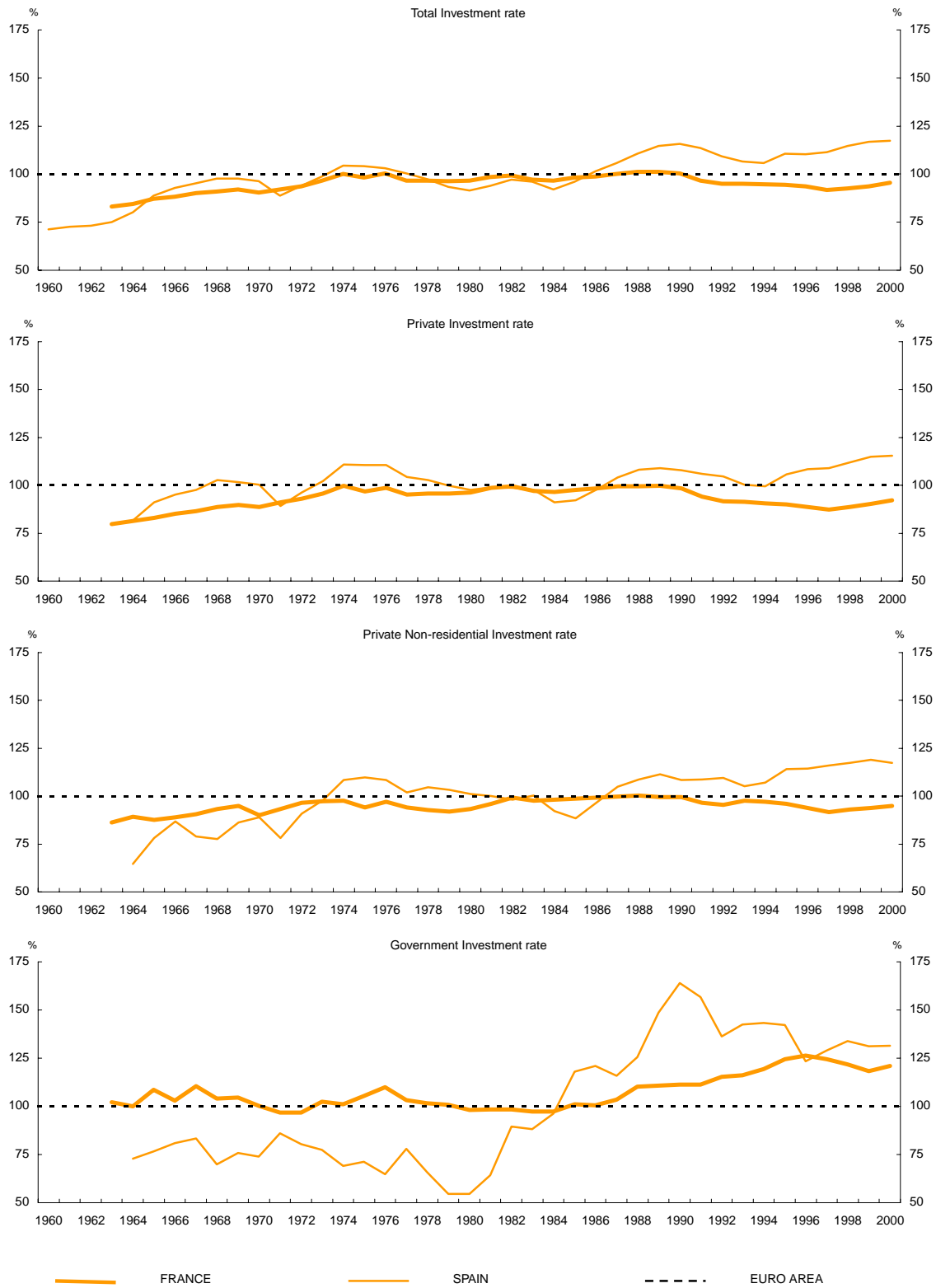
SPAIN	1964-1975	1976-1985	1986-2000	1964-2000
TOTAL	22.7	19.5	22.5	21.8
Private	19.9	17.1	18.7	18.7
Non-Residential	10.1	10.6	13.1	11.5
Residential	9.7	6.5	5.6	7.2
Government	2.9	2.3	3.8	3.1
FRANCE	1964-1975	1976-1985	1986-2000	1964-2000
TOTAL	22.1	19.8	19.5	20.4
Private	18.2	16.7	16.3	17.0
Non-Residential	10.7	10.2	11.4	10.9
Residential	7.4	6.5	4.9	6.2
Government	3.9	3.1	3.2	3.4
EURO AREA	1964-1975	1976-1985	1986-2000	1964-2000
TOTAL	24.0	20.3	20.3	21.5
Private	20.2	17.2	17.5	18.3
Non-Residential	11.6	10.6	11.9	11.4
Residential	8.6	6.6	5.6	6.9
Government	3.8	3.1	2.8	3.2

Source: OECD ADB database.

clined steeply, recovering only slightly during the 1986-1992 expansion, experiencing a stronger recovery in recent years, after the 1992-1994 recession. Despite the strong employment growth of the last five years, the Spanish employment/working-age population ratio is still relatively low, both compared to the levels at the beginning of the seventies (56.4% in 2000, 63.3% in 1970), and to its European partners (almost 6 p.p. below both the French and the euro Area level in 2000).

