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SPAIN AND PORTUGAL: FROM DISTANT NEIGHBOURS TO UNEASY ASSOCIATES

William Chislett

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Summary: Spain and Portugal lived back to back for some 300 years until they came face to face when both joined the European Union in 1986. Since then the two economies have increasingly converged. Trade and direct investment between the two countries is now very strong. Spain exports to its neighbour almost as much as it does to the United States and the whole of Latin America, and it is a major investor in the country. Spain is also Portugal's largest export market

Introduction

Portugal lay under Spanish dominance between 1580 and 1640 and after the restoration of independence the two countries lived like 'Siamese twins joined at the back'[1] for more than 300 years until they joined the European Union (EU) together in 1986 and came face to face. The Spanish film director Luis Buñuel recounts in his memoirs that Portugal seemed further away for Spaniards than India, and for the Portuguese poet Rui Bello Madrid was one of the most 'distant' cities from Lisbon.

Portugal managed to remain free from permanent Spanish domination by belonging to different international alliances. The country could easily have gone the way of Catalonia, Andalusia and other regions absorbed by Castile into a united Spain[2]. Portugal is often described as Britain's 'oldest ally' –this goes back to 1386 when England allied itself permanently with Portugal after English archers helped to secure the Portuguese throne from the Castilians. This alliance was solidified when Catherine of Braganza married Charles II of England, and Charles then played a part in achieving Spanish recognition of Portugal's independence.

There is a 200-year old dormant claim by Portugal to territories ceded to Spain around the town of Olivenza near the border with Elvas. Portugal does not recognize Spanish sovereignty over Olivenza and as a result the border between the two countries in the Olivenza area has never been clearly defined.

Even under the right-wing dictatorships of General Franco (1939-75) in Spain and António de Oliveira Salazar (1932-68) in Portugal the two countries ignored one another. Nevertheless, in March 1939, six months before the outbreak of the Second World War, and as the Spanish Civil War was ending, they signed a treaty of friendship to mutually

* William Chislett, a former correspondent for *The Times* in Spain (1975-78) and the *Financial Times* in Mexico (1978-84), has written books on Spain and Portugal. He would like to thank the following people for reading the Paper and making comments: Mauro Guillén, professor of International Management at the Wharton School of the University of Pennsylvania; Enrique Santos, chairman of the Spanish Chamber of Commerce and Industry in Portugal; José Luis del Valle, Chief Development and Strategy Officer of Iberdrola, and Peter Wise, Portugal correspondent of the *Financial Times*

[1] 'Portugal-España: siameses unidos por la espalda', *El País*, 6/I/2002.

[2] According to the Spanish historian Hipólito de la Torre Gómez, King Alfonso XIII contemplated the annexation of Portugal in the early 20th century. See *El imperio del Rey: Alfonso XIII, Portugal y los ingleses (1907-1916)*, Editora Regional de Extremadura, 2002.

protect their interests and independence. Franco played a double game: he harboured ambitions of taking over Portugal with Axis help, but was happy to allay suspicions of his designs and also to provide a channel to the British in the event that the war went their way[3]. 'We were taught to hate Spain', declared Major Vitor Alves, born in 1931 and one of the prime movers in the 1974 revolution that ended Portugal's dictatorship (under Salazar's successor Marcelo Caetano)[4]. Spain and Portugal are now part of the same military and economic alliances (Nato and the EU) and Portugal no longer feels threatened, at least militarily. Nevertheless, the Portuguese still mistrust Spain, epitomised in their still popular saying: 'Neither good winds nor good marriages come from Spain'. This is because of Spain's economic invasion of the country as a result of EU membership. All the more reason then why Portugal was jubilant when its football team knocked Spain out of the 2004 Eurocup.

Spain is the main supplier of goods to Portugal (30% of Portugal's total imports). Spain's exports to its tiny neighbour (around 10% of the total) represented in 2003 90% of the total to Latin America and the United States. Portugal, a natural extension of Spain's domestic market, was Spain's fourth largest client in 2003 and only a fraction below Italy. Around 3,000 Spanish companies are also directly operating in Portugal. Several companies have strong positions in the Portuguese economy, most notably Santander Central Hispano (SCH), Spain's largest bank which acquired the Totta Group (market share of 11%) in 2000; El Corte Inglés, the giant department store chain which chose Lisbon as its first venture outside Spain; Prosegur (security); Sacyr Vallehermoso which owns Somague, the largest construction company; Repsol YPF, which owns close to 20% of the petrol stations; and Telefónica, which has an 8% stake in Portugal Telecom (PT) and with PT jointly owns Vivo, Brazil's largest mobile telephone operator. Other Spanish stores like Zara, Massimo Dutti and Pull & Bear, all owned by the Inditex group, have clustered around the landmark Corte Inglés store creating an 'Avenida de Espanha' in the heart of Lisbon, a symbol of Spanish business prowess[5].

Banco Bilbao Vizcaya Argentaria (BBVA), Spain's second largest bank, bought the much smaller Lloyds Bank in Portugal in 1991. Lloyds had been in Portugal for 128 years and was known simply as *o banco inglês*, the English bank. For a bank from Portugal's oldest ally to decide to pull out was a bad enough blow for the government. Selling it to Portugal's historical enemy was tantamount to being stabbed in the back by your best friend.

The increasingly strong Spanish presence in the context of a single market is a very sensitive issue as it plays on Portuguese fears that they are being swallowed up by their neighbour. Furthermore, most of the investment is in highly visible sectors such as banking and construction. Spanish net direct investment in Portugal between 1992 and 2002 amounted to €6.4bn, compared with €5.1bn for the UK, €4.2bn for the Netherlands and €2.4bn for Germany, according to the Bank of Portugal. The fears may be exaggerated, but they are the logical consequence of a small country sharing a border with a much larger and more powerful one. Fifty four per cent of Portugal's territory borders Spain. Portuguese feelings towards Spain are not unlike those of Mexicans towards the United States.

In what has become known as the 'patriots' manifesto', 40 top economists and businessmen warned in 2003 of the danger of Portugal's 'decision-making centres' –a euphemism for its biggest companies– being moved abroad. Jorge Sampaio, the president of Portugal, commented that 'without centres of decision-making, there is no

[3] See p. 369 of *Franco* by Paul Preston, HarperCollins, 1993.
[4] Quoted on p. 65 of *The Portuguese* by Marion Kaplan, Penguin Books, 1998.
[5] See 'Borderline Angst' by Peter Wise in *EuroBusiness*, May 2003.

nation[6]'. Newspapers abound with headlines like 'Spanish Armada', whenever there is a major Spanish acquisition, and magazine covers erase the border with Spain and make Madrid the capital of Portugal. One Portuguese magazine summed up the situation by putting the following on its cover: 'We go shopping in El Corte Inglés, buy our clothes in Zara, book our holidays at Viajes Halcón and get our glasses at Multiópticas. Even our savings are in Spanish banks'. The weekly newspaper *Expresso* ran a section called 'The Spanish Question' during February 2004 with all manner of opinions for and against (mainly the latter) the hypothetical idea of Portugal losing its independence and becoming part of Spain.

