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Working Paper No. 94

TOWARDS SPAIN'S ACCESSION INTO THE EEC
- Trade, Growth and Policy Reform Implications -

by

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TOWARDS SPAIN'S ACCESSION INTO THE EEC*

- Trade, Growth and Policy Reform Implications -

Introduction

Following the preferential trade agreement between Spain and the European Economic Community of 1970, the Spanish Government applied for full membership in the EEC in July 1977. The official negotiations were formally opened in February 1979; they are expected to lead to a Treaty of Accession by 1982, with full integration four or five years later. The acceptance and application by Spain of the Common Market founding treaties and ensuing legislation will presumably have noticeable repercussions on the Spanish economy. This holds, above all, for both its trade orientation and growth prospects.

The purpose of this paper is to examine those repercussions and to discuss key economic policies in Spain which might be required if the country's entry into the EEC is to have the desired effects.¹ Since the effects of full integration will be greatly influenced by the present structural characteristics of the Spanish economy, it may be instructive to begin with a brief overview of the long-term development trends and a look at the performance in the recent years since the end of the Franco régime (1975). Next, the potential

* This paper has been presented at the 1979 Regional Meeting of the Mont Pelerin Society, held in Madrid, 3-6 September 1979. It reports research on the economic implications of the second EEC enlargement, being carried out by the Kiel Institute of World Economics under the direction of Klaus-Werner Schatz and the present author. I would like to thank Christiane Krieger, Rolf-J. Langhammer, and Dean Spinanger for research assistance.

¹ The analysis focuses on industry only. For an overview of Spain's economic prospects in an enlarged Community, see the Spanish White Book prepared by the Circulo de Economía (1974). A useful analysis is also provided by Musto (1977), whereas the effects on the agricultural sector have recently been analyzed by Solbes (1979).

trade effects of Spain's integration into the Common Market will be estimated. Some potential growth effects will be considered subsequently. The last section will discuss major policy implications.

Past and Current Economic Trends¹

The Spanish economy has experienced rapid growth and a noticeable structural transformation since 1959, as can be inferred from Table 1. Prior to 1959, the country has undergone an autarkic economic development, with imports limited by strong quantitative restrictions, traditional agricultural exports stagnating, and much of manufactured exports performing poorly. Following a severe stabilization programme in 1959, development policies were changed from inward-looking towards more outward-looking, by gradually liberalizing imports, reducing levels of effective protection, promoting manufactured exports and tourism, and attracting private foreign investment.

During the sixties and early seventies, real gross domestic product increased at an average annual rate of 7.5 percent.² This was a more rapid pace than what Spain had experienced in any time of comparable length before in this century; it also was among the highest rates within the OECD countries and surpassed the rate of growth of the EEC as a whole. Thus, while Spain's per capita income of \$ 341 in 1960 placed the country close to the wealthier developing countries, by 1977 the per capita income of \$ 2,954 is well above the levels in non-oil LDCs and close

¹The section draws heavily on the author's earlier work on industry and trade in Spain (1976).

²Unless otherwise indicated, all figures in the text have been calculated from the annual reports and statistical bulletins of the Banco de España and the Banco de Bilbao.

Table 1 : Selected Macroeconomic Indicators for Spain

	Unit	S p a i n			E E C
		1960	1970	1977	1977
Population	million	30.3	33.6	36.7	259.2
Gross Domestic Product	US-\$ billion	10.3	32.3	108.4	1581.0
GDP per capita	US-\$	341	963	2954	6099
Gross investment / GDP	percent	19.4	21.3	21.5	20.9
<u>Structure of Production</u>		percent			
Agriculture		23.7	13.5	9.4	4.3 ^a
Industry		35.3	35.6	37.9	42.5 ^a
Manufacturing		27.0	26.9	27.7	31.1 ^a
Services		41.0	50.9	52.7	53.2 ^a
<u>Structure of Employment</u>		percent			
Agriculture		41.7	29.1	20.0	8.4 ^a
Industry		31.8	37.3	37.0	40.9 ^a
Manufacturing		22.4	27.0	27.0	30.6 ^a
Services		26.5	33.6	43.0	50.7 ^a
Ratio of overall unemployment		1.4	1.5	7.5	5.6
<u>Functional Income Distribution</u>		percent			
Wages and salaries		49.0	55.5	65.3	72.9
Property and entrepreneurial income		51.0	44.5	34.7	27.1
<u>Foreign Trade</u>					
Exports	US-\$ billion	0.7	2.5	10.2	382.0
Imports	"	0.7	4.3	17.8	389.5
Exports / GNP	percent	7.0	7.7	8.8	24.3
Imports / GNP	percent	7.0	13.3	15.4	24.8
Tourism receipts	US-\$ billion	0.2	1.7	3.4	21.8
<u>Prices</u>					
Cost of living	1960 = 100	100	179.9	455.3	271.8
Wholesale	1960 = 100	100	139.9	312.3	249.1

^a 1976.

Sources: World Bank, World Tables 1976. - Statistical Office of the European Communities, Balance of Payments, 1970-77. - OECD, Main Economic Indicators, April 1979. - OECD, National Accounts Statistics, 1952-1977, Vol. I. - Banco de Bilbao, Informe Económico, various years.

to Italy and Ireland.¹ Although deep-seated structural imbalances at the sectoral and regional level prevail, anyone who had forecast in 1959 the performance of the Spanish economy in the sixties and early seventies would have been met only with scepticism.