The pattern of decline in the employment/working-age population ratio during the seventies and up to the mid-eighties is mainly accounted for by a huge increase in the unemployment rate and to a lesser extent, by a decrease in the participation rate. The unemployment rate, which was a mere three percent at the beginning of the seventies in Spain, France and the euro area, went up by 8 p.p. in the euro area. In France the unemployment closely followed the European pattern, while in Spain the unemployment rate increased by 18 p.p., over the same period. The singularity of the Spanish unemployment growth during these years is the result of two overlapping shocks of a very different nature; first, the oil crisis of the seventies, and second, the end of the dictatorship, which led to wholesale political reform followed by far-reaching changes in economic institutions. The participation rate fell by 5 p.p. in Spain during that period, in contrast with the small declines in France and the euro area (about one percentage point); this relatively big drop in the Spanish participation rate was mainly a consequence of the *discouraged worker effect*, reflecting the low probability of finding a job given the high unemployment rates. As seen in the statistical annex (graph I.6), both unemployment and participation rates have been more volatile in Spain than in its European counterparts, volatility that is partly accounted for by the relatively higher weight of fixed-term employment contracts (see graph I.8 in the statistical annex). This pattern is all the more noticeable during the fast unemployment growth which took place during the recession of the early nineties, when Spanish unemployment increased by 8 p.p. in only four years, reaching a peak of 24% in 1994. This was followed by a similarly fast recovery; in only six years, the unem-

INVESTMENT. EURO AREA = 100



Source: OECD ADB database.

TABLE I.4

UNEMPLOYMENT AND PARTICIPATION RATES (%)

SPAIN	1970	1986	2000	1986-1970	2000-1986	2000-1970
Employment/Working-Age Population	63.3	47.9	56.4	-15.4	8.5	-6.9
Participation rate	65.1	60.3	65.6	-4.8	5.4	0.6
Unemployment rate	2.7	20.5	14.1	17.8	-10.0	11.4
FRANCE	1970	1986	2000	1986-1970	2000-1986	2000-1970
Employment/Working-Age Population	66.0	59.6	62.0	-6.3	2.4	-4.0
Participation rate	67.6	66.5	68.6	-1.1	2.1	1.0
Unemployment rate	2.5	10.4	9.7	7.9	-0.7	7.2
EURO AREA	1970	1986	2000	1986-1970	2000-1986	2000-1970
Employment/Working-Age Population	63.7	57.5	62.2	-6.3	4.7	-1.6
Participation rate	65.2	64.1	68.3	-1.1	4.2	3.1
Unemployment rate	2.3	10.3	9.0	8.1	-1.4	6.7

Sources: OECD ADB database.

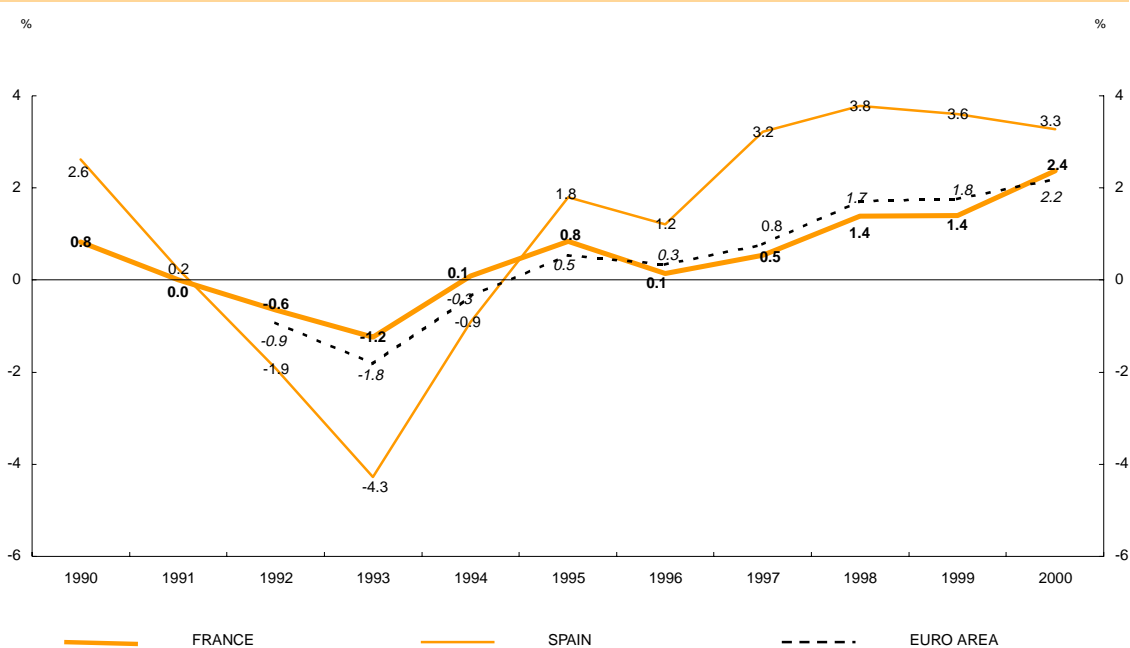
Note: The employment/working-age population figures for Spain are different from the variable shown in annex I.

The employment variable in annex I is consistent with National Accounts, whereas here the employment variable comes from the LFS.

ployment rate went down by ten p.p. to 14% in 2000. From a long-run perspective it is worth mentioning that the unemployment rate in 2000 both in France and in the euro area is still 7 p.p. higher than the rate prevailing at the beginning of the seventies. This difference amounts to 11 p.p. in the case of Spain.

