SPAIN

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The toughest of management jobs

Victor Mallet says the country requires structural reform if there is to be any hope of growth

Aesthetically and economically it must have seemed a good idea, in the depths of the crisis, to move the statue of Christopher Columbus a few dozen metres, to put it back where it was three decades ago in the middle of the square that bears his name.

The remodelling of central Madrid, however, was part of a fatal decision for the Spanish economy. Relocating the statue – one element of a vast job-creation programme involving the digging up of roads and pavements all over Spain – was the ultimate Keynesian gesture to help stave off another Great Depression.

The emergency public works programme was one of the most ambitious in Europe, and it contributed to a budget deficit so large – 11.2 per cent of gross domestic product, or more than €100bn, in 2009 – that Spain drew attention to itself as another risky Mediterranean economy, just as Greece was teetering on the verge of a sovereign debt default.

Nor did the spending have a lasting impact on unemployment, which has reached more than 4.6m and affects just over 20 per cent of the workforce – double the eurozone average.

Yet it was almost inevitable that the government would lose control of public spending when other developed nations were doing the same.

Shortly after starting his second term of office in 2008, José Luis Rodríguez Zapatero, the socialist prime minister and career politician, had been thrust into a role for which he had little appetite or experience – that of economic manager in a time of crisis.

In the earlier part of the decade, as money flowed in from northern Europe to finance unprecedented growth in home construction, Mr Zapatero and José María Aznar, his conservative predecessor, could content themselves with minor adjustments to the economy as revenues from property taxes poured into the coffers.

Other issues – including Spain's controversial contribution to the US war effort in Iraq, which Mr Zapatero ended as soon as he became prime minister in 2004 – were at the forefront of people's minds.

Since the collapse of Lehman Brothers in late 2008, however, the crisis has taken centre stage.

Economic worries have comprehensively overshadowed the current six-month Spanish stint in the rotating presidency of the European Union that had been so eagerly awaited by the administration as a showcase for the country.

Even the embarrassment caused by US president Barack Obama's snubbing of a proposed EU-US summit is now, like the recent postponement of a Mediterranean summit in Barcelona, a mere historical footnote.

Domestic politics has not been entirely absent from the front pages of Spanish newspapers over the past year.

Eta, the violent Basque separatist group, appears to be in its death throes, with the Spanish and French governments repeatedly celebrating the arrest of young Eta leaders almost as soon as they replace their jailed predecessors.

Catalan nationalists, whose activism is vigorous but peaceful, remain in dispute with the central government over the degree of autonomy to which Catalonia is entitled.

Meanwhile constitutional court judges are apparently unable to overcome their political differences to issue a ruling on a controversial Catalan statute already approved by referendum. In more prosperous times, indeed, the flawed justice system would be the focus of more international attention.

Baltazar Garzón, the country's best known judge, has been suspended in the midst of an extraordinary row between neofascists and leftists, as well as milder disputes between conservatives and liberals, over his attempts to investigate crimes committed during the civil war and the Franco dictatorship that followed.

But the economy and Mr Zapatero's handling of the crisis are the issues that rightly preoccupy Spain today.

Its recession was slightly shallower, but of longer duration, than those of most of its European neighbours, and the

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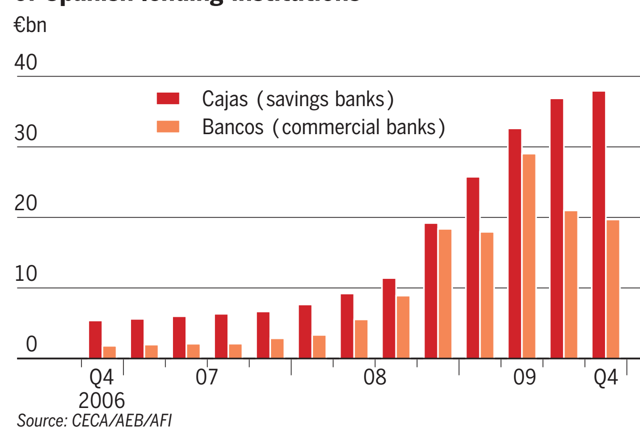
New austerity evangelist: prime minister Zapatero says he remains an optimist Bloomberg

Shrunken cajas are chastened by crisis

Savings banks

Weaker institutions are seeking partners to avoid the axe, says **Victor Mallet**



For months after the global financial crisis deepened in late 2008, it seemed to the uninitiated that the Spanish financial system had miraculously escaped the worst of the damage.

The conservative regulators at the Bank of Spain had discouraged lenders from adopting risky "off-balance sheet" accounting methods and from acquiring billions of dollars of repackaged US subprime mortgages or other toxic assets.

Bank of Spain onsite supervisors – posted in the head offices of commercial banks and *cajas de ahorros*, the unlisted savings banks – appeared as diligent as the regulators were strict.

There were no rescues of large banks of the sort seen in the UK, the US and Germany, because none was needed.

Even when the climate worsened, banks were able to soften the impact on reported profits by drawing down the counter-cyclical "generic" bad loan provisions accumulated in the good times on the orders of the prudent central bank.

Santander, the largest bank by market capitalisation in the eurozone, and BBVA, second biggest in Spain, remained profitable through the worst of the recession.

In the first quarter of this year, Santander reported a better than expected net profit of €2.21bn, 5.7 per cent higher than the same period of 2009.

All the while, however, bankers and economists in Madrid were quietly warning that Spain was harbouring its own, unresolved subprime crisis.

Lending institutions, especially the unlisted *cajas* largely controlled by regional politicians, were burdened with billions of euros of bad loans extended to property developers, construction companies and homeowners during the housing boom that peaked in 2007.

Having packaged many of these loans as covered bonds or mortgage-backed securities and sold them to German, French and other investors, the Spanish banks and *cajas* would soon find it difficult to roll over their wholesale borrowing amid growing unease about the solvency of southern European countries such as Greece and Spain.

