

## **Inside Spain 21**

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### **Foreign Policy**

*Spain defies US ban and presses ahead with military sale to Venezuela*

The government said it would go ahead with the sale of military aircraft to Venezuela despite Washington's ban on the re-export of US technology to the country. The ban means that EADS-Casa will have to acquire the technology for the 12 transport and maritime surveillance aircraft elsewhere if the deal is to be completed. Navantia, the Spanish state-owned shipyard, said the sale of eight patrol boats would not be affected by the US ban.

The US government said it had denied a request for licences to transfer US technology because 'in a region in need of political stability, the Venezuelan government's actions and frequent statements contribute to regional instability'. 'Despite being democratically elected, the government of Hugo Chávez has systematically undermined democratic institutions, pressured and harassed independent media and the political opposition, and grown progressively more autocratic and anti-democratic'.

The avowedly anti-American Chávez, Washington's bête noire in South America, has developed good relations with José Luis Rodríguez Zapatero, Spain's Socialist prime minister, and very close ones with Cuba's Fidel Castro. Rather than ostracise Chávez, as Washington would like, Zapatero believes the right approach is to keep lines open. Spain has always insisted that the boats and aircraft, which are not yet built, are to combat drug trafficking and terrorism.

The ban did not come as a surprise. Eduardo Aguirre, the US ambassador to Spain, told the Spanish government last year that Washington was reluctant to grant the permission (see *Inside Spain*, Newsletter 19, December 2, 2005). The Spanish foreign ministry put a brave face on the ban and said it would not affect relations with the US administration. Madrid's relations with Washington have greatly improved since Zapatero pulled Spanish troops out of Iraq in 2004, but they are still fraught.

The contract signed last November is worth €1.7 billion. France could replace the United States and supply the technology.

### *Spain participates in new European Gendarmerie Force*

Spain is one of five countries that launched the European Gendarmerie Force (EGF). The EGF whose other members are Italy, France, the Netherlands and Portugal aims to improve crisis management capability through the rapid deployment of forces to carry out police functions. If necessary it can work alongside troops.

Based in Italy, Spain's contribution comes from its 73,000 strong paramilitary Civil Guard. The EGF does not report directly to European institutions but it is mainly at the disposal of the EU and also of the UN, NATO and the Organisation for Security and Co-operation in Europe (OSCE).

### **Domestic Scene**

#### *Madrid cedes greater autonomy to Catalonia*

Catalonia, one of Spain's richest regions, has won its battle for greater self-government but its new charter does not go as far as its parliament wanted.

The central government did not give way on the two controversial points. It does not call Catalonia a 'nation', but it does recognise the desire to be called so. And the definition of what this constitutes is still circumscribed by the 1979 Catalan Statute of Autonomy (which recognised Catalonia as a nationality), pursuant to the 1978 Spanish constitution (which defines Spain as a nation). The new charter gives Catalonia a greater share of the taxes raised in its region but not the control over them that was sought nor the right to decide what proportion should be transferred to Madrid. The region will also not have its own Tax Agency (there will be a shared one in 2008). Catalonia will receive 50% of the personal income tax collected, up from 33% at the moment, and also 50% of VAT (currently 35%). This model can be extended to all Spain's other regions except for the Basque Country and Navarre which have their own systems. This would help to appease other regions which believe Catalonia is receiving privileged treatment.

The deal, which was approved last September by 120 of the 135 deputies of the Catalan parliament, was almost four months in the making. The national parliament in Madrid accepted the text of the new charter but the governing Socialists, whose party rules Catalonia in a coalition government, said it would have to be watered down in order to be approved. The Socialist premiers of the much poorer regions of Extremadura and Andalusia were particularly unhappy with the original text, while the centre-right Popular Party (PP) said it was unconstitutional and could lead to the break-up of Spain.

José Luis Rodríguez Zapatero, the prime minister, looked as if he had boxed himself into a corner when he unwisely said he would support anything that came to Madrid with the support of the Catalan parliament, but he managed to be pragmatic and not cross the red line he had laid down.

