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Foreign Policy

Government Seeks to Mend Fences with Bush Administration

Repsol YPF and Gas Natural Win Big Gas Contract in Algeria

The government is seeking ways to improve its relations with the re-elected Bush administration which rapidly deteriorated soon after the Socialists came to office and pulled Spain's troops out of Iraq. The Socialists had hoped for a victory by John Kerry. A further blow for Madrid was the hardly surprising appointment of Condoleezza Rice to replace Colin Powell as Secretary of State, generally regarded as the only dove in a nest of hawks.

The state of relations between the two governments was symbolically underlined by Bush not returning a post-election congratulatory call from Prime Minister José Luis Rodríguez Zapatero and the 100 minute 'farewell' meeting between Zapatero and George Argyros, the outgoing US ambassador to Spain. Far from being just a matter of protocol, the meeting was seen as an attempt to thaw the relations and put them on a new footing.

In a pointed snub to Zapatero, José María Aznar, the former prime minister who sent Spain's troops to Iraq, was invited to the White House for 40 minutes during a private trip to the US. He was the first overseas guest of the re-elected president. Aznar and Bush developed a very close personal relationship. While Zapatero is being kept at arm's length, King Juan Carlos and Queen Sofia had lunch with Bush at his Texas ranch.

Bush's father, however, spoke to José Bono, the defence minister, during a private visit to Spain. It was Bono, in explaining why the United States was not invited to participate in the Spanish national day military parade, as it had been in 2003, who said that Spain was 'no longer subordinated' or 'kneeling' before the Americans. Argyros boycotted the parade in October because at last year's Zapatero remained seated when the American flag passed by.

The only recent gesture that Zapatero has so far been able to make to curry favour with the new Bush administration was to airlift 90 American citizens out of the Ivory Coast.

According to Miguel Ángel Moratinos, the foreign minister, 'in Latin America we can deliver more than the previous government' and 'we have tremendous credibility in the Muslim world. We'll get results.' What Washington is looking for, however, is deeds that support its cause in Iraq and elsewhere in the world. In this respect the timing of Spain's efforts to forge a softer EU approach towards Cuba is not the most opportune, given the Bush administration's tough stance towards the Castro regime (see item below).

The government is in a conundrum. Zapatero has made it crystal clear that Spanish troops will not return to Iraq in any form (something widely supported by Spaniards) and he has continued to criticise the war, both in public (in an interview with *Der Spiegel*) and privately (for example, urging the prime minister of Hungary to pull out its troops). Moreover, his so-called anti-Americanism (in fact it is anti-Bushism, which is not the same) has entered the domestic political arena and the weaponry of the conservative Popular Party, the main opposition party.

Now that Bush has been re-elected the government knows that it has to change its tune in some form or other, at least the rhetoric if not the substance, not least because the poor relations are beginning to worry the business community in Spain, which fears there will be an economic cost. One idea being studied is to approach the two senators of Hispanic descent, Ken Salazar (Democrat) and Mel Martínez (Republican), the first ones in more than 40 years, with a view to them acting as intermediaries.

Jaime Malet, the chairman of the American Chamber of Commerce in Spain, says there are a number of investments and contracts which are on 'stand-by'. The US was the main foreign investor in Spain in 2003 and plays a leading role in many sectors of the economy (for example, the motor industry and pharmaceuticals). The area of greatest potential damage is business with the US government. It is widely believed, but not officially confirmed or denied, that Izar, the state-owned shipyards, lost the possibility of a contract to produce up to six ships for the Israeli navy because of the change of government. Izar left the Afcon consortium led by US military engineering giant Lockheed Martin and Bath Iron Works. Izar was also in the running to win a maintenance contract for the sixth fleet. The current impasse could also affect Spain's chances of replacing Naples as the location for USS Mount Whitney, the Nato command ship. It would be stationed at Rota, where there is a major US naval base.

Spanish investment and exports to the US are relatively small, but are growing. BBVA acquired two US banks this year and other companies are eyeing the market. The most conservative sectors of the US press have called for a boycott of Spanish goods.

As regards the political arena, the Bush administration, according to a well placed source, plans to neither favour nor actively punish the Spanish government but simply leave it out of the loop and ignore it. Punishing it would enable the government to play the victim's card. The government is already being excluded from the network of informal meetings that Washington holds from time to time ahead of international summits. There could also be a gap of as much as a year before a new US ambassador arrives, partly because of the long process of ratifying ambassadors but also because Washington is giving little importance to a replacement at the moment.

