THE EUROPEAN MONETARY UNION AND THE SPANISH LEFT

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(Paper presented at the Sixth Biennial International ECSA Conference,

Pittsburgh, PA, June 1999)

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How does the internationalization of national economies affect their governance? How does the creation of a single European market and a quasi-unified economic authority affect the ability of national governments to deliver growth and ensure fair economic results? Why and how does the Left, under varying institutional domestic conditions, embrace and adjust to a single monetary system?

Spain's experience of the eighties and nineties provides an excellent case to explore these questions. Furthering a gradual process of trade liberalization and overall economic internationalization, that started in 1959, Spain has unconditionally embraced the European Community and the European Union in the last decade and thus accelerated its progressive loss of national sovereignty over fiscal and monetary policies. At the same time, and except for Greece, it has been the country that has experienced the longest (and more solid) socialist government in the last decade and a half in Europe: the Spanish Socialist Party, Partido Socialista Obrero Español (PSOE), governed alone from 1982 to 1993 and, as a minority government, up until 1996.

To examine the relationship between economic internationalization, European integration and Leftist economic policies, this chapter is organized as follows. The first section briefly examines Spain's integration in the European Union. The second section describes the economic program and electoral support of the Spanish Socialist Party. The remaining sections explore the macroeconomic policy regime implemented by the González government. The third section shows that the main goal of domestic stability and low inflation derived from a combination of new economic ideas, the need for external balance, and the past experiences of British and French socialist governments, and was then reinforced by the process of European integration. The fourth section, that covers the period from 1987 to 1993, shows how the government, unable to secure a stable corporatist arrangement, eventually moved to a tight monetary policy that culminated in the decision to join the European Monetary System. The fifth section, which spans from 1993 to the effective creation of the euro, explores how the Spanish government managed the process of monetary unification under a prolonged economic crisis.

WHY DIDN'T THE DOG BARK?

SPAIN AND THE PROCESS OF EUROPEAN INTEGRATION

The need to fully participate in the European project has been always taken for granted in Spain. Support for Spain's membership in the European Community was intense across the political spectrum well before the transition to democracy. The center-to-the-right coalition, Unión de Centro Democrático, that governed until 1982, already asked for admission in the EC in 1977 and managed the first period of negotiations with Brussels. The PSOE proclaimed the need to join the European Common Market as soon as 1964. After stating its opposition to the Common Market in the sixties, the Spanish Communist Party eventually declared itself in favor of joining the EC by 1974-75.[1]

In contrast to the political turmoil experience in France, the United Kingdom and Scandinavia, the strength of Spain's commitment to European unification has not declined over time. After joining the European Community in 1986, the Spanish government announced the integration of the peseta in the European exchange rate system (ERM) in June 1989. Similarly, Spain warmly embraced the creation of the European Union. Monetary policy was fully devolved to the Bank of Spain in 1994. Since the mid 1990s, both the Socialist government and the present Conservative government pursued restrictive policies to tame inflation and cut the public deficit. Unions and business agreed, in turn, to (moderate) labor market reforms and to contain wage increases to ease the transition into EMU. The last phase toward the European Monetary Union eventually broke down the traditional political consensus that once prevailed among the Left on European issues. Izquierda Unida (a radical leftist coalition led by the Communist Party) questioned the stability pact and launching the euro. But its positions have remained marginal and have been contested even within the coalition.

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[1] For an analysis of the attitudes of the Spanish political parties toward the European Community, see Álvarez-Miranda (1996).

The attitudes of the Spanish political elites reflect overwhelming public support for the process of European integration. Figure 1 shows the net support among Spaniards for belonging to the EU–that is, the percent of those that consider that belonging to the European Union is good for Spain minus those that think it is bad. Although relatively high in the early 1980s, it increased throughout the 1980s to peak, at 70 percent, in 1991. It then fell dramatically in the early 1990s, mostly affected by a harsh recession and the uncertain political climate of that period, only to recover to its initial levels in the mid and late 1990s. Jointly with public opinion, the political and business elites converged in stressing the important economic benefits that entering the European Community would yield to the Spanish economy–a vast market and a place to look for readily available capital.

[Figure 1 about here]

Spain's strong support for the European Community has derived, generally speaking, from a general belief linking the integration into Europe to the culmination of the modernization process of the country. From a purely political perspective, the EC has been seen as a particularly useful mechanism to strengthen democracy. From an economic point of view, membership in Europe has been also judged as highly beneficial. In the first place, the failure of the autarkic policies essayed in the 1940s and 1950s contrasted with the economic expansion that followed the liberalization of trade approved in 1959-60 and made advisable a further commitment to free trade. In the second place, given the structure of both the Spanish economy (with an abundant mass of unskilled and semi-skilled labor, similar to today's Eastern European workers in wages and qualifications) and its European counterparts, Spain mainly benefits from a low-tariff regime within Western Europe. That is, the European market offers substantial net gains to important parts of the Spanish economy: agricultural producers; mass-production companies, such as the car industry; small firms in industrial districts, such as shoe-makers or furniture, that are still competing on price.[2] Finally, any opposition to the EC has been defused by the state by laying out generous compensation schemes for those firms and sectors that had been expected to suffer heavier economic losses. Since the process of European integration has taken place parallel to the growth of the Spanish welfare state, the bulk of the Spanish electorate has never judged the EU to be a potential threat to any redistributive policies.

A MODERATE SOCIALIST PARTY

As a result of a prolonged economic crisis since the mid 1970s and the collapse of the center-to-the-right coalition in power, the Spanish Socialist party (PSOE) was elected to office in October 1982 with an impressive majority and a lead of 21 percentage points over the conservative opposition. The Socialist government governed alone until 1993 and, in a minority cabinet with external support from moderate regionalist parties, until 1996.

After becoming the largest party in the left during the Second Republic, the PSOE had almost disappeared during the Franco regime, supplanted in terms of both organizational capacity and membership by the Spanish Communist Party (PCE). A new generation of young militants mostly drawn from Madrid, the Basque Country and Andalusia revived, however, the party in the early and mid 1970s. In 1974 Felipe González replaced a Civil War exiled as party secretary general. In the following two years militancy quadrupled to eight thousand.

Influenced by the radical leftism in vogue in Europe in the 1970s and the effervescence of the Spanish transition, the PSOE approved a militant program in December 1976 calling for sweeping

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[2] This probably contrasts with (the most unskilled) segments of the French or Scandinavian working class, who feel their living standards are threatened by the increasing labor and capital mobility resulting from European integration.

nationalizations and the construction of a classless society.[3] But, in spite of its radical ideology, as the first democratic elections were approaching, the PSOE easily moved towards the political center. The 1977 electoral manifesto limited the PSOE's demands to the elaboration of a democratic constitution, a tax reform, the extension of the welfare state and targeted nationalizations. The socialist party ran a strong campaign emphasizing the moderate, authoritative leadership of Felipe González. The PSOE emerged as the second largest Spanish party, balloting 29 per cent of all valid votes, only 5 points behind the center-to-the-right coalition UCD.

The relatively disappointing electoral performance of the PSOE in the General Election of March 1979 and in the local elections of April 1979–where the Socialist party actually lost votes in relation to 1977–convinced its leaders to move further towards the political center. After severe infighting and two national congresses in a year, González forced the party to drop its marxist label and reinforced the organizational power of the party elite. By the early 1980s, the PSOE had turned into a mainstream social democrat party that, brushing aside its former radical plans for nationalizations and the extension of worker's control of companies, favored a deep tax reform, the extension of the welfare state and the strategic use of the public sector to maximize long-term growth and reduce unemployment (Maravall 1981, part IV; PSOE 1982; Gillespie 1989).The moderate stance inspired by González paid off handsomely again. The acute economic crisis of the early 1980s and the collapse of the center-to-the-right governing coalition eventually gave González the opportunity to capture the political center and to build a broader electoral coalition in the 1982 General Election. The share of the socialist vote, as a proportion of the whole electorate, almost doubled from 20.4 per cent (or 29.9 per cent of the valid vote) in 1979 to 37.7 per cent in 1982 (or 47.3 per cent of the valid vote).

The PSOE's success derived, above all, from its capacity to form a broad coalition of middle-

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[3] For excellent analyses of the historical development of the PSOE during the democratic transition, see Gillespie (1989), chapter 5, and Gunther, Sani and Shabad (1988).

and working-class voters. The PSOE reinforced its hegemony in its natural stronghold, the industrial working class, where support went up from 35 per cent in 1979 to almost 50 per cent in 1982. Yet the electoral victory of 1982 was the result of successfully adding white-collar employees in subordinate positions (where support doubled from 20 per cent in 1979 to more than 40 per cent in 1982). The extent to which it held its natural electoral base and extended it to voters who had previously supported UCD can be observed by looking at voters' left-right self-locations. The PSOE doubled its support among extreme leftists (from 17 per cent to 37 per cent) and leftists (from 29 per cent to 55 per cent). More importantly, it became the dominant party among those located in center-to-the-left positions, who account for a fourth of the electorate, going from 51 per cent to 75 per cent, as well as the party that received the most votes in the center with 29 per cent of the vote.