The tug of war between Spain's 'historic' regions, in particular the Basque Country and Catalonia, and the central government has dogged Spain's democracy since the devolution of power after the death of the dictator General Franco in 1975. The Basque question is still not resolved to the satisfaction of Basque nationalists (see *Inside Spain*, Newsletter 10, February 7, 2005). With the Catalan deal under his belt, Zapatero will now be able to focus fully on the Basque problem. He secured parliamentary approval a year ago to launch peace talks with Eta, the separatist terrorist group that has fought for

an independent Basque state for almost 40 years, if it declared a ceasefire and laid down its arms. Eta has not yet done this, but it has not killed anyone since 2003.

Zapatero could not get the PP on board which ideally was needed because the new Catalan charter is a state and not a partisan matter. The PP, which won 9.7 million votes in the 2004 general election compared with the Socialists' 11 million, is not a force that can be ignored. However, the PP's rather hysterical standpoint on Catalonia was so far from everyone else's that there was no common ground, and its policy towards the Socialists is very much one of maximum hostility and zero co-operation. The PP began to gather signatures demanding a referendum on the new charter, something that legal experts say is unconstitutional as the charter is an Organic Law and cannot be subjected to a referendum. 'This is no minor affair, or something that just concerns one semi-autonomous region', Mariano Rajoy, the PP's leader, said. 'This is something that affects all Spaniards. In matters of this nature, the people have a right to express an opinion.'

The negotiations over the definition of Catalonia were much more than a sterile debate on semantics. One of Zapatero's proposals was to say in the new charter that Catalonia has a 'national identity', but it was not sufficient. Had he given way on this issue and called Catalonia outright a nation, instead of hedging it, a future Catalan government, in an extreme case, could unilaterally declare independence from Spain. This demand, in particular, upset certain elements in the armed forces and led to the firing of Lt.Gen. José Mena Aguado, in command of the Spanish Army's land forces, last month after he said the military might have to intervene if Catalonia went too far towards greater self-government (see *Inside Spain*, Newsletter 20, January 13, 2006).

The pro-independence Catalan Republic Left (ERC), a partner in Catalonia's government and also a supporter of the minority Socialist government at the national level by giving it a majority in the parliament, is unhappy with the deal because it does not go far enough. The ERC could vote against the new charter in the national parliament –or abstain– and could also punish the Socialists by withdrawing its support, in which case the centre-right nationalist CiU could fill the gap. The CiU has supported previous Socialist governments. It was the CiU, to the ERC's anger, which negotiated the final deal behind its back.

Madrid also agreed to invest more in Catalonia's infrastructure over the next seven years in order to compensate for the difference between the region's contribution to Spain's GDP (currently 18.5%) and the share of the state's investments it has received (which have been less than its share of GDP). Catalonia has long complained that it contributes much more to the Spanish state than it receives. This is a sensitive issue because it questions the principle of solidarity between Spain's regions.

The new charter also gives Catalonia administration of the region's railways and responsibility for immigration into the region. Catalan is accepted as an official language equal to Spanish.

According to a survey conducted for *El País*, the main daily, 56% of respondents believe the government has been weakened by the reform of the Catalan charter.

*Zapatero, first PM to visit Spanish enclaves of Ceuta and Melilla in 26 years*

José Luis Rodríguez Zapatero became the first Spanish prime minister in 26 years to visit Ceuta and Melilla on the north African coast. The tiny enclaves (see Figure 1) are major funnels for illegal immigration to Europe via mainland Spain, and Morocco claims sovereignty over them.

**Figure 1. Ceuta and Melilla**



Last October Spain moved troops to the enclaves after several hundred immigrants armed with makeshift ladders stormed the six-metre high border fences from Morocco. Eleven people were killed.

Zapatero used this incident, among others, to persuade the EU to combat illegal immigration more effectively. Spain received one-third of the 1.9 million immigrants who entered the EU illegally last year. The country is the main beneficiary of a fund, agreed at the EU summit last December, to combat illegal immigration, and it also won more aid for the enclaves which are among the poorest parts of Spain.