GRAPH I.5

EMPLOYMENT GROWTH



Source: OECD ADB database.

The other singular feature of Spanish labour market dynamics is the high variability of the participation rate. The strong decline in the participation rate up to the mid-eighties was due to a decrease in the male participation rate (3) (see graph I.7 in the statistical annex), this decline being particularly intense in the two extreme age groups; both youths and men over the age of 55 experienced sharper reductions in their participation in the labour market. This decline is to be seen, in part, as a consequence of more time being spent in education and partly as a consequence early retirement. These factors, while also being present in France, are nevertheless more acute in Spain, as the lack of opportunities in the labour market reinforced both of them. With the recovery of economic activity, in 1985, the Spanish participation rate started to increase rapidly, reflecting the end of the *discouraged worker effect* and, in particular, entry into the labour market of large numbers of women who had previously been discouraged by the gloomy labour market performance. The presence of women in the labour market has traditionally been very low in Spain when compared to European levels. This is to some extent a cultural feature; but the delayed growth in female participation in the labour market in Spain also reflected also the lack of opportunities that characterised the market at the time. Despite the faster growth in the female participation rate in Spain since 1986, the gap between Spain and France is still wide, amounting to 13 p.p. in 1997.

The fast economic growth experienced by the Spanish economy since 1994, and particularly during the last four years, with average GDP growth of 4%, well above the euro area average, has translated into a remarkable employment performance, with an average of around 500,000 net jobs created per year. In France, from 1995 onwards, particularly at the end of the period (1998-2000) an upward trend was observed, in terms of job creations. The growth of employment increased by 2,6 % in the manufacturing sector and 3,4 % in the service sector: 460 000 jobs might have been created or kept between 1994 and 1997. Net job creation further increased at the end of the period (4).

However, as shown in graph I.5, Spain maintained a positive differential with respect to France, which closely followed the pattern observed in the euro area, although with a narrowing gap. Graph I.5 depicts employment over a complete cycle, showing the relatively high volatility of job creation in Spain. This is one feature of the Spanish labour market that is closely linked to the high weight of fixed-term contracts in Spain. Until the mid-eighties, with the exception of temporary jobs in seasonal activities (agriculture, tourism), employment contracts were assumed to be open-ended and workers could be dismissed only under limited conditions entailing sizeable redundancy payments. This was considered to be as an important obstacle to the hiring of new workers. In order to overcome these rigidities in employment contracts, a new law was passed in 1984, which introduced a new type of contract namely, fixed-term contracts, with low severance payments. Since their introduction this type of contracts has been widely used by firms. In fact, the fast employment growth during the recovery that started in 1985 relied mainly on this type of temporary jobs (graph I.8 in the statistical annex), which very soon accounted for a high proportion of total employment (one-third). The effects of this type of contracts on the various labour market variables have been extensively studied. They seem to have increased labour turnover, lowered labour and total factor productivity owing to the lack of investment in human capital formation for workers on fixed-term contracts, and to have enhanced the bargaining power of workers with permanent contracts, leading to unjustified wage rises at the beginning of the nineties. With the aim of counterbalancing the negative effects of the high use of temporary contracts, reform initiatives were implemented in 1994 and 1997 and further measures were approved in March 2001 in order to encourage new

(3) The LFPR series shown in the statistical annex (graph I.7) comes from OECD Labour Force Statistics and differs from the one shown in graph I.6, which came from OECD ADB database. In the case of France these differences are unimportant. In the case of Spain the differences are wider.

(4) Crépon B, et Deplatz R. "Une nouvelle évaluation des effets des allègements de charges sociales sur les bas salaires" *Économie et Statistique*, n° 348, 2001-8.

permanent jobs and thereby reduce, the share of temporary contracts in the economy. The central element was a new type of permanent contract with lower firing costs for those groups with special difficulty finding permanent jobs (the long-term unemployed, temporary workers, young people and elderly workers and women in particular sectors). These contracts included, as an additional incentive, a two-year reduction in social security contributions of between 20 and 60 per cent depending on the targeted group. As shown in graph I.8 in the statistical annex, the impressive job creation in the Spanish economy during the last four years has been mainly based on the permanent segment, so that, from this viewpoint, the reform has been successful. Nevertheless, the use of fixed-term contracts has also expanded, and the reduction in the share of temporary contracts has been small declining from a peak of 35% of total employment in 1995 to 32% in 2000.