The first clear jolt came in March last year, when the central bank intervened over a weekend to seize control of Caja Castilla La Mancha, a small *caja* in central Spain that was having liquidity problems after overextending itself in loans to local projects.

Three months later, the government established the Fondo de Reestructuración Ordenada Bancaria or Frob, a €9bn bank restructuring fund that can leverage itself 10-fold and thus deploy up to €99bn.

In the months that followed, not much happened, despite increasingly loud appeals for consolidation from Miguel Angel Fernández Ordoñez, Bank of Spain governor, who wanted the 45 *cajas* that account for about half the financial sector to rationalise themselves and reduce their number by at least a third.

By the end of 2009, there was no doubt that a round of mergers was imminent.

Politicians across Spain, however, continued to resist the loss of influence and patronage that the closure or merger of their regional financial fiefdoms would imply.

By last month, several sets of negotiations were under way, but only a few mergers – including two in Catalonia – had been concluded, granted Frob financial support and presented to the European competition authorities for approval.

There were mutterings of discontent among Spanish bankers and financial analysts about the lack of determination shown by the Bank of Spain.

Then the central bank pounced again..

In another weekend takeover, the Bank seized control of CajaSur, an ailing savings bank controlled by the Roman Catholic church in Córdoba, shortly after 1am on Saturday May 22. The priests in charge of CajaSur had refused to consummate a marriage with Unicaja, in southern Spain, in spite of months of negotiations and public threats from the authorities.

The surprise move unnerved international financial markets – although CajaSur held only 0.6 per cent of the Spanish financial sector's assets – but there was no doubt it was necessary.

Fitch, the credit rating agency, reckoned CajaSur would have defaulted without state support and said its tier one capital ratio was just 1.94 per cent, which was below the minimum requirement and left it with a capital shortfall of €523m.

At the end of last year, CajaSur's bad loan ratio reached 10.2 per cent of its assets, double the Spanish average.

But the Bank of Spain's shock tactics do appear to have galvanised directors of the weaker *cajas* to seek partners and avoid the axe.

Within days, four – Caja Mediterráneo, Cajastur, Caja Extremadura and Caja Cantabria – announced plans to pool their operations in a joint holding group, while in Catalonia, Caixa Girona was negotiating to be taken over by La Caixa, the Barcelona-based lender that is by far the biggest and strongest of the *cajas*.

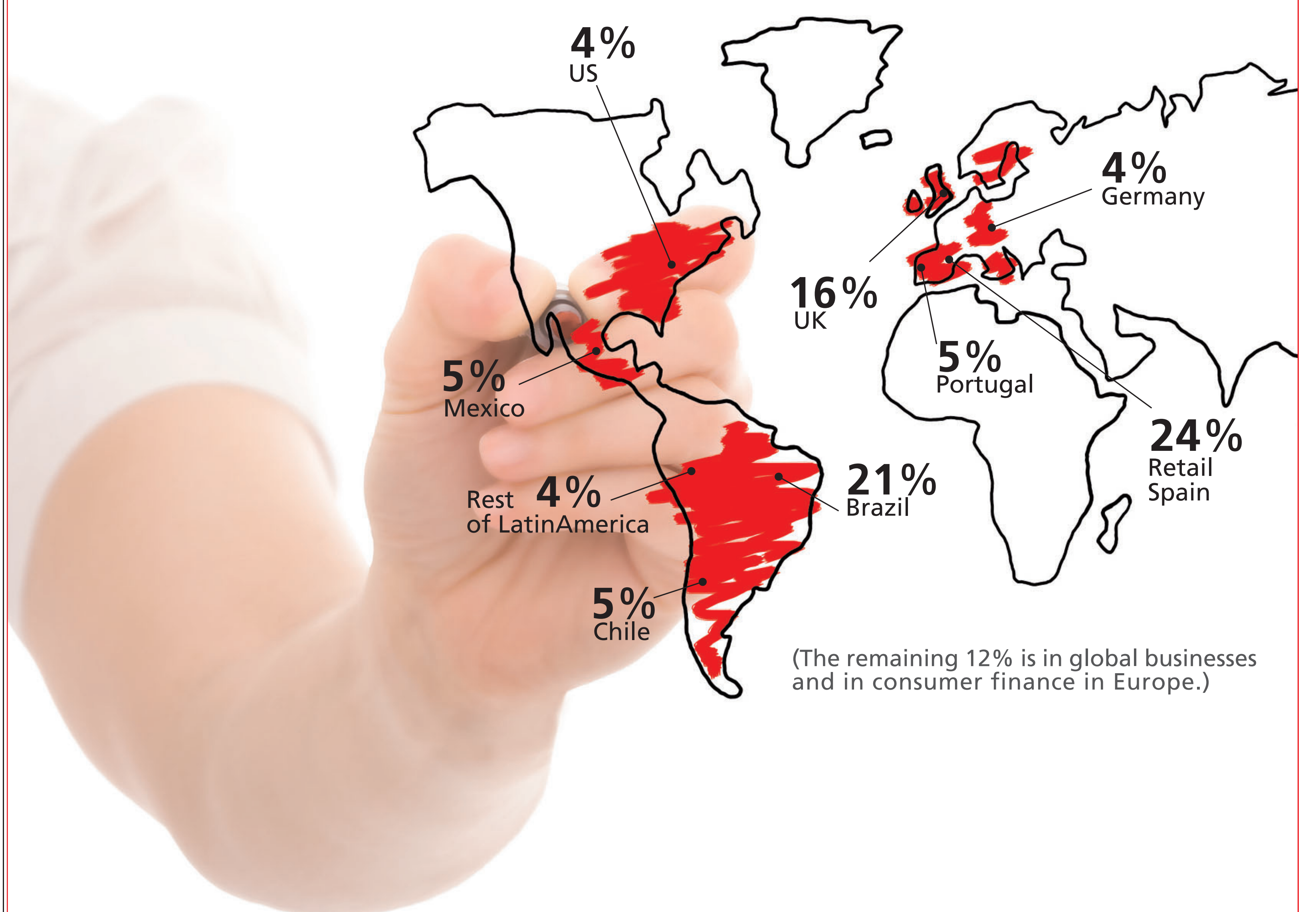
Then Caja Madrid, the second biggest, said it was in talks to join forces with five smaller *cajas*.