THE SEARCH FOR MACROECONOMIC DISCIPLINE, 1982-86

The Break with Keynesianism

In spite of the dismal performance of the Spanish economy and of the generic promises made during the electoral campaign that a future socialist government would engage in expansionary policies, the González government immediately rejected the implementation of countercyclical policies to boost internal demand in the fashion the French socialist government had essayed just a year before.[4] As the minister of Economy made clear very soon, the cabinet had to "reject the expansion of domestic demand,

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[4] The PSOE's electoral manifesto explicitly called for an "expansive policy" (PSOE 1982, p.7). As discussed by Maravall, himself a minister in the González government, "in spite of the economic crisis, in the summer of 1982 and before the general elections in October González still believed that the future government would have a considerable margin of maneuver for expansion, for increases in public expenditure, and for substantial job creation" but "by September the future minister of the economy, Miguel Boyer, gradually came to know the real depth of the crisis" and therefore the need to avoid pure counter-cyclical measures (Maravall 1995, p.95). Boyer, who had not participated in the elaboration of the manifesto, was quick to emphasize in press declarations, made after the electoral victory and before the formation of government, that the socialist cabinet would not pursue "either a stabilization policy or an intense expansive policy." (*El País*, November 24th and 27th, 1982)

to get, in the short term, an increase in employment, for it would lead to an escalation of the external imbalance and of inflation, and, on the other hand, to the contraction and the crowding out of that private investment we need so much to renew the productive system" (Boyer 1983a, p.42). Starting with a first set of measures in December 1982 that included the devaluation of the peseta, the cabinet instead drafted a so-called package of adjustment measures for the following two years designed to combat the remarkable economic disequilibria that were thought to hamper healthy economic growth rates in the medium-term. The government vowed to fight a growing public deficit and high inflation and to restore business profits, then at a record low, in order to resurrect private investment.[5]

The dismissal of countercyclical demand management in favor of a more rigorous macroeconomic policy–based on emphasizing price and wage moderation and the restoration of profit margins as a precondition for economic recovery–can be traced back to two sets of factors. On the one hand, the fiasco of the French experience a year before convinced the government that expansionary policies could only be attempted by one country alone at the risk of incurring in high economic and electoral costs (Boyer 1983a, 1983b, 1984; Borrell 1990; PEMP 1985, vol. 1, p.8; Dehesa 1988, especially p.30).[6] The calamitous Labor administration in Britain in the late 1970s served as well as a strong warning against expansionary strategies.

On the other hand, the Spanish academic community, and, as a result, most of the policy-making elite, progressively accepted that the country's persistent poor economic performance over the last decade derived from structural factors that could not be solved by merely boosting internal demand. In the aftermath of the first oil shock, a Keynesian countercyclical strategy linked to social compensation

[5] In 1982, profitability in the private sector, excluding power-generating companies, was 1.2 per cent (OECD 1988, p. 10)

[6] By November 1981 the French Minister of Finance had already indicated that it was necessary "to pause before announcing further reforms." By June of 1982, that is, several months before González was elected, the French government abandoned its macroeconomic policy and implemented an austerity plan. The deflationary strategy was strengthened in the Spring of 1983. See Hall (1986), pp. 199-201.

policies (through tax reforms and an increase in public expenditure) started to be drafted by some economists in 1975-77, was adopted by the annual reports published by the Bank of Spain and then endorsed by the 1977 OECD annual survey on Spain. Since this plan squared well with the need to sustain social peace to complete the democratic transition successfully, Fuentes Quintana, an economist himself, implemented it as the minister of Economy in the first democratically elected government. Nonetheless, the combination of a sluggish rate of economic growth, a new external shock that undermined the chance to sustain countercyclical policies, and the realization that macroeconomic management was not enough to restore national competitiveness, led to the creation of a new consensus among the economics profession. By 1980, a set of influential papers, many of them by former supporters of demand management policies, were echoing the growing concern in the rest of Europe about the role of structural factors and the need to adopt financially sound policies. The economic turmoil suffered by Spain in the late 1970s turned out to be defined as a 'supply-side' crisis produced by a strong growth of real wages that had endangered profits and thus the creation of net employment (Rojo 1981; also Fuentes 1979). Several annual reports of the Bank of Spain accepted this interpretation by the early 1980s and were calling for the curtailment of inflation, the moderation of wage costs and the reduction of the public deficit (Banco de España 1983, pp. 56 ff. and pp. 141 ff.; Banco de España 1984, pp. 22 ff).[7] The overall consensus among Spanish economists about the causes of the crisis translated directly into the economic team nominated by González in 1982 that would control the ministry of Economy and Finance and its related ministries throughout the decade.[8] Designing and carrying out a non-expansionary macroeconomic strategy created strong tensions both within the Socialist party and in

[7] For a more detailed account of this change of ideas among economists, see Serrano and Costas (1988). For a self-conscious analysis of this process of change from a Keynesian to a broadly defined neoclassical understanding of the state of the economy, see Rojo (1986).

[8] In drafting the first, short-term response to the crisis, the government showed a clear consensus (Sevilla 1985).

relationship between the government and the socialist trade union (in the mid and late 1980s). But it was always clear that those opposed to stabilizing macroeconomic policies, even within the governing party, were unable to come up with a credible and, from a technical point of view, rigorous policy alternative.[9]

From Stabilizing the Economy to Engineering a Social Pact

Although the government steadily clang to its overall goal of steady, non-inflationary growth and a balanced macroeconomic framework over the decade, the actual policy instruments used to achieve them changed over the decade according to the evolution of the business cycle, the behavior of trade unions and the process of European integration. During the first parliamentary term, mostly characterized by a severe economic downturn, moderately restrictive policies in 1983-84 were followed by a social pact with trade unions. As economic conditions improved in the second half of the 1980s, concertation with unions proved impossible and the government had to rely again on a tightening of fiscal and monetary policy.

During the first two years in office, González first relied both on a partial tightening of monetary policy accompanied by some wage moderation, secured through an intermittent incomes policy, and on a mild reduction of the public deficit. The broadly accommodative monetary policy implemented under the centrist minority government (Poveda 1986; Argandoña 1990; Banco de España 1983) was slightly reversed.[10] The monetary authorities decided to reduce their monetary target, the liquid assets in the

[9] The need for macroeconomic stability was eventually accepted by most sectors of the PSOE. Thus, in the programmatic renewal movement mainly sponsored by the center-to-the-left branch of the party in the late 1980s and which crystallized in the so-called Programa 2000, one-country demand-management policies were definitely and explicitly rejected (see Programa 2000 (1988), particularly p.30).

[10] For an explicit acknowledgement by the economic authorities that the accommodating monetary policy followed until 1982 had failed to spur economic activity, see the 1983 annual report of the Bank of Spain (p. 117), and the declarations of the minister of Economy before the Parliament in May 1983 (Boyer 1983a, p.25).

hands of the public (or ALP), by two points and a half in relation to the previous year.[11] An initial overshooting of the monetary base was quenched by a strong downward adjustment of the money supply in the middle of the year. Real short-term interest rates jumped from around 3 per cent to almost 11 per cent in six months and the Bank of Spain eventually decided to increase the supply of bank reserves to ease the pressure on them. Then, by the beginning of 1984, a change in the levels of compulsory reserve requirements of private banks, the reform of the financing system of the public deficit to reduce its direct resort to the central bank, and, essentially, a weak demand in the private sector allowed the government to reconcile the reduction of short-term interest rates to levels below those of 1982 with the achievement of the monetary targets that had been planned to combat inflation.

Although monetary policy played a certain role in breaking inflationary expectations, the government implemented it cautiously and jointly with some sort of incomes policy–in 1983 tacitly, then in 1985-86 in an explicit way.[12] Keeping with the traditional practice of the 1970s, monetary targets continued to be set by compounding future inflation and output growth as they were forecasted by the government in its budgetary plans, and they were determined by winter, when the key decisions on wages had already been made. Therefore they were not generally used in an active way to influence wage and price expectations in the monetarist fashion dominant in other European nations at that time (OECD 1986, pp. 18 ff.; OECD 1988, pp. 64 ff). As a matter of fact, the anti-inflationary drive was partially dependant on the development of wage negotiations.