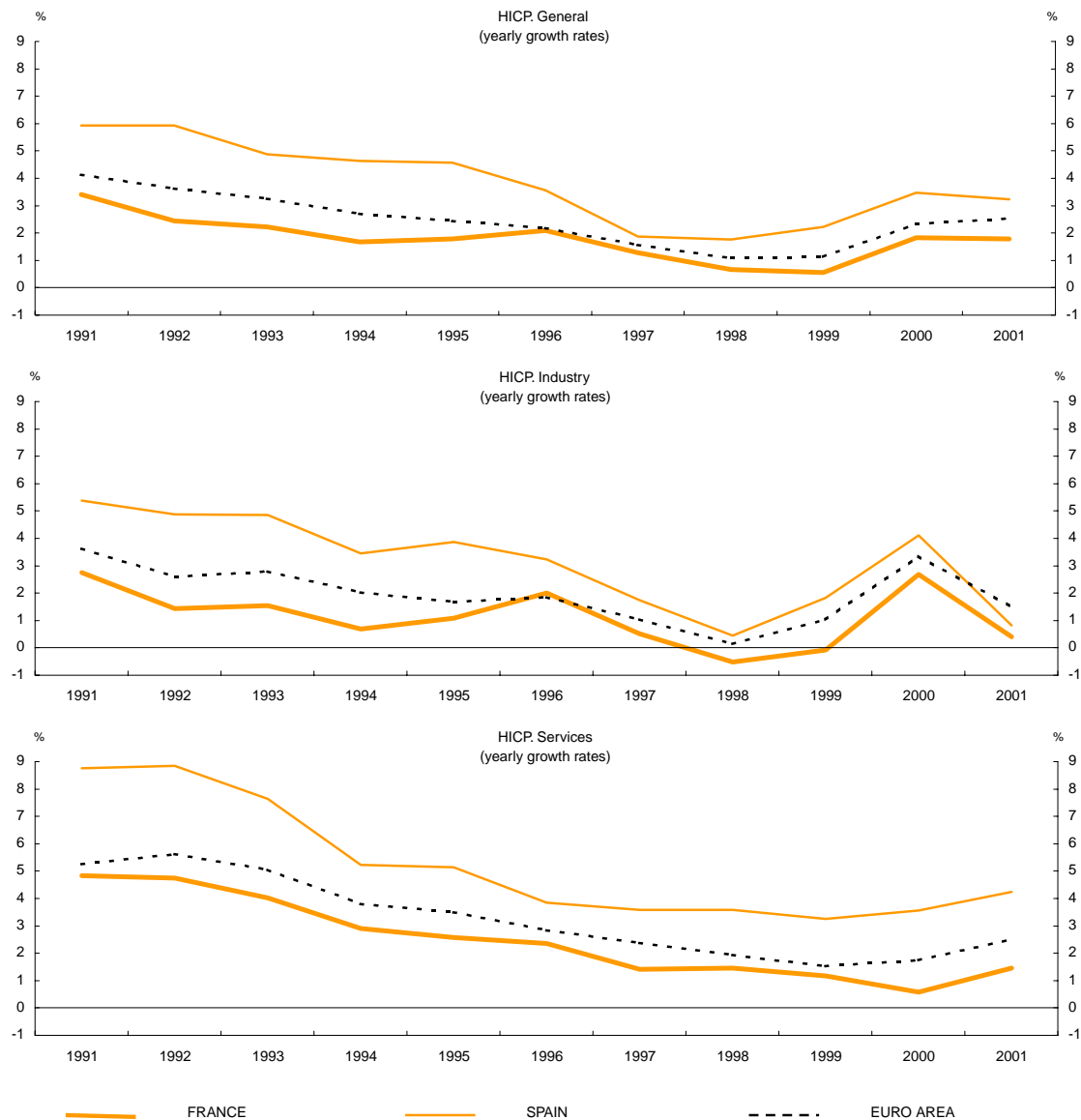
In France, over the whole period (1991-1999), the use of fixed-term contracts was not as developed as it was in the case of Spain: their proportion in the total employment only amounted to 4.1 % in 2000 (2.7 % in 1990). However, the high proportion of permanent jobs contracted during the 1998-2002 period contributed to the decrease in the number of precarious jobs. On the other hand, in terms of wages, the measures taken to reduce contributions on low salaries, implemented from 1993 onward have been developed, so as to play a key role in employment policy. The measures aimed at reducing the decrease in the number of unqualified jobs, which represented a high proportion of low paid employees. The gradual decrease in employers' contribution rates contributed to reducing the labour cost on low wages. For a worker earning the guaranteed minimum wage, the decrease in the rate of social security contributions was only 5.4 % of gross salary in July 1993, then it was 18.2 % in October 1996. Under the "Aubry" act, companies which implement a collective bargaining agreement with a 35 hour working week along with an undertaking to create new jobs or protect existing ones can get support measures in the form of a reduction in social security contributions especially on low and medium wages. For a worker earning the "guaranteed minimum wage" this reduction represents about 20 % of the labour cost. Such incentives contributed to the increase in job creations between 1994 and 1997. (See annex II on characteristics of the French and Spanish labour markets).

6. COSTS AND PRICES

At the beginning of the nineties the Spanish inflation rate was about 6%, two percentage points above the average rate in the euro area. This differential declined rapidly up to 1997, when it reached a minimum of 0.3 p.p. with respect to the euro area, reflecting the fast process of nominal convergence driven by the Maastricht treaty. During the following years, and particularly in 1999-2000, the relative performance of prices deteriorated somewhat with respect to the euro area, partly reflecting the rise in oil prices which began in 1999 and affected to a greater extent countries like Spain, with a higher degree of dependence on imported energy. In 2001 the inflation gap between Spain and the euro area amounted to 0.7 p.p. During the whole period the inflation rate in France was below the euro area average. There was a progressive narrowing of the gap until 1996, which was subsequently reversed. In 2001 the gap between inflation in France and the euro area was 0.7 p.p. (graph I.9).