Zapatero was able to grasp the scale of the immigration problem first hand when he visited a detention camp. Hundreds of immigrants greeted him shouting '*residencia, residencia*', in reference to the residency papers they would like to have.

The Moroccan government said Zapatero's visit was 'inopportune' but it did not press the issue. Despite the sovereignty claim, Rabat is co-operating more with Zapatero's Socialist government to contain illegal immigration than with the previous centre-right administration of the Popular Party.

The visit, the first since Adolfo Suárez visited Melilla in 1980, was very symbolic as it came hard on the heels of the controversial agreement to grant more self-government to Catalonia, one of Spain's richest regions. By going to the enclaves, Zapatero reminded Spaniards that Ceuta and Melilla are also part of Spain.

It was the newspaper *Melilla Hoy* that published a series of letters by disgruntled army officers protesting the firing of Lt.Gen. José Mena, commander of the army's ground forces, for publicly criticising the plans to give Catalonia more home rule (see *Inside Spain*, Newsletter 20, January 13, 2006).

*Government draws up emergency plans to cope with Spain's drought*

The Environment Ministry has drawn up emergency plans to cope with Spain's worst drought in 125 years. If there is not a lot more rain in the worst-hit parts of the country

water restrictions in homes and agriculture will have to be introduced affecting an estimated 11 million people. Water used in irrigation is already being restricted.

The drought is now in its second year. Initially, it was said to be the worst in 47 years. The average level of reservoirs is less than 40% of their capacity, 25 points below that in 2004.

According to the National Drought Observatory, Madrid, Ciudad Real, Albacete, Puertollano, Seville, Granada, Jaén, Úbeda, Malaga, the Costa del Sol, Valencia and Sagunto are in a state of ‘alarm’, ‘critical’ or ‘very delicate’.

The drought has lowered the output of electricity from hydraulic resources considerably. In 2005, for the first time, electricity production from wind exceeded that from hydraulic resources. REE, the electricity grid operator, said wind energy production rose 28.5% to 20,026GWh while electricity from hydraulic sources slumped 35.1% to 19,307GWh.

*Court suspends Eta-linked Basque party for a further two years*

Spain’s High Court banned the outlawed Basque political party Batasuna from holding a rally and suspended all its activities for a further two years. The pro-independence party was first outlawed in 2003 because of its ties to the Basque terrorist organisation Eta.

*Spain ranks low among developed countries in environmental protection*

Spain was ranked 23rd out of 133 countries in the 2006 Environmental Performance Index (EPI), drawn up by environmental experts at Yale University and the Earth Institute at Columbia University (see Figure 2). Among the 29 most developed countries, Spain was ranked 20<sup>th</sup>.

**Figure 2. Environmental Performance Index, Selected Developed Countries**

<b>Country</b>	<b>Score</b>
1. New Zealand	88.0
2. Sweden	87.8
3. Finland	87.0
5. United Kingdom	85.6
11. Portugal	82.9
12. France	82.5
21. Italy	79.8
22. Germany	79.4
<b>23. Spain</b>	<b>79.2</b>
28. United States	78.5

Source: Yale University and Earth Institute, Columbia University.

The EPI ranks countries in 16 indicators tracked in six established policy categories: environmental health, air quality, water resources, biodiversity and habitat, productive natural resources and sustainable energy. As a quantitative gauge of pollution control and natural resource management results, the index provides a tool for better policymaking and shifting environmental decision making onto firmer analytical foundations.

The European Parliament recently criticised the voracious urban development along the Mediterranean coast in the region of Valencia (see *Inside Spain*, Newsletter 20, January

13, 2006), and King Juan Carlos expressed his concern informally to a group of ecologists after he flew over the area.

### **The Economy**

#### *Gas Natural gets the go-ahead for its hostile bid for Endesa*

The Socialist government gave the green light for Gas Natural's €2 billion hostile take-over of the larger Endesa subject to various conditions. It would create the world's third-largest power utility by customers, as well as Spain's first integrated gas-and-electricity player.