Warming of Relations Between Cuba and Spain, Dissidents Released

Cuba has re-established formal contacts with Spain after a freeze in relations and released several dissidents including the writer Raúl Rivero. The moves followed a decision by the European Union to study how to promote political dialogue with the regime and a vote by the European Parliament against the lifting of the EU's sanctions unless political prisoners are released and progresses made towards democracy.

The EU unanimously agreed in 2003 to reduce high-level governmental visits and participation in cultural events in Cuba after the summary execution by firing squad of three people, who hijacked a ferry in an attempt to escape the country, and the roundup of 75 dissidents including Rivero (see *Inside Spain*, Newsletter 7, November 4, 2004). He was sentenced to 20 years in prison. Countries also decided to invite dissidents to national holiday celebrations at their embassies in Havana as a sign of support for the regime's opponents. The regime retaliated by freezing out embassies from all official contacts, but it did not break diplomatic relations. Spain is the first of the EU countries with whom Cuba has re-established formal contacts.

The EU's committee of Latin American experts, known as Colat, asked ambassadors in Havana to draw up a report on how to promote 'a constructive dialogue with the government and the opposition'. Colat believes the lack of dialogue with Cuba is not positive and that some kind of relations should be restored, but it did not go as far as to endorse the lifting of sanctions which is what Spain wants.

'The releases are good news', said Miguel Ángel Moratinos, the Spanish foreign minister. 'The decision of the Spanish government is to continue working, with its colleagues in the EU, to obtain normalization of diplomatic dialogue by all the member states with Cuba.'

Spanish Foreign Minister Accuses Previous Governemnt of Backing a Failed Coup Against Venezuelan President Hugo Chávez

The Socialists triggered a political storm when Miguel Ángel Moratinos, the foreign minister, accused the previous conservative government of backing a failed coup against Hugo Chávez, Venezuela's president, in 2002.

Moratinos said in a television program, while Chávez was on an official visit to Spain, that Spain's ambassador to Venezuela during the coup attempt was instructed by the government of then-Prime Minister José María Aznar to support the rebellion. Chavez said, 'I have no doubt that this is true'.

The Popular Party, which was defeated in the March elections, demanded that Spanish Prime Minister José Luis Rodríguez Zapatero formally retract his minister's comments. Moratinos said he would address parliament's foreign commission to explain his remarks.

Chávez was full of praise for the Socialists and said the bad patch in the relations between the two governments had been overcome. Petróleos de Venezuela (PDVSA) is set to form a joint venture with Repsol YPF, the first state-private enterprise since the passing of a new law in Venezuela requiring joint tenders for exploiting Venezuela's oil reserves. Repsol will bring to the table its oilfield at Menegrando around Lake Maracaibo and PDVSA its Barua and Motaran fields, near Menegrando.

Socialists and Popular Party to Campaign for 'Yes' Vote in European Constitution Referendum

The ruling Socialists and the Popular Party (PP) will both campaign in favour of adopting the new European Constitution which will be put to a referendum in Spain on February 20. Some regional parties and Izquierda Unida (United Left) plan to vote 'no' because they believe the constitution does not meet their demands.

The Socialists' main argument in favour of the constitution, in the words of José Luis Rodríguez Zapatero, the prime minister, is that 'Europe represents peace, democracy and security in a world battered by violence and wars. And if Europe advances, Spain gains.'

The Socialists have asked the PP to bury their differences with them over other matters during the campaigning and present a united front as regards the constitution. Opinion polls show that Spaniards will vote in favour of the constitution; the main issue, and an important one for the government, is the level of voter participation.

Domestic Scene

Spain Arrests the Most Islamist Militants in the EU this Year

Spain has arrested more than 100 Islamist militants so far this year, almost half of whom are still in prison. This is the largest number among EU countries and is the result of police investigations following the March 11 terrorist attack in Madrid which killed 191 people and injured 1,500. Most of them are Algerians or Moroccans living in Spain.

Judge Baltasar Garzón says he has established links between the March 11, Casablanca, September 11 and other attacks. The first trial of a suspect implicated in the March 11 bombings opened and a 16-year-old Spaniard, known as *El Gitanillo* (the little gipsy), was given a six year prison sentence for trafficking a significant amount of explosives used in the attack.

Spain's Population Greying at One of the Fastest Rates

The pace at which Spain's population is ageing is one of the fastest in the European Union. Between 1992 and 2003 the proportion of the population over the age of 65 rose from 14.1% to 17.1% compared with an increase for the EU-25 as a whole over the same period of two percentage points (see Figure 1).