Spain's outstanding growth performance was industry-determined. Manufacturing value added has increased at a rate slightly exceeding overall economic growth. In 1977, its share in gross domestic product was almost 28 percent (Table 1). Compared with an international cross-section standard of reference, this share is roughly in line with what one would have expected of a hypothetical country with similar per capita income and population as Spain. At the same time, the share of agriculture in GDP fell substantially. During the sixties, industrialization in Spain entered the stage of far-reaching vertical diversification. Manufacturing activities now include, in addition to the production of traditional consumer goods (such as food, beverages, tobacco, textiles, clothing, footwear, leather, furniture, printed matter), a wide range of intermediate and capital goods (such as basic metals, chemicals, electrical equipment, machinery, ships, automobiles). Two of these "new" branches - the automobile industry and the chemical industry - were the most important contributors to manufacturing growth, certainly favoured by a massive inflow of foreign capital and technologies.

Prior to 1959, the net inflow of private long-term capital from abroad was almost negligible, reflecting the antipathetic attitude of the Government towards foreign investment as well as low profitability expectations in a closed economy. After the official changes to an open-door

¹The 1977 figure is biased in an upward direction due to inflation. In prices and exchange rates of 1964, per capita incomes were \$ 455 and \$ 1,105, respectively.

posture, the presence of foreign capital has increased strongly, with an annual average of \$ 883 million during the period 1959-78. The ratio of this inflow to the country's gross fixed capital formation increased thereby from 3.4 to 11 percent, with implications for the allocation of resources being probably larger than what is suggested by these figures. Roughly one third of the capital inflow is foreign direct investment, which has originated with 40 percent in the EEC and has been particularly strong in the chemical, automobile, electrical, and food processing industry, in addition to construction (Castañe, 1973). Until recently, foreign-controlled firms produced mainly for the domestic market; nowadays they have become export-oriented too (Muñoz, 1978).

The policy of opening-up the economy has also led to a strong expansion of manufactured exports (Donges, 1973). Excluding (traditional) processed food products, their value rose from \$ 0.3 billion in 1959 to \$ 9.4 billion in 1978 and their share in total exports increased from 35.5 to 71.8 percent. Spanish manufacturers are exporting now, on average, 21 percent of their output, as compared with 2 percent in 1959. The export assortment not only includes raw-material based and labour-intensive products, where Spain used to have a comparative advantage; it also consists, with an increasing weight, of standardized "product-cycle" goods, which can be regarded as indication of the country's potential to diversify her export structure within a relatively short period of time. This development compares favourably with observed results for most other industrializing countries. Although the rapid expansion of both manufactured and total exports (which account now for 1.02 percent of world exports, as compared with 0.45 percent in 1959) was insufficient to close Spain's traditional trade deficit, it is a significant achievement in itself because it occurred in spite of a number of economic-policy distor-

tions which could have negatively affected Spain's export competitiveness.

In fact, the development strategies pursued during the sixties and seventies, though more rational than the preceding excessively inward-looking ones, have not been optimal. On the contrary, there are still considerable differences in the inter-industry pattern of incentives and hence in the domestic resource cost of saving or earning foreign exchange, thereby leading to inefficiencies in the allocation of resources among economic activities. As a consequence, the manufacturing industry (as well as the agricultural sector) is excessively fragmented, many industrial firms produce well below optimum scale, the installed equipment is somewhat obsolete in a number of branches, several companies operate with a negative value added at world market prices, monopolistic and oligopolistic market structures have emerged which involve significant "X-inefficiencies" for given plant size and factor prices, and only a few firms are known for applying modern organizational techniques and for engaging in research (Lluch, 1974). Furthermore, there are still a number of high-cost industries, including iron and steel, non-ferrous metals, and industrial chemicals, which - because of their critical position in the economy's input-output network - contribute to the proliferation of defective cost structures over the whole industry and inhibit other firms from becoming efficient producers. It also is noteworthy, that Spain's industry has not absorbed as much labour released from the agricultural sector as required, thereby forcing an important proportion of the labour force to emigrate to the EEC and elsewhere.

The problems which the Spanish economy is facing have been exacerbating in recent years. Not only was the country negatively affected by the oil price explosion and the world

economic recession. The political change from Franco's long-standing authoritarian corporate state towards a representative democracy, initiated in December 1975, has complicated even more the future growth. The successive governments which have held office since Franco's death have been more preoccupied with political issues (such as the draft and implementation of a democratic constitution, elections at the national and municipal levels, regional demands for autonomy, continuing armed terrorism) than with economic matters. Essentially, their economic actions have been directed against what they regarded as the major social injustices of the previous régimes. Equity issues have taken precedence over efficiency considerations; increasing levels of private and public consumption have been given priority over the growth of net fixed investment. In an atmosphere of deteriorating labour-management relations with many strikes and lock-outs, money wages are rising sharply and so does their share in national income, labour productivity is declining rapidly, profitability of private investment is falling markedly, and both risk capital and entrepreneurial talents are emigrating to some extent.

All this has cast a damper on the booming economic development, it has caused a number of companies (including government-controlled ones) to go bankrupt, and it has led to a decrease in the utilization of productive capacities and an increase in the unemployment and underemployment rates to levels hitherto unknown in the postwar period.¹ At the same time inflation persists to a considerable amount and has been exceeding the rates of the other OECD

¹The average annual rate of growth of real GDP was only 2 percent during the period 1975-78. Real investment decreased, on average, by 1.4 percent. One fourth of industrial productive capacities is not used, while the number of unemployed people increased by 46.1 percent per annum, especially affecting young people.

countries with the exception of Iceland and Portugal.¹ Although Spain has developed a rather sound economic basis from which the integration into the EEC can be pursued without suffering unmanageable structural adjustment difficulties, the need for a reversal of the recent trends is inescapable if actual or potential international competitiveness should not be reduced to almost nothing.