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[11] Since the mid 1970s, the Spanish monetary policy has been conducted through the management of a broad measure of money supply, mainly regulated through the level of bank reserves. The substitution of ALP for M3 took place in 1982-83.

[12] For an eclectic defense of combining monetary policy with other instruments, see the 1983 annual report by the Bank of Spain (p. 108). Similarly, for the position that using a restrictive monetary policy alone as rather costly because wages are largely predetermined and the former would mainly impinge on private output and employment, see Martínez Méndez (1981), Rojo, then chief of the Research Department of the Bank of Spain (Rojo 1983), and the declarations by the Director of the Bank of Spain, Mariano Rubio, in April 16th 1986, reported in OECD (1988).

An implicit incomes policy developed in 1983 when, although without the participation of the government, unions and businesses formally agreed to a wage pact. Following the collective bargaining system initiated in the national pact of 1977, companies were to raise nominal wages in line with expected inflation across the country.[13] While preserving real wages, this bargaining scheme had the virtue of not exacerbating inflation. Yet, in indexing wage increases to officially expected price increases, it did not help to depress inflation significantly either.

Nationwide negotiations for 1984, however, collapsed (Espina 1985). Wages grew above the official forecast and inflation averaged 11.3 per cent. In short, by 1984 the inflation differential with the European Community was almost identical to the one experienced two years before. Overall the deflationary process was relatively slow and mostly dependent on a fall in the world level of prices (OECD 1986, p.111; OECD 1988, pp. 17-20). From the experience of these two first years it was clear that, unless the government were willing to impose harshly tight policies, it would have to draw unions back into the negotiation table to achieve the goal of price stability.

[Table 1 about here]

In order to sustain its macroeconomic policy, the González government pledged to reduce the public deficit, which had grown rapidly in the early 1980s, by half a point of the GDP per year until 1987 (PEMP 1985, vol.1, p.38; vol.4, p.39).[14] Yet, like the monetary policy being pursued, fiscal policy turned out to be rather mild.[15] Table 2 reproduces the stance of the Spanish budget; its annual overall change;

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[13] More exactly, business and labor generally agreed to an increase on the basis of the inflation forecast by the government plus an automatic adjustment mechanism to match all increases over the expected target. All other increases, based on productivity gains, were left to sectoral-level negotiations. As table1 shows, all collective agreements always matched the governmental inflation forecast.

[14] On the need to contain the budgetary deficit to sustain the monetary policy, to expand national savings and to avoid crowding out private investment, see the Medium-Term Economic Plan (PEMP 1985, vols. 1 and 4) and Boyer (1983a).

[15] Official declarations were somewhat contradictory. In the only year in which fiscal policy clearly tightened, the minister of Economy assured Parliament in July 1983 that fiscal policy would be neither expansive nor contractive (Boyer 1983a, p.43). The Medium-Term Economic Plan, fully drafted later,

and, finally, the annual change in the structural deficit, i.e. the fiscal deficit if the GDP were to grow at its potential rate. In controlling for the performance of the economy, this last result shows the net effect of governmental discretionary decisions concerning the budget. All the data are reproduced for the first four years of the socialist government. Similar data are shown for the first four years of both the British and German conservative governments–which did follow tight fiscal policies. Except for 1983, in which the overall government deficit declined by 0.8 points of GDP to 4.8 per cent of GDP, completely as a result of the explicit governmental effort to balance the budget, the Spanish fiscal policy was expansive. Even before the planned expansionary action of 1985, the public deficit remained at the level inherited by the PSOE. In fact, in attempting to control the deficit, the socialist cabinet was at pains to compensate the impact of its restrictive policies through all sorts of social transfers to low-income households (Boyer 1983a, p. 36).

[Table 2 about here]

After almost two years, the stabilization strategy implemented by the government had achieved its goals partially at best. Overall, the government had gained some credibility for its anti-inflationary policies and some of the short-term economic constraints faced in 1982 had eased substantially. Helped by the devaluation of the peseta by eight per cent against the dollar in December 1982 and mostly by a world-wide downward trend of raw material and food prices that eased the imports bill (OECD 1986, 1988), the current account balance experienced a surplus–of $ 2 billion–in 1984, the first time in five years. By the end of the year inflation was running at 9 per cent, ie. only one point above the government target. Nonetheless, consumer prices had still increased 11.3 per cent during 1984 and the differential with the EC average inflation had hardly fallen (see table 1). Moreover, there was no firm economic recovery in sight. Private investment had fallen another 2.4 percentage points to 15.9 per cent of GDP,

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defended budget discipline in stronger terms at a time in which fiscal policy had taken an expansionary role.

domestic demand had contracted one per cent in 1984, and unemployment had reached almost 2.9 million people or 21.7 per cent of all active population by the end of the year. Entering the second half of its parliamentary term, the government decided to attempt a broad social pact that could at the same time further its anti-inflationary goal and rekindle the economy. Given the frail state of the economy, UGT (General Workers' Union), the socialist trade union, was willing to secure a national agreement that could strengthen the position of the PSOE and would move the economic policy closer to a 'social democratic corporatist' model (Zufiaur 1985; Espina 1991).

By the second semester of 1984, the economic authorities started loosening monetary policy–ALP was allowed to grow to the high part of the planned band and real interest rates fell under 2 per cent–and approved a monetary base target for 1985 (13 per cent increase of ALP) slightly higher than for 1984. At the same time the government started negotiations with the socialist trade union, UGT, the communist one, CCOO (Workers' Commissions) and the business organization (CEOE) to sign a national compact on labor relations and social policy in the summer of 1984. After prolonged conversations that delayed the presentation of the budget for 1985, the government, UGT and the CEOE signed a tripartite agreement in October 1984. This national agreement, Acuerdo Económico y Social (AES), drafted a general macroeconomic framework–in line with government forecasts–that projected inflation to be 8 per cent in 1985 and 6 per cent in 1986 and a GDP growth rate of 2.5 per cent in both years. The AES covered as well a wide range of issues that stretched from labor relations and wage settlements to specific budget concessions made by the socialist cabinet to attract the social partners. The socialist trade union agreed to pay increases ranging from 5.5 to 7.5 per cent in 1985 and from 90 to 107 per cent of the government's inflation forecast for 1986, jointly with catch-up provisions in case inflation exceeded the official forecast. In exchange, the government pledged to commit significant resources--up to Pta. 165,150 million or about 0.5 per cent of GDP--into public investment, public works for the unemployed and unemployment benefits. Similarly, it accepted a reduction in fiscal revenues of Pta.

125,000 million in tax allowances for low income families and in a slight reduction in the employers' social security contributions. In the area of social policies the government promised an extension of unemployment benefits (from 25 per cent to 48 per cent of all unemployed in two years) and higher pensions. The trade unions agreed, in turn, to a set of measures directed to make more flexible one of the most rigid labor markets in Europe. Still, the social pact did not include any real expansionary measure in the fashion of traditional neocorporatist pacts. The 1985 budget planned an increase in tax revenues of 0.8 points of GDP and provided for a further decline in the budget deficit of 0.5 points of GDP.

Although the government seemed to play with the idea of expansion when the agreement was signed,[16] it was not until the following spring that the cabinet approved several fiscal measures to boost private demand. Shortly after it was announced that private consumption had fallen by almost 1 per cent in 1984, and in the face of decelerating exports, the government decided to act swiftly. Tax withholdings were reduced, especially among low income groups, to boost private consumption by one point of GDP. Several measures, such as full free depreciation for 1985-86 investments, were introduced to promote private capital formation. As a result, fiscal policy was overtly expansive in 1985. The overall government balance worsened by 1.4 points of GDP to 6.9 per cent of GDP. As a matter of fact, the fiscal impulse engineered by the government amounted to 2.4 points of GDP (see table 2). In 1986 the deficit fell almost one point to 6 per cent of GDP--mostly due to an improved economic activity and only slightly (0.3 points) due to the government discretionary effort (González-Páramo and Roldán 1992).[17]

EUROPEAN INTEGRATION, MACROECONOMIC STABILITY AND DOMESTIC ADJUSTMENT. THE PATH TOWARD A FIXED EXCHANGE RATE REGIME, 1987-93

[16] See the interview with the minister of Economy Miguel Boyer in *El País* in October 14, 1984 (pp.62-63) in which the adjustment period is declared almost closed.

[17] Monetary policy was accommodating too. Real short-term interest rates fell sharply to an average 3 per cent in 1985-86.