The main reason for the persistence of a positive inflation differential between Spain and the euro area is to be found in the higher intensity of the *dual inflation* phenomenon in Spain, i.e. the tendency of inflation rates to be faster in the non-tradable goods sector than in tradable sector is more intense in Spain than in other European countries. This is shown in the last two panels of graph I.9, where prices of non-tradables are proxied by the service component of the HICP, while tradables are proxied by the HICP industrial goods component. During the first part of the past decade, the behaviour of goods prices rapidly converged with the pattern observed in the euro area as a whole. In 2001, a negative differential with respect to the euro area

HARMONISED INDEX OF CONSUMER PRICES (HICP)



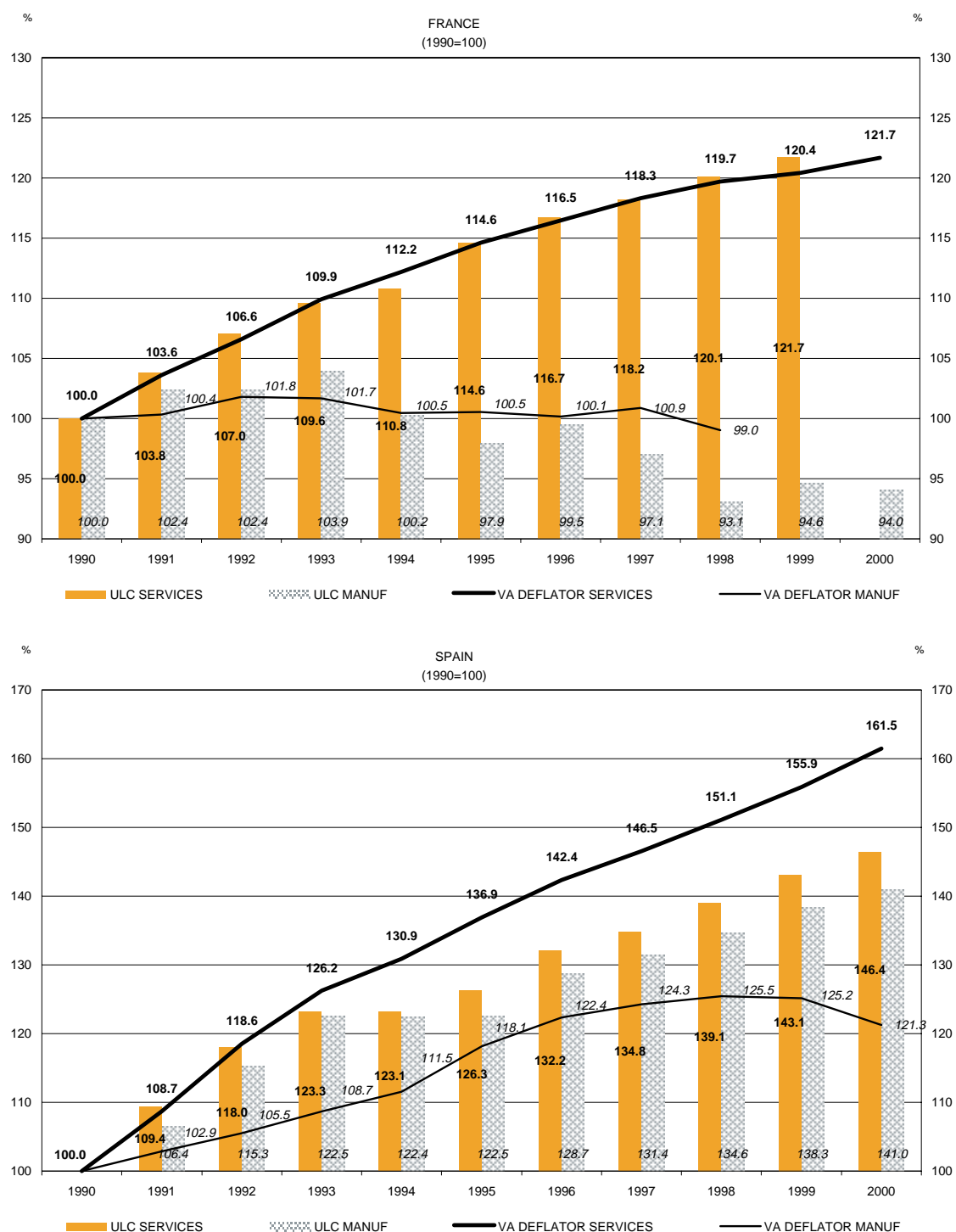
Sources: ECB and Banco de España.
Spanish growth rates in 1991 and 1992 are those of CPI, as HICP data are not available.

was attained for the first time, of -0.7 . Final prices of services also followed a pattern of convergence up to the mid-nineties, when the inflation differential reached a low of 1 p.p. with respect to the euro area. This development has stopped in the last few years, with the service component of inflation remaining stable at an average annual rate of 3.6%, while in the euro area it followed a declining trend up to 2000. In 2001, both in Spain and in the euro area, final prices of services experienced an acceleration of similar magnitude, so the service differential of inflation stood at 1.7 p.p.