Potential Trade Effects of Integration

The EEC is one of the most important markets for Spain's exports (absorbing about 46 percent) and one of the main sources of supply of imported products (with a share of about 34 percent). These shares, which incidentally have been decreasing since the early sixties, are only marginally lower than those of the EEC member countries in their mutual trade (Alcaide, 1979, pp. 14sqg.). The import structure shows a preponderance of capital goods, the export structure one of foodstuffs. The balance of trade with the EEC is negative. Provided that Spain does not pay higher prices for goods imported from the Common Market than for those available elsewhere, the trade deficits can be considered to be a good indicator of benefits accruing to the country from its trade relations with the EEC; they reflect the extent to which the Community transfers resources to Spain at world market prices and to which a rational division of labour is enhanced. Hence, much of the concern in Spain about these trade deficits is rather misplaced.

As far as trade in manufactures (excluding processed food) between Spain and the EEC is concerned, it is note-

¹The austere stabilization measures introduced in October 1977 under the so-called Moncloa Pact signed by the political parties with parliamentary representation, after the peseta was devalued by 31.2 percent in July, slowed down the rise of the consumer price index in 1978 (to 19.7 percent, as compared to 24.5 percent in 1977).

worthy that Spain imports are dominated by chemicals and machinery (SITC 5+7), which can be roughly regarded as relatively human capital-intensive goods; the other categories of manufactured goods (SITC 6+8), which typically are more labour-intensive, account for the overwhelming part of the exports into the Community (Donges and Schatz, 1979, pp.220sqg.). Thus, Spain's trade in manufactures with the EEC seems to be governed by patterns of comparative advantage. In recent years, however, Spain has expanded exports of machinery and chemicals into the EEC at higher rates than exports of other manufactures. Hence, her trade structure has become more similar to the EEC's foreign trade structure as time passed, thereby increasing the degree of intra- (as opposed to inter-) industry specialization between the two.

In order to better assess the evolution of international competitiveness of Spain's tradable sector over time, it has become common practice among economists to look at the relative trade balance, or the relative export-to-import ratio, of commodity groups, i.e. Balassa's "revealed comparative advantages" (RCA). The basic assumption is that a country's imports indicate which of the domestic industries are relatively non-competitive, while these country's exports point to the industries which display comparative competitiveness. Hence, a positive trade balance represents a competitive advantage, a negative balance reflects a competitive disadvantage in international trade.¹ The higher the RCA index, the

¹The RCA index does not necessarily reflect real comparative advantages. It is based on actual trade figures which may differ from those predicted by the theory of comparative advantage as a result, for instance, of distortions, originating in protective measures against imports or in export incentives. If Spain restricts imports of certain goods, the RCA index of the industry in question might be biased in an upward direction; by the same token, it might look worse than it deserves if the EEC or other countries impose barriers to Spanish exports. It should also be noted that no allowance has been made for the possibility of export price differentiation among countries of destination, of product heterogeneity within individual industry groupings, and of substantial differences in the absolute trade values.

more successful the industry's trade performance.

RCA indices have been calculated for 1961, 1970 and 1977, distinguishing between the EEC and the rest of the world. The ranking of 28 industrial commodity groups is shown in Table 2. Spain's industry exhibits a strong competitive position in footwear, leather manufactures, travel goods, wood and cork manufactures, and clothing. Not surprisingly, these are all labour- and/or raw material-intensive products, as are textile yarn, metal manufactures, and miscellaneous articles, which enjoy a small positive trade balance with both areas. It is worthwhile, however, that Spain has been improving international competitiveness in a number of more capital-intensive goods falling into the "product-cycle-" category; chemical fertilizers, plastic materials, rubber manufactures, paper products, and transport equipment are cases in point.

There are some differences in ranking of RCA indices between Spain's trade with the EEC and the rest of the world, with a tendency to widen recently. Spearman's rank correlation coefficients are 0.83 in 1961, 0.81 in 1970 and 0.63 in 1977 (all statistically significant at the 0.1 percent level of confidence). Large disparities in favour of trade with the EEC occur, for instance, in non-ferrous metals, chemical elements, leather manufactures, wood and cork products, and clothing. The competitive position of Spain's industry is, on the other hand, much stronger in trade with the rest of the world in, for example, non-metallic mineral manufactures, plastic materials, sanitary and heating apparatus, and rubber manufactures. As Spain's trade with the non-EEC world includes trade with the overseas developing countries, which account for 60 percent of this total, it is not surprising that the largest differences of RCA ranking in favour of this trade include capital-intensive goods; it reflects the fact that Spain is relatively well-endowed with physical capital and skilled labour in comparison to these countries.

Table 2 : Indices of 'Revealed Comparative Advantages'^a
in Spain's Trade in Manufactures