The Pressure of an Integrated Market and the Failure of a Corporatist Strategy, 1987-89

Economic conditions in Spain eventually turned around by mid-1985. After several years in which domestic demand and overall growth had been almost flat, private consumption grew by around 2 per cent in 1985–the strongest increase since 1977–and then by 3.6 per cent in 1986. Partly due to the national wage agreement of 1984, inflation fell to 8.3 per cent by the end of 1986 and then to less than 5 per cent by the summer of 1987. Above all, by the summer of 1985 Spain entered an expansionary cycle that, after peaking at the end of 1988 (with GPD growing at an annual rate of 5.5 per cent in real terms), lasted through the beginning of 1992. Following a severe contraction since the mid 1970s, total employment started to expand by mid-1985 and unemployment to decline in relative terms in the first semester of 1986.

After securing the integration of Spain in the European Community, the socialist government won a narrow victory in the referendum on the Spanish membership in NATO held in March 1986. Three months later, González was returned to office with 43.5 per cent of all votes, which gave him an impressive lead of almost 18 percentage points over the Conservative party.

As soon as the economy started to grow, the ministry of Economy, now in the hands of Carlos Solchaga, abandoned the temporary fiscal impulse engineered in 1985, firmly believing that an expansionary demand policy was generally inappropriate to deal in the medium run with the supply-side bottlenecks that besieged the Spanish economy. Instead, the cabinet emphasized again its commitment to achieve a general macroeconomic framework that, based on the containment of wages and prices, a reduced public deficit, and a balanced current account, could deliver long-term non-inflationary growth.[18] The increasing economic openness of the Spanish economy, and, more particularly, the integration process into the European Community since 1986, reinforced the cabinet's and party's commitment to an

[18] See Solchaga in the presentation of the Budget for 1986 (*El País*, September 19th and 25th, 1985, and October 3rd), for 1987 (Solchaga 1986b) and for 1988 (Solchaga 1987). See also Zabalza (1987).

economic policy concerned with enhancing the level of national competitiveness through the achievement of low inflation.[19] The integration into a vast economic market progressively characterized by the free circulation of goods and capitals weakened the capacity to engineer an isolated expansion.

To fight inflation, particularly in an increasingly internationalized economy, it was clear to top government officials that they were left with only two possible policy alternatives to achieve those goals. On the one hand, the government could attract unions into a social compact to ensure moderate wage increases and therefore lower inflation. On the other hand, were social concertation not available, the cabinet would be forced to quell inflation "through either a more restrictive monetary policy, the exchange rate, appreciating the peseta, or a blunt reduction of public expenditure" (Solchaga 1988, p.29).[20]

The first alternative was clearly the preferred course of action to the socialist cabinet. It responded to the traditional social democratic project that included the union movement in the policy-making process in order to build strong welfare policies. It avoided harsh monetary policies that could alienate an essential part of the socialist electorate. It had worked well during 1985-86 in reducing inflation and sustaining the economic recovery. And, finally, given the governmental conviction, espoused publicly and supported by official reports, that wages were the main causal component of the inflationary process,[21] a social compact to moderate them appeared to be the most direct and less costly

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[19] The expression of 'national competitiveness through low inflation' is borrowed from Blanchard and Muet (1993). For the position of the cabinet, see Dehesa (1988) and Solchaga (1990). For the party, see Programa 2000 (1988).

[20] A straightforward exposition of these two alternatives and their costs and benefits by the minister of Economy himself can be found in the presentation of the Budget for 1989 (Solchaga 1988, pp. 29 and ff.), the Budget for 1990 (Solchaga 1990, pp. 33 and ff.) and the Budget for 1992 (Solchaga 1991b, pp. 12 and ff.).

[21] See, for example, Solchaga, for whom "labor costs have the most decisive impact on all economic costs" (1988, p.29). Similarly, a report prepared by the Ministry of Economy on collective bargaining since 1977 and presented by Guillermo de la Dehesa, then secretary of State for Economic Planning, pointed that the trade union's excessive concentration on salary increases, with little concern for productivity, had forced employers to reduce their labor force in order to control unit costs. The report

way to reduce inflation.[22]

For that purpose, the government made several attempts at social concertation during the decade. In order to control inflation, the government repeatedly asked the economic agents to abide by the wage bargaining pattern that had been employed since the first national accords were struck in 1978. According to that model, wage increases should be limited to the level of expected inflation–a target which was based, in turn, on government forecasts.[23] In exchange for wage moderation, the government promised to negotiate a "social wage", around the "differences in taxation endured by wages and low incomes and by higher incomes; as well as the structure and volume of social expenditure" (Solchaga 1988, p.30).

In the negotiating rounds for 1987, however, UGT, the socialist trade union, which had been instrumental in securing the social agreement of 1985-86, disassociated itself from the governmental program for social concertation.[24] As unionists tirelessly stressed, the social concertation of 1985-86 had resulted in a fall in real wages of almost one point but unemployment had barely decreased. Thus, rejecting the traditional model of wage settlement that linked wages to expected inflation, the UGT leaders asked for a wage increase two points above the official inflation target of 5 per cent for 1987 in

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ended up recommending wage restraint and more flexibility in wage settlements as a means to increase employment (*El País*, April 9th, 1988).

[22] The governmental attribution of inflation to wage pressure declined, however, in the late 1980s. Instead, as the behavior of prices started to diverge between the tradeable and the non-tradeable sectors (close to EC inflation in the former but well above the EC average in the latter), the government started to focus its attention on the second. See Zabalza (1989, 1991) and Solchaga (1991a). See also OECD (1992), pp. 57-76.

[23] Still they were complemented by catch-up provisions in case inflation exceeded the official forecast. All other increases, based on productivity gains, and hence above the inflation target, were to be determined at the sectoral level.

[24] Espina (*La Vanguardia*, February 12th, 1989, reproduced in Espina (1991) locates this shift in the aftermath of the 1986 elections for union representatives in which UGT's expectations of winning a strong mandate were not fulfilled. Blaming these results on its participation in the 1985-86 social compact, UGT would have decided to adopt a more critical stance towards the government in order to regain votes to its left. For a more structural, long-term interpretation of this behavior, however, see below, pp.183 and ff.

order to restore real wages. Underlying their specific demands on wage bargaining, unions were proposing a macroeconomic strategy essentially at odds with the government understanding of the Spanish economy. Claiming that wage pressure had no substantial impact on inflation, they urged González to expand demand strongly to absorb unemployment. The clash over macroeconomic policies was compounded by growing disagreements on social policies and on the role of the state in the economy. The unions urged the government to comply with the promises signed into the 1984 national agreement (AES), so that unemployment benefits reached at least 48 per cent of all the unemployed (20 points over the actual level of coverage), and to accept the pension system they had drafted. Finally, UGT started to sketch a plan that called for an increasing public control of all investment through so-called 'investment funds' to be determined by law.

The government appeared uncompromising. Breaking the established wage setting system threatened the anti-inflationary policy in course. Furthermore, in the wake of a recovery in fiscal revenues, the reduction of the public deficit to increase the level of national savings and investment had priority over a boost of public consumption and social transfers. Similarly, the proposal to control private investment was flatly rejected by the government.[25] Negotiations quickly became sour and a national collective agreement for 1987 turned out to be impossible.[26]

The wage agreements for 1987 between unions and business organizations averaged an increase of 6.5 per cent, therefore close to the UGT demands (see table 3). Inflation, however, fell 3.5 percentage points to an average 5.3 per cent in 1987–and by the end of 1987 it had dropped to 4.6 per cent. To government and unions alike, the outcome confirmed their corresponding policy positions. On the one hand, Solchaga, invigorated by the almost perfect match between the planned goal and the actual result,

[25] See Solchaga (1988), p.29. Similarly, see the declarations of Felipe González to *El País* in December 4th, 1988.

[26] For a clear exposition of the position of the socialist trade union's demands, according to its general secretary, Nicolás Redondo, see Redondo (1988). See also the historical analysis of Espina (1991).

announced an inflation target of 3 per cent for 1988. On the other hand, for the trade unions the wide gap between wage and price increases definitely upheld their claim that both were only weakly linked. Consequently, UGT responded to the ambitious government target by asking for pay increases ranging from 4 to 6 per cent in 1988 and by insisting that social expenditures should be strongly expanded. Given the optimal combination of accelerating growth and falling inflation, enjoyed at that time by the Spanish economy, the incentives for a social pact grew dimmer and eventually the prospects for a national agreement waned again.

