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THE SPANISH ECONOMIC EXPERIENCE: LESSONS AND WARNINGS FOR LATIN AMERICA

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Executive Summary (1):

(1) Spain's success in creating a thriving and prosperous market economy out of the stagnation and isolation which characterized the autarchic, state-dominated economy of the early Franco era has become a provocative reference point for other economies engaging in market reform, particularly in Latin America.

(2) Spain's transition to a market economy has been long and gradual. It has also enjoyed a benign, even positive, external environment throughout most of the period of liberalization and opening.

(3) The sequencing of Spanish reforms allowed for an extended period of intense growth during the early phases of transition, from the late 1950s until the early 1970s, facilitating the creation of a domestic consensus for further economic reform.

(4) Spain avoided a significant build-up of external debt throughout its long transition, and also remained free of externally imposed policy conditionality during the early phases of reform –at least until it began to negotiate its entry into the European community after the democratic transition–. This benevolent external financing environment was also strengthened by the noticeable economic aid Spain received during the 1950s and early 1960s from the US and by the significant EU transfer payments it enjoyed during the late 1980s and 1990s.

(5) Integration into the EC, and later the EU, has been an indispensable tool in Spain's market transition process and has significantly contributed to sustained growth and prosperity. The tangible prospect of Spanish entry into the European single market always made Spain a much more attractive destination for investment than had this possibility never really existed. It also served as the fulcrum for sustaining consensus on, and momentum towards, deeper market reform.

(6) The end result has been that over the last 50 years, Spain has implemented the entire corpus of the so-called Washington Consensus –including stabilization, liberalization, structural reform and institutional transformation and modernization–. Real per capita income has increased nearly six-fold during this period of market transition. Importantly, Spain has retained a higher degree of 'national ownership' over its reform process than in most other transition cases.

(7) Latin American economies have not enjoyed such a benevolent external economic and political environment over the course of their reform efforts. Nor have they remained free of external debt or policy conditionality. Likewise, the pacing and sequencing of Latin American reform efforts have been quite different from those in Spain. In the end, the region's economies have never been able to develop significant and sustainable

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economic growth as a result of their market reforms, nor have they been capable of maintaining sufficient domestic consensus to continue on the road to complete market transition without debilitating interruptions.

(8) While Latin American economies cannot hope to replicate the Spanish model so successfully, further regional economic integration, along with continued market and institutional reforms, represents the strategy with the most likely chance of success.

Introduction

Ever since the collapse of the communist system, Spain has become a frequent point of reference for societies engaged in a transition to market democracy. Countries from the former 'second' and 'third' worlds have increasingly pointed to Spain as a possible model for their own democratic and market reforms. Spain's success in consolidating a multiparty democratic system out of the troubling legacy of the Franco dictatorship, and in generating a prosperous market economy from what had become, by the early 1950s, a textbook study in autarchy and state economic control, has rightly been considered worthy of serious further study.

While the Central and Eastern European countries were the first to formally use the rhetoric of Spain as a transition model –understandably, given the timing of their transitions, the clear-cut nature of the task after 1989 and the obvious prospect of their entry into the European Union– with time, the comparison has been made more and more with respect to the new democracies and incipient market economies of Latin America.

True, the Spanish case is somewhat unique. Before it began its dual transition to market democracy, Spain had more in common with the state-dominated fascist economies of the former axis powers (dismantled and rebuilt by the allies after WWII) than with the command economies of the communist bloc and the various 'socialisms' and 'populisms' of the developing world. Nevertheless, a broad range of features which characterized its pre-transition economic model make it an interesting case for comparison.

Spain's economic model during the first half of the Franco regime had much in common with the so-called import substitution industrialization (ISI) models of Latin America and other developing countries. Trade protectionism was very high, particularly against final consumer goods, which were discouraged through a system of import tariffs, quotas and other trade controls. Despite the continuing existence of a private sector during even the height of Franco's autarchic, nationalist model, the degree of state ownership, intervention and regulation was also quite significant, particularly within the so-called 'commanding heights' of the economy, including heavy industry, communications and transport infrastructure, and the energy sectors. What is more, the Spanish private sector enjoyed either significant state protection or subsidies. Price controls and state subsidies were common features in the majority of sectors. Even the agricultural sector exhibited a high degree of state regulation and price control (although it was one of the first sectors to experience some reform). Foreign investment flows were tightly regulated and a typical system of exchange controls was in place, giving the state an effective legal monopoly over the ownership of foreign currencies and fiat power over the official exchange rate.

Among the significant differences between the Latin American reform experiences and the case of Spain have been the context, timing, pacing and sequencing of the transition to market democracy. These important differences apart, however, pre-transition Spain did have much in common with Latin American realities. The dominant and often asphyxiating roles of state, church and elites in pre-transition Spain, along with a number of economic realities impeding its growth and development, place Spain in a category where many

Latin American countries, even despite twenty years of reforms, can also be fruitfully compared.

Nevertheless, this analysis of the Spanish experience as a reference for Latin American countries yields rather sobering conclusions. Spain has implemented, over a span of nearly 50 years, the entire corpus of the Washington Consensus –including stabilization policies, market liberalization, structural reform and institution building and transformation. Spain's transition to market democracy, however, has been rather long and gradual. Importantly, during the first phases of economic transition, Spain never lost nor surrendered its policy autonomy, and therefore remained free to define the architecture of its own reforms and set its own pace. Spain also received significant economic assistance, free of policy conditionality, during the early phases of economic transition, and enjoyed an increasingly positive external economic and political environment during the first 15 years of this process of economic transformation.

Furthermore, at the beginning of this process, in the late 1950s, Spain had no explicit game plan for market transition (and would not begin to develop one until Franco died in 1975). Most policymakers in the Franco regime did not even conceive of early reform as the first step on the road to a liberal market economy. While some of those responsible for executing the first liberalizations might have held out the hope that, with time, they might be followed by further reform, there were others in the Franco regime who only accepted the early reforms grudgingly and out of a painful sense of pragmatism. In these reluctant circles, economic reform was viewed as an inconvenient necessity that, while remaining limited, might nevertheless shore up the regime.

The detonating factors which pushed the regime towards limited economic opening and liberalization were intense inflationary pressures and severe external imbalances which simply could not be sustained in light of the excessively closed and regulated nature of the economy. In this sense, the origins of Spanish market reform bore much in common to Gorbachov's *perestroika* programme, conceived of as a strategy for injecting some essential oxygen into the economy so that the regime might be further legitimized. The results, however, were remarkably different –as was the external economic and political environment facing Spain– allowing further market reform, at a later date and under a new political regime, to proceed fairly smoothly.

Spain's early reforms were limited and controlled, but they delivered the goods –the rapid growth of the 1960s–. This early success was to become extremely important as a popular legitimizer for later phases of market reform. When the domestic and international environment became more difficult and complex in the 1970s, Spain quickly seized the opportunity of European integration, and used it as both the stick and carrot for deeper market reform. Spain was therefore able to create and maintain sufficient domestic consensus on economic liberalization and opening despite a severe and extremely painful economic adjustment from 1975 to 1985. As a result, the Spanish economy was able to enjoy a second period of rapid growth during the late 1980s upon entering the EC.

Due to Spain's deepening institutional linkages within the EU, a renewed period of stagnation and instability in the early 1990s was successfully contained and the damage limited, allowing Spain to push on to the final phases of market reform. The drive towards –and successful entry into– the EU's new Economic and Monetary Union (EMU) buoyed the Spanish economy through its third period of extended and intense growth over the last eight years, bringing it to the place it occupies today as the 8th largest economy in the advanced world and one of the most dynamic in the OECD, with a per capita income some 87% of the EU-15 average (2).

Despite the backward position Spain occupied at the end of its Civil War in 1939, compared to the realities of Latin American economies Spain has been quite fortunate, even lucky. The 'Spanish miracle' of creating a market democracy out of the stagnant, rigid and unsustainable realities of the early Franco period has always been intimately bound up with the prospect –and then the reality– of integration into the heart of Europe. As Ortega y Gasset once wrote, 'Spain is the problem, Europe the solution'. While Latin American economies could learn much from an analysis of Spain's experience, they cannot hope to easily duplicate it. The constructive lessons are ultimately all indirect, and the warnings derived from a study of the Spanish case define many of the challenges facing Latin America.

This paper attempts to analyse those lessons and warnings that can be identified from the Spanish experience as relevant for the continuing reflection on optimal policy recommendations for Latin America. The categorization and separation of lessons from warnings is somewhat artificial, given that many of these lessons contain implicit warnings while many of the warnings encapsulate implicit lessons. Nevertheless, for Latin American countries continuing to search for the policy formulas that could consolidate political and economic reforms undertaken to date and propel their societies towards the goal of achieving and sustaining tangible prosperity, such lessons and warnings could be of significance.