Figure 1. Population Over the Age of 65 (% of Total)

Countries	1992	2003
France	14.4	16.3
Germany	15.0	17.5
Italy	15.5	18.2*
Spain	14.1	17.1
United Kingdom	15.7	15.6*
EU-25 average	14.3	16.3

(*) 2002.

Source: Eurostat.

The greying of the Spanish population reflects the country's low fertility rate (which recently stopped declining, largely because of immigrants) and longevity (Spaniards live 79 years on average, higher than in the United States).

The Economy

Repsol YPF and Gas Natural Win Big Gas Contract in Algeria

Repsol YPF and Gas Natural have won a large contract to produce gas in Algeria and freeze it for export, beating off competition from BP, Total and Eni. The two companies will invest €1,628 million. Algeria, the world's second largest producer of natural gas, is Spain's main supplier and an increasingly important client.

Repsol won a gas contract in Iran in September with Royal Dutch/Shell (see *Inside Spain*, Newsletter 6, October 4, 2004). The latest one is its first with Gas Natural and it comes less than a month after Repsol's chairman, Alfonso Cortina, stepped down and was replaced by Antonio Brufau, the former chairman of Gas Natural. Repsol controls 30.8% of Gas Natural and La Caixa, the big Catalan savings bank, has a 30% stake and also 12% of Repsol. The two companies will produce gas in an area where there are proven reserves.

The contract covers the development of gas reserves in the Algerian Sahara over the next 30 years and includes the construction of a liquefaction plant in Arzew, Algeria's LNG capital, from where the natural gas will be marketed. The plant, which could be operational by 2009, will have an annual capacity of 5.2bn cubic metres, equivalent to 20% of Spain's domestic consumption.

Gas Natural Acquires Enron Project in Portugal

Gas Natural is to invest €400 million in building two combined-cycle electricity generators in Sines, Portugal. The two generators will have a combined capacity of 800 MWs. Construction is due to begin next year and the plant will become operational in 2007.

The investment is part of Gas Natural's European expansion programme, and comes ahead of the much delayed launch of the unified Spanish-Portuguese electricity market, now scheduled for June 2005. The project had originally been initiated by now-bankrupt US energy giant Enron.

Caja Madrid Enters Mexican Mortgage Market

Caja Madrid, Spain's second largest savings bank, is to acquire 25% of the Mexican mortgage company Hipotecaria Su Casita (HSC) for €45 million. HSC is Mexico's second largest mortgage lender with a market share of 21%. Caja Madrid has an option to lift its stake to 40%.

The agreement comes hard on the heels of the acquisition by BBVA, Spain's second largest commercial bank, of Mexico's Hipotecaria Nacional, also a mortgage company (see *Inside Spain*, Newsletter 6, October 4, 2004).

Lending in general and mortgages in particular are very under-developed in Mexico, and there is huge untapped potential.

European Commission Blocks Government's Plan to Save Ailing Shipyards

The European Commission's competition authorities oppose the government's rescue plan for shipyards because it allows savings banks to acquire part of a new civil shipbuilding division (see *Inside Spain*, Newsletter 7, November 4, 2004).

Under the plan of the state industrial holding company, SEPI, one business would comprise Izar's shipyards in Ferrol, Cadiz, Puerto Real and Cartagena –all military shipyards– while the other would comprise Izar's civil shipyards. SEPI would continue to have full control of the military shipyards and 49% of the civil ones. Spain's savings banks, which have a special status and are effectively politically controlled, would be allowed to acquire 21% of the civil shipyards, and the rest would be in private hands. This would mean that the civil yards would still be majority controlled by the public sector and in contravention of EU competition rules for receiving public aid.

The crisis at Izar was brought to a head by the EU demanding that €1.2 billion of illegal state aid granted by the previous government be repaid by January 1, 2005. Shipyard workers took to the barricades again as they fear that the plan will be shelved and replaced with SEPI's original plan, which was to sell off any merchant yards left out of a new public company that will take over Izar's defence work.

Meanwhile, Izar received a much needed shot in the arm in the form of contracts worth €600 million to build three ships for Repsol and Gas Natural which would ensure work for the shipyards until 2009. Repsol and Gas Natural need to increase the size of their fleet of tankers as a result of winning a major contract in Algeria (see separate item).