SITC	Group of commodities	Trade with EEC ^b			Trade with rest of world		
		1961	1970	1977	1961	1970	1977
51	Chemical elements and compounds	-6.3	-25.5	-67.0	-0.4	-40.4	-28.4
52	Mineral tar and crude chemicals from coal, petroleum and natural gas	-14.1	-100.0	45.5	-100.0	-100.0	-91.8
53	Dyeing, tanning and colouring products	-99.9	-71.4	-53.5	-54.5	-25.9	-12.2
54	Medical and pharmaceutical products	-41.0	-59.1	-45.6	-52.1	-41.6	-40.3
55	Essential oils and perfume materials	19.0	5.2	-19.6	48.0	34.2	7.4
56	Manufactured fertilizers	-43.1	2.5	48.9	26.5	7.2	75.5
57	Explosives and pyrotechnic products	-100.0	-9.3	-59.1	-100.0	46.6	-22.3
58	Plastic materials, regenerated cellulose & artificial resins	-96.8	-77.9	-71.0	-95.3	-22.5	-3.4
59	Other chemicals	-2.0	-37.0	-55.4	-50.7	-59.2	-46.3
61	Leather and leather manufactures	75.6	57.9	83.3	86.0	45.1	-5.7
62	Rubber manufactures	-99.5	61.6	58.5	33.8	74.7	83.2
63	Wood and cork manufactures (excl. furniture)	87.6	83.7	78.5	83.4	73.4	55.3
64	Paper, paperboard and manufactures thereof	-93.7	-46.5	14.8	-61.8	-34.8	-23.7
65	Textile yarn, fabrics, made-up articles and related products	80.5	34.7	22.0	70.0	32.5	23.5
66	Non-metallic mineral manufactures	-48.2	4.7	-5.4	33.1	34.8	66.6
67	Iron and steel	17.3	-43.6	7.5	44.3	-72.5	28.3
68	Non-ferrous metals	40.2	14.2	3.6	5.0	-60.3	-54.8
69	Manufactures of metal	-70.7	16.5	24.4	34.4	61.1	58.7
71	Non-electrical machinery	-85.0	-58.9	-45.1	-57.2	-30.3	-28.4
72	Electrical machinery, apparatus and appliances	-72.4	-24.9	-39.7	-28.8	-22.8	-33.3
73	Transport equipment	-93.9	27.1	43.1	-73.0	23.7	62.0
81	Sanitary, plumbing, heating and lighting fixtures and fittings	95.3	31.3	-18.9	90.9	76.8	48.5
82	Furniture	80.8	54.4	48.5	100.0	82.7	66.7
83	Travel goods, handbags and similar articles	92.8	17.0	77.8	100.0	90.0	51.9
84	Clothing	83.7	42.9	60.2	69.6	81.2	29.6
85	Footwear	100.0	88.5	93.6	100.0	98.5	96.2
86	Professional, scientific and controlling instruments; photographic and optical goods; watches and clocks	-94.2	-76.4	-77.9	-79.6	-70.7	-82.9
89	Miscellaneous manufactures	35.6	20.9	19.1	75.7	60.5	13.5

^a Calculated as $RCA = \left[\frac{(x_i - m_i) : (x_i + m_i)}{\sum_{i=1}^n (x_i - m_i) : \sum_{i=1}^n (x_i + m_i)} \right] \cdot 100$, standardized so that the values range from -100 to +100; x_i, m_i denote industry's i exports and imports, respectively. For details see Hiemenz and Schatz (1979, p. 97).

^b Nine member countries.

Sources: OECD, Statistics of Foreign Trade (Series C), various issues. - United Nations, Commodity Trade Statistics, various issues. - Ministerio de Hacienda, Estadística del Comercio Exterior de España (C.U.C.I.), various issues.

In all likelihood the mutual removal of tariffs after the Agreement of Accession is signed holds the prospect of some trade expansion for Spain, operating on the import side as well as on the export side. The EEC average External Common Tariff on dutiable non-agricultural imports stands at 8.1 percent, whereas Spain's average tariff level lies at 17.3 percent; of the reciprocal tariff reductions provided by the 1970 Preferential Trade Agreement are taken into account, the nominal tariff averages become 3.7 and 12.7 percent, respectively (Puig et al., 1978, 88sqg.). Despite these modest levels, scope for tariff liberalization remains for two reasons: First, the tariff rates on a great number of import items exceed the average level, especially so in the case of Spain. Second, nominal tariffs rise with the stage of processing, so that the effective rates of tariff protection are considerably higher than the nominal rates, particularly for durable consumer goods.

The extent of the expected trade-expanding effects critically depends, apart from initial tariff levels and sizes of total trade, on the price elasticities of supply and demand. Since Spain accounts only for small proportions of EEC's total manufactured exports and imports (about 2 percent each), it seems reasonable to regard the import supply from, and the export demand of, the Community in her trade with Spain as infinitively price elastic ("small country" assumption).¹ The industry-by-industry price elasticities of Spanish import demand have been found to range between -0.65 and -2.20, while the price elasticities

¹If Spain's exports into the EEC are disaggregated at branch levels, the "small country assumption" might be less justified in the case of canned fruit and vegetables, beverages, and footwear, which account for 7 to 9 percent of EEC's imports.

of Spain's export supply are in the neighbourhood of +0.02 to +1.75.¹

In quantifying the trade effects, 1974 was chosen as base year.² The import effects may consist, on the one hand, of "trade creation" (e.g. increased imports from low-cost producers in the EEC at the expense of higher-cost Spanish producers) and, on the other hand, of "trade diversion" (e.g. substitution of imports from higher-cost producers in the Community for imports from lower-cost producers in non-EEC countries). Their amount is given in Table 3.³ The increase of Spain's manufactured imports over actual 1974 imports would amount to \$ 1 billion per annum or 11.1 percent. The three most important branches in the incremental imports are machinery (30.1 percent), industrial chemicals (13.7 percent), and electrical equipment (10.2 percent). These are branches with high capital and technology inputs, in which the competitive position of the Community is very strong (as can be inferred from the RCA indices). The bulk

¹To obtain the price elasticities, Spain's import demand and export supply functions have been estimated by (lagged and non-lagged) OLS regressions for 23 manufacturing branches, using annual data for the period 1960-77. Details are available upon request. The estimates of import elasticities are consistent with those obtained by Bonilla (1978) for three aggregated groups of products, using quarterly data for the years 1962-72.

²Use of more recent years would have been abnormal in terms of levels of economic activity as well as import and export intensities of the Spanish industry.

³The estimates compare the full integration situation with the present one, thereby ignoring the transitional period (still to be negotiated). Moreover, they are static in nature and do not take into account either Keynesian multiplier effects or changes in Spain's factor endowments and in the allocation of resources which may result from the accession. Adjustments in the exchange rates that would be required to compensate for changes in the balance of trade brought about by liberalization are also omitted. Finally, the calculation of "trade diversion" traditionally rests upon the assumption that Spain's production, her imports from the EEC, and those from third countries, are equally substitutable, since disaggregated estimates on substitution elasticities are not available.