Constructive Lessons

Lesson One: Underdeveloped, relatively autarchic and state-dominated economies can develop successfully and sustainably with policies oriented towards economic liberalization, opening to international trade and investment and deeper international economic integration.

At first glance, such a lesson comes as no surprise –and by some, this would be considered self-evident, if not banal–. It is indeed accepted as a basic assumption by the broad consensus on optimal economic policy in the world today. All of the advanced market democracies engineered such a transformation over the last two centuries, although this evolution tended to be a very gradual and organic development from monarchies and mercantilism to markets and democracies. However, since the height of the Cold War period, such a transition has only been achieved successfully and sustainably by Europe's Mediterranean countries, led by Spain, and certain countries in East Asia. Among this limited field, Spain emerges as one of –if not the– most successful and dynamic of transition cases.

On the basis of per capita income, the Spanish case stands out as one of the most striking. In 1959, the year Spain's famous Stabilization Plan put an end to the country's official policy of autarchy, per capita income was well under US$500 a year, barely enough for the World Bank and the United Nations to categorize Spain as something more than a developing country. Today it stands at over US$20,000 both in terms of current exchange rates and purchasing power parity (or some 55% of US levels and around 87% of the EU-15 average). In real terms, this has supposed a nearly 5.5-fold increase since the unveiling of the Stabilization Plan (3). Moreover, this per capita GDP growth has been accompanied by an improvement in general inter-personal income distribution, as the country's Gini coefficient has fallen from over 0.4 to slightly less than 0.3 (4).

A number of other typical criteria for evaluating the extent and sustainability of a transition from underdeveloped to developed economy status also point to Spain's success. The contribution of agriculture to the GDP has fallen to below 4% while the percentage of the workforce engaged in agriculture has also dropped from nearly 50% in the 1950s to around 6% today. The weight of services in the economy has also risen from under 40%

in the 1950s to around two-thirds (5). Throughout the transition to a market-based economy, Spain was generally successful in attracting international investment, and until the mid-1990s the country was a significant net importer of capital. Nevertheless, since 1997, Spain has become a large net exporter of capital. Between 1992 and 2001, as a nation Spain was the world's eighth largest net exporter of capital, most of which was destined for Europe and Latin America (6).

In terms of demographic dynamics, Spain has also seen both its birth and death rates drastically fall during the last 20 years. It has moved through the demographic transition with such force that it now faces a potentially significant ageing crisis in the mid-term future. These demographic trends have been paralleled by a major shift away from net emigration to significant net immigration, generating the kinds of socioeconomic concerns common in the most advanced economies of the West (7). In turn, Spain has been transformed from a net importer of remittances in the 1960s and 1970s to a significant exporter of remittances by the late 1990s.

Indeed, the nature of current Spanish economic dilemmas and policy concerns places it firmly in the camp of advanced market democracies. Spain now debates the nature of its foreign development aid, its role as a foreign investor in emerging market economies, its position as a leader of liberal market reform in Europe, the future of its immigration policies and social security reforms, its ultimate place in the integration of EU financial markets, and, in the words of Spain's outgoing president, its self-perception of having recently entered the 'big leagues' of the international arena (8).

None of this would have been possible or sustainable without well-executed market reform. A strong consensus among economists and informed commentators both inside and outside of Spain maintains that the modernization of Spanish society and the continued deepening and widening of economic prosperity in Spain have been dependent on a thorough transition from a closed, heavily state-dominated economy managed by an authoritarian dictatorship to an open, integrated, (increasingly, if not completely) liberal, market-based democracy.

Lesson Two: The timing, pacing and sequencing of such 'market transitions' –along with the vicissitudes of the international economic and political environment– are important for ultimate and sustainable success.

Viewed in retrospect, the Spanish transition to an integrated market economy has been gradual, prudent and astute, particularly in comparison with the panoply of roughly comparable transitions begun in the wake of the Third World debt crisis and the fall of the Berlin Wall. Most importantly, Spanish market reforms concentrated first, during the late 1950s and early 1960s, only on those limited liberalizations which would likely propel the domestic economy forward, through significant inflows of direct investment and foreign exchange, while leaving tougher structural reforms and financial liberalization, likely to imply tangible economic sacrifices and potential instability, for later stages of transition once the dynamics of liberalization had taken hold in a positive fashion. Furthermore, the earlier stages of Spanish market transition coincided with a benevolent international economic and political environment which –together with a significantly improved domestic and international perception of the Spanish economy– served to underpin and reinforce this early growth.

Paradoxically, most Spanish analyses place emphasis on the supposedly rapid pace of the transformation that the economy and society have undergone. Indeed, one of the strong domestic assumptions in Spain is that both its economic success and its potential future dilemmas have partly been bound up in the unprecedented rapidity of its long series of reforms.

Nevertheless, the origins of Spain's market transition can de dated to no later than the end of the 1950s. Possible dates for the origins of Spain's economic transition include: (a) 1953, when agricultural prices were first partially liberalized (9) and US aid began to arrive in noticeable quantities; (b) 1957, when a new liberally-oriented team of economic advisers coalesced around Franco; and (c) 1958-59, when Spain entered the IMF and launched the well-known Stabilization Plan.

On the other hand, possible reference dates for the conclusion of the Spanish transition might include: (a) 1999, when the Spanish peseta merged with the euro; (b) 2001, when the state's last tranche of shares in Iberia, the former state-owned airline, was floated in a public share auction, representing the completion of the last major Spanish privatization, some 15 years after the divestiture process began; or (c) some undetermined date in the future, when Spain becomes a net contributor to the EU budget, ceases to receive the more than €8bn it currently enjoys in net terms from the various EU spending programmes and transforms its economic growth model from one that relies on *extensive* growth (based on continuing additions to the capital stock and the labour force) to one that relies on intensive growth (based on increases in total factor productivity, stemming from improvements in R&D and innovation, more rapid incorporation of technological advances into economic production and increases in human capital).

Viewed from this perspective, it is difficult to argue that the Spanish market transition has been anything but gradual. Such an evaluation is reinforced by the observation that even China, whose transition is universally labelled as 'gradual,' only began its initial moves towards liberalization in the late 1970s with its first agricultural reforms. Although it is admittedly difficult to neatly apply the polar categories of 'shock therapy' and 'gradualism' to many transition cases, it seems reasonable to argue that Spain's transition, placed in the post-WWII context, has indeed been rather long and gradual, allowing for sufficient consensus to emerge and for workable political bargains to be struck. While the pace of reform has certainly not been uniform since the 1950s, the sequencing of such reforms, along with the external environment which Spain has faced at particular moments along the way, has certainly been an important factor in maintaining momentum and ultimately achieving success.

Aside from being gradual, Spain's transition to a market economy was characterized by a very fortunate sequencing of reforms. Here the Spanish case differs significantly from the majority of Latin American transition experiences in which the bulk of reforms was concentrated first in the 1980s, in the wake of the debt crisis, and then again in the 1990s, in response to the emergence of the Washington Consensus. Presented in broad terms, Spain's transition was sequenced in the following manner.

(1) The agricultural sector was gradually liberalized, beginning with the price reforms of 1953.
(2) Macroeconomic stabilization (including cuts in subsidies and other spending, tax increases, and monetary tightening) was undertaken from 1959 through the early 1960s.
(3) In the early 1960s, the regime engaged in a limited financial opening, with reforms that concentrated on encouraging inflows of foreign direct investment. Accompanying this were a number of other policies which began to encourage both migration of Spanish labour abroad (and the concomitant flow of remittances) and an inflow of European tourism. All three of these policies contributed to a healthy flow of private external finance during the 1960s which conveniently did not imply the direct contracting of foreign debt.
(4) Fiscal reform and the beginning of financial sector reform began in the late 1970s, once multiparty parliamentary elections had been held and a new democratic constitution ratified.
(5) In the late 1970s and early 1980s, a renewed effort at macroeconomic stabilization was undertaken, designed to break an incipient wage-price spiral and bring down inflation.

(6) During the negotiations over Spanish entry into the EC, initial structural reforms were enacted, particularly in heavy industry and mining, closing down inefficient production and certain economic lines in direct competition with Germany and France.
(7) Deeper structural reforms were implemented as of 1986, when Spain formally entered the EC. These included: (a) phased elimination of trade barriers on products and services within the EC, and Spanish incorporation –via EC membership– into the GATT framework; (b) a phased privatization programme, beginning in 1986, in which smaller, more successful state-owned firms were auctioned directly to private investors, and in which larger, less profitable state firms were restructured and then floated in tranches on the stock market, beginning in the early 1990s and intensifying during the latter part of the decade; and (c) a phased elimination of controls on capital movements and other financial flows, culminating in completely free capital markets by 1993.
(8) Yet a third period of macroeconomic stabilization and policy convergence, beginning in 1993 with the inauguration of the second phase of EMU and culminating in 1998 with the peseta's entry into the single currency as a founding member of the euro.