The deal is fiercely opposed by the centre-right opposition Popular Party (PP) and was rejected last month by Spain's competition board, the TDC. Endesa said it was considering filing a suit in Spain's Supreme Court to block the acquisition. Its attempt to get an EU high court to impose interim measures to make sure that the EU's Commission instead of Spanish anti-trust authorities ruled on the bid failed. Endesa feared Spanish authorities would be more likely to approve the deal.

The TDC voted six 'against' and three 'for' the merger, a vote split down party lines, with the six dissenters being members of PP and the three who voted in favour belonging to the Socialists. The court's recommendation was not binding. Nevertheless, the government seems to have taken its views into account by toughening the conditions, particularly the level of disposals required of the combined group, which is higher than Gas Natural had itself offered to do when it launched the take-over, in order to avoid creating monopoly power.

The conditions for the take-over are:

#### 1. Gas transport

- Must release 1.8bcm per year of gas for three years from 2007
- Must release excess gas from Sagane 1 contract with Algeria
- Both the above to be done through public tenders from December 2006
- Must sell Endesa's stakes in Saggas and Reganosa regasification plant
- Must cut its stake in Enagas to 1% from 15%

#### 2. Electricity generation

- Must sell 4,300 megawatts of electricity capacity
- Cannot buy any combined cycle power plant for two years
- Must award power customers the right to cancel contracts without penalty

#### 3. Gas and electricity supply

- Must sell electricity marketing business and Endesa's gas business
- Must sell shareholdings in any marketing competitor, Naturgas Energía and Gas Natural de Álava

Gas Natural's original offer of €2 billion could be raised as Endesa's share price has risen. Endesa's shareholders have the last word.

The government favours the creation of national champions to compete on the world stage. Both companies have interests in Latin America, Italy, France, Portugal, Algeria and Morocco

### *Government unveils its tax reform*

Corporate tax on large companies will be gradually reduced from 35% to 30% over five years and the top rate of personal income tax will be cut from 45% to 43%. The reforms will take effect as of 2007.

People earning less than €9,000 a year will not pay taxes, while the middle wage bracket has been divided into two categories, with the lower end paying income tax of 24%. The tax rate for small businesses (with a turnover of less than €8 million) will be reduced from 30% to 25% and that for all types of savings to 18%.

There has been a spectacular increase in the number of taxpayers since the death of General Franco in 1975 and the establishment of democracy –from 400,000 in 1978 to 16.5 million today– but Spain's tax burden (35.1% of GDP in 2004) is still below the EU-15 average (40.5%), and the reforms will do little to increase it. The level of tax fraud, largely concentrated among the self-employed and in companies, and black money (mainly in the construction sector) is still very high. In some segments of the economy employers earn less than their employees.

### *Repsol YPF re-evaluates energy reserves*

Repsol YPF, Spain's oil and natural gas giant and a major player in Latin America, wrote down 25% of its proved oil and gas reserves, as part of an ongoing energy audit. Changes in Bolivia's energy law and also in the quality of some assets in Argentina prompted Repsol to re-evaluate reserves and write off 1.25 billion barrels of oil equivalent.

As a proportion of total proved reserves, the Repsol downgrade eclipsed that of Shell, which two years ago admitted to overstating reserves by 20%.

The company has frozen €400 million of planned investment in Bolivia pending talks with the administration of Evo Morales, the new Socialist president, which is to nationalise its oil and gas reserves.

### *Santander abolishes account fees*

Grupo Santander, Spain's largest bank and the 10<sup>th</sup> in the world by market capitalisation, abolished administration and services fees on current accounts into which salary or pension payments are paid, as well as current accounts held by customers with a pension plan or mortgage. The move in the intensely competitive retail banking market looked as if it would spark a fees war among banks.

The measure, which seemed to be in response to competition from online banks such as ING Direct, is initially expected to benefit 2.2 million current Santander customers, as well as the 800,000 new customers the bank is expected to attract this year.