The flow of trade and investment, however, is not all one way, although it is very much larger from Spain as one would expect because of its much stronger economic muscle (see Table 1). Just as Portugal is Spain's largest market for its exports, so Spain is also Portugal's main export market (23% of Portugal's total exports). More than 300 Portuguese companies operate in Spain. The main ones include Sonae, which owns Tafisa, the leading wood-based board company (with companies in Germany, the UK, France and Africa), Galp, which has more than 240 petrol stations, the transport company Luís Simões and Electricidade de Portugal (EDP), which has acquired Hidrocantábrico, Spain's fourth largest power company.

Table 1. Comparative Indicators, Spain and Portugal (2003)

	Spain	Portugal
Population (millions)	41	10.4
GDP (US$ bn PPP)	928	185
Per capita GDP (US$ PPP)	22,746	17,820
Per capita GDP (EU-25 = 100)	95	75
Total labour costs per hour worked (US$)*	13.2	5.8
Unemployment rate (%)	11.3	6.4

(*) Production workers in the manufacturing sector.
Source: Eurostat, Economist Intelligence Unit and Confederation of Swedish Enterprise.

The pace of integration of the two economies will be stepped up when the two countries begin to operate the much-delayed Single Iberian Electricity Market (MIBEL). Spain is western Europe's fifth largest power market and Portugal the eleventh largest. Together, they form a market slightly larger than Italy's.

The project with the greatest tangible impact on the integration of Spain and Portugal is the building of four high speed rail links between the two countries (see Map 1). The first one is due to be completed in 2009 and will link Porto, in the north of Portugal, with Vigo in northern Spain. A year later Lisbon and Madrid will be connected. The travel time by train between the two capitals will be cut from 10 to three hours. The third link (2015) is between the Portuguese coastal town of Aveiro and the Spanish university city of Salamanca and the fourth one (2018) between Faro in the Algarve and Seville. Madrid and Lisbon are already linked by a dual carriageway that goes virtually all the way between the two capitals.

[6] See *El País*, 25/IV/2004.

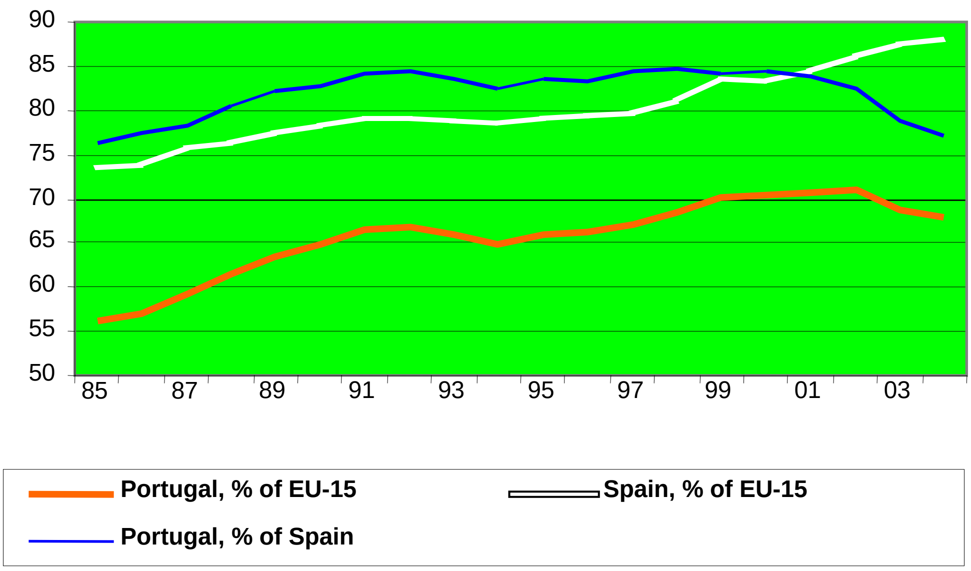
Map 1. High Speed Train Connections between Spain and Portugal

On the international front, Spain and Portugal, once former rivals in Latin America (Brazil, the most populous country, was under Portuguese rule for three centuries), work together in the Iberoamerican Community of Nations, founded in 1991, which holds annual summit meetings of heads of state and government. The previous centre-right Spanish government of José María Aznar and the former Social Democrat government of José Manuel Durão Barroso both actively supported the US-led invasion of Iraq, symbolized in the photograph of Aznar, Barroso, George Bush and Tony Blair at their summit meeting in the Azores shortly before the invasion in March 2003. The decision of José Luis Rodríguez Zapatero, the Socialist prime minister elected in March 2004, to withdraw the 1,300 Spanish troops from Iraq and pursue a less Atlanticist foreign policy was sharply criticised by Durão Barroso. Portugal kept its 128 troops in Iraq. But Zapatero and Durão Barroso quickly agreed to bury their differences at their first meeting in Lisbon in May and not let it spoil the otherwise good relations between the two countries. Durão Barroso will take office as president of the European Commission in November.

Converging economies
Spain and Portugal followed similar political and economic paths during the 20th century: Portugal deposed the monarchy in 1910 and declared a Republic (Spain followed the Republican route in 1931, which was cut short by its 1936-39 civil war); both countries had long dictatorships (1932-74 for Portugal and 1939-75 for Spain); both countries liberalised their heavily protected economies to varying degrees (Spain began in the 1950s and Portugal not really until the 1970s) and both joined the EU together (1986) and were founder members in 1999 of European Monetary Union (the euro).

The economic progress made by both countries, as measured by per capita income, has been strong. Spain's per capita income rose from 60% of the EU-15 in 1960 to 86% in 2004 and Portugal's from 40% to 66% (see Table 2). Both countries have benefited significantly from EU structural and cohesion funds (see Table 3). Spain is the largest beneficiary in absolute terms but in terms of GDP they represent more for Portugal. The structural funds received by Portugal in 1989-93 and 1994-99 represented 3% of GDP a year compared to 0.7% and 1.4% respectively for Spain. These funds have enabled both countries to greatly improve their infrastructure and to achieve higher rates of economic growth than the EU average over most of the last 20 years (see Table 4). There was real convergence for Portugal towards Spain until 2001 and then divergence as a result of the slowdown in the Portuguese economy. In 2001, Portugal's per capita income peaked at 71% of the EU-15. Three of Portugal's regions –Centre, North and the Azores– are among the 10 poorest regions in the EU-15 and only one of Spain's, Extremadura, which borders with Portugal.