Business Forum Created to Defend Interests in Latin America

The government has established a forum among 12 multinationals that have invested heavily in Latin America in order to better gauge the region's situation and be in a position to defend their interests more effectively, particularly in the event of a crisis.

Spanish banks, utilities and telecommunication companies have invested more than €100 billion in Latin America and in countries such as Chile, Mexico and Brazil have very strong positions (see Elcano's *Spanish Direct Investment in Latin America: Challenges and Opportunities*, www.realinstitutoelcano.org/publicaciones/libros/SpanishDirect.pdf).

The 2001 crisis in Argentina hit some companies very hard, particularly those whose tariffs were frozen, and several are still battling with the government to obtain reasonable increases. There are also disputes in Chile, Peru, Bolivia and Brazil. One of the main worries of companies is the lack of legal security.

The 12 companies are Telefónica (telecommunications), Repsol (oil), Gas Natural, BBVA and Banco Santander (banks), Endesa, Iberdrola and Unión Fenosa (electricity), Agbar (water), PRISA (media), Sol Meliá (hotels) and ACS (construction).

The companies are represented on the forum at a high level and there are also senior government officials from the foreign, tourism and commerce and economy ministries. The Socialists' move brings Spain closer to the practice of other countries, such as the United States and France, whose administrations work more closely with companies.

The previous centre-right government tried to set up a similar forum but it never got off the ground because companies have different priorities among the countries and are a mixed bag of interests. This problem persists, but at least the forum should enable the government to keep its ear closer to the ground.

The forum, if successful, could also become a useful foreign policy tool. Mauro Guillén touches on this issue in a new book to be published in early 2005 (*The Rise of the Spanish Multinational Firm*, Cambridge University Press). He argues that the increased presence of Spanish firms abroad has shaped foreign policy more than the reverse. There is very little evidence, he says, indicating that firms have been used by the government in its pursuit of foreign-policy goals, although it is true that it has benefited from the enhanced stature generated by foreign investment.

The story of Spain's rise in just a decade as a major outward investor (more than €100 billion in Latin America alone) is a remarkable one, and as Guillén points out a book on the Spanish multinational enterprise not too long ago would have been regarded by many as a work of fiction. Guillén, a professor of international management at the Wharton School of the University of Pennsylvania, knocks down three widely-held myths about Spanish multinationals. They are: (1) the process was driven by a small cadre of 'new conquistadors'; (2) Spanish firms invested mainly in Latin America because of the shared language and culture; and (3) Spanish foreign direct investment is 'anomalous' (and perhaps doomed to ultimately fail) because Spanish firms lack the requisite technological and managerial skills to succeed in the global economy. He believes, however, that many Spanish multinationals are still 'far from the global frontier in terms of financial, organisational, managerial, and technological capability'. Similarly, Spain and its government seem relatively lacking and unprepared when it comes to coping with the economic, financial, diplomatic, political and social consequences that increased outward foreign investment entails.

His main argument, cogently expressed, is that while Spain has indeed become a 'normal' country from the point of view of its integration with the global economy, it continues to be a 'second-rate country, aspiring but unable to join the club of the most advanced and powerful countries in the world'. He argues that the gap separating Spain from the elite club of countries is not merely to be seen in such simple statistics as per capita income, but also qualitative (power and influence).

For example, in some areas Spain has been able to acquire a new presence, as for instance in the Basel Committee on Banking Supervision, in which there is a Spanish permanent representative since 2001. However, Spain still lacks a permanent executive director at the IMF (although its managing director is a Spaniard, Rodrigo Rato), where smaller countries from the standpoint of GDP or FDI like Australia, Belgium, the Netherlands, Switzerland or Saudi Arabia have more voting power. And Spain is not a member of the G7 –where many important decisions are made–.

While Latin America is one of the book's focal points, because the bulk of Spanish outward investment is in that region, Guillén performs a useful service by reminding us that Spanish multinationals are also becoming increasingly prominent actors in the European corporate landscape in their own right. Santander's purchase of UK's Abbey National (see *Inside Spain*, Newsletter 7, November 4, 2004) is the latest big investment. This is a major book and likely to be the standard work on the subject.

IMF Urges Greater Fiscal Restraint and Stronger Pension Reform, Forecasts Lower Economic Growth

The government inherited a 'propitious environment' to pursue its priorities of fiscal stability, transparency and productivity enhancement, but it needs to move to a larger-

than-targeted budget surplus in 2005, put pension reform higher on the policy agenda and correct the shortcomings of its housing plan.