The shape of the country's savings bank network has yet to be finalised, but by the time the Bank of Spain's deadline expires on June 30, it is certain that Spain will have many fewer *cajas* – perhaps fewer than 25 – and that the chastened savings bank sector will have a much smaller share of the banking market than it had at the peak of the property market.

Only the best international bank can pay the biggest dividend in the world

Thanks to a solid retail banking model and geographical diversification, Banco Santander distributed **EUR 4.92 billion of its 2009 profits in dividends.**

Geographical distribution of 2010 first-quarter profit:



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Banks become country's biggest landlords

Property crisis

It could take five or six years to absorb surplus stock, finds **Mark Mulligan**

When José Luis Rodríguez Zapatero, the prime minister, last month announced an average 5 per cent pay cut for the country's 2.8m civil servants, there was a collective shudder from the beleaguered real estate and banking sectors.

With unemployment at 20 per cent, and job insecurity in the private sector at an all-time high, lenders and home vendors have been relying on public sector workers – who are virtually impossible to fire – to prop up flagging businesses.

Even a relatively small cut in monthly wages could put further downward pressure on house prices, say sector experts, and even shrink the field of eligible mortgage applicants.

"In reality, it is more of a problem for general retailers," says the country head of one international real estate agency in Madrid. "However, even 5 per cent less can change the metrics of a housing mortgage."

Austerity measures such as the salary cuts – as well as a 2 percentage point hike in value-added tax and the elimination of fiscal relief for first home-buyers – are mere aftershocks to a sector that collapsed spectacularly three years ago under the weight of rising interest rates, oversupply and an impending global crisis.

If the bursting of the housing bubble in 2007 were not enough, the global credit crunch and recession that followed have driven some of Spain's – and Europe's – biggest and most highly-leveraged real estate groups into bankruptcy.

The big ones left standing – mainly Colonial, Metrovacesa, and Royal Urbis – have only survived thanks to complex debt-for-equity and debt-for-asset swaps with Spanish and foreign financial institutions.

These arrangements, along with two years of mortgage and corporate loan defaults, and the winding-up of several property funds, have made Spanish banks among the country's biggest landlords and property vendors.

According to recent figures from the Bank of Spain, the value of so-called "foreclosed assets" on lenders' balance sheets reached €60bn at the end of last year.

While content until now to dribble the most saleable – or discountable – properties on to the market via auctions, subsidised sales to employees and special promotions, banks are now coming under increasing pressure to shed more non-performing assets at any cost to avoid heavy writedowns on top of the profit-eroding provisions and impairment charges already booked over the past two years.

To accelerate the hitherto sluggish financial sector restructuring, the Bank of Spain late last month announced plans to tighten rules on how banks value acquired properties and non-performing loans.

> The value of foreclosed assets on lenders' balance sheets hit €60bn at the end of last year

It said all lenders would have to provision for 100 per cent of a bad loan within a year of it being listed as doubtful, compared with the current period of between two and six years.

At the same time, banks will now be able to offset loan collateral – usually property or land – against the provisions, but only after sharp writedowns on the value of the guarantee.

The third proposed change will oblige banks to increase their writedowns on assets acquired in payment of debts. Assets bought through debt-for-property swaps, unless the owner receives a higher bid, must be written down immediately by at least 10 per cent, rising to 20 then 30 per cent over the following two years.

Although home construction has slowed considerably since the end of 2007, most experts say it could take another five or six years to absorb surplus stock. A recent survey by idealista.com, the property website, found nearly 690,000 completed, unsold new homes in the country.

After adding unfinished developments and unsold public housing, the figure is closer to 1m.

Nor is the imbalance between supply and demand limited to residential property.

As in many parts of the western world, office and commercial rents and property values have fallen heavily in response to company downsizing and a broader slump in demand.

In Madrid, this is especially true in the case of Torre de Cristal, one of four skyscrapers erected on central Madrid's northern fringe just as the crisis was taking hold. Despite offering huge discounts to potential lessees, letting managers of the 52-storey office tower are yet to sign up a single tenant.

As well as the downturn, the lack of takers reflects fears that having such a prestigious address in times of extreme austerity would not sit well.

This applies to government departments, several of which have considered taking space in the tower. "It is just too much of a trophy address for the times we are living in," says one letting agent.

Eco stripes have not come cheap

Renewable energy

Mark Mulligan considers a complex web of subsidies and tariffs

It only takes a short drive around the blustery central plains, sun-scorched south or the windswept ridges of the north-east to realise the importance of renewable energy in Spain.

Wind turbines abound and countless photovoltaic generation parks can be spotted on most journeys.

Outside Seville, the capital of Andalusia, 624 huge, tracking mirrors direct the sun's powerful rays at a 40-storey, thermal tower, the first of its type in the world.

The intense Andalusian heat converts water into steam that drives a turbine capable of producing 11 megawatts of electricity. A second tower has been erected nearby, consolidating the region and neighbouring Extremadura as the centre of solar thermal energy in Europe.

That Spain has become a global reference in renewable energy is a source of pride for government officials and business leaders.

In a drought-prone country with no hydrocarbons, uncompetitive coal mines, and a moratorium on nuclear plants, the drive to reduce reliance on fossil fuels and water is not only good for the environment, but central to energy security.

Under government targets, renewable generation sources – including hydro-electric – should account for 40 per cent of installed capacity by 2020.