With respect to this sequencing of reforms, a number of other issues should be mentioned. First, when Spain began to liberalize its economy, its political culture was highly centralized and authoritarian. The authoritarian ('decree') nature of decisions which had constructed the autarchic, quasi-fascist, heavily state-dominated economy during the first half of the Franco period (1939-57) continued to characterize decision-making on economic reform during the last phase of the regime (1958-75). While much of the decision-making that went into the early transition period was concerned with the political sustainability of the regime, the government did not have to worry itself with potential popular resistance to reform. Indeed, the opposition to economic reform was overwhelmingly concentrated in certain recalcitrant factions within the regime (10).

Secondly, the regime was acutely aware of the political convenience of stimulating economic growth, something which had eluded policymakers since the beginning of the regime's experiment in autarchy. The GDP did not regain its pre-civil war level until 1951 (11), and even the limited economic growth of the 1950s had depended on the regime's first tentative moves toward economic rationalization (the 1953 reform of agricultural prices, for example) (12) and appearance of limited financial inflows (the 1953 bases agreement with the US, which secured essential external financing –some US$1.3bn during the period 1950-63– and stimulated the beginning of the end of Spain's isolation from the mainstream of international political and economic affairs) (13).

Significantly, however, during the early transition period of the 1950s –between the end of Spain's state-dominated autarchy and the beginning of its gradual market reform– the external environment steadily improved. Spain actually received significant economic largesse from the US, equivalent to over 1% of its GDP on an average annual basis between 1950 and 1963 (nearly the same relative net levels of transfers Spain receives today in the form of EU structural and cohesion funds and agricultural spending). Furthermore, during the late 1950s, Spain emerged from its international isolation and was accepted as a member in the world's principal international organizations, lending the country an enormous boost in terms of international credibility.

While it has long been the consensus in Spain that the US aid during the 1950s was significantly lower than that received by its European neighbours via the Marshall plan between 1948 and 1952 (in which Spain was not included), this is something of a simplification of the underlying picture. Spain's US aid in absolute terms was roughly equivalent to the level of Marshall Plan assistance to Germany and higher than the average quantity received by all of the 15 Marshall Plan beneficiaries. Nevertheless, there were major differences between Spain's US aid and the Marshall Plan assistance. First, Spain's aid was spread out over 14 years, while the Marshall Plan lasted only four years

(1948-52) and was mainly concentrated during the two first years of the programme. Secondly, much of Spain's aid was given in the form of concessional loans, while most of the Marshall Plan consisted of grants.

Finally, and probably most importantly, attached to Marshall Plan assistance were a number of conditions for economic liberalization and integration, while US aid to Spain ultimately came with no strings attached (other than the all-important concession of rights to construct and use key military bases in Spain). Although one might argue that the Spanish economy during the 1950s might have stood to gain from more intense reform, allowing for US aid to be absorbed more efficiently and productively, this could have conceivably implied a potential source of political instability for the regime. The ultimate consequence might have been a reform process that slipped out of control, leading to irresistible demands for both market and democratic reform simultaneously. The impressive growth of the 1960s, under such a scenario, might not have become a reality.
Therefore, Spain's early receipt of external assistance implied no pressures at all for economic or political reform. Spain remained free of any external policy dictates (unlike the scenario that many Latin American countries faced when entering into their borrowing relations with the IMF) and could pursue its economic reform at its own pace and in its own way. Spain could thus enjoy the direct benefits (eg, the relief of productive and financial bottlenecks) and the indirect effects (eg, positive impact on economic sentiment) of US aid, without having to cede any sovereignty over economic policy.

Thus, by 1958, to avoid falling even further behind Spain's neighbours in Europe (real per capita GDP had fallen from over 60% of the average in West Germany, France, Italy and the UK at the end of WWII to less than 50%), and to avert a crippling financial crisis which might threaten the stability of the regime (by this time, exchange reserves could no longer meet external obligations), the government had few alternatives to at least some limited market reform. At this stage, coinciding with the emergence of a critical mass of more liberally-minded economic advisers in key positions within the regime (the so-called Opus Dei 'technocrats'), Spain managed to enter the IMF, the World Bank and the OECD (then still the Organization for European Economic Cooperation, the OEEC) in 1958. Within the context of general consultations with these international organizations, Spain drafted and implemented the so-called Stabilization Plan of 1959, which formally ended Spain's official objective of autarchy and a strictly national economy.

In brief, the Stabilization Plan undertook what its name suggested –a rationalization of macroeconomic policy aimed at stabilizing the state's fiscal position (through an increase in taxation and a reduction of state subsidies) and reducing the inflationary pressures generated by an opaque and chronically loose monetary policy–. The Plan also envisioned a range of further market reforms, similar to those required by IMF lending packages today. However, *in the realm of liberalization and structural reform, the only significant change that actually occurred during the 1960s came in the area of restrictions on foreign direct investment, which were significantly loosened*. Indeed, while the Stabilization Plan was partly the result of Spain's first significant interaction with the IMF – a fact which places Spain in a similar analytical context with most of the Latin American countries– *Spain managed to avoid any significant obligations with the Fund and did not engage in any significant structural reforms until the late 1970s and early 1980s* (14).

This is perhaps one of the unique features of the early phase of the Spanish transition. Rather than seriously contemplate a 'big bang' transition, Spanish policymakers chose to avoid implementing the kind of reforms –like trade liberalization or privatization– which would have generated inevitable adjustment pressures early on, and which would likely have either destabilized the regime or at least required significant IMF finance in order to attempt to manage them. Thus, rather than accept the first signs of unemployment in Spain (in 1959, while per capita income remained miserably low, unemployment was still under 1%) (15) and the political instability it could easily generate, the liberalizing reforms implemented within the context of the Stabilization Plan were strictly limited to those that would: (1) attract private foreign finance and help alleviate the state's problems financing the economy's external imbalances; and (2) stimulate domestic economic activity, rather than undermine it, as in the fashion of the 'stabilization' undertaken by Latin America in the 1980s, or by Russia in the early 1990s. These limited but well-timed liberalizations basically boiled down to a significant new inflow of direct investment (averaging 0.4% of GDP from 1960 to 1974), tourism revenues (nearly 4% of annual GDP on average), and remittances income (over 1% of GDP on average) which stimulated growth and consumption, and eliminated Spain's external financing constraints, at least until the oil shocks of the 1970s.

Furthermore, not only was the initial phase of Spain's market transition gradual and astutely sequenced, the external environment facing Spain was also highly favourable, particularly between 1960 and 1974. Although Spanish exports were still prejudiced by the highly protectionist trade policies of the regime during the 1960s (in this period only minor trade reforms were enacted, allowing for intermediate and capital goods imports to face somewhat lower tariffs), the European economic boom proved to be an important engine for Spanish growth. Exports as a percentage of GDP grew from a mere 4% in the early 1950s to over 13% of a greatly expanded Spanish economy by the mid-1970s. The proportion of Spanish exports destined for Europe increased from around 40% to nearly 50% of the total. In addition, Spain entered into a preferential trade accord with the European Community (on terms quite favourable to the Spanish) in 1970, setting the stage for a continued process of trade integration with Spain's European partners which would begin in earnest during the late 1980s, once Spain had entered the EC and began to systematically dismantle its system of trade barriers.

The European boom of the 1960s also contributed to Spanish growth by offering Spanish migrant labourers money wages which, while low in the context of continental Europe, were still much more attractive than wage levels in Spain. Like the Mexicans and other Latin American migrants in the US today, Spanish workers sent home significant remittances in the form of hard currencies which both supplemented family incomes and purchasing power and helped underpin the state's foreign exchange reserves. The Spanish tourism industry (and related sectors like construction and services) likewise received a significant stimulus from the European boom.

Inflows of remittances averaged around 1% of GDP from 1961 to 1974 and covered between 20% and 35% of the trade deficit during the period. Until 1974 (the year of the first oil price shock), remittances and tourism revenues together tended to compensate for the growing trade deficit during most of the period. Tourism revenues grew from US$125mn in 1959 (1% of GDP) to some US$3.1bn in 1973 (4% of GDP) and nearly US$3.5bn in 1975 (16). When investment inflows are tabulated along with tourism income and remittances, the positive picture is clarified: throughout the period, and up until the oil shock, Spain's basic balance steadily improved, reaching a surplus of 2.5% of GDP by the early 1970s (17).