These are some of the conclusions of the annual review of the economy by the International Monetary Fund (IMF). It also expresses concern at the ‘unrelenting rise in house prices and household indebtedness’ which has ‘engendered an overvaluation in the housing sector and raised the economy’s vulnerability to adverse developments’.

The IMF forecasts real GDP growth stabilising at 2.6% in 2005, lower than the government’s target of 3%. Its central assumption for oil prices is US\$11 a barrel higher than the figure in the government’s budget.

The Fund says the 2005 budget target of a general government surplus of 0.1% of GDP would imply a broadly neutral stance and that a ‘better outcome is both possible and desirable’. At the central government level it says the advocated restrictive stance would require containing spending below the budget ceiling, avoiding parliamentary amendments that complicate this task, and safeguarding the contingency fund for truly exceptional circumstances. In social security, the expected surplus –likely to be further boosted by more immigrants paying into the system– should be fully saved, resisting pressures for cuts in social security contributions or increases in social spending. Finally, regional governments need to tighten their belts more, as fiscal discipline at lower levels of government is crucial in as highly a decentralised system as that of Spain.

A higher budget surplus in 2005 would also help towards constituting the buffer required to deal with the fiscal consequences of aging (see next item) and enhance long-term fiscal sustainability.

The IMF says the Toledo Pact has been an effective instrument to build consensus on an agenda for pension reform, but –after partial measures in 1997– progress has been ‘disappointingly slow’. Spain’s demographic shock is further away than in other countries, but it will be ‘considerable’ even under favourable population and immigration assumptions. There should be a gradual increase in the effective retirement age and an improved alignment of benefits and contributions. In particular, features of the pension calculation mechanism which now perversely encourage early retirement need to be corrected.

As regards the housing plan, the IMF says it fails to tackle the fundamental problems, whose resolution would require: (a) phasing out the unequal fiscal treatment arising from generous tax relief that favours home ownership and weighs heavily on the budget; (b) changing a legal framework that is prejudicial to rental activity and smothers the supply of rental units; and (c) reforming the laws and regulations governing developable land that, along with insufficient transparency in the urban zoning process, limit its supply. ‘Until and unless these key issues are dealt with resolutely, other measures will likely be palliatives with limited effect.’

Spain Lags Way Behind in Meeting the Lisbon Strategy Targets

Four years after the launch of the so-called Lisbon strategy to make the European Union by 2010 ‘the most dynamic and competitive knowledge-based economy in the world capable of sustainable economic growth with more and better jobs’, Spain’s results are

far from meeting the objectives (see Figure 2). But Spain is not alone. The report by the High Level Group chaired by Wim Kok says the overall results are generally ‘disappointing’ because of an overloaded agenda, poor coordination and conflicting priorities (see http://europa.eu.int/comm/lisbon_strategy/pdf/2004-1866-EN-complet.pdf).

Figure 2. Employment, Productivity and R&D Spending

Country	Productivity per Person Employed (EU-15 = 100)	Employment Rate (%)	Employment Rate Females (%)	R&D Spending (% of GDP)
France	113.7	63.2	57.2	2.2
Germany	94.3	65.0	59.0	2.5
Italy	103.6	56.1	42.7	1.1
Spain	94.8	59.7	46.0	1.0
Sweden	96.5	72.9	71.5	4.3
United Kingdom	101.9	71.8	65.3	1.9
EU	93.1	62.9	55.1	1.9
United States	121.6	71.2	65.7	2.8
Lisbon target 2010	-	70.0	60.0	3.0

Source: Eurostat and OECD for the US.

Greater productivity and higher R&D spending are among the Spanish government’s policy objectives, and a Herculean effort will be needed to bridge the gap. As regards the employment rate (employed people between the ages of 15 and 64 as a percentage of the total population), Spain’s increase between 1999 and 2003 of 1.5 points was three times the EU-15 average, but it is still the lowest apart from Italy.

Spain Unveils Europe’s Most Powerful Computer

IBM and the government unveiled Europe’s most powerful computer and the fourth largest in the world. Mare Nostrum, expected to be fully operational in January 2005, will be capable of carrying out 40 billion operations per second. It is to be used for scientific research in medicine, climate change, and new materials for the aeronautics and mechanical engineering industries.

Weighing 60 tonnes, the machine occupies a space less than the size of half a basketball court (160 m²), comprises 4,500 processors, has a storage capacity of 128 terabytes and cost US\$70 million. It will be the centrepiece of the Barcelona Supercomputing Centre.