However, these green credentials have not come cheaply: under legislation enacted in 2004, every kilowatt of electricity produced by renewable sources is guaranteed a market.

At the same time, generous feed-in tariffs, in the form of guaranteed wholesale prices, have helped compensate wind and, more recently, solar energy producers for the high costs of installation, generation, grid connection and maintenance.

The compensation system helped turn the country into the world's leading per-capita producer of wind energy, with 20,000MW of installed capacity at the end of 2009. In recent years, investors have piled into thermal solar and photovoltaic plants, spurred on by price supports.

Although subsidies are not paid directly by the state, they have accumulated over the years in the so-called tariff deficit, the difference between the real costs of electricity production and delivery and what consumers pay in the regulated market.

This difference – which also reflects high oil and gas prices in the past – is financed by electricity utilities with the guarantee of eventual reimbursement in the form of price increases to electricity users. However, the current government is loath sharply to raise power bills in the middle of a recession, so is looking to cut costs.

According to the Photovoltaic Business Association (AEF), uncertainty about the severity of the next round of subsidy cuts has stopped the flow of credit to the sector and forced the postponement of about €10bn in projects.

Many in the sector blame conventional electricity generators, dismayed by the deflationary effect of renewable energy on wholesale prices, for putting pressure on the government. More than that, however, the debate has divided opinion between champions of wind energy and solar parks.

While defending "all technology that contributes to sustainable development", Ignacio Sánchez Galán, executive chairman of Iberdrola, a global leader in wind generation, says solar parks were being subsidised based on outdated, inflated transaction costs. This makes them inefficient.

"In 2009, wind turbines produced more than 14 per cent of Spain's electricity and accounted for 16 per cent of total production costs," says Mr Galán, "while solar energy supplied just 2 per cent and accounted for 16 per cent of supply costs."

Many electricity bosses say privately that generous subsidies in the sector encouraged overcharging by equipment suppliers, land owners, solar farm developers and operators. This has hidden recent efficiency gains in the sector. In addition, the national energy commission has alleged irregularities in the installation and connection of thousands of photovoltaic plants.

> 'In 2009, solar energy supplied just 2 per cent of electricity and accounted for 16 per per cent of supply costs'

While admitting anomalies, the AEF argues for broader reforms of how regulated electricity prices to household and businesses are calculated, and a fully liberalised market.

Renewable energy enters wholesale "pool" price calculations at zero marginal cost, meaning the more wind and solar energy that enters the system, the lower the wholesale price compared with the generation using oil, gas and coal.

However, the final price to consumers and industry takes in a range of factors. These include transmission, taxes, the renewable premium and accumulated tariff deficit, plus charges to compensate for the high price of supplying the country's islands and the residual cost of liberalising the market, among others.

If this structure were simplified, says the AEF, the government could maintain its commitment to green energy. "The photovoltaic industry shouldn't have to take the fall for an unsustainable economic system," it said in a recent statement, "nor for the exorbitant growth in energy costs in recent years."

Strong fiscal medicine will either cure or kill

Economy

The government must balance austerity against the need for economic growth. **Victor Mallet** reports

Spain was in a strong fiscal position when the global financial crisis engulfed Europe two years ago.

Why is it now the focus of attention among nervous international investors and sceptical hedge fund managers? Why is it the presumed object of a controversial €750bn eurozone rescue package, and why has its sovereign debt been downgraded by two of the three main credit rating agencies?

The two main answers to these questions are: first, contagion from Greece, the much smaller and more troubled economy at the other end of the Mediterranean; and second, the government's initially slow and hesitant reaction to the gathering storm.

It is at the very least curious – some Spaniards would add "unfair" – that a country with a public debt burden 20 percentage points below the European average should be labelled a feckless southern European state.

In 2009, public debt as a proportion of gross domestic product was 55.2 per cent, below the level of Britain and about half that of Greece or Italy. Spain, under José Luis Rodríguez Zapatero, the socialist prime minister, was in fact something of an orthodox rarity in Europe, running budget surpluses for three consecutive years.

Banks, protected by the prudent regulation and tight supervision of the central bank, were also markedly more robust than many of their bailout-dependent rivals in the US, the UK or Germany.

Mr Zapatero's mistake was to listen too closely to the advice of Keynesian economists and spend heavily in the early months of the crisis to stave off a Great Depression.

This criticism may sound like wisdom with the benefit of hindsight, except that Pedro Solbes, who was then finance minister, repeatedly issued prophetic warnings about the dire consequences of Mr Zapatero's free-spending ways; he was unceremoniously dumped for his pains and replaced with the more loyal Elena Salgado.

The result of collapsing tax revenues and frantic spending on the job-creation programme known as "Plan E" (the E was mainly for employment) was not just the digging up of pavements and roads all over Spain.

It was also a budget deficit last year of 11.2 per cent of GDP – more than €100bn – which while lower than Britain's was still regarded as terrifyingly large by investors. Private sector debt, and the country's exposure to creditors abroad, also remained alarmingly high.

Then came contagion. After the collapse of confidence in Greece, which really does have an unsustainable accumulation of debt, the markets were casting around for the next victim among the weaker members of the eurozone.

The UK was not even in the euro and could always benefit from the devaluation of sterling. Ireland had already imposed drastic austerity on itself.

Spain and Portugal were the obvious targets.

Mr Zapatero and his ministers were by this stage tinkering with minor austerity plans, but their lack of conviction was plain. Sovereign debt markets were gripped by panic and the interbank markets again began to freeze up, as they had after the fall of Lehman Brothers in late 2008.

The European Union and the International Monetary Fund were forced to act. In the early hours of Monday May 10, the EU unveiled an extraordinary €750bn rescue plan for the eurozone. No one in authority said so publicly, but Spain was the main target.

There were, of course, conditions attached. Two days later – after a telephone call in which US president Barack Obama urged Mr Zapatero to take "resolute action" – the Spanish prime minister announced a sharp acceleration in the drive to cut the country's budget deficit.