Table 3 : Trade Creation and Trade Diversion Effects^a of Spanish Trade Liberalization
against Imports of Manufactures from the EEC

(Millions of US-\$)

ISIC	Branches	1974	1974	Trade creation	Trade diversion	Overall import expansion
		Imports from EEC countries	Imports from non-EEC countries			
311/2	Food products	252.3	613.8	46.7	3.9	50.6
313	Beverages	35.6	18.4	6.7	0	6.7
314	Tobacco	7.7	80.9	-	-	-
321	Textiles	98.6	122.1	24.7	1.0	25.7
322	Wearing apparel	22.0	14.4	6.3	1.0	7.3
323	Leather products	16.7	29.5	1.6	0	1.6
324	Footwear	3.2	3.3	0.6	0	0.6
331	Wood products	12.6	7.0	1.8	0	1.8
332	Furniture and fixtures	24.0	9.9	6.1	0	6.1
341	Paper products	72.8	224.8	17.4	1.7	19.1
342	Printed matter	40.0	23.4	9.0	0.2	9.2
351	Industrial chemicals	771.6	407.7	134.3	14.7	149.0
352	Other chemical products	197.2	115.2	15.0	0.7	15.7
353	Petroleum refineries	81.0	925.9	6.6	1.5	8.1
354	Miscellaneous petroleum and coal products	39.5	929.5	3.7	11.7	15.4
355	Rubber products	40.2	53.2	12.9	0.8	13.7
356	Plastic products	85.1	23.8	31.2	0.6	31.8
361	Pottery, china and earthenware	17.9	10.6	4.5	0.1	4.6
362	Glass products	58.6	8.3	14.8	0.3	15.1
369	Other non-metal mineral products	70.0	37.1	6.6	0.2	6.8
371	Iron and steel	74.2	51.9	12.8	0.1	12.9
372	Non-ferrous metals	117.9	126.0	18.7	1.0	19.7
381	Metal products	326.9	163.8	77.8	3.4	81.2
382	Non-electrical machinery	1072.5	469.7	243.5	83.4	326.9
383	Electrical machinery	366.8	208.1	102.7	8.4	111.1
384	Transport equipment	300.3	333.8	81.4	5.9	87.3
385	Professional goods	215.0	175.9	18.7	14.6	33.3
390	Other industries	81.8	60.4	18.7	5.0	23.7
3	Manufacturing	4502.0	5238.4	924.8	160.2	1085.0

^a Calculated as follows: Trade creation (TC_i) = M_i η_i [Δt_i : 1 + t_i]

Trade diversion (TD_i) = TC_i (Mn_i : V_i)

M = initial Spanish imports from EEC 1974

η = price elasticity of import demand

Δt = the change in the Spanish import tariff rate on imports from EEC

t = the initial tariff level on imports from EEC, reduced according the Preferential Trade Agreement provisions (1974).

Mn = Spanish imports from non-EEC countries

V = domestic production

i = subscript for three digit ISIC category

Source: Basic trade data from UN, Commodity Trade Statistics, 1974. - Output data from UN, Yearbook of Industrial Statistics, 1975. - Tariffs from Banco de Bilbao, Arancel de Aduanas 1960, 6th edition, Bilbao 1976. - Trade data were reclassified from SITC into ISIC on the basis of the relationship established in UN, Statistical Papers, Series M, No. 43 (1966), No. 4, Rev. 1+2 (1971). - Own estimates on price elasticities of Spanish import demand (Table A-1).

of the import expansion represents "trade creation" which accounts for 35.2 percent of the total increase. There is only one branch - petroleum and coal products - for which "trade diversion" is larger than "trade creation", affecting mainly suppliers from East European countries.

The estimated export effects are \$ 155 million per annum, i.e. 6.2 percent increases over 1974 levels (Table 4). Processed food, beverages, and transport equipment would account for almost the half of this incremental exports. The first two are branches in which Spanish suppliers have been displaying significant price and/or quality advantages over the French and Italian ones. Free access to the Common Market will enhance this competitive position. As to transport equipment, the estimates are consistent with the ongoing tendency to integrate Spain's automobile industry in the vertical internationalization of car production, out of which additional exports of parts and components as well as finished passenger cars will emerge anyway.

As imports will increase faster than exports, Spain's trade position vis-à-vis the EEC would worsen.¹ These figures should be taken only as rough indicators of what might happen, rather than as exact orders of magnitude, since the estimates of price elasticities of export supply are highly sensitive to the choice of base years. Yet, it becomes obvious that the integration will lead to a significant need for structural adjustment within the Spanish industry. How heavy this burden might be, depends on the timetable for the mutual tariff removal. As it can be expected that the EEC's trade barriers will be abolished more rapidly than the other way around, Spain's manufacturers will initially be able to benefit from a better access to the Common Market than the EEC producers

¹Various studies on the trade effects of the different preferential trade agreements between the EEC and Mediterranean countries have led to similar results (Pomfret, 1976).

Table 4 : Expansionary Effects^a on Spain's Manufactured Exports of EEC Trade Liberalization
(Millions of US-\$)

ISIC	Branches	Spanish Exports to EEC in 1974	Export Expansion
311/2	Food products	417.8	47.3
313	Beverages	157.0	16.0
314	Tobacco	1.5	0.4
321	Textiles	86.6	5.0
322	Wearing apparel	57.9	7.1
323	Leather products	67.0	1.4
324	Footwear	48.5	3.2
331	Wood products	20.3	1.9
332	Furniture and fixtures	16.7	0.5
341	Paper products	42.1	2.0
342	Printed matter	27.6	1.3
351	Industrial chemicals	174.4	12.2
352	Other chemical products	63.3	2.6
353	Petroleum refineries	176.1	4.0
354	Miscellaneous petroleum and coal products	54.7	0.8
355	Rubber products	61.9	3.7
356	Plastic products	41.3	3.7
361	Pottery, china and earthenware	11.5	0.5
362	Glass products	19.4	0.9
369	Other non-metal mineral products	49.7	1.8
371	Iron and steel	28.9	1.1
372	Non-ferrous metals	32.7	1.4
381	Metal products	145.5	5.9
382	Non-electrical machinery	197.5	6.6
383	Electrical machinery	125.1	6.8
384	Transport equipment	263.1	12.4
385	Professional goods	39.3	2.1
390	Other industries	63.9	2.4
3	Manufacturing	2491.3	154.8

^aCalculated by the formula

$$\Delta X_i = t_i X_i [1 + \epsilon_i (1 + t_i)]$$

X = initial Spanish exports to EEC 1974.

t = initial Common External Tariff rate on Spanish exports.