Table 2. Per Capita GDP in Purchasing Power Parities



Source: Eurostat.

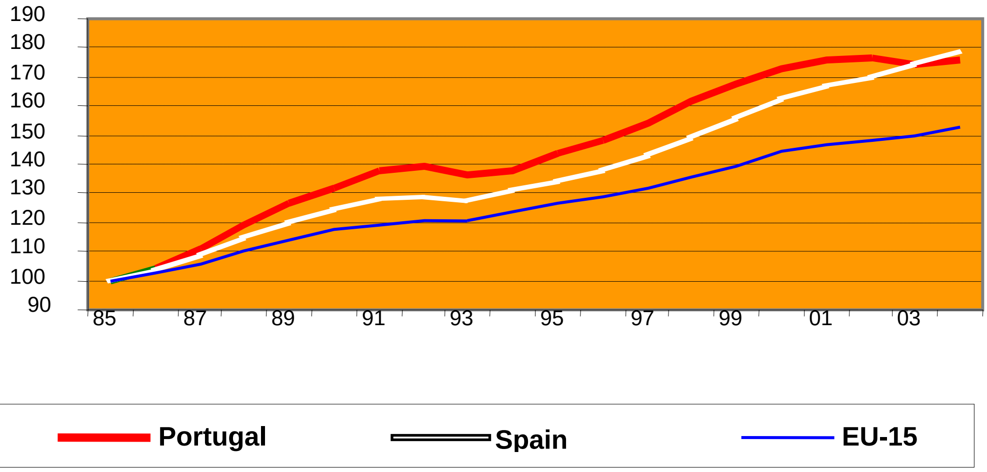
Table 3. Gross EU Structural & Cohesion Funds for Spain and Portugal, 1989-2006 (€ mn)

	1989-1993	1994-99	2000-06
Portugal	9,174	15,041	22,760
Spain	14,229	34,449	56,205

Source: European Commission.

Portugal's growth was faster than Spain's until the end of the 1990s when it slowed down. Its recession in 2003 was the deepest among the EU-15. Spain averaged annual GDP growth of 3% between 1994 and 2004 compared with Portugal's 2.3%. Portugal's macroeconomic picture has deteriorated in recent years. Portugal broke the EU's Stability Pact in 2001 with a general government budget deficit of 4.4% of GDP (2.7% in 2002 and 2.8% in 2003), compared with Spain's balanced budget (small surplus in 2003), and its general government debt is also higher (59% of GDP in 2003 as against Spain's 50%). Portugal's unemployment rate, however, is much lower than Spain's, partly because of its more flexible labour market (6.3% in 2003 vs Spain's 11.3%).

Table 4. GDP Volume Indices



Source: Eurostat.

As a result of EU membership the business cycles of Spain and Portugal are more in sync with one another as one would expect after almost 20 years of belonging to the same economic club. While a rise in cross-country business cycle correlation has also been experienced by other European countries, it has been relatively more pronounced for Iberian regions[7].

As well as a much larger economy, and one that has generally performed better, Spain also has the advantage of a more dynamic private sector than Portugal's. This is not to belittle the efforts that Portugal has made in some quarters to create stronger private companies. The sheer size of the Spanish economy (five times larger than Portugal's in purchasing power parities) makes it easier for Spanish companies to become bigger through mergers and acquisitions and so attain critical mass and economies of scale. Spanish companies have been much bolder in venturing abroad, most clearly exemplified by the massive direct investment in Latin America.

Both countries are now experiencing the relocation of domestic and foreign companies to lower-cost countries, particularly to some of the eastern and central European countries that joined the EU in May and to Morocco. Portugal's labour costs are still substantially lower than Spain's but they are much higher than countries like the Czech Republic and Hungary. The decline in the competitiveness of the Spanish and Portuguese economies is underscored by the 2004 IMD World Competitiveness Yearbook. Spain slipped from 27th position in 2003 to 31st in the ranking of 60 countries and regions and Portugal stayed put at 39th (see Table 5).

[7] See 'Economic Integration and Regional Business Cycles: Evidence from the Iberian Regions' by Salvador Barrios and Juan José de Lucio, *Oxford Bulletin of Economics and Statistics*, Volume 65 2003, pp 497-515. The authors measure the business cycles of Spain and Portugal with employment figures for the 1988-98 period. One could also measure it with GDP. They then calculate to what extent the business cycles of the two countries are correlated with each other and also the correlation between Spain's 17 autonomous regions. The same is done for Portugal's regions. This gives a benchmark for comparison. One would expect the Spain-Portugal correlation to be lower than the regional correlations within each country. The size of that gap is the so-called border effect.

Table 5. Decline of Competitiveness in Spain and Portugal

	2004	2003	2002	2001	2000
Spain	31	27	23	24	25
Portugal	39	39	33	32	28

Source: IMD Competitiveness Yearbook 2004.

There is a tendency among some Portuguese private companies to play the victim card and seek government help from the Spanish onslaught, but Portuguese governments have shown little sympathy with the idea of state mollycoddling to help companies stand up to their Spanish rivals.

Trade

Trade between Spain and Portugal has been growing at a fast pace since both countries joined the EU in 1986. Until the 1980s, trade was not very significant: Spain supplied 5.5% of Portugal's total imports in 1980 and took 3.6% of Portugal's exports. Between 1994 and 2003 the volume of Spain's exports to Portugal more than doubled and its imports from Portugal also rose by a similar amount (see Table 6). Portugal was Spain's fourth largest export market in 2003, taking almost 10% of its total exports and supplying 3.2% of Spain's imports (see Table 7). The relative significance of these figures is more dramatically emphasised when they are seen in the light of Portugal's (much smaller) overall trade. Spain took 30% of Portugal's total exports in 2003 and supplied 22% of its imports (see Table 8).

Table 6. Trade Between Spain and Portugal, 1994-2003 (US$ mn)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Exports to Portugal	5,720	7,521	9,039	9,720	10,453	11,321	11,031	11,811	12,663	15,013
% of total exports	7.8	8.3	8.7	9.0	9.2	10.0	9.5	10.1	10.1	9.6
Imports from Portugal	2,527	3,349	3,642	3,437	3,818	4,162	4,291	4,337	5,092	6,726
% of total imports	2.7	2.9	2.8	2.7	2.7	2.7	2.7	2.8	3.1	3.2

Source: ICEX.