For the first time since the crisis began, Mr Zapatero did more than the markets expected. It was not exactly "shock and awe", but he announced a 5 per cent cut in civil service pay, a freeze on pension levels, abolition of a €2,500 childbirth allowance from next year and a €6bn cut in public sector investment.

The political price was high: the markets were impressed, but the socialists' trade union allies were appalled, while the rightwing opposition scented an opportunity. When the austerity decree was presented to parliament a fortnight later, it was approved by a majority of only a single vote.

Spain has set itself some challenging deficit targets – much more challenging, at least, than anything that had been proposed in the UK at the time of going to press.

The idea is to reduce the Spanish public deficit to 6 per cent of GDP by next year, an effort of 5.2 percentage points, or more than €50bn. Even for the eurozone's fourth largest economy, this is a tall order.

Economists say the danger is that the fiscal medicine – administered to Spain by Germany, the other northern eurozone states, the IMF and bond investors – will prove so harsh that it will choke at birth the very economic recovery that is needed for the measures to work.

Uncowed crowd: government employees demonstrate against austerity measures in Barcelona — Reuters

GDP growth
Annual % change

Unemployment rate
Per cent

Sources: IMF; Thomson Reuters Datastream

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Foreign policy needs a rethink above and beyond Europe

Guest Column

JOSE IGNACIO TORREBLANCA

This month, Spain will reach the end of its rotating presidency of the European Union.

It will do so with mixed feelings. On the one hand, as a deeply Europeanist country, it will be proud to have facilitated the transition to the new system of powers envisaged by the Lisbon Treaty.

On the other hand, it has been the first country to swallow the bitter medicine of accepting the secondary role the treaty gave national capitals.

The uncertainties over the treaty required Spain to prepare for a traditional rotating presidency in which both José Luis Rodríguez Zapatero, the prime minister, and Miguel Angel Moratinos, the foreign minister, would take on central roles.

That was a well-known path that Spanish diplomacy had already travelled successfully during the presidencies of 1989, 1995 and 2002.

This time it has been very different. The arrival of Herman Van Rompuy and Lady Ashton as the EU's president and foreign affairs chief respectively meant that Spain was obliged to hand over the helm on the two most visible issues: the handling of the financial crisis and foreign policy.

The economic crisis has had a very negative impact on both Spain's image abroad and its room for political manoeuvre in the EU.

The country has a 20 per cent unemployment rate, unmatched among large EU economies, and an explosive accumulation of debt.

Mr Zapatero's initial promise to lead a transformative presidency and not merely an administrative one has had to be shelved.

But there are deeper structural factors that explain the particular problems of this six-month stint.

Spain is a country whose national and European interests have conveniently coincided for many years.

Despite the economic crisis, the almost 25 years that have passed since it joined the EU have been the best in its history.

However, those comfortable times now lie in the past. Just as the euro has plunged into crisis, so too has Spain's policy on Europe.

Perhaps only Germany has surpassed Spain in fusing so intensely its national identity with that of Europe, an important reason why Helmut Kohl and Felipe González were able to work together in such harmony.

The Germany of Mr Kohl – he was chancellor from 1982 until 1998 – has changed into a country that looks to the future much more than the past, and that is as global as it is European.

Spain has yet to complete a similar transformation that might allow it to bring its past to a close and forge its own vision of Europe, the world and its role on the international stage.

Its foreign policy has had three priorities since the onset of democracy: Europe, Latin America and the Mediterranean.

It is not difficult to see that this foreign policy agenda has been exhausted.

Latin America no longer requires Spain or the EU to achieve its global goals, and it does not seek political or economic inspiration from either.

As for the Mediterranean, 15 years after the launch of the Barcelona Process, the "Europeanisation" of the Mediterranean region remains unfinished business rather than a reality.

In Europe, Spain's objective has been twofold; integration into the EU and, at the same time, the integration of Europe.

Under the slogan devised by José Ortega y Gasset, the essayist and philosopher – "Spain is the problem, Europe the solution" – Spanish Europeanism has been not only a policy aimed at satisfying the national interest, but an instinct, a reflex.

For every problem, there has been one solution: "more Europe".

But the EU is now a 27-member entity that has reached the limits of political integration, is worn out by successive enlargements and disorientated in its global role.

In other words, Europe has become a problem in itself, which forces Spaniards to question their most deeply held beliefs.

As the struggle about participation in the G20 shows, Europe's lack of international will leaves Spain in a difficult position.

Without a European Union that talks and behaves like a real global actor, Spain feels obliged to behave like other big EU economies and fight for its share of power in international organisations, satisfying its national interests bilaterally and establishing strategic agreements with the biggest powers.

Now, the country knows it has to look beyond Europe, Latin America and the Mediterranean, but it has doubts about how and when to do this, and whether with Europe or on its own.

Spain has grown up, but it has not found a coherent foreign policy language.

José-Ignacio Torreblanca is senior fellow and head of the Madrid office of the European Council on Foreign Relations (ECFR)

Difficult tasks for awkward double act

Profile
Elena Salgado & José Manuel Campa

Victor Mallet on the finance minister and her deputy

Rarely can a task have been so thankless as running Spain's finances during the latest phase of the economic crisis.

Elena Salgado, who replaced Pedro Solbes as finance minister in April last year, has so far been unable to convince Spanish business leaders and foreign investors that the socialist government is doing anything other than improvising plans day by day to restore order to the country's finances.

It did not help that the 61-year-old Ms Salgado was chosen as much for her loyalty to José Luis Rodríguez Zapatero, the embattled prime minister, as for her economic competence and ministerial experience.

Nor was it any comfort that Mr Solbes' repeated warnings about the dangers of excessive fiscal stimulus spending were subsequently proved horribly correct.