ϵ = price elasticity of export supply.

i = subscript for the three digit ISIC category.

Source: As Table 3. - Instituto Nacional de Estadística, Comercio Exterior de España - Números Índices. Madrid 1976. - Idem, Anuario Estadístico de España, 1978. - Own estimates on price elasticities of Spanish export supply (Table A-1).

will have to the Spanish market. The net trade impact will therefore be less strong during the transition period than Tables 3 and 4 suggest. Furthermore, while the impact of increased imports on domestic output and employment will be the smaller the more internal demand for the industry's products will be increasing, the structural adjustment process might also imply a strengthening of both the Spanish industry and the non-tradable sector.

Potential Growth Effects

Turning now to dynamic aspects, both customs union theory and practical experience within the EEC show that mutual trade liberalization in the process of Spain's full integration might stimulate economic growth through the impetus to factor productivity and investment. A rise in productivity can be due to increases in plant efficiency forced by foreign competition and to large-scale economies on a wider market. A quantification of the productivity gains is beyond the scope of this paper, since detailed empirical industry studies would have to be carried out. But some general remarks, based on scattered information,¹ may support the view that those gains could be quite substantial.

As has been mentioned earlier, the prevailing levels of protection have created much "X-inefficiency" at the firm level. Among the many high-cost producers there are not only those who would not be able to compete with imports, but also those who could actually compete - if it was a matter of survival - by reducing costs. The latter firms are simply not on their production possibility frontiers, because their managers prefer a "quiet life" over profit maximization, which is an attitude they can afford under

¹Mainly provided in industry analyses published in Economía Industrial (Ministry of Industry).

protection and in view of the fact that domestic competition does not function sufficiently well in Spain. Examples can be found in all branches, but they are particularly noteworthy in basic metals, shipbuilding, automobiles, and textiles. State-owned companies tend also to perform poorly in this regard. Increased import competition from the EEC might present a challenge to the ability of management of such firms to improve the organizational and technological efficiency, to intensify the control of quality, and even to develop and market new products. This will no doubt be the case in the private sector and hopefully also in the public sector. Increased "X-efficiency" might make the trade effects of the accession more favourable for Spain, since firms will appear as more competitive in their production for both exports and import substitutes.

The economies-of-scale-hypothesis emerges from the observation that Spain's industrial structure is dominated by a large number of very small firms: about 80 percent employed less than five people and 95 percent less than 50 people. Only a few of them have entered into product specialization and/or are complement to larger producers. According to a report by the Ministry of Industry (1974), Spain's largest firms (in terms of employment and value of output) lag far behind the largest firms in the Community due to their limited domestic market, though there are a few exceptions from this role in shipbuilding and construction. Even in branches where empirical studies have shown economies of scale to be very great, the leading Spanish firms (including the foreign-controlled ones) in general do not have the capacity size to take full advantage of scale economies. The steel industry (suffering from proliferation and imbalanced facilities in the sequence of production processes), the heavy electrical equipment industry (with its largely overlapping product lines), and the automobile industry (displaying an excessive variety of passenger car makes) are outstanding cases in point.

Empirical estimates of production functions for the Spanish manufacturing industry reveal that there is a large economies of scale potential in many industries (Donges, 1972, pp. 598sqg.; Méndez, 1975, pp. 245sqg.). Moreover, Méndez found unit costs decreasing substantially with size of establishment for furniture, paper manufactures, printed matter, rubber tires, paints and varnishes, perfumes and soaps, plastic materials, glass products, and machinery. The integration of the Spanish industry into the Community would, by widening the market, facilitate the exploitation of economies of scale in these industries. It would also open opportunities for introducing large-scale production in newly established plants, particularly in heavy mechanical equipment where automation is making great headways in Europe. Though the domestic market may not provide sufficient outlet even at higher levels of per capita income, the Common Market does; exports, then, contribute via linkages to more efficient production for the national market on a large scale, too. The widening of the market for Spanish producers may also permit increased specialization (both vertically and horizontally) on an optimum scale, for instance in the paper industry, basic chemicals, railway equipment, electrical engineering, automobile parts and components, and scientific instruments. All this is subject to the condition, that Spanish firms increase substantially their expenditures on "research and development";¹ a less fragmented industrial structure might help to bring about such efforts.

As in the case of improved "X-efficiency", increased realization of economies of scale should enhance the positive trade effects for Spain. Those firms, in which the minimum

¹The R & D-to-GNP ratio (excluding expenditures for the acquisition of foreign licenses and for technical assistance) has been increasing since the mid-sixties, but is with 0.37 still one of the lowest in Europe (Rodríguez, 1977).

long-run average costs exceed the world price by more than the Common External Tariff, will decline or be even driven out by import competition, thereby creating an adjustment problem to the Spanish economy. The other existing, or newly established, enterprises operating on downward-sloped scale curves will be expanding by replacing imports and increasing exports.

Improved "X-efficiency" and economies of scale might have a parallel effect on the volume of investment. New equipment will be needed in order to withstand foreign competition, to achieve specialization and to increase the scale of production. Furthermore, complete new plants may be constructed in activities where Spain's comparative advantage is particularly strong, reflecting also an inter-industry reallocation of resources from lower- to higher-productivity and skill requirements sectors. At the same time, there will be disinvestment in the less efficient firms; but this is unlikely to cause the overall investment volume to fall or to only increase at modest rates, provided appropriate government policies are pursued.