Table 7. Spain's Main Trading Partners, 2003

	% of Total Exports	% of Total Imports
France	19.0	23.6
Germany	12.0	16.0
Italy	9.7	9.0
Portugal	**9.6**	**3.2**
United Kingdom	9.3	6.4
United States	4.1	3.7

Source: ICEX.

Table 8. Portugal's Main Trading Partners, 2003

	% of Total Exports	% of Total Imports
Spain	**22.6**	**29.1**
Germany	15.1	14.5
France	12.6	9.8
United Kingdom	10.4	4.7
Italy	4.7	6.3
Belgium	4.3	2.7

Source: ICEP.

Spain has run an increasingly large trade surplus with Portugal (US$3.2bn in 1994 and US$8.2bn in 2003). Portugal's trade coverage ratio with Spain has steadily declined and in 2003 only 54% of its imports were covered by exports. Spain's main exports to Portugal are motor industry components, cars and steel, while Portugal's to Spain are chemical products, clothing and also motor components (see Tables 9 and 10).

Table 9. Spain's Main Exports to Portugal, 2003

	% of Total Exports to Portugal
Motor industry components and accessories	8.3
Cars	5.4
Steel	4.0
Fuel and lubricants	3.8
Plastic raw materials and semi manufactures	3.7
Computer hardware	3.5

Source: ICEX.

Table 10. Spain's Main Imports from Portugal, 2003

	% of Total Imports from Portugal
Chemical products	10.2
Clothing	10.1
Motor industry components and accessories	9.8
Steel	7.1
Bottles and packaging	4.4
Wood and paper semi-manufactures	4.2

Source: ICEX.

Galicia and Northern Portugal

Nowhere are the ties between Spain and Portugal stronger than between Galicia and Northern Portugal. The two regions, on either side of the border, with a shared history, culture, language and economy, particularly in fisheries, form what is called a Euro-region. Their combined population is more than 6 million. They work closely together on various projects which have helped to boost the development of two of the poorest regions of the EU-15 and overcome their peripherality on the edge of Europe. Galicia's per capita GDP is 66.5% of the EU-15 average and North Portugal's 57% (see Table 11).

Both regions qualify for structural funds from the EU as their per capita GDP is less than 75% of the EU average (known as Objective 1 regions). However, the EU enlargement as of May 2004 has sharply reduced the average per capita income and as a result of this 'statistical effect', it is not completely certain that Galicia will still qualify for structural funds for the 2007-13 budgetary period Portugal's three regions, however, are likely to continue to receive funds.

Table 11. Poorest Regions in the EU-15*

	EU-15 = 100
Central Portugal	57.8
Northern Portugal	56.9
Azores (Portugal)	55.7
Galicia (Spain)	66.5
Extremadura (Spain)	53.5

(*) Latest figures, 2001.
Source: Eurostat.

The relationship between Galicia and North Portugal was strengthened in 1991 with the creation of a Working Community between the two regions. The so-called Territorial Co-operation Communities combine all the Galician town councils and Portuguese municipal councils along the border. There is also official co-operation between trade unions, consumer institutes and employers' associations. As an autonomous region Galicia is able to negotiate some matters directly with the Portuguese government in Lisbon without having to refer them to Spain's central government in Madrid.

The most important future project is a high-speed train link between Vigo and Porto scheduled to be operating in 2009 (see Map 2).

Both regions have dynamic private sectors (Galicia, for example, is the home of the world-renowned fashion group Inditex and Porto is the bastion city of Portuguese entrepreneurs). Trade between the two is substantial and very much in Galicia's favour (see Table 12).

Table 12. Trade between Galicia-Portugal (€ mn)

	Exports	Imports
1998	1,084	508
1999	1,191	651
2000	1,418	783
2001	1,677	920
2002	1,674	996
2003	1,676	1,070

Source: Spanish Customs.

Direct Investment

Spanish direct investment in Portugal is concentrated in the financial, construction and department store/supermarket sectors, but there is also investment in many other areas including electricity, services (for example, security and IT), petrol stations and tourism. Spanish gross direct investment in Portugal averaged €1,111 million a year between 1993 and 2003, compared with €1,196 million of annual Portuguese investment in Spain over the same period (see Table 13). Portugal's figure, however, is artificially swelled by €9,169 million in 2001 which was largely invested in foreign securities holding companies (known as ETVEs, whose tax treatment is better in Spain than in Portugal) and is not direct investment in the accepted sense. Excluding the 2001 figure, Portugal's annual gross direct investment in Spain was €362 million.

Table 13. Spanish Gross Direct Investment in Portugal and Portuguese Gross Direct Investment in Spain, 1993-2003 (€ mn)

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
In Portugal	462	370	1,352	497	740	467	790	3,454	1,140	1,033	1,916
In Spain	141	83	92	164	96	228	149	1,844	9,169*	1,086	107

Note: figures rounded up to the nearest decimal.
(*) Including funds in ETVEs (foreign securities holding companies).
Source: Spain's Directorate of Trade and Investment.

The largest Spanish owned company in Portugal in terms of the number of employees is the Totta banking group of Grupo Santander, followed by the security services company Prosegur (see Table 14). Banco Bilbao Vizcaya (BBVA) owns a smaller bank (see following section) and the insurance company Mapfre is active in all types of insurance. Overall, Spanish-owned banks and insurance firms employ close to 9,000 people in Portugal, according to a study in 2003 by the Spanish Chamber of Commerce and Industry in Portugal. Of the 3,000 Spanish companies in Portugal, 50 of them employed around 30,000 workers and the other 2,950 companies are believed to employ more than 100,000 people. The study is not conclusive, however, because many companies did not provide information as they were sensitive about it becoming public and provoking an anti-Spain backlash.

Table 14. Spanish Companies in Portugal with the Largest Number of Employees

Company	Number of Employees
Totta (banking)	6,579
Prosegur (security)	4,041
Somague (construction)	3,431
El Corte Inglés (department store)	2,000
Inditex (clothing)	1,233
BBVA (banking)	1,110

Source: Spanish Chamber of Trade and Industry in Portugal.

Spanish companies' share of the Portuguese construction sector is estimated at around 30%. The big Spanish firms, Sacyr Vallehermoso, Ferrovial, Dragados and FCC, which have wide experience of working abroad, are all in Portugal as well as many much smaller ones. Spain is currently enjoying a construction boom; the sector generates close to 20% of GDP (less than 10% in Portugal). Portugal's main investment in the Spanish construction sector is via Cimpor, the big cement company, which has more than 25 plants.