[Table 3 about here]

With demand growing heartily, however, the disinflation process became stalled by the summer of 1988. After reaching an all-out low of 4.4 per cent in the second quarter of 1988, inflation bounced back to 5.7 per cent at the end of the third quarter, therefore threatening to broaden the inflation differential with the European Community and to upset González's macroeconomic strategy. The socialist cabinet had to face again, even though more intensely, the dilemma of either attracting trade unions back into a social compact or using stabilizing fiscal and monetary policies alone. But concertation could not come about easily. With actual inflation two points higher than the official target, the cabinet's credibility had been seriously damaged among the social partners. Moreover, encouraged by the expectations generated by the economic boom, unions' demands had radicalized over time. The negotiations between the cabinet and the unions during the summer of 1988 stumbled upon the same obstacles of previous years. Besides, a youth employment and training scheme (*Plan de Empleo Juvenil*, PEJ) designed by the cabinet to subsidize employers to take on school leavers on short term contracts and at the minimum wage, was adamantly opposed by the unions. In order to merely open negotiation rounds in the fall, UGT demanded the immediate withdrawal of the PEJ, the extension of unemployment coverage according to the 1984 agreement and increases in pensions and public sector wages to compensate for higher than expected inflation. With negotiations in a stalemate, UGT and the communist union, CCOO, joined in a one-day general strike in December 1988 to bring the government to its knees and to extract from it a set of social concessions whose cost was put at least at Pta. 450 billion ($ 3.9 billion or more than 1 per cent of the 1988 GDP).[27]

Given the extraordinary success of the strike, González promptly conceded the cabinet's defeat in parliament, and agreed both to shelve the youth employment plan and to adjust pensions and public sector wages to inflation, but rejected the expansion of unemployment coverage levels. After long and tense negotiations at the beginning of 1989, the government decided to stick to the initial offer made by González in December, whose cost was put at Pta. 190 billion ($ 1.6 billion). At that point, the stable pattern of social concertation established in the mid-seventies could be declared irreversibly lost.

The government attempted repeatedly, however, to set up a new social agreement to cool down the economy and to reduce inflation. Explicit calls made by the minister of Economy in July 1989 and by González in August 1989 were rejected by UGT. In response to the entry into the European Community exchange rate system, UGT and CCOO launched a joint platform ("Propuesta Sindical Prioritaria") demanding more extensive social expenditure (including the recognition of the so-called 'social debt' or all promises on social expenditure made by the government in 1984 though still to be implemented), greater government planning of the economy, an extensive housing policy and a fairer tax system.

A slight setback in the general parliamentary elections of October 1989, mostly to the benefit of a loose coalition to the left of the PSOE, which put the socialist party one seat below the absolute majority, pressed González to renew his effort at achieving a grand social pact. Shortly after formal talks were revived at the beginning of 1990, the government made strong concessions on social issues. Minimum pensions were to be raised up to the minimum wage level in 1990 (in 1983 the minimum pension was only 77.87 per cent of the minimum wage) and the same would be implemented for widows'

[27] The historical development that led to the general strike can be followed through the set of newspaper articles edited by Juliá (1988).

pensions in 1992. Increases on pensions were scaled to favor the lowest income levels. The government established non-contributive pensions–that is, pensions for people that had never paid social security contributions--paying Pta. 26,000 monthly in 1991–about half the legal minimum wage. In addition, the ratio of unemployed people covered by several kinds of unemployment benefits–including the scheme for temporary rural workers–was expanded. While in 1988 only 28.8 per cent of all those that had registered as unemployed were covered (2.5 points above the 1983 level), in 1991 the ratio had gone up to 51.9 per cent -that is, around 1.4 million recipients. Accordingly, unemployment benefits would jump from 2.7 per cent to 3.8 per cent of GDP in three years–at a time in which unemployment fell more than 3 percentage points.[28] In spite of those unconditional social concessions, all governmental expectations for wage moderation proved illusory. At the beginning of the year the minister of Economy warned that were wages to rise above 7.3 per cent, harsh fiscal and monetary measures must ensue. The first major collective agreement of 1990, in the construction sector, called for a wage rise of 8.5 per cent and all wage settlements during the first quarter of the year averaged 8.3 per cent. Meanwhile, in the UGT's national congress in April 1990, its leader, Nicolás Redondo, assured union representatives that he would keep on with "the syndical strategy begun in 1987: definitive rupture with the PSOE and the maintenance of joint action on wage claims with CCOO" (EIU 1990, 3rd trimester).

Government plans to unveil a global 'competitiveness pact', aimed at stimulating Spanish productivity in the immediate future, were announced by the summer of 1990. Unions immediately interpreted the proposal as yet another incomes policy to ensure that real wage increases were offset by productivity growth, and, while presenting the budget for 1991, Solchaga had to announce a delay on the negotiations on the pact. Even with economic growth beginning to slow down, the negotiation rounds for 1991 yielded an average wage increase of 8.1 per cent. Pressed by the stringent conditions laid down in

[28] All data are taken from Godé (1990), Jiménez Fernández (1990, 1991), Ruiz Alvarez (1992) and García Perea and Gómez (1993).

Maastricht for the European Union, yet willing to avoid restrictive fiscal and monetary policies, the government eventually presented a competitiveness pact, under the name of 'Social Pact for Progress', in June 1991. The pact insisted in approximating wage increases to the rates prevalent in low inflationary European countries and asked for wage increases to be linked to productivity gains. Yet it asked for salary reviews to be subject to a common clause in order to guarantee that wage earners would see some increase in real incomes. In a departure from a previous position within the government, it called for a set of controls on distributed profits, which could not grow at a pace higher than wages, and designed favorable tax incentives for those profits reinvested in the company.[29] Although further away from a traditional incomes pact to control wages, the 'Social Pact of Progress' failed again to attract the trade unions. Wage settlements for 1992 fluctuated around an increase of a 7.2 per cent and, after a renewed period of confrontations,[30] the unions staged a second one-day general strike in the spring of 1992, which was, however, mostly a failure.

As an alternative to the strategy of social concertation, the government could have curtailed union power and, above all, reformed the labor market to make it flexible, highly responsive to the economic cycle and less prone to inflationary pressures. The government, however, was unwilling to follow that path. After the government legalized some forms of temporary contracts in 1984 with the acquiescence of unions, further attempts to reform a highly regulated labor market were regularly staved off. As a matter of fact, new legislation passed in the early 1990s enhanced union power and labor market rigidities in the labor market. The legislation on labor procedures approved in 1990 increased the compensation to be paid to workers that had been unfairly laid off. A 1991 law on new employment

[29] Other measures had to do with introducing more competitiveness in the service sector, inviting unions to participate in the policing of price movements, investment strategies and job creation, and a set of reforms in the labor market.

[30] Mostly triggered by a set of reforms, approved in January 1992, to reduce unemployment subsidies (prolonging the contributory period and reducing both the level and duration of subsidies).

contract monitoring extended the right of workers' representatives and unions to screen the legality of most new hiring contracts. On-going negotiations (since 1991) on the regulation of the right to strike showed the capacity of unions and the left wing of the PSOE to sustain a legal environment favorable to the former. And after the cabinet had drafted a moderate proposal which excluded all main demands from unions, the latter outmaneuvered the government through direct negotiations with the socialist parliamentary group (Fernández-Castro 1993).

Electoral Pressures and a Loose Fiscal Policy

From 1985-86 to 1989, the government was able to pursue its program of fiscal consolidation with little political costs. The general government deficit fell from 6.9 per cent of GDP to 2.8 per cent of GDP four years later (Table 4). The decline in overall net lending was driven more by the spectacular improvement experienced by the Spanish economy in the mid 1980s than by a disciplined fiscal policy. Adjusting for the economic cycle, it is clear that the government only designed a restrictive fiscal policy in 1986 and 1987 (see table 4, column 3). Fiscal restraint waned, however, from 1988 on. Even in the presence of a booming economy, the size of the 'fiscal impulse' (that is, the change in the budget balance adjusting for the business cycle) oscillated around 1 point of GDP during four years in a row.

[Table 4 about here]

Up until 1988 all expenditure overruns were comfortably absorbed by unexpected high revenues. The governmental fiscal strategy underwent, however, considerable strain from 1989 on. The intensifying pressure from unions to increase social spending could have been warded off had the PSOE kept its majority in Parliament. But the electoral losses suffered in 1989—which deprived the PSOE of an outright majority—persuaded the cabinet to increase social transfers to avoid losing more popular support. Contributive pensions were upgraded and to some extent equalized, and new categories, such as non-contributive pensions, were created. Unemployment benefits were extended to cover more than half the registered unemployed by 1991. Health coverage was improved and expenditure on public education increased more than any other item excluding fixed capital formation.[31]

The expansion of social spending severely jeopardized the governmental budgetary plans. Reversing its slighly downward trend since 1985, total public expenditure rose from 41.1 per cent of GDP in 1988 to 43.3 per cent of GDP in 1990. Afterwards, partly due to a sharp economic downturn, public spending increased hastily, at an annual average of 2 percentage points of GDP during the following three years. By 1993, it amounted to 49.6 per cent of GDP. Since the expansion of social expenditure was done without reducing public spending on capital formation—which constituted the core of the PSOE's economic strategy since the mid 1980s—higher taxes would have been necessary to avoid a fiscal deficit. Taxes were raised, however, in a limited way. On the one hand, the Socialist party reckoned that an increase in taxes could endanger its grip on key centrist voters. On the other hand, the government believed, incorrectly, that economic growth would quicken again in the future and hence would easily absorb any deviation from fiscal orthodoxy (as it had done in 1987-89). Accordingly, the general government deficit rose from 2.8 per cent of GDP in 1989 to 4.9 per cent of GDP in 1991.