The upshot was that Spain managed –without any significant sovereign foreign indebtedness, and with no noticeable external conditions imposed on domestic economic policy or the political behaviour of the dictatorship– to generate an economic boom from 1960 to 1974 during which average annual GDP growth rates nearly reached double digits, making it the fastest growing economy in the OECD, saving only Japan. While the pace of economic reform stagnated during the 1970s, and economic performance deteriorated (average annual growth rates slowed dramatically to no more than 2% and inflationary pressures surged, bringing CPI increases to a peak of 27% by 1977), Spain was in a decent position, once the democratic transition of the second half of the decade was completed, to resume macroeconomic stabilization and move on to the real grunt work of market reform.

Very importantly, however, the economy had experienced an intense period of industrialization and modernization which had brought Spanish per capita GDP from around 60% of the European average at the time of the Stabilization Plan to around 80% by the time of Franco's death in 1975. Almost no sovereign borrowing was needed to facilitate this achievement: an increased external debt burden, therefore, did not complicate further transition reform in Spain, as has been the case in innumerable other countries, particularly in Latin America, Africa or the former Soviet sphere.

It is often commented that Spain's early period of market reform and growth during the 1960s could serve as a constructive model for Latin American countries today. The combination of tourism, remittances and foreign investment which spearheaded Spain's early take-off hold out the promise that a similar take-off might be achieved in Latin American countries where foreign investment and remittances –and increasingly tourism– have increased significantly during the last decade. Nevertheless, caution is in order. The timing and sequencing of Spanish reform policy which stimulated this triad of inflows was significantly different from that in Latin America where trade and financial account liberalization occurred before such inflows became important and where external debt became a significant issue (*see Warnings below*).

This intense period of economic growth from 1960 to 1974 served a number of key positive functions which proved crucial to the sustainability of future reform. On the one hand, the 1960s boom helped legitimize the nature of the Franco regime –if for no other reason than because the regime finally delivered the long-sought after breakthrough to potential economic prosperity–. On the other hand, the enormous growth of the 1960s helped moderate the evolution of the democratic transition, as the various opposed domestic factions realized how much was at stake, were conscious of popular demand to consolidate the 1960s consumption boom and make its sustainable in the future and came to understand that Spain's attractiveness as a potential partner in the European Economic Community hinged to a large degree on its success in consolidating its breakthrough to developed country status.

This universal awareness among relevant elites in Spain helped forged the political consensus upon which the democratic transition rested and provided for an unusually high degree of collaboration on economic policies and objectives between government economic policymakers, trade union leaders, the Socialist and Communist opposition parties, and business and industrial elites which was epitomized in the Moncloa Pacts of 1977, one of the key events which, along with a profound reform of fiscal/taxation policies, cleared the way for continued market transition in Spain.

Lesson Three: Regional integration can help stimulate and cement the changes wrought by market transition.
The oil shocks of the 1970s, together with the death of Franco and the subsequent imperative to negotiate a consensus agreement on Spain's democratic transition, implied a period of much slower growth. While growth had averaged 7% annually from the time of the Stabilization Plan to the first oil shock (the highest of any similar period in modern Spanish history), from 1974 to Spain's entry into the EC in 1986, average annual GDP growth slowed to under 2%, with recessions in 1979 and 1981.

Higher oil prices hit the Spanish import bill hard while intensified competition from East Asia eroded Spanish export competitiveness. From 1972 to 1974, the trade deficit nearly trebled, and would do so again as a result of the second oil shock at the end of the decade. While per capita GDP had reached nearly 80% of the average of the current EU-

15 by 1975, it had slipped to under 72% by the time of Spanish entry into the EC. An intense adjustment of deindustrialization took hold during the period, partly as a requirement of EC accession negotiations. Industry's share of the GDP fell from over 31% in 1974 to under 28% in 1985. Unemployment, which had remained under 2% until 1972, rose steadily during the decade and reached 17% by 1985.

The rigor which macroeconomic policy had acquired from the Stabilization Plan of 1959, as well as the flexibility it enjoyed as a result of the economy's improved external financing during the 1960s, vanished in the tougher economic and political climate of the 1970s. Inflation returned to hit of peak of 27% in 1977 while the peseta's exchange rate – which had stayed relatively stable at around 60 pesetas to the dollar from 1959 to 1975– lost approximately one-third of its value between 1975 and 1977, and continued to fall, hitting an average annual low of 170 to the dollar in 1985.

What allowed Spain to weather such an intense negative adjustment? A number of interrelated factors explain how Spain stayed on track for future growth and further market reform. First, there was the positive experience of the limited reforms of the Stabilization Plan and the impressive growth of the 1960s. Consciously or not, Spain had exercised its policy autonomy in an astute way, engaging in limited liberalizations which reinforced the positive external economic environment to produce growth. Hence, the Spanish population, while wary about the direction of political reform in the 1970s, retained a very positive impression of early market liberalization. Government policymakers had delivered the goods, raising living standards noticeably for the first time in modern Spanish history and moulding a mindset among Spaniards which was more pragmatic and realistic than ever before. Although market reform slowed to a standstill during much of the 1970s – given that further reform in an environment of stagflation was likely to upset the hard won political consensus between potentially competing economic interest groups– by the time of the Moncloa Pacts and the first parliamentary elections in 1977, Spanish society was more or less united in its resolve to push on with further economic reforms and resume the growth path of the 1960s.

The positive experience of the 1960s combined with the haunting memory of the Civil War and the early Franco regime to produce this new political and economic consensus. Spain had experienced not only acute poverty and hunger during the heyday of Franco's autarchy, but also extreme international isolation. In the wake of Spain's return to the international community in the late 1950s, the Franco regime had attempted to sound out the members of the EEC with respect to possible Spanish entry as early as 1962. During the 1960s and early 1970s, the EEC members had made clear that Spanish entry would be considered, but only after a democratic regime had been firmly installed. By 1978, with the political transition firmly on track, the thrust of Spanish foreign and economic policy became singularly oriented toward achieving this plausible goal.

The prospect of EC entry, more than any other single factor, served to concentrate Spanish policy efforts and to forge a popular consensus with respect to the future direction of the country. Without this tangible prospect it is not clear that such an unprecedented policy consensus could have been sustainable; nor would it have been easy to weather the intense economic adjustments of the late 1970s and early 1980s (18).

Initially this consensus was directed at re-attaining macroeconomic discipline and stemming the loss of the economy's competitiveness. The Moncloa Pacts produced a minimally sufficient amount of mutual goodwill and policy coordination among the principal economic agents (government, trade unions and political parties) to start to bring inflation down. By the time the first PSOE (social democratic) government took office in 1982, price increases had moderated to 14%. In preparation for Spain's eventual entry into the EC single market, the PSOE economic programme focused on continued macroeconomic stabilization during these years, bringing inflation down still further to under 5% by 1987, and attempting to contain the government budget deficit, which had risen sharply, in the aftermath of the UCD's tax reform in 1978 and the first efforts to construct a modern welfare state, from under 1% of GDP in 1977 to over 6% be the time the PSOE assumed the government. Through more disciplined fiscal and monetary policy, the PSOE economic team managed to bring the deficit to below 3% by 1987. The potential political price, however, was high, as unemployment (already in double-digits) rose to over 17% by the time of the election in 1986.

Nevertheless, consensus was maintained –and the social democrats were re-elected– on the basis of Spain's successful negotiations to enter the EC in 1986. With sufficient stablilization efforts in place, and Spain's EC entry secured, rapid growth returned in the second half of the 1980s, creating anew a favourable climate for undertaking the next stage of serious market reforms, including gradual yet significant trade and capital liberalization, deregulation of domestic markets, harmonization of the regulatory framework with that of the EC and the beginnings of a wide-sweeping privatization campaign.

From 1987 to 1991, annual growth averaged between 4% and 5%. During this period, inflows of foreign investment boomed again (particularly FDI, but also portfolio flows), bringing the basic balance, which had fallen into significant deficit during the 1970s, back into surplus. Total net investment inflows increased from under 1.5% of GDP in 1985 to over 2% by 1992 (19). By the beginning of the 1990s, Spain's trade had nearly coalesced into its current open pattern, with exports accounting for nearly 25% of GDP, and with nearly 70% of all exports destined for Europe.