The Portuguese construction sector is much more atomized than Spain's and thus ripe for mergers and acquisitions: the 10 largest companies generate around 11% of activity compared with 45% in Spain. Sacyr Vallehermoso acquired Somague, Portugal's largest construction company. Somague has business in Brazil, China and African countries such as Angola (a former Portuguese colony).

El Cortes Inglés, Inditex and Cortefiel, the main Spanish department store and fashion chains, are also major players in Portugal. El Corte Inglés built its first store outside of Spain in Lisbon while Inditex has 200 Pull & Bear, Zara, Massimo Dutti, Bershka, Stradivarius, Oysho, Kiddy's and Zara Home shops. One-quarter of Inditex's 800 shops outside of Spain are in Portugal.

In petrol and other fuels Cepsa, Propel (owned by Cepsa) and Repsol all operate service station networks in Portugal. Cepsa was first off the mark in 1989 and today has more than 150 service stations and a market share of around 8%. Repsol almost quadrupled its share of the market from 5% to 19% in July 2004 in one swoop when it acquired Shell's 303 service stations in Portugal. In October it agreed to purchase Borealis Polimeros, the Portuguese subsidiary of the Danish company for €200 million. Galp, the Portuguese company, is the market leader with 45%. Galp, with 5% of Spain's market, wanted to acquire Shell's 360 stations in Spain. Repsol is barred from increasing its network of service stations in Spain until 2005 under liberalisation measures approved in 2000.

As a country with an agricultural sector that is still relatively strong, Spain is Portugal's leading supplier of meat, fish, dairy products, vegetables and fruit. Fish, for example, are the sixth largest Spanish export to Portugal, even though the country is also a fishing nation. Several Spanish food companies have strong positions in Portugal including Pescanova and Panrico.

Banking

Portuguese sensitivity to Spanish investment was most clearly highlighted by Santander Central Hispano's (SCH) attempt in 1999 to forge an alliance with the Champalimaud group. Antonio Champalimaud, Portugal's richest individual, agreed to sell to SCH his family's 40% controlling stake in Mundial Confiança, an insurance company, which in turn controlled Portugal's third-largest financial group. The Portuguese government blocked the deal, ostensibly because it said insurance sector regulations had been breached, even though the European Commission had given its blessing to the sale. The legal battle ended with a negotiated settlement that gave Champalimaud a 4% stake in SCH in return for his 52% holding in the Portuguese group. The state-owned Caixa Geral de Depósito, Portugal's biggest bank by assets, then acquired this stake from SCH before selling Banco Totta & Açores and Crédito Predial Português back to SCH.

In 2003, Santander (which first established itself in Portugal in 1988 when it acquired 10% of Banco Comércio e Indústria and largely pioneered pure investment banking activities in the country) bought Royal Bank of Scotland's 13% stake in Banco Santander Portugal (BSP), bringing its stake close to 100%. Santander owns three banks, Banco Totta e Açores (universal bank), Crédito Predial (mortgage lending) and BSP (high net worth and urban customers), as well as an investment banking arm, Banco Santander de Negocios. Through its ownership of Totta, Santander has a representative office in Johannesburg.

Santander Totta is the fourth-largest banking group in Portugal by assets and the third ranked private sector banking group (see Table 15). It has a market share of around 11% and generates some 10% of SCH's overall earnings. In key products such as mortgages, insurance or mutual funds, Totta's market share exceeds 15%. Overall, Santander is the largest bank in the Iberian Peninsula. Its total assets (it is a major player in Latin America) surpass the combined assets of all the banks in Portuguese hands. The same goes for Banco Bilbao Vizcaya Argentaria.

In 2002, SCH made Portuguese one of its two official languages, on a par with Spanish. This has far-reaching implications and reflects the group's strategy of focusing on southern Europe and Latin America while maintaining strong local roots and domestic brands.

Table 15. Main Banks in Portugal (*)

	Strength Tier 1 Capital (US$ mn)	Size Assets (US$ mn)	Soundness Capital Assets Ratio (%)	Return on Assets (%)	Cost/Income Ratio (%)	BIS Capital Ratio (%)
Banco Comercial Português	4,819	85,486	5.64	0.79	63.55	11.8
Caixa Geral de Depósitos	3,640	93,676	3.89	1.1	58.9	9.8
Banco Espírito Santo Group	3,271	54,664	5.98	0.83	50.61	13.13
Banco Totta & Açores	1,806	36,403	4.96	1.1	49.91	10.5
Santander Central Hispano	21,408	444,012	4.82	1.17	63.1	12.43
Banco Bilbao Vizcaya Argentaria	18,176	362,655	5.01	1.33	56.77	12.7

(*) Figures for 2003.
Source: The Banker, July 2004.

Banco Bilbao Vizcaya (BBV), as it was called before it merged with Argentaria to form BBVA, Spain's second largest bank, was the first Spanish bank to buy an outlet in Portugal when it acquired Lloyds Bank's retail network (first established in 1862) in 1991. BBVA has a market share of around 1% in Portugal and concentrates more on the medium and high income segments. Francisco González, BBVA's chairman, denied reports in 2003 that the bank was looking to increase its presence in Portugal by acquiring another bank. He said BBVA would grow organically in the country, but this has not quelled the speculation that it would like to buy another bank. Such a move would be fiercely resisted by the Portuguese authorities.

The much smaller Banco Popular, the most efficient bank in Spain with the highest return on equity, owns Banco Nacional de Crédito Inmobiliario (BNC) with more than 100 branches. BNC has 4.5% of Popular. The Barcelona-based Banco de Sabadell, which acquired Banco Atlántico in 2004 from the Arab Banking Corporation, and Banco Comercial Português (BCP), Portugal's largest private sector bank, also have a crossed-shareholding agreement. Sabadell owns 3.1% of BCP and BCP 3% of Sabadell. Each bank can increase its stake to a maximum of 20%.

Caixa Geral de Depósitos, the state-owned savings bank and Portugal's largest bank, also bid for Banco Atlántico but lost to Sabadell. Caixa's bid was only €50 million less than Sabadell's €1,500 million and it did not make a counter offer. The regional government of Catalonia admitted before the sale that it preferred Banco Atlantico to be acquired by a Catalan or Spanish bidder rather than a foreign one. This raised speculation that Caixa Geral lost the bid for 'political' reasons.