Making Explicit the Low-Inflation Commitment: Joining EMS

The government's incapacity to either achieve a social pact or restrain the public deficit forced González to rely, in turn, on a tight monetary policy to achieve the overall goal of macroeconomic stability. After several years in which monetary policy had gone through several phases-from tight in 1984 to accommodating in 1985-86, interest rate policy came to play a stronger and more distinctive role in the summer of 1988. Economic and political conditions had clearly changed at that time. While

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[31] The increase in social spending had come through higher pensions (3.4 points more as a proportion of total disposable income), unemployment benefits (1.3 points), education (1.8 points) and health (1.8 points) (Bandrés 1993).

inflation was experiencing an upturn, the renewal of the social compact to combat it looked increasingly unpromising. Public authorities eventually decided to raise intervention rates in early September.[32] Further measures adopted in February 1989 to curb private credit and foreign capital inflows sent nominal short-term interest rates up to 15 per cent. In real terms the latter were among the highest in Europe–about 5 percentage points above German interest rates.

Still, the measures taken in February were soon perceived to be insufficient. Due to accelerating financial innovations that had boosted liquidity in the Spanish financial market, the traditional system of targeting monetary aggregates had become increasingly uncertain as a means to conduct monetary policy. In addition, the increasing mobility of capital within the EC was making impossible the conciliation of both a monetary policy directed to reducing inflation and the maintenance of an exchange rate favorable enough to Spanish exports. Cutting through all these dilemmas, the Spanish government eventually decided to join the EMS in June 1989.

It was obvious to the socialist cabinet that the combination of a system of fixed exchange rates and the progressive removal of all barriers to capital movements implied surrendering all its autonomy in the area of monetary policy.[33] Barred from employing a devaluation, all macroeconomic instruments had to be directed towards pushing the Spanish inflation rate to the same level that the core of the Community was having since, "in a system of fixed exchange rates, maintaining an inflation rate higher than our economic environment would only lead to worsen our competitiveness" (Zabalza 1990, p. 59).

Still, several factors pushed the government to embrace the ERM. First, there seemed to be no

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[32] I refer to 'public authorities' in general to denote the low level of independence enjoyed by the Bank of Spain and the fact that monetary policy mostly resulted from the combined action of the ministry of Finance and the central bank at that time. On the political and institutional status of the Bank of Spain, in a comparative perspective, see Grilli, Masciandaro and Tabellini (1990) and Alesina and Summers (1993).

[33] A detailed, self-conscious discussion of the policy consequences of this regime by the then Deputy Minister for Planning and Budgeting can be found in Zabalza (1990).

other way to make credible the governmental commitment to a low-inflation goal, particularly in the face of a growing inability to make any binding agreements with the Spanish unions. Second, there was widespread agreement among the government's economic team on the neutral or quasi-neutral effects of monetary policy, at least in the medium run. This consensus has a clear ideational component–the economy was believed to adjust relatively quickly to inflationary surprises. As expressed by the Bank of Spain, "the costs of joining the EMS would be nominal rather than real because, in an economy like the Spanish one, with a high level of wage indexation, any variation in the nominal exchange rate would quickly be transmitted into prices and the capacity to affect the level of competitiveness and real growth would be transitory." (Banco de España 1989, p.39) [34] But the degree to which the government was committed to high interest rates to defend a fixed exchange rate system, even if that meant a painful appreciation of the peseta in real terms, may have had some relationship with the political basis of the Socialist government: it was only after 1993 that regionalist parties (with strong connections to small businesses especially sensitive to currency fluctuations) has a direct voice in government to influence monetary policy. Third, a credible commitment to a low-inflation area was expected to reduce the interest premium Spain was thought of paying to reduce inflationary expectations. Fourth, the PSOE traded its support for a fixed-exchange regime (and monetary union) for generous structural funds paid for by other European countries. By the early 1990s Spain was receiving net transfers equal to around 0.5 per cent of its GDP. As a result of the implementation of the Delors II package, EU net transfers doubled to around 1 per cent of GDP after 1995. Finally, there is some indication that the socialist government played with the possibility that, by forcing the process of European integration, it would be possible to

[34] See also Solchaga (1990). A good analysis of the policy reasoning that lead to the integration of Spain in the ERM can be seen in Malo de Molina and Pérez (1990). See also the Bank of Spain's *Informe Anual* for 1989 (Banco de España 1989), especially pp. 37 and ff.

gain enough political leverage to support a coordinated expansionary policy in the future.[35]

To sustain the commitment to an (implicitly) coordinated monetary policy (with the EC) and to decelerate the rhythm of domestic activity, the integration into ERM was followed by a package of fiscal measures to reduce the deficit and a temporary set of credit controls.[36] As pointed out above, in spite of successive calls for fiscal discipline both from within the government and from the Bank of Spain (Banco de España 1989, pp. 98 ff.; Banco de España 1991, pp. 99 ff.) to sustain the anti-inflationary strategy and to avoid overburdening the monetary policy, the public deficit could not be tamed. Fiscal policy turned out to add fuel to the expansion of domestic demand. Accordingly, monetary policy was left alone to sustain the disinflationary macroeconomic strategy of the socialist government. Nominal short-term interest rates reached 16 per cent at the end of 1989 and then fell to 15 per cent throughout 1990. In real terms that implied rates of 8 per cent until the end of 1990.

THE PROCESS TOWARD MONETARY UNIFICATION UNDER AN ECONOMIC RECESSION, 1992-96

Economic activity suffered a sharp downturn by mid 1991. From the second quarter of 1992 to the third quarter of 1993, the Spanish GDP fell for six successive quarters. About half a million jobs were lost and the unemployment rate peaked in 1994, reaching a high of 24.2 per cent. By 1993 the general government deficit had increased by 2 percentage points to around 6.9 per cent of GDP. Public debt jumped, in turn, from 45 per cent of GDP in 1991 to 64 per cent of GDP in 1994.

Even in the face of a sharp downturn in economic activity, wage increases and inflation remained

[35] See, for example, the declarations of the minister of Economy before the Parliament at the end of 1989 (Solchaga 1990, p.33), as well as Dehesa (1988, pp. 32-38).

[36] The latter consisted in imposing a ceiling on bank credit expansion to the private sector of 13 per cent for the second semester of 1989, restricting the use of substitutes for bank deposits not subject to the minimum reserve ratio and raising the official intervention rate. The former has been examined in the previous section.

high, and, to sustain Spain's commitment to EMS, interest rates were kept extremely high throughout 1992. As the year progressed, a mounting climate of uncertainty over the Maastricht project turned against the ERM. By the end of the summer of 1992, rising German interest rates and the generalized financial turmoil of European markets put pressure on the peseta. Nominal short-term interest rates were raised to over 15 per cent—almost 10 per cent in real terms. Yet, as the EMS crisis extended over time and the worldwide economic downturn hit Spain, it eventually became apparent that the government was increasingly trapped into implementing a very costly economic strategy. Forced by the international financial markets and pressed by a growing fiscal imbalance, the government accepted the need for a prolonged round of devaluations – by 5 percent in September 1992, by 6 percent two months later, and then by 8 percent in May 1993. Although the government's macroeconomic strategy continued to be bound by the project of monetary unification, the policy mix to meet the Maastricht requirements shifted substantially thereafter.

Facilitated both by the stabilization of foreign exchange markets, after the widening of the ERM bands in August 1993, and, especially, by a reduction in interest rates in the rest of the European Union, monetary policy loosened systematically. Interest rates, that peaked in early 1993, were allowed to decline. The Bank of Spain cut its intervention rate from around 13 percent early in 1993 to about 9 percent at the beginning of 1994, and then to 7.35 percent in August 1994.