The main features of cost and price developments in the two economies are shown in graph I.10, for both manufacturing and services sectors. Starting in the mid-nineties, unit labour costs in manufacturing declined in France, as compensation per employee grew less than the labour productivity. This decline in unit labour costs was partially passed through to prices, as

UNIT LABOUR COSTS AND VA DEFLATORS

GRAPH I.10



Source: AMECO database.

measured by the GVA deflator, while also enabling unit margins to be widened. This contrasts with the developments in Spanish manufacturing, where unit labour costs have grown steadily since 1996, reflecting a rate of wage growth well above the slow pace of improvements in la-

bour productivity. Given the high degree of exposure of manufacturing to international competitiveness, this relative wage pressure has resulted in downward adjustment of unit margins (the GVA deflator increased by a yearly average of 1.4% from 1994, one percentage point below unit labour cost growth)

The higher unit labour costs observed in the service sector in both countries, relative to the manufacturing, which reflect the lower productivity performance of the former, have had different effects on prices in the two countries. In France, the GVA deflator in services has been closely linked to the growth path of unit labour costs (the average yearly growth of the GVA deflator was 2.3% in the period 1990-1998, which as the same growth experienced on average by unit labour costs). By contrast, in Spain, inflation in services has outpaced the growth of unit labour costs (the GVA deflator grew by 4.9% on average over the past decade, one p.p. above the growth rate experienced by unit labour costs). This resulted in a widening of unit margins, possibly reflecting the inadequate degree of competition in this type of activity.

7. MONETARY AND FINANCIAL CONDITIONS

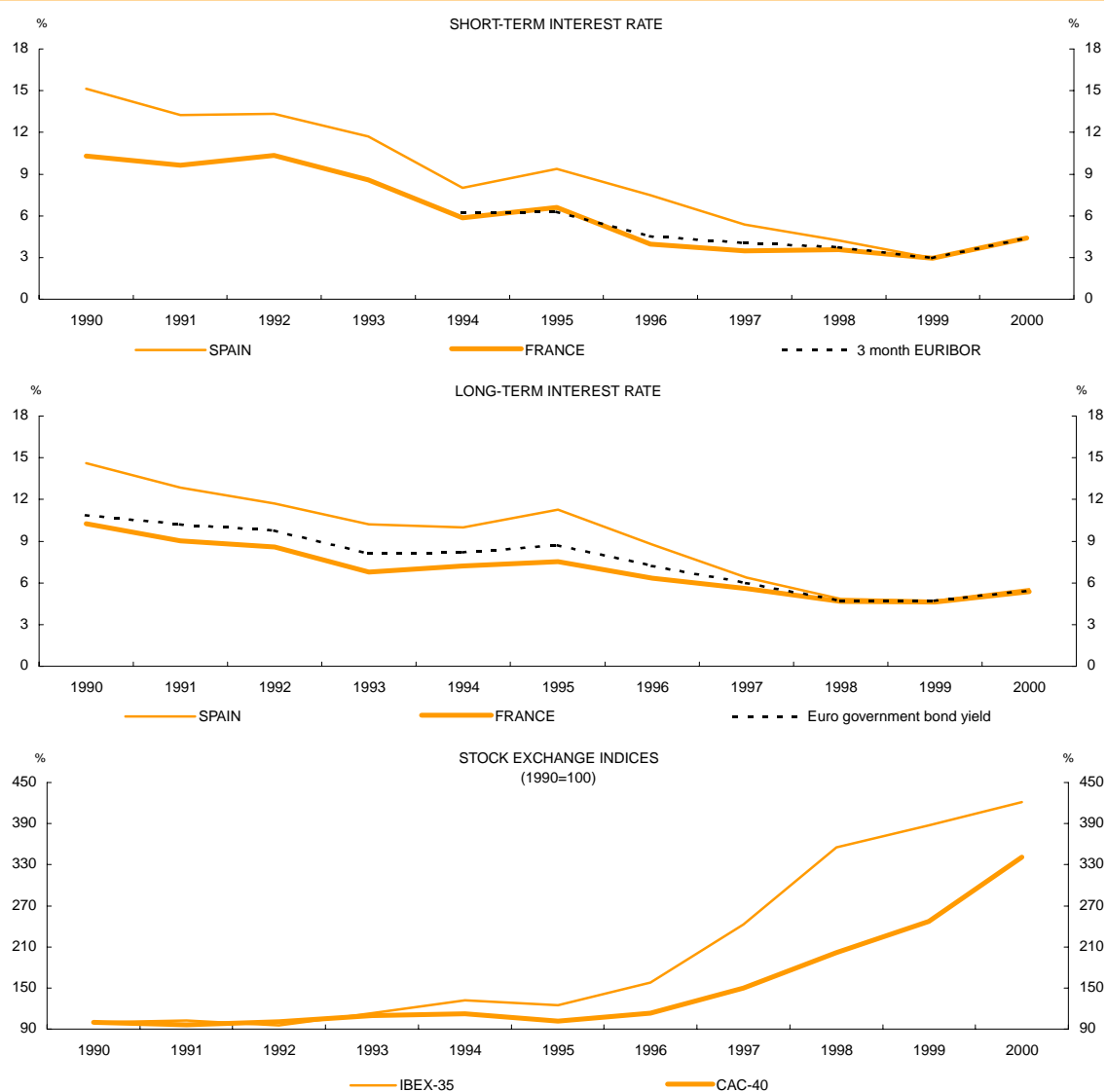
The nineties was a decade characterised by a progressive easing of monetary and financial conditions in both the Spanish and the French economies. During this period short-term interest rates saw significant reductions (see graph I.11), which in Spain amounted to 12 percentage points and which were more moderate in France (about 7 percentage points). Long-term interest rates also displayed a declining trend influenced by the monetary policy stance, the ensuing reduction in fiscal deficits and the progressive deceleration of prices, which helped to push nominal interest rates down towards historically low levels. The latter factor was particularly important in Spain where the inflation rate declined from 6% in the early nineties to 2% at the start of Stage Three of EMU. Lastly, the prospects for the creation of a monetary union were a major factor in promoting the convergence process, thus favouring the easing of monetary and financial conditions in both countries.