Spain's savings banks are also present in Portugal. Caja Duero, Caixanova, Caixa de Galicia and Caja Madrid all have one or more branches in the country.

Portugal's main banking presence in Spain is through Caixa Geral de Depósitos, which acquired Banco Extremadura from Banco Bilbao Vizcaya in 1991, Banco Luso Espanhol from Chase Manhattan in 1991 and Banco Simeón from Argentaria in 1995. The combined market share of the three banks is small. Banco Espírito Santo is also present in Spain. It has a small network of branches and also acquired two Spanish brokerage houses, Benito y Monjardín and GES Capital.

Telecommunications
Telefónica Móviles (TEM), the mobile telephone arm of Telefónica, and Portugal Telecom (PT), the dominant telecommunication groups in each country, have a crossed shareholding agreement and a strategic alliance for North Africa and Latin America. Telefónica has 8% of PT (and can raise it to 10%) and PT less than 1% of Telefónica (1.5% ceiling). The two groups pooled their interests in Brazil to create Vivo, the commercial name of Brasilcel, a 50-50 joint venture and the largest mobile telephone operator not only in Brazil but also in the southern hemisphere. Vivo has more than 23.5 million clients, giving it a market share of 56% in its areas of operation and 45% for the whole of Brazil. TEM and PT spent €430 million during the last part of 2004 on increasing their stakes in four companies: Telesudeste Celular (from 86.7% to 91%), TeleLeste Celular (from 27.9% to 50.6%), CRT Celular (from 51.5% to 67%) and Tele Centro Oeste Celular (from 28.9% to 50.6%).

In Morocco, TEM and PT are partners, along with a group of local investors, in a GSM cellular operator called Médi Telecom, known by its commercial name as Méditel (market share of 43%).

While Brazil is the only country in Latin America where PT operates, Telefónica is the mobile telephone leader on its own in Argentina (1.9 million subscribers in March 2004), Chile (2.5 million) and Peru (1.6 million) and second in Mexico (3.7 million). Its position in many Latin American countries was greatly strengthened by acquiring all of Bell South's cellular assets in the region in March 2004. This acquisition added 11.6 million customers and made Telefónica the world's fourth-largest mobile phone operator by client numbers.

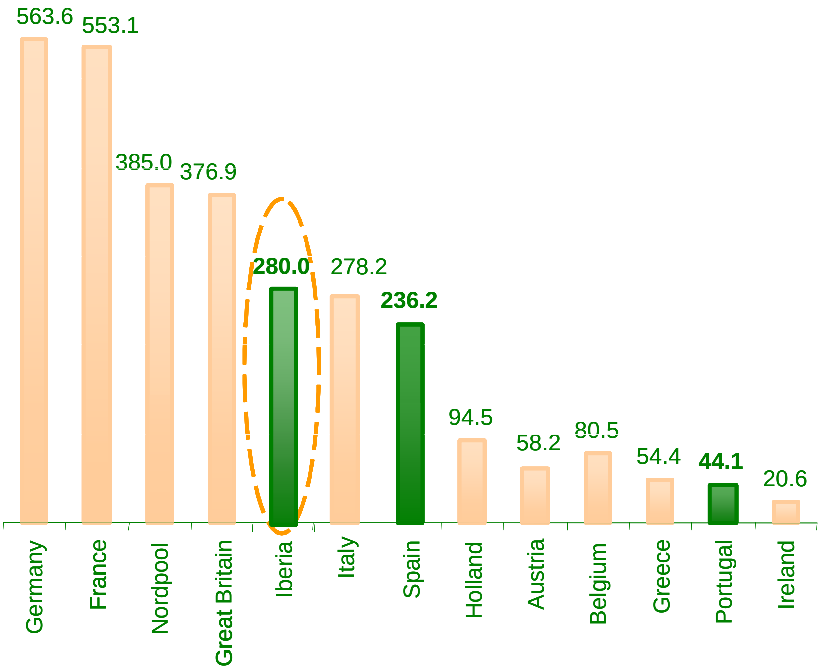
The Brazilian cellular market has substantial growth potential. Mobile telephony penetration in Vivo's areas of operation at the end of the first quarter of 2004 was 30%, well below figures for other markets with similar per capita income. Vivo's customer base rose by 1.2 million in the first quarter.

Telefónica increased its stake in PT from 4.8% to 8% in April 2004 and denied it was seeking to increase its holding in Vivo and gain majority control.

Single Iberian Electricity Market (MIBEL)
The much delayed single electricity market for Spain and Portugal, agreed in November 2001 with an original start-up date of January 2003, will not begin until June 2005. It would be Western Europe's fifth-largest power market after Great Britain (see Table 16). Spain and Portugal have limited natural energy resources and need a competitive and well supplied power market to realise their full economic potential.

The two market operators, OMEL (Spain) and OMIP (Portugal), have exchanged 10% of their shares, but the Portuguese stranded costs recovery framework has not been approved and the development and harmonisation of the necessary regulations in both countries is still pending. OMEL would be responsible for the daily (spot) market and OMIP in charge of secure long-term energy supplies.

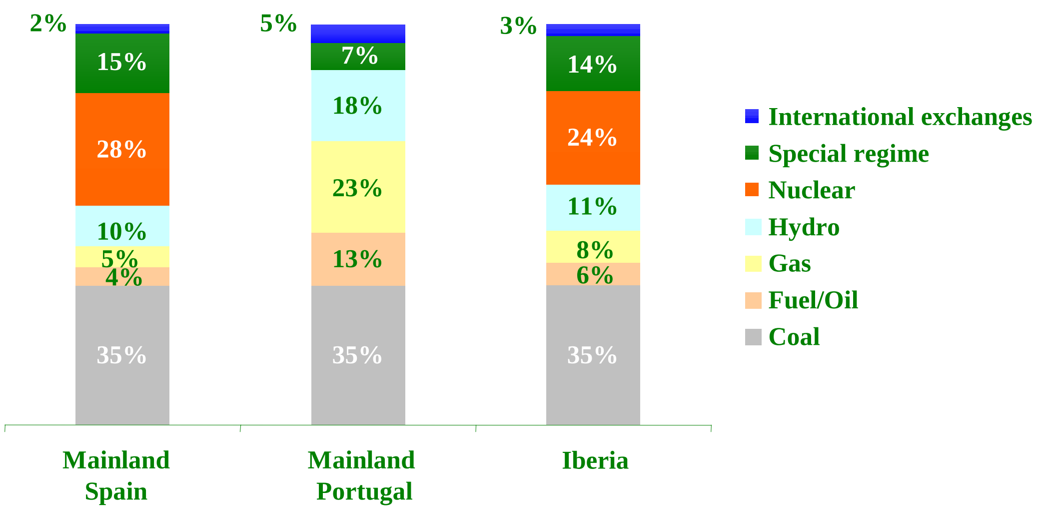
Table 16. Iberian Market – Relative Size (2003 production, TWh)



Source: International Energy Agency and Iberdrola.