Apart from increased domestic savings, the inflow of foreign capital might remain an important source of financing the expectedly growing investment in Spain. The country has, in spite of its current economic problems, a promising development potential; and the supply of labour (including the relatively skilled one) is rather elastic at wages, which are still among the lowest in Western Europe.¹

As Spanish legislation on foreign investment is very liberal,² firms from the advanced EEC countries could regard Spain even more than in the past as a natural location for

¹ Both these variables explained a large share of the variation of direct foreign investment in Spain since 1960 (Donges, 1976, pp. 112sqg.).

² The most recent expression of this attitude has been the Royal Decree-Law No. 1388/78, promulgated on June 23, 1978, which removed the restrictions on the entry of foreign banks into Spain.

redeploying labour-intensive production; and companies from non-EEC countries may want to use the opportunity for exporting goods from Spain, free of tariff and non-tariff barriers, to the Common Market.¹ Increased foreign investment in Spain would not only enlarge the stock of technological know-how in this country, but also be to a certain degree a substitute for labour emigration from Spain to the Community, thereby increasing the overall economic growth rates in both parts, as Hiemenz and Schatz (1979) have shown. In view of the current structure of foreign capital penetration into Spanish industrial sectors, Cordero (1978, pp. 65-66) expects the following eight branches as being particularly dependent in their future performance from the investment decision of foreign companies: Transport equipment (especially motor-cars), electrical machinery, chemical industry, miscellaneous manufactures, non-metallic mineral production, non-electrical machinery, non-ferrous metals, and food processing (in this order).

Implications for Policy Reform

To recapitulate, full membership in the EEC gives Spain the opportunity to expand trade and accelerate economic growth. Whether or not these opportunities materialize, lies in the hands of Spanish government themselves, e.g. it depends on the conduct of appropriate policies. To be sure, the Spanish economy needs to be disentangled from the many bureaucratic interferences to which it has been subject for decades (Schwartz et al., 1979, pp. 109sq.). Major areas of concern are trade policies, industrial policies, competition policies, and labour market policies.

¹The recent decision of General Motors to establish a factory in Spain has been justified, inter alia, in these terms.

Appropriate trade policies are of great importance because they will critically determine the ability of Spanish manufacturers to produce competitively import substitutes and exportable goods. What is at stake anyway in view of Spain's entry into the EEC is the reduction of the existing levels of protection to harmonize them with those of the Common External Tariff. This will make present trade policies more rational. But the Government will presumably face powerful vested interests of high-cost producers demanding a long period of transition for the tariff cuts. Assuming that these high costs are due to comparative disadvantages, such demands should be rejected on the grounds that protection cannot by itself transform the cost disadvantages into advantages. They should also be rejected on the grounds that the postponement of the structural adjustment caused by the EEC integration will make the Spanish industry only more vulnerable to future competition from the Community, that it is hard to see how sheltered high-cost producers will be encouraged to improve their methods of production and the quality of their products, and that the maintenance of protective measures (particularly quantitative import restrictions) discriminates against exports which should become the prime mover in Spain's future industrial growth.¹ Thus, a relatively short period of transition has considerable advantages for the Spanish economy, though it may not be an easy task for the Government to pursue an effective policy of adjustment assistance in favour of trade-impacted workers, firms and regions.

¹ Under EEC regulations it will not be possible to reduce or neutralize the discrimination against exports resulting from protection by outright subsidies or tariff drawbacks to exporters. What is possible, and would be advisable in any case, is to provide export credits and export insurances as well as assistance to the financing of trade fairs participation to an extent comparable to actual arrangements in the EEC.

As to industrial policies, the government authorities favour private initiative co-existing with public enterprises, but they still adhere to Francoist corporate state philosophy that the control of the sectoral and geographical allocation of manufacturing investments is in the national interest. Consequently, the establishment, extension and alteration of many industrial activities require prior government authorization. This typically creates uncertainty among applicants, involves substantial procedural delays, channels resources of firms into the cultivation of good relations to government officials rather than into efficiency-raising efforts, and introduces some significant misallocation into the patterns of industrial development, which may impair the competitiveness of Spanish firms in the enlarged Common Market. A relaxation of regulatory policies at the industry level seems therefore to be required.

Industrial policies should also be reconsidered with regard to the direct government control of industrial firms through the National Industry Institute (INI). It was created (in 1941) as an instrument of autarchic development policy for promoting new enterprises defined as being in the "national interest". In practice, however, the INI's activities have been extending across the board,¹ including also the take-over of losing companies. As INI-controlled enterprises receive a more favourable treatment than private firms, investment by the latter is discouraged. Moreover, the poor performance of many firms with INI participation,

¹Based on the sectoral share in annual volume of sales, INI-controlled firms play a dominant role in mining (32 percent in 1975), steel (44 percent), petroleum refining (40 percent), shipbuilding (81 percent), and motor car industry (41 percent), as compared to 20 percent in total industry. Source: Ministerio de Industria (1978). It appears that the share of publicly-controlled firms is in Spain, on average, lower than in the United Kingdom, comparable to that in France and Italy, and higher than in F.R. Germany.

which is reflected in low profits or persistent losses, casts many doubts upon the centralized manageability of such a wide range of enterprises. Hence, INI should concentrate on activities involving a high social rate of return on invested capital, such as supporting research and development in indigeneous industrial technology in some areas, particularly machinery. On the other extreme, it should divest itself of its ownership in such enterprises which do not require public support (any longer) for being commercially viable; food processing, textiles, automobiles, chemicals, and even electric utilities are cases in point. The other companies, where INI's participation is regarded by the Government as necessary (mainly basic industries), should be allowed to operate more autonomously, so that good and poor performers can be more easily detected, thereby stimulating the management to improve "X-efficiency" and to undertake process and product innovations.¹ The Italian experience with decentralizing decision-making in the public sector (Institute of Industrial Reconstruction) has much relevance for Spain.