The progressive opening of investment and other capital flows produced significant foreign penetration into the Spanish economy. By 1989, some 22,000 firms had some foreign capital; by 1991, this foreign participation was greater than 50% in some 10,000 Spanish companies. While such intense foreign penetration implied a potential loss of economic sovereignty and a much higher degree of vulnerability to exchange rate volatility and speculation (net inflows of portfolio investment had shot up from negligible quantities in 1980 –which covered only 0.25% of the current account deficit– to 1.5% of GDP in 1989, covering approximately half of the external deficit), it did stimulate a significant transfer of technology to Spain and a noticeable reorganization of business management and practices. Also, for the first time, Spain developed a growing exposure to external debt. From 1986 to 1992, external debt rose from US$24bn (9.7% of GDP) to US$78bn (12.5% of GDP), half of which was held by the private sector. Although this rising debt did imply higher servicing costs (sensitive to both currency and international interest rate fluctuations), it supplied a convenient supplement to domestic public and private investment, and was driven in part by the increasingly positive international risk rating of the Spanish government and the economy in general (Moody's sovereign risk assessment for Spain was Aa2 between 1988 and 1992) (20).

Spain's entry into the EC implied a gradual but complete integration (in terms of trade, investment, and capital flows) into the new Single European Market by 1993. Trade in manufactured products was completely liberalized with respect to Spain's European partners by 1993, while full Spanish integration into the Common Agricultural Policy was scheduled to be completed by the mid-1990s, according to Spain's accession formula. Full liberalization of capital movements for Spain within the EC was negotiated to also coincide with the completion of the single market in 1993. By the end of the 1980s, as the Maastricht Treaty negotiations began, Spain was fully integrated into the EC process, and well on its way to transposing the corpus of European single market legislation into Spanish law. By this time, Spanish per capita GDP was over US$13,000 (having risen from under US$5,000 in 1985, an increase in real terms of 25%), or some 80% of the European average, and over half the US level (21).

By the 1990s, Spain was locked into the EC and its single market. The country was enjoying strong growth, underpinned by an intense international integration process and a competitive shock to the domestic economy. European integration provided both the stick and the carrot for Spanish market reform, guiding it, stabilizing it and, as we will see below, providing key transfer payments for helping to deal with the accompanying adjustments. For better or for worse, Latin American economies have not enjoyed this prospect of profound economic and institutional integration with a group of advanced economies during the major stages of their attempted market reforms.

Lesson Four: Monetary integration, in particular, can help make increasing prosperity sustainable by structurally lowering interest rates, eliminating country risk premiums and providing a stimulus for improved macroeconomic policy performance.
If integration into the EC gave Spain the opportunity to solidify the gains of early reform and the incentive to continue, the new EU programme to create an Economic and Monetary Union (EMU) gave Spain the necessary traction to break into the core of advanced market economies.

Although Spain suffered from the European exchange rate crisis in September of 1992, and experienced four devaluations between 1992 and 1995, it re-emerged nearly unscathed in its pursuit of the Maastricht convergence criteria laid down in the Maastricht Treaty of 1993 (22). The peseta had strengthened significantly during the late 1980s boom as the capital account was gradually liberalized, reaching nearly 100 pesetas to the dollar in 1990, only a year after Spain had entered the European Exchange Rate Mechanism (ERM). Interestingly, the downward pressure that the peseta was to come under in 1992 was brought on by the determination of Spanish economic authorities to continue to meet the country's commitment to exchange rate stability within the ERM (one of the principal objectives of phase one of the EMU project). This meant that Spanish interest rates, already in double-digits during the 1980s boom, had to remain extremely high in light of the interest rate pressure coming out of Germany during its reunification effort. Meanwhile, and partially under the pressure of these high rates, the Spanish economy was slowing rapidly as the US recession of 1990-91 spread to Europe. Spanish growth slowed from 4.1% in 1990 to 2.2% in 1991, 0.8% in 1992, and finally plunged into a 1% contraction during 1993. Spanish monetary policy remained tight, in an effort to buoy the peseta and keep it within its ERM band with respect to the ECU and the deutschmark, while fiscal policy (already relatively loose with the budget deficit at around 4% of GDP) faced the dilemma of either contracting (and exacerbating the recession) or loosening (with the resulting deterioration of the budget deficit, one of the key Maastricht convergence criteria). With unemployment already close to 20%, Spain was reluctantly swept along this latter path and the deficit widened to nearly 7% of GDP by 1995.

As late as 1995 it was evident that Spain had not yet broken completely free of the vicious cycle of rising deficits, high interest rates, currency crises and dependence on volatile international markets that characterizes many emerging markets even today. Nevertheless, the EMU project provided Spain with a valuable disciplinary monetary framework and a concrete goal to pursue. In the wake of the ERM crisis, the EMU timetable agreed upon at Maastricht was modified to delay the birth of the euro from 1997 to 1999. This gave Spain the necessary time it needed to meet the convergence criteria. Taking advantage of the economic upturn in 1995, Spain began in that year to reduce its budget deficit. Against the expectations of many, Spain managed to generate sufficient confidence to stimulate a return to growth (over 4% on an average annual basis from 1996 to 2000), reduce the deficit (under 2% by the time the peseta was accepted into the euro club), moderate inflation (also down to around 2% by 1998) and stabilize the peseta.

Interest rates –the key variable interacting with all the other convergence criteria– went on an incredible downhill slide, with long-term rates falling from around 15% in 1990 to just over 4% today (23).

Spanish policymakers seized the opportunity provided by the prospect of entering the euro. From 1995 on, sufficient budget discipline was exercised to generate increasing confidence that Spain might actually meet the convergence criteria, a dynamic which in turn made lower deficits much easier to achieve. This growing confidence conspired to help bring interest rates down in Spain faster than in the rest of the EU. By 1998, the so-called 'Spain premium' (the difference between Spanish long-term interest rates and those in Germany) had nearly vanished, falling from over 500 basis points to close to zero, where it remains today. Collapsing interest rates stimulated rapid growth, and both these phenomena placed significant downward pressure on the budget deficit.

On the other hand, other aspects of the external environment also improved enormously from 1995. World growth, driven by the US boom, fed into European and, therefore, Spanish growth. Oil prices fell throughout most of the 1990s, from their highs around US$40 a barrel during the Gulf crisis to around US$10 a barrel in 1998. This trend also helped to drain some of the inflationary pressures out of the rapid growth since 1996, allowing Spain to squeeze macroeconomic disequilibria out of the economy while simultaneously achieving GDP growth of around 4% –a difficult trick not easily achieved in Latin America–. Furthermore, Spain's *virtuous cycle* became so positive that even an increasingly turbulent exterior economic environment at the end of the decade –including emerging market crises, particularly in the Southern Cone, and a tripling of oil prices– could not derail Spain's impressive macroeconomic improvements. Until the Argentine crisis of 2001/02, the emerging market crises had exerted no noticeable impact on Spanish economic progress. As Spain successfully entered the euro, it also experienced significant renewed increases in both inward and outward investment. From the time of the ERM crisis to the Argentine default, Spain become the world's 8th largest net investor, with many of Spain's largest firms improving their income statements on the back of investments made in Latin America (24).

Monetary integration –involving the surrendering of the peseta and Spanish monetary policy sovereignty– has effectively shielded Spain from external shocks and financial contagion, and has even served to make Spain's remaining structural vulnerabilities and policy weaknesses much less noticeable, and certainly less of a drag on growth. Even the recent financial crises in the Southern Cone, to which Spain was more highly exposed than any other advanced economy, have had only a marginal effect on the whole of the Spanish economy. One recent estimate calculates that the Argentine crisis drained only 0.2 percentage points from annual growth during the period 1999-2002 (25).

Relevant Warnings

The Spanish case continues to provide a useful point of reference for countries attempting to follow a similar path towards advanced, prosperous market democracies. However, the Spanish case clearly reveals the importance of external factors and deep regional integration with advanced economies. One could argue that the uniqueness of the Spanish case means that the lessons it has to offer are actually warnings which underline the enormity of the challenge facing Latin America countries.

Warning One: Consensus is key. Domestic political consensus is essential for the reform process to be sustained, particularly in a democratic context. In Spain, however, such a consensus was a fortuitous result of particular, unique historical circumstances.
As mentioned above, domestic consensus was conveniently not a necessary prerequisite during the early phases of Spanish economic reform. The Spanish regime was not

democratic and the initial reforms were born of a growing influence of liberal economists within Franco's circles and the increasingly dire financial situation of the state. Nevertheless, the boom engineered during the 1960s created a consensus for pursuing the kind of policies most likely to restore growth after the economic adjustments that were to follow. In the tricky Spanish environment of the 1970s, this consensus widened to include the democratic consensus and the nearly universal Spanish desire to enter Europe, the unifying theme which remained a constant integrating factor among the Spanish electorate during all three democratic Spanish governments (the UCD, the PSOE and the PP). In addition to the success of the 1960s, the Spanish consensus was also underpinned by a widespread desire across the political spectrum to avoid lapsing back into the fractious segmentation of the body politic experienced during the civil war. This consensus –threatened seriously only once, when the labour unions challenged the government's privatization plans by invoking one of Spain's largest general strikes in 1988– has facilitated the efforts of Spanish policymakers to continue on the path of reform.