Both markets are reasonably similar as regards generation. The Spanish market is more diversified as it has nuclear energy (see Table 17). The degree of competition, however, varies considerably. The Spanish generation market is liberalised, with six significant producers, four of which are large national companies and two are controlled by European utilities. More companies are joining the market. Interconnections with Morocco, France and Portugal allow producers to operate on equal terms in the market via pool purchases and/or sales.

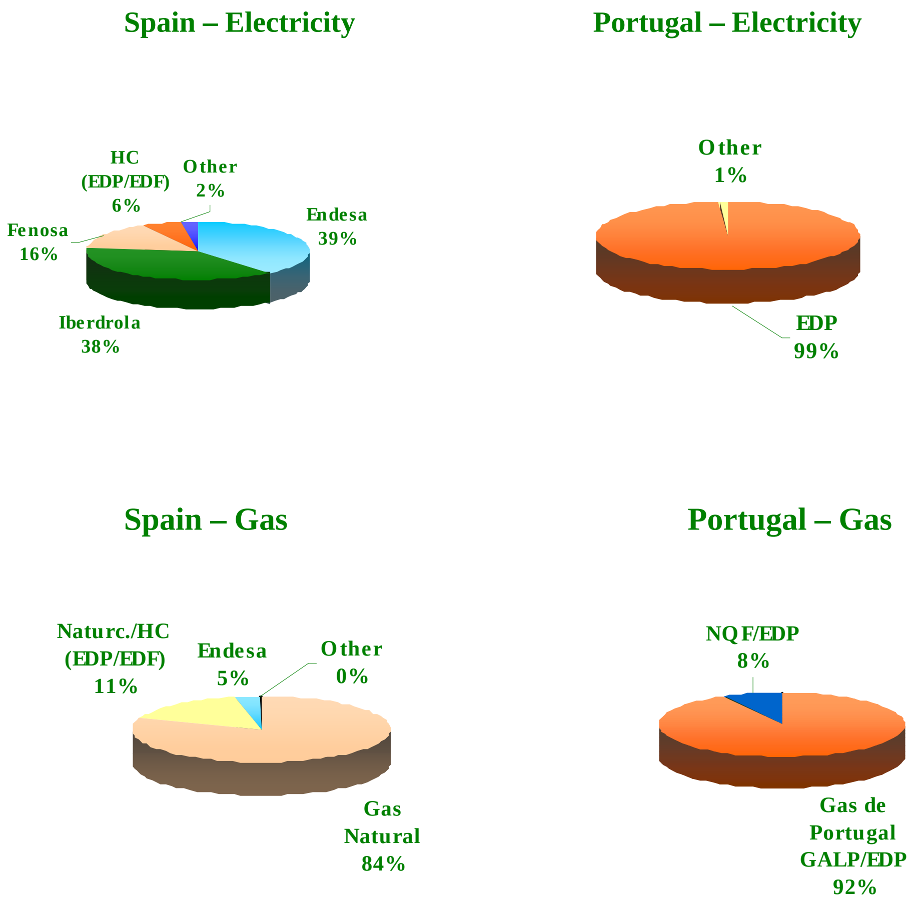
Table 17. Generation Mix, 2003



Source: Country reports.

The Portuguese market, however, is dominated by Electricidade de Portugal (EDP), 26% owned by the state, which has an 82% share of generation and almost 100% of distribution (see Table 18). In contrast, the respective figures for Endesa, the leader in Spain, are 44% and 38%. Portuguese consumers stand to benefit more than Spanish ones from competition as their prices would fall to a greater extent.

Table 18. Electricity and Gas Distribution – Market Shares, 2003



Source: Company reports.

MIBEL has spurred a number of deals in the countries' electricity sectors. In December 2001, EDP acquired 40% of Spain's Hidrocantábrico, giving it a large foothold in the Spanish market. EDP, however, was not able to fully exercise its voting rights in EDP until agreement was reached over creating MIBEL and the interconnections between Spain and Portugal were strengthened. The Spanish government was able to limit the voting rights of a foreign or domestic company that acquired a significant stake in a utility to 5%. The original idea of this law was to prevent foreign companies from controlling privatised companies. EDP took full control of EDP in July 2004 after buying out the other shareholders.

In March 2003, EDP through Hidrocantábrico acquired 62% of Naturcorp, the natural gas distributor in the Basque Country, making it the second largest gas operator in Spain as Hidrocantábrico also owns Gas de Asturias. In October 2002, Endesa and Portugal's biggest industrial holding company Sonae launched a 50:50 joint venture electricity distribution company, Sonae Comercialización de Energía (Sodesa) which supplies close to 30% of the Portuguese market.

Even if there was a total and immediate liberalisation of the Portuguese market tomorrow, there would still be other issues to resolve to make the single market an effective reality.

The main one is the limited capacity of the interconnections between the two countries. Maximum interconnection with Portugal on winter peak demand is around 2%. This is projected to double by 2006, lower than the EU's objective of 10% interconnection for Europe's six satellite markets, seen as necessary to achieve the full benefits of market liberalisation. Price harmonization cannot be achieved until there is increased interconnection of the countries' grids. The construction of the second Cartelle-Lindoso interconnector is a step in the right direction but this increase in capacity is not enough.

Convergence of Iberian gas markets is also under study. Because of Portugal's geographic location, much of its energy imports are transported through Spain. The completion of the Maghreb-Europe pipeline in 1996, which connected the Iberian Peninsula to Algerian natural gas sources, has enabled Spain and Portugal to boost gas consumption.

The five distributors in Spain give the regulatory body a frame of reference to indirectly encourage efficiency by comparison. In contrast, in Portugal EDP controls more than 90% of gas distribution (via Gas de Portugal) as well as 100% of electricity distribution. Iberdrola controls two small gas distribution companies in Portugal. In Spain Gas Natural, the dominant player, has a market share of more than 80%.

As distribution is regulated, it could be argued that such domination is not a problem. However, antitrust authorities believe that the internal barriers to new entrants created by companies undertaking both electricity and gas distribution should not be underestimated. Full control of the distribution in a country as well as ownership of other activities create inefficiencies and encourage cross-subsidies. Territories where a participant can simultaneously distribute electricity and gas need to be reduced to the minimum in both countries. The agreement signed in February 2004 between the Portuguese government and Iberdrola, which allowed the latter to gain control of two small gas distribution companies, is an important step in the right direction.