The easing of financial conditions was also remarkable in the stock market where share prices showed unusual increases in the second half of the nineties (see graph I.11). From 1996 to 1998 prices on the Spanish stock market rose at an average annual rate of 42%, benefiting from the significant reductions in interest rates. Nonetheless the rate was lower in the last two years. In France stock market developments followed a similar pattern although with a different timing. At first the increase in prices was smaller than in Spain, but in the last two years the French index outperformed the Spanish one.

During the nineties the exchange rate, which is also an asset price relevant to any assessment of the monetary and financial conditions of an economy, showed strong fluctuations (see graph I.12 in the statistical annex). These were particularly intense in the period of crisis in the ERM (1992-1993), which very much affected the Spanish peseta and ended up with a widening of fluctuation bands. After that period in which several currencies in the ERM were devalued (the peseta among them), the basket of currencies that were subsequently to participate in Stage Three of EMU appreciated against the dollar. The Spanish peseta and the French franc followed this general pattern. In the three years prior to the start of Monetary Union fluctuations in French and Spanish foreign exchange markets became more moderate as required by the criteria established in the Maastricht Treaty. The nominal effective exchange rate also followed the pattern that has just been described, although with more moderate fluctuations. During the period crisis in the ERM the Spanish effective exchange rate experienced its largest depreciation in the nineties, in contrast to

GRAPH I.11

INTEREST RATES AND STOCK EXCHANGE INDICES

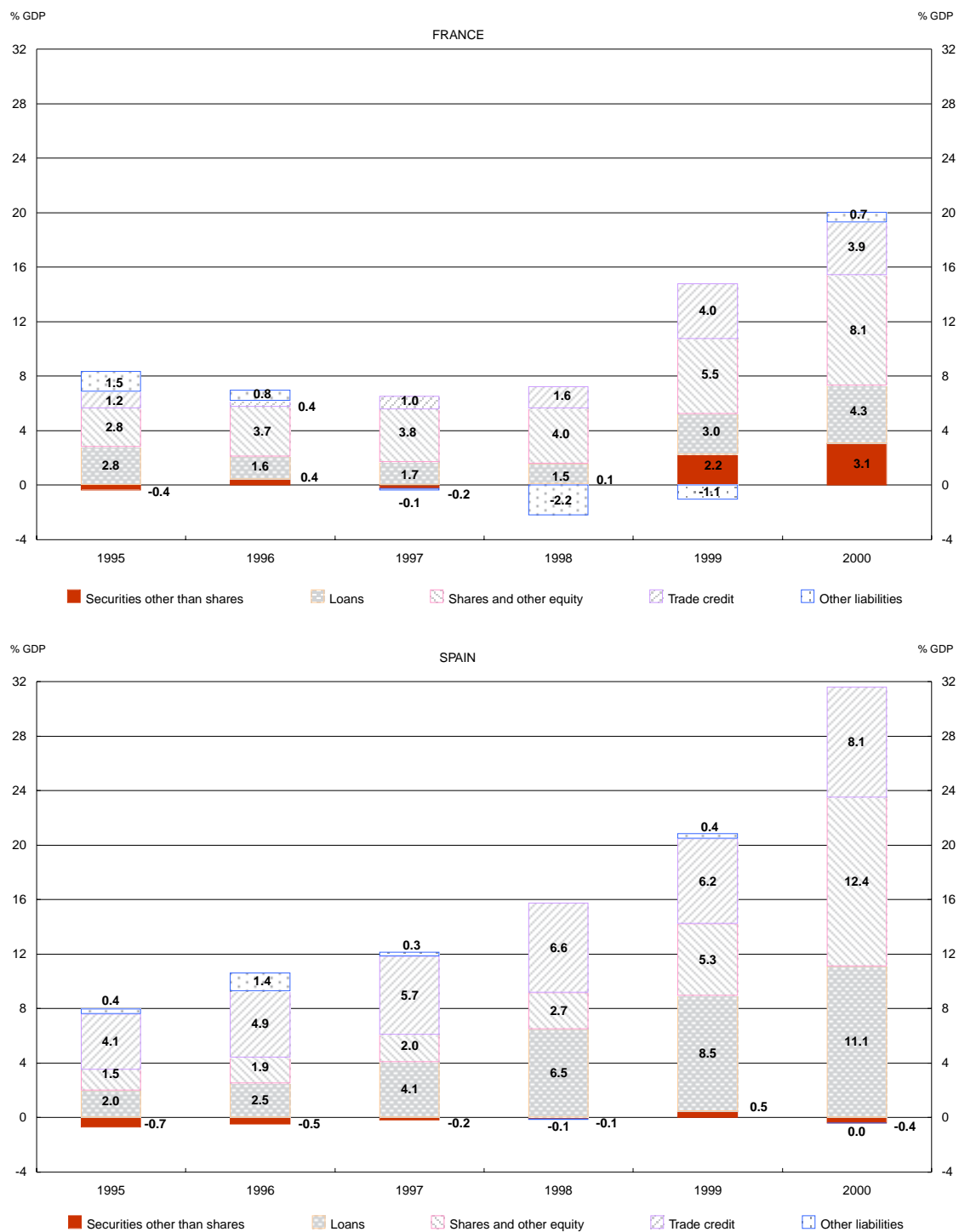


Sources: OECD, Banco de España and Banque de France.

the French index which appreciated even though the exchange rate against the dollar depreciated. The importance of non-dollar transactions with the rest of the world may underlie this development in the case of France. Since 1995, however, there has been virtually no significant difference between the effective exchange rate developments of Spain and France, so that international competitiveness advantages have become determined by production costs rather than exchange rate developments.