Small wonder, then, that Ms Salgado looked exhausted in Brussels in the early hours of Monday May 10, when, as finance minister of the country holding the rotating presidency of the European Union, she announced the €750bn EU-International Monetary Fund rescue for the eurozone – a plan aimed largely at saving Spain from the international collapse of confidence in the sovereign debts of southern European states.

She has not been entirely alone in the line of fire. Shortly after she took her place at the finance ministry, David Vegara, the deputy finance minister, disappointed not to be offered the top job, left for the IMF. His departure was a blow, but his replacement was an inspired choice.

José Manuel Campa, a 45-year-old professor of finance at the Iese business school, has exactly the kind of reputation in the Spanish corporate world that Ms Salgado lacks. He was among the 100 economists to sign a manifesto calling for a wholesale reform of the rigid labour market for the sake of its economic future – at a time when Mr Zapatero contemplated no such thing.

Mr Campa, confident in English from time spent at Harvard University and other US and international institutions, is the one chosen to sweet-talk international bond investors with talk of budgetary discipline, while Ms Salgado holds the fort at home or in EU meetings.

Whatever differences they might have, however, this awkward double-act of the past year has been marked by a convergence of views, at least in public.

Ms Salgado has learned to talk the language of the capital markets on which Spain depends.

Mr Campa – whose meeting with bondholders in London in February was overshadowed by an outburst from José Blanco, the public works minister, against speculators and foreign conspirators – has been obliged to hide his scorn for the economically illiterate members of the government. He has also denied that he wants to resign in frustration.

In recent interviews with the FT, the differences that emerge between Ms Salgado and Mr Campa are therefore usually ones of tone rather than substance.

Both are struggling – as are ministers in other European governments – to balance the need for austerity through cost-cutting and tax rises with the need for economic growth, which would bring down unemployment and boost government income via increased tax revenues.

"We are a strong economy but it's not the German or the French economy and therefore for us it's very important to generate confidence in the markets," says Ms Salgado.

"The balance between growth and fiscal consolidation has moved towards fiscal consolidation in the short term."

> 'Cutting salaries and freezing pensions is something we only do because we have to'

Ms Salgado, who described the latest €15bn of public spending cuts as "painful but unavoidable", does not hide how uncomfortable it is for a left-wing government to slash social spending.

"We would never have started them here, the cuts," she says. "We're a socialist government and therefore cutting salaries and freezing pensions is something we only do because we have to. There is a moment when you have to do it and we did it."

In a separate interview, Mr Campa emphasised the differences between Spain (with an accumulated government debt that is about 20 percentage points lower than the European average) and the weaker eurozone economies such as Greece. He said he believed the markets did not understand the historical strengths of the economy or its export sector.

"We have a large deficit, but that has not been our history," he says. "Our current debt level is not very high, [but] it's rising fast and the challenge for us, and the goal, is to make sure it stabilises."

Mr Campa says people had forgotten that Spain's notorious property bubble had accounted for only about a third of the growth that pushed up investment as a share of gross domestic product to about 30 per cent in 2007. The rest had gone into public infrastructure, machinery and equipment that could contribute to growth.

"It's been a model of how to use the regional development funds in the European Union," he says. "They are putting too little emphasis on the fact that Spain has gone through a huge investment boom of which two-thirds, broadly speaking, covers productive investment.

"We have a network of productive capabilities which I think is being underemphasised or [overshadowed] by the problem that we have, which is obviously the challenge of the real estate boom we had in the past."

For all their differences, Ms Salgado and Mr Campa share a desire to see Spain recover from its worst economic crisis since the death of the dictator Francisco Franco in 1975.

What is not clear is whether either of them will remain in government long enough to be there when it happens.

Elena Salgado (right) and her deputy, José Manuel Campa, a finance professor who is respected in the corporate world Getty

The toughest of management jobs

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main accusation levelled against the prime minister by business leaders and ordinary voters is that he has consistently been over-optimistic and therefore failed to take timely corrective action.

As one Spanish banker puts it: "Zapatero was fine for the bonanza, but this is war."

Mr Zapatero does not deny the charge of optimism, but likes to quote Bill Clinton as saying that pessimism never created any jobs. "When you're leading a government, you have to adopt a positive vision of your country," Mr Zapatero says.

"Spain has major achievements during its 30 years of democracy, but also problems. Now we're going through a difficult time, but we're going to get out of this . . . and if we do things well, we'll be stronger for it.

"Yes, I have to admit that criticism of being an optimist." Spain, Mr Zapatero insists, "is not going to fall back into the second division" of nations.

But when it does finally emerge from the crisis, it may not be with Mr Zapatero at the helm. The country's economic travails – and particularly the latest round of austerity measures that included a 5 per cent pay cut for civil servants – have sharply reduced his popularity.

When the parliament approved the austerity decree last month, it did so by a margin of a single vote after a debate in which the conservative opposition, regional parties and the far left all attacked the government's handling of the gravest economic crisis since the death of Franco in 1975.

Because the Socialists do not have an absolute majority, the other parties could force an early election as soon as this autumn (the next general election is not otherwise due until 2012) by withholding support for the government's budget law for next year.

Opinion polls suggest that if there is an early election, the conservative Popular party under Mariano Rajoy would win a clear majority, even though voters are almost as disparaging about the uncharismatic Mr Rajoy as they are about the smiling face and easy rhetoric of Mr Zapatero.

Whoever runs Spain in the years ahead, however, will face a thankless task.

The country relied too much on a construction industry that spawned a surplus of 1m flats and houses. However, the age of plenty is over, and budget deficits must be cut at least until 2013.

Nor can policy focus only on austerity in the short term. When Fitch, the credit rating agency, cut Spain's sovereign rating last month, it said the country's sparkling 3.3 per cent average real growth rate between 2000 and 2008 was driven largely by immigration and other demographic factors, not by improved productivity.