By the middle of 1993, the economy turned around. Spurred both by the recovery of international demand and by the devaluations of 1992-93, which led to a 20 per cent improvement in Spain's international competitiveness, exports boomed.[37] GDP grew by 2 percent in real terms in 1994, private sector investment rebounded sharply and the unemployment rate began to decline by the end of 1993. After a short pause in the second half of 1995, domestic consumption grew quickly in 1996 and

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[37] Thanks to moderate wage increases in the following years, this gain in competitiveness did not erode subsequently.

overall GDP expanded by around 3 percent annually. In spite of new growth and a loose monetary policy, inflation did not pick up. Although wage growth was higher than consumer price inflation after 1995, several factors explain the deceleration of price increases. First, since a a significant portion of contracts were either part-time or fixed-term contracts (many of them in the service sector, where most of employment growth took place), a substantial part of the workforce was subject to the discipline of the market. Second, Spain benefitted from a drop in international input prices. Finally, wage negotiations took place in a peaceful labor market. This resulted from two, labor market reforms (which were, otherwise, mostly marginal in their impact on the legal framework) negotiated among the government and social partners in 1994 and 1997.

Against a background of low interest rates and faster economic growth, the government committed itself to a significant reduction in the public deficit. The Socialist government, now in power with the external support of the Basque and Center center nationalist parties, announced a 'convergence program' in June 1994 (approved by the European Union's ECOFIN Council in October 1994) to reduce the general government deficit by 4.4 percent of GDP in 1996 and 3.0 percent in 1997. To accomplish these goals, the González government drafted a tight budget for 1994, based on the compression of current public spending (through a freeze in public sector wages and public sector hirings, cuts in unemployment compensations and a reform of the system of temporary disability payments) and public capital formation. Although the containment of the public spending was relaxed in 1995 and new elections in 1996 forced the government to automatically extend the 1995 Budget to the following year, the public deficit continued to fall in the following years.

In a way that illustrates the general consensus over the European project among Spanish voters and elites, the new Conservative government of José María Aznar, in power after the elections of March 1996, embraced the convergence program of the previous cabinet and pursued the same fiscal policy of the latest González government. Public sector wages were frozen again, social benefits were virtually

But the incentive structure of the small and radicalized Spanish trade unions was seldom aligned with the goals of the PSOE government. A corporatist pact was only possible in 1985-86 in response to a critical economic downturn. As the economy overheated and the labor market tightened up in the late 1980s, any chances of a social pact waned. Equally pressed to increase social spending–to satisfy its core constituencies–and to avoid higher taxes–to maintain its centrist voters, the Socialist government allowed the public deficit to rise rapidly. The resulting expansionary fiscal policy only reinforced the need to use high interest rates to choke inflation and sustain the peseta.[38] After the currency realignments of 1992-93, and favored by both a decline of interest rates among Spain's main EU partners and strong public opinion support for monetary union, the PSOE (and afterwards the PP) could loosen monetary policy and cut the public deficit in time to meet the Maastricht requirements.

Without corporatist institutions and in a fully internationalized macroeconomic regime, social democracy is left with two fundamental policy tools. On the one hand, it must focus on building up a public stock of human and physical capital (to ensure the competitiveness of the domestic economy while equalizing conditions). On the other hand, it needs to develop a set of policies geared toward domestic compensation to ensure that those sectors losing from further economic integration do not thwart the underlying pro-free-trade coalition. These two responses were present under the González government in Spain. Public expenditure rose by a fourth under the PSOE's government. Two thirds of the increase was allocated to raise public savings as well as fixed and human capital formation. Key public firms were asked to join in the effort to revamp the supply side of the Spanish economy. Moreover, unemployment benefits were expanded, pensions were upgraded and a universal health care system was established. It was that economic strategy of high taxes, public investment and generous

[38] In Boix (1998b) I show this policy mix of budget deficits and high interest rates is common in noncorporatist countries governed by socialist parties. By contrast, wherever unions are strong and parties are well-organized political machines, those political dilemmas are less pressing, and, consequently, fiscal conservatism and cheap credit can go hand in hand.

social transfers which maintained González in power for sixteen years (the last three with the external support of centrist regionalist parties). Although the PSOE lost part of its massive support of 1982, it consistently polled close to two fifths of the vote through the mid-nineties. Among blue-collar workers and the rural 'proletariat' of temporary workers the PSOE received 60 per cent of the votes cast (or over 40 per cent of the total electorate). Support was almost as high among pensioners and the unemployed receiving state benefits. In 1993 the PSOE continued to lead the Conservative party among lower-middle classes with a small advantage.[39]

The creation of a fully integrated European space is, at the same time, generating, or perhaps intensifying, a new policy dilemma among the Spanish Left. Confronted with growing capital mobility, the Socialist party has leaned to favor more tax coordination at the European level to avoid an erosion in welfare and wage standards. Still, it is unclear whether the Spanish Left will be capable of attracting its European counterparts into solidaristic policies to sustain its programmatic commitment to the welfare policies. As a matter of fact, given that the skills of Spanish workers and the technological edge of Spanish firms are still lagging in European terms, it may be equally tempted to compete for foreign investment on tax and subsidies advantages (which conflict with the strategy of European-wide tax coordination). The strategy that several Spanish regional governments have pursued in courting foreign firms in the last years seems to show that the actual support for tax coordination may be weaker than the programmatic declarations of Spanish politicians could make us believe. If that were the case, we would then witness a political realignment of substantial proportions at the European level–from a factor- or class-based conflict within each state to a system in which the cleavages would be basically pitting nations and, more properly, regions against each other.

[39] For analysis showing that the development of generous social policies contributed to strengthen the core of the electoral coalition that supported the PSOE—the industrial working class, agricultural laborers, the retired population, the unemployed—in spite of the sharp economic crisis that hit Spain in the early nineties, see Boix 1998a (chapter 6) and Maravall and Fraile (1998).

untouched, public investment was curtailed and indirect taxes were increased. Although now in opposition, the PSOE supported the fiscal program of the Aznar government. As a result of the government's announced commitment to the convergence criteria and with financial markets anticipating Spain's entry in EMU as an initial member, the Bank of Spain resumed cutting its intervention rate (that had gone up in 1995) from 7.25 percent in mid-1996 to around 5 percent at the end of 1997. Long-term interest rate differential with Germany, that had been over 3 percent until 1996, would finally become minuscule (0.5 percentage points). The fall in interest rates would then feed into the budget in the form of much lower interest payments–in fact accounting for about half of the reduction in the general government deficit. With inflation subdued and the public deficit reaching a historical low, Spain entered EMU.

CONCLUDING REMARKS

The analysis of this chapter allows us to understand the economic strategy of a social democratic government in Southern European countries, that is, in nations characterized by the absence of corporatist institutions at home, under a condition of increasing economic interdependence (mostly due to the process of European integration).

The Spanish experience corroborates the literature on social democratic corporatism. Unless they can count upon a highly organized labor movement, left-wing governments progressively abandon expansionary policies to fight unemployment. Moreover, it shows that the social democratic road to macroeconomic discipline is a notoriously bumpy one. The British Labor party endured several electoral defeats before it dumped Keynesian recipes in the late eighties. The French Left suffered something akin to an identity crisis (as well as the electoral setback of 1986) as it embraced the doctrine of the 'franc fort' in the mid-eighties. In Spain, the González government never discarded the possibility of striking a deal with the union movement to secure low wage increases in exchange for full employment measures.

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TABLE 1. SPANISH MONETARY AGGREGATES, CONSUMER PRICES AND WAGES , 1982-86

	1982	1983	1984	1985	1986
SPANISH MONETARY AGGREGATES (ALP)					
Target	18.6[a]	16.0 $\pm$ 2	12.5 $\pm$ 2	13.0 $\pm$ 2	11.0 $\pm$ 2
Outcome	16.6	15.9	13.3	12.9	12.0
CONSUMER PRICES					
Spanish target	12.0	8.0	8.0	6.0	na
Spanish outcome	14.4	12.2	11.3	8.8	8.8
Average EEC	10.9	8.7	7.3	6.2	3.8
Differential Spain-EEC	4.5	3.5	4.0	2.6	5.0
WAGE EVOLUTION					
Wage agreement	12.0	11.4	7.8	7.9	8.2
Compensation per employee[b]	13.8	14.4	11.4	8.6	7.9
Real wage increase	-0.6	+2.2	+0.1	-0.2	-0.7

[a] Until 1982 the Bank of Spain employed M3 instead of ALP to conduct monetary policy. This figure is an OECD estimation on the M3 targets for that year.

[b] Proportion between Total Wages and Total Waged Population.

Source: For monetary policy and consumer prices, **OECD Historical Statistics**; Banco de España (several years); **OECD Economic Surveys. Spain** (several years). For wages, Espina (1991), p. 262, 272 and 273.