Domestic consensus has been seemingly rare in the case of Latin American reform efforts, particularly in the early phases during the 1980s. This no doubt has complicated efforts at market reform, making it difficult for continuity to be maintained across administrations. Even after the emergence of the so-called Washington Consensus, the renewed reform consensus in various countries remained quite fragile in light of the chain of emerging market crises during the second half of the 1990s. Today, Brazil is probably the closest example of a case where the reform consensus has survived (Chile is perhaps another), but Lula is certainly not yet out of the woods –witness his declining approval ratings over the course of 2004–. Nor is it clear that sufficient consensus exists in the other major economies of Latin America for the reform impulse to regain momentum.

Furthermore, few if any Latin American countries have enjoyed the very favourable circumstances that Spain faced during the early phases of reform. Whereas Spain remained free of large external debt burdens, retained its policy autonomy and experienced the success of rapid growth during the first 15 years of its market transition, most Latin American countries had the opposite experience. Many registered their most rapid growth rates during the last decades of the ISI model and state-dominance in the economy. The origins of their reform processes, on the other hand, were characterized by both a significant build-up in external debt and the beginnings of policy conditionality with the IMF. Indeed, the first decade of market reform in Latin America, while characterized by limited –even timid– liberalization (as was the case in Spain), was also marked by economic stagnation during the 'lost decade' of the 1980s (the antithesis of the Spanish experience) (26). Far from forging a national consensus in most Latin American countries, the beginnings of market reform in the 1980s were accompanied by intensifying national discord over the validity and desirability of market reform. Only with the collapse of the communist world and the wave of reform sentiment that swept the world in its wake was anything like a working consensus for reform achieved in most Latin American countries. But even this fragile consensus of the 1990s has come under extreme pressures, as a result of the emerging market crises, particularly the crisis in Argentina, threatening future reform.

Warning Two: Social welfare is crucial. The consolidation of democracy in Spain and, along with it, the maintenance of political consensus for economic reforms, was underpinned by a significant package of fiscal reform and the accompanying creation of a welfare state similar to the dominant European model.
The growth of the 1960s was obviously a key lever that Spain used to maintain consensus for further reform. Nevertheless, the stagnation of the 1970s and the painful adjustments that Spain would have to undertake in order to enter the EC could easily have undone the early consensus had not the attraction of Europe also represented the prospect of

achieving other social goals beyond growth. Social justice and the state's guarantee for the basic needs of Spanish society also played a significant role. The fundamental fiscal reform undertaken in the late 1970s by the UCD (Union of the Democratic Centre) rationalized Spain's antiquated tax regime, making the sharing of the tax burden more progressive and laying a sound financial foundation for the coming transformation of the state. Given the UCD's growing left-wing opposition, such reforms proved to be essential for the maintenance of the Spanish consensus.

Moreover, a modern, extensive welfare state was rapidly constructed during the first two PSOE mandates, allowing Spain to quickly converge with the European social model. Considering the real possibility of a backlash among the PSOE's leftist constituencies (to say nothing of the opposition Communist Party, which reformulated itself into the IU, or United Left) to the intensifying market reforms the government was bent on undertaking, the convergence with European welfare standards not only mollified growing left-wing discontent but also eased the burden of structural adjustment and contributed to improved income distribution. This proved to be a very useful moderating influence over the potential opposition to the tough reforms upon which Spain would continue to embark.

Social justice, basic welfare guarantees, fiscal solvency and sustainability, and efficient income distribution are not areas in which Latin American economies are strong. Even in the case of Chile, a relative success story, income distribution remains very poor and could still threaten stability and efficiency in the future (27). Although in recent years the trend has been towards improvement in many of these areas, as Brazil and Mexico have battled to undertake fiscal reform, it is clear that these achievements remain crucial factors in the future sustainability of market reform and prosperity in the region. Unfortunately, most Latin America countries remain at a disadvantage compared to Spain in the 1970s and 1980s, for they lack the effective stick and carrot that Europe represented for Spain.

Warning Three: Generous external financing also plays a role. Political consensus in Spain, along with adjustments implied by the Single Market and EMU, were facilitated and sustained by significant inflows of European Funds during the 1980s and 1990s.
The EU's structural funds, sectoral aid (through the Common Agricultural Policy and the Common Fisheries Policy) and national cohesions funds, are an integral aspect of the world's deepest and most extensive regional integration process. Furthermore, these EU funding programmes involve high levels of intergovernmental policy collaboration and at least some sharing of national sovereignty. Such EU funds function in a manner similar to international aid but have fundamentally different impacts and implications than do IMF loans in Latin America.

Since the Maastricht Treaty, Spain has been the single largest net recipient of EU funds. In recent years, while Spain has contributed approximately €6bn annually to the EU budget, it has received approximately €14bn annually through the major EU spending programmes. This net inflow of some €8bn a year represents the equivalent of nearly 1.3% of annual GDP. There is some controversy over how much this has and continues to contribute to Spanish growth, but the consensus of opinion tends to attribute some 0.2 percentage points of annual growth to these funds. Beyond this direct impact on domestic demand, however, EU funds have contributed significantly to the build-up of infrastructure development and to social stability –if not inter-regional convergence– unleashing important dynamic effects within the less-developed regions of Spain.

The days of Spain's leading net recipient status in the EU are probably numbered. Despite French resistance, constant reformist pressures continue to be exerted upon the CAP. Furthermore, much of what Spain receives in structural and cohesion funds is now threatened by the coming enlargement of the EU into Central and Eastern Europe where per capita incomes are typically between 30% and 40% of the EU average. The enlargement of the EU-15 to the EU-25 (and then EU-27) will, overnight, place Spanish per capita income well above 90% of the EU average, the threshold for receipt of cohesion funds, and push most of Spain's regions above the 75% threshold for most of the structural funds.

Therefore, sometime soon Spain will face the challenge of adjusting to this declining flow of EU funds (to say nothing of the increased competitive pressures the enlargement implies in terms of trade and investment diversion). Although many believe that the Spanish economy is mature and dynamic enough to meet this test, the outcome of this adjustment is likely to depend on a range of new economic policy reforms that, strictly speaking, lie beyond the realm of market transition: namely, policies designed to transform Spain's predominantly extensive growth model into sustainable intensive growth based upon significant increases in productivity (28). Spain's success in graduating from EU net recipient status and in transforming the extensive growth of the past into the intensive growth of the future will certainly inform our ongoing evaluation of the prospects for the success of market transitions in other parts of the world.

While the jury on Spain's ultimate success is still out, it is clear that at no time has any Latin American country ever enjoyed the privileged position that Spain recently has with respect to significant and ongoing transfer payments. IMF bailout packages, consisting of credit lines and loan commitments, simply do not serve the same function. Nor do meagre levels of development assistance. Although the Mexican economy has benefited in a number of ways from NAFTA, this integration process is clearly not nearly as profound as EU integration. President Fox has recently voiced the idea of infusing NAFTA with deeper institutional integration –no doubt thinking of the Spanish experience in the EU– but to little avail, given the US preference for integration models of a much shallower nature, particularly bilateral and regional free trade associations. In the current climate, even the Central America Free Trade Accord is likely to meet stiff resistance in the US Congress. Recent developments in the quest for a Free Trade Association of the Americas have also pointed to a lighter version of the FTAA than even the Bush Administration has been pushing for, as Brazil has taken the lead in resisting the acceptance of a US-designed architecture for the agreement.

Warning Four: Monetary integration is not always a panacea, and can only be sustainably successful if other fundamental reforms precede it.
Monetary integration has certainly been a boon for Spain, if not a panacea. Some of the direct and indirect benefits have been outlined above. Nevertheless, one of the principal critiques of monetary integration has traditionally pointed to the dangers of surrendering monetary sovereignty when one's economy does not form part of an optimal currency area with the other economy or economies in question, given the potential for asymmetric economic shocks. This critique was certainly a central part of the pre-euro debate in Spain and Europe and has also been present in discussions of dollarization in Latin America.