Electricity and gas supply are at different stages of liberalisation. In Spain, since 1 January 2003, all customers are able to freely choose their provider, in gas as well as electricity. As a result, 23 million electricity customers and 5 million gas customers have full freedom of choice. Approximately 31% of electricity is supplied through the liberalised market. Advances in the gas market are significantly greater: 75% of the total supply is liberalised.

In Portugal, since January 2002, all mid-voltage (1kV) customers are eligible to switch suppliers, which represented in 2003 around 3,900 GWh. As of 1 July 2004 all customers were able to switch suppliers.

But there is no liberalisation in gas supply in Portugal. Service to residential and commercial customers is done through several distribution companies, mostly owned by Gas de Portugal which EDP and the Italian energy group Eni sought to acquire in August. The European Commission sent a formal charge sheet in October raising concerns over the deal. The Commission is concerned that the deal would remove a natural competitor to EDP in the electricity generation market and raise the entry barriers to other groups seeking to break into the Portuguese market. The deal would give the combined entity a huge customer base and create the only vertically integrated gas and electricity provider in the Portuguese market. Unless the companies can satisfy the Commission's objections, the deal is likely to be either prohibited or require concessions like divestments. Spanish players in MIBEL support the acquisition with certain conditions such as opening the electricity market to new generators.

Gas supply to major users is provided by Transgas with the possibility of negotiating the tariff if yearly consumption exceeds 68GWh.

Portugal needs to accelerate the liberalisation of its electricity market. This would involve the privatisation of EDP or a substantial reduction in the state's shareholding, perhaps through a capital rights issue not subscribed by the company. The European Commission also needs to clarify the issue of a mechanism that enables EDP to compensate for the breaking of existing long-term contracts but without giving it an unfair advantage. Such a mechanism is not needed in Spain as the market is already fully liberalised.

Conclusion
The degree of integration of the Spanish and Portuguese economies is already high and is bound to increase, particularly in an enlarged EU of 25 countries which will continue to add new members (Bulgaria and Rumania in 2007 and possibly Turkey in 2015). The enlargement has put Spain and Portugal back on the periphery of Europe; the two countries need each other in order to counterbalance the EU's expansion to the East. The entry of former communist nations with much lower labour costs is eroding one of the previous competitive advantages of the two countries for multinationals, and Spanish and Portuguese companies are also beginning to relocate. Economically, at least, it would make sense for Spanish and Portuguese companies to forge closer links, either through outright mergers or more indirectly through crossed-shareholding agreements. Spain and Portugal are ripe, for example, for a cross-border merger of banks. Politically, however, it is another matter.

Appendix 1. Main Spanish Acquisitions and Investments in Portugal
The Portuguese company partly, majority or fully owned by the Spanish company is in brackets (along with the sector to which it belongs).

- Acesa (Brisa, motorways)
- Banco Bilbao Vizcaya Argentaria (acquired Lloyds Bank)
- Banco Popular (Banco Nacional de Crédito Inmobiliario, banking)
- Banco Sabadell (crossed-shareholding agreement with Banco Comercial Português)
- Caixa Galicia (Galician savings bank plans to open 60 branches by 2008 in Portugal)
- Campofrío (Fricarnes, meat)
- Cepsa (petrol stations)
- CIE Automotive (Plasfil, motor industry components)
- Corporación Industrial Egaña (CIE) (Plasfil, motor industry components)
- Cortefiel (own clothing shops as well as Springfield and Women's Secret)
- Dragados (Sopol, construction)
- El Corte Inglés (shopping centre in Lisbon)
- Endesa (Portugal Tejo Energía and Pegop, electricity)
- Europac (Cartopor, Papel do Ave and Gescartão, paper)
- FCC (Ármalo Rosa Cobetar, construction)
- García Baquero (Lacticínios Âncora, milk)
- Gestamp-Gonvarri (Tavol)
- Halcón (travel agency)
- Iberdrola (electricity)
- Inditex (Zara, Pull & Bear and Massimo Dutti clothing shops)
- Indra Sistemas (IT)
- Industrias Titán (Tintas Leme, paint)
- Mapfre (insurance)

- Pescanova (fish)
- Prosegur (security)
- Recoletos (Económica SGPS, publisher of Diário Económico)
- Repsol (petrol stations)
- Roca (Sanitana, bathroom equipment, and construction of a plant to make taps)
- Sacyr Vallehermoso (Somague, construction)
- Grupo Santander (Totta Group)
- Spanair (code share agreement with Portugalia, airline)
- Telefónica (Vivo, joint venture with Portugal Telecom in Brazil, and crossed-shareholding)
- SOS Arana (SIPA, rice)
- Uralita (construction of building materials plant)

Appendix 2. Main Portuguese Acquisitions and Investments in Spain
The Spanish company partly, majority or fully owned by the Portuguese company is in brackets (along with the sector to which it belongs).

- Banco Comercial Português (crossed-shareholding agreement with Banco Sabadell)
- Banco Espírito Santo (Benito y Monjardín and GES Capital, financial group)
- Barbosa & Almeida (Vilesa, glass containers)
- Brisa (Acesa, motorway concessions)
- Caixa Geral de Depósitos (Banco Extremadura, Banco Simeón and Banco Luso Espanhol, banking)
- Cimpor (Corporación Noroeste, cement, 18 plants bought from Readymix Asland and seven from Italcimento)
- CIN (CROS Pinturas, Pinturas Lobo, DISA Pinturas, paint)
- Colep (Censa, bottles)
- Electricidade de Portugal (Hidrocantábrico, electricity)
- Ferpinta (steel tubes)
- Finantia (Banco Finantia Sofinloc, banking)
- Fisipe (Acordis, acrylic fibres)
- Galp Energia (more than 240 petrol stations)
- INAPA (distribution of paper)
- Lactogal (dairy products)
- Logoplaste (packaging)
- Nutrinveste (Agribética, olive oil)
- Portugal Telecom (Vivo, joint venture with Telefónica in Brazil, and crossed-shareholding)
- Portugalia (code share agreement with Spanair, airline)
- Quimigal (Elnosa, chemicals)
- Sanindusa (Unisán, bathroom equipment)
- Sonae (Tafisa, woodpanels; joint venture with Endesa, electricity distribution, and shopping centres)
- Sotancro (Vidriera del Atlántico, glass)
- Teixeira Duarte (GSC, environmental services)

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