Spain and Italy were the only EU countries to record a decline in productivity over those eight years.

Almost everyone – even, reluctantly, the socialist government – therefore now believes that reform of the rigid labour market is essential if the competitiveness of the economy is to be restored without taking the unthinkable step of quitting the euro.

With growth now threatened by austerity, and austerity demanded as a condition of sovereign solvency, it is hard not to feel sympathy for any European leader caught up in these dilemmas of modern Keynesianism.

That cannot hide the fact that Mr Zapatero, or whoever succeeds him, faces one of the world's toughest management challenges in the next couple of years.

'The trick is to develop brand rather than land'

The Balearics

Mark Mulligan says the worst excesses of overdevelopment have been avoided

Son Forteza is as far removed as you can get from the sunburnt masses and rundown hotels of Mallorca's popular coastal resorts.

Tucked away at the base of the Balearic island's brooding Tramuntana range, the 16th century stone farmhouse has been restored and refitted as an "ideas factory" and events centre for Camper, the hip shoemaker and design group that began life in the nearby city of Inca, once an important centre of European footwear production.

However, Inca's shoe factories are long gone, the victims of price competition in the 1970s and 1980s from northern Africa, Portugal and parts of mainland Spain.

Even those sustained by Camper's orders well into the 1990s have gone the way of so much of Spain's light industry over the years, leaving Inca as the Balearic equivalent of a rustbelt town.

A few leather workshops and artisanal stores are the city's mainstay now, and that is largely thanks to the tourists who pass through on the way to the beach resorts of the north coast.

For a generation now, the Mallorcan economy has been centred on tourism and property development – the two sectors where Spain's recession began.

Industrial crafts and agriculture have made way for package holidays and second residences for sun-starved northern Europeans.

Aside from Camper, the island's best-known companies are now international hotel operators, such as Sol Meliá, Riu, and Barceló.

Air Berlin, the low-cost German carrier, uses the island's outsized airport as a hub for southern Europe.

Tourism and its auxiliary service sectors account for at least 70 per cent of economic activity on the Balearic Islands – which include Menorca, Ibiza and Formentera – against a national average of just over 10 per cent.

Rags to riches stories abound, and for most of Spain's 10-year economic boom, the islands' residents enjoyed among the highest standard of living in the country.

Both Mallorca and Ibiza are peppered with multi-million dollar mansions and villa conversions owned by royalty and celebrities.

"In Mallorca and Ibiza, there was no transitional phase," says Joana Barceló, head of tourism at the Balearics regional government.

"We went directly from a mainly agrarian economy to one based on tourism."

Despite this rapid transformation, wholesale destruction of the islands' natural assets has been largely avoided.

Although corruption, poor planning and simple bad taste have resulted in ugly buildings in some of the early resort areas, Mallorcan officials were the first in Spain to recognise the perils of overdevelopment, and take action.

A €2-a-night eco-tax was levied on five-star hotel guests across the islands in 2002 to help fund conservation of national parks, recycling initiatives and the demolition of dilapidated hotels.

The levy was abolished two years later, and corruption involving land deals and tourist resorts remains a problem.

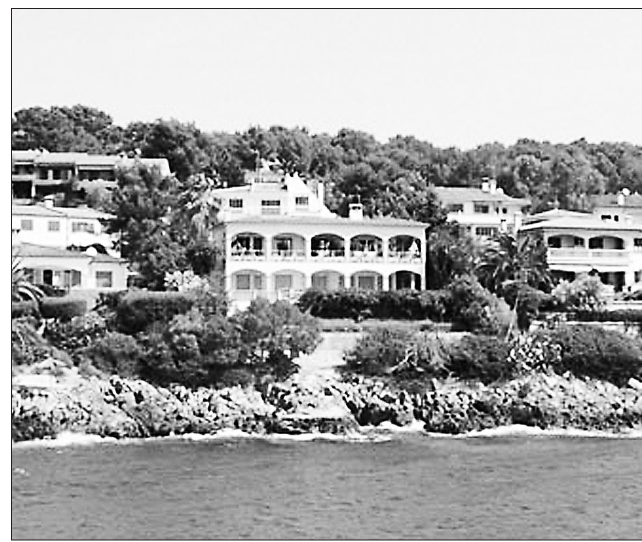
However, successive regional and local governments have largely moved towards reducing sharply the amount of land available for housing and hotels, demolishing illegal structures and extending protected areas.

> When mass-market tourism dominates your economy, it would be absurd suddenly to reject it out of hand

"The fact that Mallorca was the first part of Spain to give itself over to mass tourism means that it was also the first to develop an environmental conscience," says Maria Lluïsa Dubon Pretus, Mallorca's regional minister for land use.

With aesthetic sensibility and sustainable development now embedded in public policy, the islands' main problem at the moment is the global financial and economic crisis.

Consumer sentiment, business and convention travel, company and government financing – all were hit all at once.



70 per cent of economic activity in the islands is tourism Alamy

The downturn has battered the economy, driving unemployment from less than 10 per cent to above 22 per cent, and forcing numerous travel agencies, tour operators and property developers into creditor protection. Ancillary businesses have gone down with them.

The euro's strength against the pound – which has recently started to waver – was particularly hard on the Balearic economies, where UK tourists and second home-buyers form the biggest market after Germany.

After a sharp drop last year, arrivals in Mallorca from the UK have continued to fall this year, down nearly 30 per cent year-on-year to the end of April.

The German market was also weakened by recession, although the decline in visitor numbers has been slightly smaller

"Until September 2008, we had become used to double-digit growth every year," says Daniel Chavarria Waschke from property agents Engel & Völkers in Mallorca.

"Then business just stopped dead. Only recently have we noticed signs of a pick-up," he says.

If there is an upside, it is that it has helped focus minds on how to add value to a slightly jaded tourism model, while consolidating support for sustainable development.