In Spain's case, on balance, monetary integration has been beneficial. Since entry into the EC, Spain's economic cycle has progressively moved towards greater synchronization with those of its European partners (29). Nevertheless, recently Spain's economy has continued to grow even while France and Germany have flirted with recession. In this case, the asymmetric shock suffered by Germany and France has implied very loose monetary policy for Spain –given its higher inflation rate and its intense housing market boom– which has tended to underpin growth even during the last few years of generalized slowdown. On the other hand, Spain's inflation rate (hovering around 3% for the last few years, some two percentage points above Germany's) has been kept in check by a relatively tight fiscal policy, which over the last two years has kept the budget nearly in balance, allowing Spain to indulge in the comfortable rhetoric that it has made its economy more dynamic than those of the Franco-German axis while simultaneously meeting the Europeanist commitment to the Stability and Growth Pact, even as the principal authors of the pact continue to flout it.

When the next asymmetric shock hits Spain on the downside, it is hoped that the Spanish economy will be flexible enough to absorb the blow. In such a case, Spain would be able to rely on a looser fiscal policy to take up some of the slack, but the Eurozone's Stability and Growth Pact would (at least theoretically) somewhat limit this compensatory policy tool. Nevertheless, the key pre-requisite for monetary integration is for the economy to be flexible and open. In this sense, Spain –unlike most of the cases of dollarization in Latin America– performed fairly well before the Bank of Spain formally ceded monetary policy to the ECB.

By 1995 when Spain seriously began its bid to meet the Maastricht convergence criteria and qualify as a founding member of the new single currency, most of the heavy grunt work of market reform had been undertaken, or at least begun. Spain was already deeply involved in the process of privatization, trade with Europe had been completely liberalized and extra-EU trade policy had been brought in line with the common EU tariffs (subject to EU commitments within the framework of the WTO). Capital flows had likewise been fully freed from restrictions. Even labour market reform had been undertaken gradually through a series of reforms in 1984, 1994 and later in 1997. While further labour market reform remains one of the pending issues for Spanish economic policy, in reality the Spanish labour market has become one of the most flexible in Europe due to the widespread use of temporary contracts which imply much lower labour taxes and costs of firing than do the traditional (yet increasingly scarce) fixed indefinite contracts. In the last ten years, nearly 90% of all new jobs in Spain have been created with temporary contracts. While this has produced an increasing precariousness in the labour market and an irrational duality (between a shrinking elite of expensive fixed contracts and a growing mass of inexpensive temporary contracts), it has achieved the goal of increased flexibility and lower costs for employers (30).

The problem that monetary integration implies for Latin America, particularly if it is conceived of as a simple unilateral dollarization, is at least two-fold: first, this would entail a loss of monetary sovereignty with no compensatory input into monetary policy (as Spain enjoys through its membership in the ECB) and no accompanying transfer payments to help absorb the corollary adjustments (as Spain enjoys via the Cohesion Funds, created to help offset the adjustments provoked by EMU).

Furthermore, most Latin American countries have not undertaken the sufficient range of market reforms to be flexible enough to successfully endure the inevitable adjustments and asymmetric shocks. While Panama, El Salvador and Ecuador have not fared too poorly since dollarizing their economies, it is clear that this form of monetary integration has not been the great stimulus that entry into the euro has been for Spain. The case of Argentina, however, is even more sobering. The experience of near-formal dollarization in Argentina –regardless of whether it was ultimately avoidable or not– clearly ended badly. In the end, the market reform process in Latin America remains incomplete. While certain reforms of the 1990s were executed poorly (some privatizations), others were simply not undertaken (labour market reform). Furthermore, an entire 'second generation' of institutional reforms await the large majority of Latin American countries (31).

Nevertheless, there are other potential forms of monetary integration that might be contemplated in Latin America. One would be regional monetary integration, like the currency union that is sometimes contemplated by the members of MERCOSUR. This kind of monetary integration might have helped contain some of the more debilitating impacts of the emerging market crises upon Brazil, Argentina and Uruguay. Nevertheless, such a monetary union currently faces very important obstacles and is clearly still someway off into the future even in the most optimistic scenario. It is not clear that the national economic policy agendas of the MERCOSUR members will remain sufficiently in sync –and sufficiently oriented toward market reform in the future– to plausibly allow for a monetary union that functioned reasonably well. And, in the end, the impact of Spain's taking shelter under the monetary wings of Germany and France is quite likely to be different from that of Argentina taking shelter under the monetary wings of Brazil –or vice versa–. Still, this possibility remains tantalizing, at least for Brazil, and for good reason. Nevertheless, the conclusion to be drawn from a comparison of the Spanish and Latin American experiences is that monetary integration should be the crowning achievement of an integration process which helps drive market transition, and not conceived of as a substitute, or crutch, for other necessary economic reforms.

Another potential option would be a formal currency union centred on the US dollar, with institutional integration similar to that implied by EMU membership in Europe. This, however, does not seem to be on the cards anytime soon. Nevertheless, if Latin American countries hold out the hope of somehow replicating the Spanish experience, a deeper form of economic integration across the Americas could potentially deliver this result, so long as it involved trade, investment, capital market and monetary integration, and included some form of budgetary transfers similar to those in the EU. Perhaps this may seem like nothing more than a fool's dream today; nevertheless, if the experience of Spain, relative to that of other developing countries, is anything to go by, successful market transition and complete international economic integration –to say nothing of increasing and sustainable prosperity– might just have to wait for some such Union of the Americas.

Tentative Conclusions

The Spanish case offers some interesting lessons and warnings for Latin American countries attempting to emulate Spain's economic success. Spain enjoyed a very favourable external environment as it gradually transformed the statist economy of the Franco regime into an integrated market-based economy. It sequenced its reforms in a way that immediately generated growth, avoided complicating policy conditionality (until it came in the form of EC membership decades later), and created sufficient domestic consensus for continuing to engage in deeper market integration and restructuring. It managed to successfully leverage maximum benefits from its EC membership, including significant transfer payments and full participation in the formulation of EU policy. The ultimate result has been the transformation of an economy characterized by poverty and near total international isolation into a prosperous market democracy, free of onerous debt burdens and increasingly insulated from shocks generated within the international economy.

Latin American countries might understandably look to Spain as a reference point for their attempts to generate a similar transformation. However, given the numerous false starts along the road to market transition in the region, along with the continuing shocks debilitating Latin American economies, it will clearly be difficult to replicate such resounding success. Many of the lessons to be extracted from the Spanish experience unfortunately only offer help in hindsight. Spain's reform sequencing –in which capital flows, for example, were only gradually freed once deep reforms were already well underway– cannot be easily followed in Latin America, where market reforms have already been packaged and implemented in their own particular contexts and with apparently only limited success to date.

Nevertheless, in broad terms, one must attempt to identify certain policy directions which offer at least some promise. The single most important political lever in Spain's reform recipe has been the wholehearted commitment to regional economic integration. In this sense, regional economic integration –along with continued market-oriented policies and deeper institutional reforms– presents Latin America with perhaps its best strategy for achieving sustainable long-run prosperity. While such a strategy is bedevilled with tough political obstacles, it remains difficult to see how the majority of Latin American economies will be able to generate sufficient traction within the international economy to benefit from the continuing processes of globalization without taking advantage of the synergies which deeper regional integration still has to offer.

Furthermore, it seems clear that the region must forge ahead with a second generation of institutional reforms aimed at modernizing state institutions and improving the productive base of the economy. Perhaps Latin America countries would be best served by focusing not on Spanish successes (which have been fortuitously influenced by a string of positive external factors) but rather on lingering weaknesses in the Spanish economy, like poor performance in productivity growth and the formation of human capital. At least then Latin American economies would be concentrating on areas in which they have a chance of making autonomous progress vis-à-vis the advanced economies, instead of pursuing a strategy in which they remained vulnerable to the shifting winds of the international economy.