At least as important as these reforms to enhance the competitiveness of Spanish industries in the enlarged Common Market, is the strengthening of competition policies in order to allow the market mechanism to direct resources to their most efficient uses. Up to now Spanish legislation has been rather permissive towards restrictive business practices. Therefore, it is most likely that Spanish firms will attempt to form producer's cartels (or similar arrangements), arguing that this will ease their required restructuring. However, cartelization would not be in the interest of the Spanish society. Evidence abounds that the assurance

¹A financial reorganization of most of such enterprises is required in the first place, however.

of an acceptable rate of return on the existing capital stock reduces the incentive of cartel members to undertake productivity-raising investments. Thus the productivity gap between the Spanish and the EEC industry is bound to widen in this case. There is, however, a good chance that the gap can be narrowed if investment decisions are allowed to be guided by changing relative prices.

Given the need of greater competition, the Government may face a dilemma: while it is expected to promote mergers of firms in order to achieve efficient sizes of plants, this obviously involves the danger of generating monopoly positions with unfavourable effects for the economy as a whole. However, one important fact will ensure that such positions do not materialize, namely the existence of increased imports from the Community. A more concrete appraisal can only be made on an industry-by-industry basis, trading off economic costs and benefits of growing concentration.

Labour policies should be directed to make factor markets more flexible, thereby increasing inter-industry labour mobility, allowing production to be reorganized, and avoiding an excessive use of capital-intensive technologies in production. At present, the labour regulations, inherited from the Franco era, seem to operate in the opposite direction: employees and workers are heavily protected against dismissal and they are entitled to severance pays. Although the intent of such policies appears socially justified, experience in many countries (including EEC members) shows that they induce negative feedbacks; that is they increase the real wage costs of labour (which is in relatively large supply in Spain) without a corresponding increase in productivity (Soltwedel and Spinanger, 1976). This certainly would impair the international competitiveness of manufacturing production. While it may seem to run

counter to the professional goals of social policies, a relaxation of the job-tenure regulations seems to be indispensable to help to adapt Spanish industry to the changing international conditions. And at the same time it would be also in the interest of Spanish labour force itself, since the benefits from the present policy accrue only to the pool of labour actually employed, while a large and increasing number of job seekers, particularly in the big cities and among the youth, are failing in their attempt to find employment.

Having said the above, it is extremely important for the Spanish Government to restore private business confidence in Spain's future economic development. Only in this case will productive investment increase **again**, so that overall growth can be accelerated and job opportunities rapidly expanded. Otherwise negotiations with the EEC could be protracted considerably, since the prevailing unemployment in the Community will create much resistance against the possibility of Spain to export her own unemployment through the (enlarged) common labour market.

Table A-1: Tariffs and Price Elasticities for Estimating the Trade Effects

ISIC Branches	Nominal tariffs ^a on Spain's imports from		Common external tariffs ^a of EEC on imports from		Price elasticity of Spanish import demand	Price elasticity of Spanish export supply
	EEC	third countries	EEC	third countries		
311/2 Food products	9.47	13.30	10.53	12.14	-2.14	0.07
313 Beverages	12.48	15.25	9.33	12.11	-1.70	0.09
314 Tobacco	0	0	22.67	43.67	-2.22	0.09
321 Textiles	14.71	21.81	3.61	8.27	-1.96	0.58
322 Wearing apparel	19.54	27.75	4.96	11.50	-1.76	1.38
323 Leather products	5.15	9.46	1.96	4.91	-1.95	0.02
324 Footwear	11.36	20.05	3.66	8.08	-1.81	0.73
331 Wood products	9.51	16.68	3.27	6.74	-1.63	1.75
332 Furniture and fixtures	18.38	25.14	2.42	6.04	-1.65	0.65
341 Paper products	15.71	16.98	3.79	9.47	-1.76	0.27
342 Printed matter	15.48	18.79	3.25	8.23	-1.68	0.40
351 Industrial chemicals	10.76	14.39	6.81	9.31	-1.79	0.03
352 Other chemical products	11.70	15.88	3.94	9.13	-0.73	0.07
353 Petroleum refineries	3.86	5.95	2.12	5.31	-2.20	0.07
354 Miscellaneous petroleum and coal products	5.38	7.02	1.54	3.85	-1.83	0.02
355 Rubber products	17.64	24.72	3.96	8.56	-2.14	0.48
356 Plastic products	21.65	29.33	4.45	10.85	-2.06	0.97
361 Pottery, china and earthenware	17.46	23.33	3.89	9.37	-1.68	0.06
362 Glass products	15.56	20.80	3.32	8.30	-1.87	0.34
369 Other non-metal mineral products	6.27	8.65	1.38	3.42	-1.59	1.60
371 Iron and steel	10.43	11.94	2.79	5.71	-1.83	0.36
372 Non-ferrous metals	9.17	12.58	2.55	6.53	-1.89	0.60
381 Metal products	13.96	18.39	2.99	7.40	-1.94	0.35
382 Non-electrical machinery	12.94	16.77	2.47	6.18	-1.98	0.32
383 Electrical machinery	17.61	22.94	3.28	8.25	-1.87	0.62
384 Transport equipment	19.06	23.01	3.08	7.69	-1.69	0.50
385 Professional goods	14.89	19.57	3.62	9.06	-0.67	0.45
390 Other industries	14.08	19.89	3.01	7.51	-1.85	0.06
3 Manufacturing	12.65	17.05	4.45	9.20	-	-

^a Unweighted averages (1974).

Sources: As Tables 3 and 4.

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