The decision reverses the trend among Spanish banks of sharply increasing their fees –a sore point among customers and a source of many complaints– to offset the effect of low interest rates and shrinking spreads. It was the innovative Santander that broke ranks in 1989 with its high interest-bearing current account.

*Spain's inflation rate highest in the Euro zone*

Spain's inflation rate of 3.7% in 2005 was the highest in the Euro zone and 1.5 points above the average of 2.2% (see Figure 3).

**Figure 3. Euro Zone Inflation Rates\***

	%
<b>Spain</b>	<b>3.7</b>
Greece	3.5
Luxembourg	3.4
Belgium	2.8
Portugal	2.5
EU-12 average	2.2
Germany	2.1
Netherlands	2.1
Italy	2.1
France	1.8
Austria	1.6
Finland	1.1

(\*) Ireland not available.

Source: Eurostat.

In January year-on-year inflation was 4.2%, double the government's target for 2006, according to advanced figures from the National Statistics Office. Higher inflation is eroding the competitiveness of Spain's exports.

*Car output in sharpest fall since 1993 recession*

Spain's production of cars fell 12.6% in 2005 to just over 2 million units, the biggest fall since the 1993 recession. Total output of all vehicles was down 8.6% at 2.75 million units.

The main reason for the decline was the stagnation of the EU market, which takes around 85% of Spain's exports of vehicles and where the country is facing increased competition from Eastern Europe and Asia. Exports of cars were 13.3% lower than in 2004 at 1.7 million units.

Declining car sales are usually the sign of an economy which is slowing down. Spain's, however, shows no signs of abating in 2006 as domestic demand remains buoyant and the unemployment rate of 8.7% at the end of 2005 was the lowest level since 1978. But external demand is flagging.

*Spain remains the world's second largest tourism market*

A record 55.6 million tourists came to Spain in 2005, keeping the country in second place, after France, in the global ranking. The number was 6% more than in 2004, according to the World Tourism Organisation. Spending per tourist, however, was lower.

Tourism generates around 12% of GDP and is the sector that employs the most people directly and indirectly.

*Spain received one quarter of EU funds in 2005*

Spain was again the largest recipient of gross funds from the EU in 2005. It received €7,879 million, 24% of the total distributed to the 25 countries and to the two candidate countries Rumania and Bulgaria (see Figure 4).

**Figure 4. Recipients of EU Funds in 2005, Selected Countries**

<b>Country</b>	<b>€Millions</b>
France	2,208
Germany	4,395
Greece	2,578
Hungary	401
Italy	4,215
Lithuania	186
Poland	995
Portugal	2,684
Slovakia	201
<b>Spain</b>	<b>7,879</b>
United Kingdom	3,280

Source: European Commission.

Spain negotiated a very favourable deal last December at the EU summit in Brussels and will remain a net recipient of EU funds throughout the 2007-13 budgetary period (see *Inside Spain*, Newsletter 20, January 13, 2006).

#### *Watchdog tightens corporate governance guidelines*

The National Securities Market Commission (CNMV) called on companies to appoint more independent directors, pay more attention to minority interests and explain why they have so few women members on their boards.

The CNMV's recommendations are not yet binding but as of 2007 companies will be required to report whether they comply with the code or explain why they don't.

According to the guidelines an independent director should not be a recent former employee, have ties to management or financial or business dealings with the company. The CNMV recommends at least one third of the board should be independent directors. The code will require companies to reveal the compensation paid to each director, instead of just providing a global figure for board expenses, and that shareholders be allowed to vote for each nominated board director individually, rather than by slates. It is also suggested that Spanish companies trim their bloated boards to a maximum of 15 members.

The code urges companies to abolish by-laws that protect them from take-overs, such as rules that limit voting rights. The code will also require greater disclosure of related-party transactions, both between a parent company and a subsidiary, and between a company and its board members.

A final version will be submitted to the government after companies and shareholders have commented on the recommendations. Most of the companies that form the IBEX-35 index said the new code was too interventionist and restrictive. Most of them do not meet the recommendations, particularly on what constitutes an independent director.