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Notes:

(1) This paper was originally prepared for the Center for Strategic and International Studies (CSIS) in Washington, D.C. in January 2004 as part of a CSIS-sponsored initiative to review the post-Washington consensus scenario.
(2) IMF World Economic Outlook Database, April, 2004 (*http://www.imf.org/external/pubs/ft/weo/2004/01/data/index.htm*), and Eurostat, Structural Indicators, January 2004 (*http://europa.eu.int/comm/eurostat/Public/datashop/print-catalogue/EN?catalogue=Eurostat*)
(3) In 1959, Spanish per capital GDP –at the then current exchange rates, and calculating in 1959 pesetas– was approximately US$333. When calculated at the then current exchange rates but using constant 1995 pesetas, it stood at US$7,250. For historical GDP, per capita income and exchange rate data see Leandro Prados de la Escosura, *El progreso económico de España (1850-2000)*, Fundación BBVA, Madrid, 2003, and Julio Alcalde Inchausti's Statistical Appendix in Juan Velarde Fuertes (coord.), *1900-2000 Historia de un esfuerzo colectivo: Cómo España superó el pesimismo y la pobreza*, Volume II, Fundación BSCH, Madrid, 2000.
(4) For income distribution data, see Julio Alcalde Inchausti, 'La renta nacional de España y su distribución,' in Juan Velarde Fuertes, *op. cit*. Extending the stark comparison with Russia further, the Gini coefficient of the Soviet Union at the end of the 1980s was around 0.28 while it had risen to nearly 0.5 by the end of the 1990s.
(5) For figures on the evolution of the sectoral composition of Spanish GDP, see Julio Alcalde Inchausti Statistical Appendix, *op cit*.
(6) See William Chislett, *Spanish Direct Investment in Latin America: Challenges and Opportunities*, Real Instituto Elcano, Madrid, 2003.
(7) See Richard Sandell, *The Ageing of the Population (Part I): The Scope and Future Outlook in Spain*, 22/IV/2003, and *The Ageing of the Population (Part II): The Spanish Situation Compared to Other Countries in the European Union*, 21/V/2003, Analysis of the Real Instituto Elcano, Madrid, 2003.
(8) Spain's former president, José María Aznar, has even spoken of the legitimate case Spain can make to be included in the G7 (G8), presumably re-dubbing it the 'G8' (G9).
(9) The earliest tentative and limited minor reforms, ushered in around this date under the sponsorship of Commerce Minister Manuel Arburúa, involved a significant increase in agricultural prices, a move which helped increase agricultural output and productivity, eliminate ongoing food shortages and the spectre of hunger, and relieve key input bottlenecks in other areas of the economy. Note here the similarities with the

sequencing of China's early reforms, in which debilitating controls on agricultural prices were the first areas of the economy to be liberalized. Importantly, much of the policy prejudice against the agricultural sector, characteristic of developing country ISI models, was eliminated in Spain early on at the origin of its market reforms.
(10) In this sense, the Spanish reform process shares with the Chilean case an authoritarian political regime that initiated market reforms. On the other hand, Pinochet attempted to follow the Chicago Boys' advice to undertake a 'big bang' type reform process, while Franco's technocrats did not. The timing and sequencing of the Chilean reforms also contributed to a severe downturn relatively early on in the reform process (GDP contracted well over 10% in 1981-82).
(11) For this and other related GDP data, see Leandro Prados de la Escosura, *op. cit.*, and Julio Alcalde Inchausti's Statistical Appendix in Juan Verlarde Fuertes, *op. cit*.
(12) For a discussion of Arburúa's first tentative reforms, see Joseph Harrison, *The Spanish Economy from the Civil War to the European Community*, MacMillan, 1993, p. 20. The extent of liberal reforms during the 1950s, despite the presence of often much more significant reform rhetoric, remained essentially limited to these scant achievements, at least until the Stabilization Plan of 1959. Even then, the extent of market reform remained extremely limited until the late 1970s.
(13) For a discussion of the political economy, volume and economic impact of the US aid to Spain in the 1950s, see Oscar Calvo-Gonzalez, *The Political Economy of Conditional Foreign Aid to Spain 1950-1963: Relief of Input Bottlenecks, Economic Policy Change and Political Credibility*, 2002, Ph.D. Dissertation (unpublished), Economic History Department, London School of Economics and Political Science. There is still an open debate among Spanish economists and historians as to what generated the initial limited upturn in the economy during the 1950s. One school of thought holds that this early period of growth was essentially underpinned by the direct impact of US aid in alleviating critical productive and financial bottlenecks which had strangled the economy during the most intense phase of autarchy in the 1940s. Another school of thought maintains that the principal effect of US aid, while positive, was more indirect: the upturn in domestic economic activity was driven by improved domestic economic sentiment that stemmed from the legitimization and credibility effect of US aid and subsequent improvements in future expectations. In any event, after growing only some 10% in real terms during the entire decade of the 1940s (less than 1% on an annual average basis), the Spanish economy grew by more than 50% during the 1950s (more than 4% on an annual average basis). See Leandro Prados de la Escosura, *op. cit*.
(14) See Oscar Calvo-Gonzalez, *op. cit*., on the scant IMF and other official financing of the Stabilization Plan.
(15) See Julio Alcalde Inchausti, *op. cit*.
(16) Data on tourism revenues and remittances come from Carlos Barciela, María Inmaculada López, Joaquín Melgarejo and José A. Miranda, *La España de Franco (1939-1975): Economía*, Editorial Síntesis, Madrid, 2001.
(17) *Ibid*.
(18) Furthermore, the significant inflow of FDI into Spain during the 1960s was in part stimulated by the recognition that, eventually, Spain would likely enter a widening and deepening common market in Europe. Likewise, actual Spanish entry into the EC in 1986 provided a key rationale for the renewed inflows during the late 1980s.
(19) The sum of net foreign inflows and net Spanish outflows rose from 3% of GDP in 1985 to 15% in 1992.
(20) For the investment figures from this period, see Keith Salmon, *The Modern Spanish Economy: Transformation and Integration into Europe*, Pinter, London and New York, Second edition, 1995.
(21) Per capita GDP figures for this period come from the IMF's World Economic Outlook database.
(22) Spain re-imposed some capital controls during the height of the ERM crisis in 1992, but had eliminated them again by the end of 1993.
(23) See Guillermo de la Dehesa, 'Balance de la economía española en los últimos veinticinco años', ICE, *25 años de constitución española*, n. 811, December 2003.
(24) During the late 1990s, some of Spain's largest firms (SCH, BBVA, Telefónica, etc) generated between 20% and 50% of their net earnings in Latin America. See William Chislett, *Spanish Direct Investment in Latin America: Challenges and Opportunities*, Real Instituto Elcano, Madrid, 2003.
(25) See Jorge Blázquez and Miguel Sebastián, 'El impacto de la crisis argentina sobre la economía española,' in Carlos Malamud and Paul Isbell (Coord.), *Anuario Elcano: América Latina 2002-03*, Real Instituto Elcano, Madrid, 2003.
(26) Average annual GDP growth for the Latin American region as a whole was 5.1% in the 1950s, 5.6% in the 1960s, and 5.5% in the 1970s –the three decades of the state-led import-substitution industrialization model–. During the region's first decade of (admittedly, tentative) reforms –the so-called 'lost decade' of the 1980s– regional GDP growth on an average annual basis was a mere 1.2% while average annual per capita GDP growth was actually negative (-0.1%). During the 1900s, a decade characterized by much more intense

reform, GDP growth picked up, rising to 3.8% on an average annual basis between 1991 and 1997 (the year the emerging market crises broke out, beginning with the Asian crisis). Nevertheless, between 1998 and 2002 –the period dubbed the 'lost half-decade' (*el lustro perdido*) by ECLAC, regional GDP growth slowed considerably to 1.3% annually. See Pedro-Pablo Kuczynski and John Williamson, *After the Washington Consensus: Restarting Growth and Reform in Latin America*, Institute for International Economics, Washington, D.C., 2003.
(27) The Gini coefficient in Chile (0.56) remains nearly double that of Spain (0.3). See José Juan Ruiz, 'Los Siete Pecados Capitales de América Latina', in Carlos Malamud and Paul Isbell (Coord.), *Anuario Elcano: América Latina 2002-03*, Real Instituto Elcano, Madrid, 2003.
(28) Productivity –particularly total factor productivity growth– remains one of the central weaknesses in the Spanish economy. The growth rate of this key measure, which expresses the contribution to growth from influences other than additions to the capital stock and labour force (including innovation, applications of technological advances to economic production, and improvements in human capital), has collapsed during the 1990s. It now represents the central economic challenge of the future for Spain. Average annual total factor productivity growth since 1975 has been 0.925%, against annual growth of 1.25% in the EU and 1.1% in the US. Most alarmingly, however, this TPF growth rate has declined in Spain, from 1.6% during 1975-85 to a mere 0.5% from 1995 to 2001. While it has also fallen in the EU, TPF growth remains around 1% annually, while this crucial productivity growth variable in the US actually increased to 1.5% during 1995-2001. In terms of the actual current levels of TPF, if the EU level represents 100, it is only 85% in Spain and as high as 112% in the US. See Guillermo de la Dehesa, 'Crecimiento y productividad de la economía española,' *El País*, 18/X/2003.
(29) See William Chislett, *The Internationalization of the Spanish Economy*, Real Instituto Elcano, 2002, p. 67.
(30) See Guillermo de la Dehesa Romero, 'Balance de la economía española en los últimos veinticinco años', ICE, *25 años de constitución española*, n. 811, December 2003.
(31) See Pedro-Pablo Kuczynski and John Williamson, *After the Washington Consensus: Restarting Growth and Reform in Latin America*, Institute for International Economics, Washington, D.C., 2003.

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