The significant reductions in interest rates that took place in Spain and the growth of private expenditure led to an acceleration of domestic credit to the private sector in the second half of the nineties (see graph I.13 in the statistical annex). This followed a period of slow growth against the background of a slowdown in economic activity in the first years of the decade. The fast pace of credit growth in the most recent years was the result of an acceleration in loans to households and in bank lending to non-financial firms. In the case of France, domestic

NON-FINANCIAL FIRMS' LIABILITIES



Sources: Banco de España and Banque de France.

credit to the private sector followed a rather different path, recording negative rates of growth in several years. Nonetheless, at the end of the decade the rate of growth of credit also increased progressively in France, to reach 10% in 2000. In accordance with the developments in the two countries, the ratio of credit to GDP in Spain, which was below that of France in the

TABLE I.5

DIRECT & PORTFOLIO INVESTMENT

	<u>1990-1993</u> Average	<u>1994-1996</u> Average	<u>1997-2000</u> Average
SPAIN			
Direct & portfolio investment abroad	1.5	1.2	12.7
Direct investment	0.8	0.8	5.5
Portfolio investment	0.7	0.3	7.2
Inward foreign direct & portfolio investment	8.5	1.4	8.7
Direct investment	2.8	1.4	3.0
Portfolio investment	5.7	0.0	5.7
FRANCE			
Direct & portfolio investment abroad	3.6	3.3	13.4
Direct investment	2.1	1.6	6.3
Portfolio investment	1.4	1.7	7.1
Inward foreign direct & portfolio investment	4.4	0.6	8.6
Direct investment	1.4	1.4	2.4
Portfolio investment	3.1	-0.7	6.2

Sources: IMF and Banco de España

early nineties, rose by 20 percentage points to stand above the French ratio at the end of the decade. In contrast, the ratio declined in France by about 15 percentage points up to 1999, rebounding slightly in 2000.

In most countries bank lending is the main source of financing for households. However, in the case of firms, bank lending is just one of several sources of funds. According to data from the financial accounts of French and Spanish non-financial companies, loans amounted to only 25-35% of their resources, although that proportion declined in France during the period 1995-2000, while in Spain it increased. The remaining sources of funds were market financing (short-term paper, bonds, shares and other equity) and trade credit. However, the importance of these items is different in the two countries and has also evolved in a different way (see graph I.14). In Spain the main sources of funds during the second half of the nineties were loans and trade credit, resources from share issuance acquiring greater significance in 1999 and 2000. Market financing from securities other than shares was virtually irrelevant. However, in France short-term securities and bonds issues were more important, although this cannot be seen in the graph due to the importance of other items, which partially offset the amount of short-term securities and bonds issued. Share issuance has generally been more significant in France than in Spain, although as mentioned above it became increasingly important in Spain during the last two years. Finally, trade credit seems to be a more important source of financing for Spanish companies than for French ones, although, when netting trade credit assets and trade credit liabilities, Spanish firms appear to have been net lenders throughout the period while French firms have been net borrowers most of the time.

The portfolio of financial assets has also experienced significant changes as a result of the notable increase in the acquisition of foreign companies and the proliferation of mergers, acquisitions and cross-shareholdings. In 1995, the acquisition of shares and other equity amounted to only 0.7% of GDP in Spain, and 1.3% of GDP in France. These percentages increased throughout the period to reach 14.2% and 10.4% respectively in 2000. In both coun-

tries a large part of this increase was related to the complete or partial acquisition of foreign companies and cross-border alliances. In the case of Spain, investment in Latin America played a significant role (representing between 50 and 65% of direct investment outflows in 1998 and 1999) although its share decreased in 2000. European Union countries, meanwhile, have accounted for about 30 – 40% of these outflows during the last three years. To give an idea of this process of increasing international expansion of French and Spanish companies, table I.5 presents some figures from the balance of payments.

Although a sectoral breakdown of flows is not available, the figures for direct investment presented in the table are fairly representative of non-financial firms' foreign investment and financing. Portfolio investment has also been included since participation in foreign companies or funds by non-residents investors is sometimes included in this category. Nonetheless, it should be noted that sectors other than non-financial firms – financial institutions and general government – are also relevant in this kind of investment. According to these figures three different periods may be distinguished. In the first one the Spanish economy received funds from the rest of the world representing 8.5% of GDP, in annual average terms, although a good deal of that amount was portfolio investment. Foreign investment in France was also significant during this period, but of lesser importance. In the second period (1994-1996) both countries experienced a slowdown in funds from the rest of the world, mainly related to the weaker economic conditions prevailing in most industrialised countries. The most recent period (1997–2000) was mainly characterised by a large increase in outward direct and portfolio investment both in France and Spain, as a result of the big interest of domestic companies in foreign markets and the surge of cross-border mergers and alliances. At the same time inward foreign investment also rebounded in both countries, reflecting this same process as well as an international reallocation of portfolio investment after the start of Monetary Union.