TABLE 2. A COMPARATIVE LOOK TO FISCAL STRATEGIES IN THE EARLY 1980S

	AS PER CENT								
	GENERAL GOVERNMENT FINANCIAL BALANCE			CHANGE IN OVERALL GOVERNMENT BALANCE [a]			CHANGE IN STRUCTURAL GOVERNMENT BALANCE [a b]		
	Spain	UK	Germany	Spain	UK	Germany	Spain	UK	Germany
First year[c]	-4.8	-3.2	-3.3	+0.8	+1.1	+0.4	+0.9	+0.6	+1.2
Second year[d]	-5.5	-3.3	-2.5	-0.7	-0.1	+0.8	-0.4	+0.9	+0.2
Third year[e]	-6.9	-2.6	-1.9	-1.4	+0.7	+0.6	-2.4	+2.9	+0.6
Fourth year[f]	-6.0	-2.4	-1.1	-0.9	+0.2	+0.7	+0.3	+1.1	-0.3
Change in first four years of government				-0.4	+1.9	+2.5	-1.6	+5.5	+1.7

[a] In figures on deficit change, a negative sign means expansionary change and a positive sign represents a restrictive change.

[b] The change in the structural government balance corresponds to the change in the fiscal deficit that would have taken place if the GDP were to grow at its potential rate. The change in the structural balance therefore shows the net effect of governmental discretionary decisions concerning the budget.

[c] 1979 for the UK; 1982 for Germany; 1983 for Spain.

[d] 1980 for the UK; 1983 for Germany; 1984 for Spain.

[e] 1981 for the UK; 1984 for Germany; 1985 for Spain.

[f] 1982 for the UK; 1985 for Germany; 1986 for Spain.

Sources: For United Kingdom and West Germany, **OECD Economic Outlook**, several years. For Spain, the first two columns, Bank of Spain's **Annual Report**. For the Spanish last column, data from González-Páramo and Roldán (1992).

TABLE 3. CONSUMER PRICES AND WAGES IN SPAIN, 1987-92

	1987	1988	1989	1990	1991	1992
CONSUMER PRICES						
Spanish target	5.0	3.0	3.0	5.7	5.8	5.3
Spanish outcome	5.3	4.8	6.8	6.7	5.9	5.9
Average EMS-core[a]	1.4	1.9	3.1	3.0	3.4	3.3
Differential Spain-EMS	3.9	2.9	3.7	3.7	2.5	2.6
WAGE EVOLUTION:						
Wage agreement	6.5	5.4	6.7	8.1	8.1	7.2
Compensation per employee[b]	7.5	6.0	6.3	9.2	8.6	9.3
Real wage increase	2.2	1.2	-0.5	2.5	2.7	3.4
Change in labor productivity	2.5	2.2	0.7	1.0	2.1	3.0[c]

[a] Core EMS countries comprise Germany, France, Belgium, Denmark, Ireland, Luxembourg and Netherlands. This definition follows OECD (1992). Own weighted estimates using national GDP in 1985.

[b] Proportion between Total Wages and Total Waged Population.

[c] Estimate.

Source: For consumer prices, **OECD Historical Statistics**; Banco de España, **Annual Reports**; **OECD Economic Surveys**. For wages, Espina (1991) and **OECD Economic Surveys of Spain**. For compensation per employee and labour productivity, from **OECD Economic Surveys of Spain**.

TABLE 4. GENERAL GOVERNMENT FISCAL POLICY IN SPAIN, 1985-97

	AS PER CENT OF GDP		
	GENERAL GOVERNMENT FINANCIAL BALANCE	CHANGE IN THE OVERALL GOVERNMENT BALANCE FROM PREVIOUS YEAR	CHANGE IN THE STRUCTURAL GOVERNMENT BALANCE PREVIOUS YEAR [a] (FISCAL IMPULSE)
1985	-6.9	+1.4	+2.4
1986	-6.0	-0.9	-0.3
1987	-3.1	-2.9	-1.2
1988	-3.2	+0.1	+1.5
1989	-2.8	-0.4	+1.2
1990	-3.9	+1.1	+1.0
1991	-4.9	+1.0	+1.0
1992	-4.6	-0.3	n.a.
1993	-6.8	+2.2	n.a.
1994	-6.3	-0.5	n.a.
1995	-6.5	+0.2	n.a.
1996	-4.5	-2.0	n.a.
1997	-2.9 [b]	-1.6 [b]	n.a.

[a] The change in the structural government balance corresponds to the change in the fiscal deficit that would have taken place if the GDP were to grow at its potential rate. The change in the structural balance therefore shows the net effect of governmental discretionary decisions concerning the budget.

[b] Estimate.

In figures on deficit change, a positive sign means expansionary change and a negative sign represents a restrictive change.

Sources: For the first two columns, IGAE (1993) until 1992; OECD (1998) afterwards. For the last column, data from González-Páramo and Roldán (1992).

Figure 1. Public Support for Belonging to the European Union, 1980-97

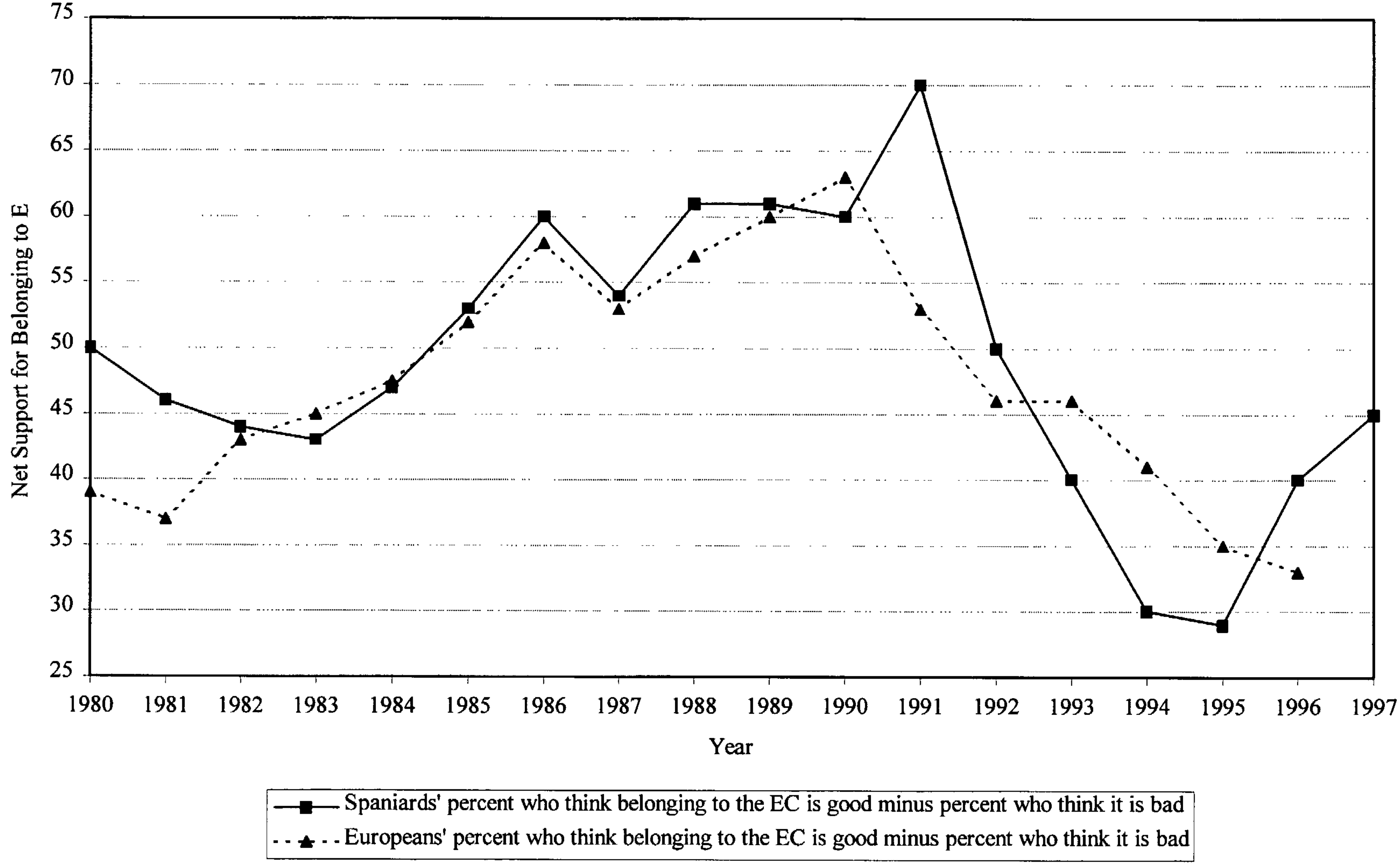

Figure 2. The Evolution of Nominal Short-Term Interest Rates in Spain and Germany, 1982-97