"When mass-market tourism dominates the sector which, in turn dominates your economy, then it would be absurd suddenly to reject it out of hand," says Joan Gual de Torrella, chairman of the Mallorcan Chamber of Commerce.

"However, Mallorca also has renowned cuisine, good hospitals and clinics, spectacular natural beauty and a store of know-how and experience in tourism."

"The trick now is to develop the brand rather than the land."

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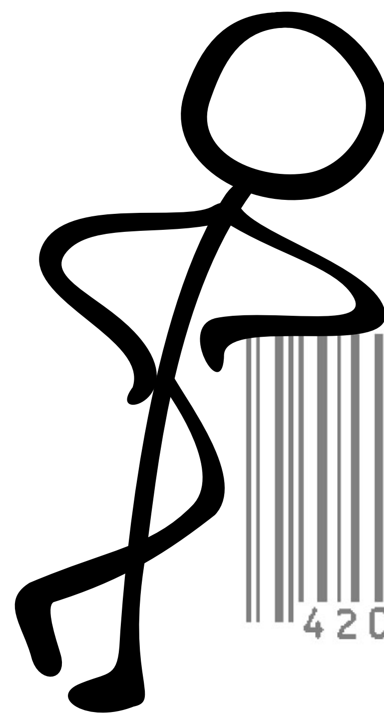

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Spain

Chimneys and farms give way to IT

Asturias

The region has steadily reduced dependence on heavy industry and primary agriculture. **Victor Mallet** reports

Belarmino Feito, founder of Asturfeito: his company is building the rotating and elevating bases for the Atacama Large Millimeter Array telescope system in Chile Victor Mallet

The Principality of Asturias, one of the smaller of the 17 autonomous regions of Spain, is home to some of the most startling contrasts in the landscape of the Iberian peninsula.

One moment, you could be in a picturesque fishing village looking out over the Bay of Biscay, or driving down a steep, green valley among mountain lakes. The next, you are confronted with a coal mine or a massive ArcelorMittal steel plant belching steam and smoke.

Asturias, however, is more than just an awkward mix of cow pastures and heavy industry.

One clue to how the region is transforming its economy lies in a storage yard outside one steel plant north of Gijón, where sections of wind-turbine towers gleam white against the rusting factory walls as they await transport and assembly for Spain's ubiquitous wind farms.

Like other parts of the industrialised north, Asturias has steadily reduced its dependence on heavy industry and primary agriculture and encouraged investment in newer sectors such as information technology and tourism, as well as promoting companies that add value to the steel and coal for which the region is known. *Del carbon al ratón* (From coal to the [computer] mouse) is the region's economic slogan.

The starting point for this transformation was far from ideal. Under the autarchic policies of Francisco Franco, the late dictator of Spain, heavy industry in the principality was state controlled and internationally uncompetitive, as immediately became clear when Spain joined the European Union in 1986.

"Asturias was the epitome of crisis in the 1980s and 1990s," says Vicente Alvarez Areces, the Socialist regional premier for the past 11 years. "All the sectors came into crisis together – mining, shipbuilding, agriculture, textiles. There was extraordinary social conflict. In 1999, Asturias had the highest unemployment in Spain."

The change today is obvious. At 16.6 per cent of the workforce, unemployment is still high by European standards, partly because of the latest recession, but it is below the overall Spanish level of more than 20 per cent.

In the old industrial town of Blimea, next to lines of red-brick social housing built for coal miners, is an incongruous modern building of black and blue glass where El Corte Inglés, the big retailing group and conglomerate, has established an outpost of its IT arm.

There the 116 staff – the average age is less than 30 – conduct research and development, customise SAP software for clients, convert documents into digital format and manage data hosting services.

Another big IT presence is CSC (Computer Sciences Corporation) of the US, which originally came with chemicals group DuPont – a big customer that set up a large plant here in the 1990s – but now serves customers across Europe from its Asturias centre. Among other tasks, CSC's 380 staff remotely monitor computer networks at Renault plants. Again, the average age is just 32.

Investors like the relatively high level of education in Asturias, as well as the good transport and communications infrastructure, and they particularly appreciate the low staff attrition rate.

CSC says staff turnover is about 5 per cent, compared with about 20 per cent across the IT sector.

IT and communications businesses now account for about 5,000 jobs – more than coal – while the number employed in the steel industry has fallen to less than a third of the 30,000 or so it reached in the 1990s.

But the changes in the economy are not just in the service sector. "Heavy industries have not disappeared," says Graciano Torre González, regional industry minister. "ArcelorMittal remains hugely important."

The trick is to develop businesses that can use the steel in a productive way. Belarmino Feito, founder of Asturfeito, launched his business 21 years ago with a small workshop of 40 square metres. Today he employs 150 in 33,000 sq m of factory space, focusing on designing and making systems for solar power plants and other renewable energy sources, including wave power.

He is currently building – to the extremely fine tolerances required by astronomical observers – the rotating and elevating bases for a giant radio telescope system to be installed in Chile, the Atacama Large Millimeter Array or Alma.

In the old days of state industry, says Mr Feito, "there was no specialisation, and companies didn't compete outside. Their clients were all in the area. But there was lots of reconversion of industry in the 1980s and 1990s."

Mr Torre agrees. "It's a totally different economy," he says.

The global crisis and a Spanish recession that lasted for seven consecutive quarters have taken their toll here, as in the rest of the country, causing job losses and reducing orders and exports.

Budgetary austerity, furthermore, means central and regional governments will inevitably be less generous than before with investment promotion funds that have helped to modernise the Asturian economy in the past decade.

Even so, private sector executives and regional officials say they see encouraging signs, including rising production indices, to suggest the worst may be over for the real economy, especially for those parts focused on international markets.

"We're in a globalised world," says Mr Alvarez, the Asturias premier, who has just emerged from a meeting with his ministers on how to implement the central government's latest austerity plans at the regional level. "Our companies must be in China, Mexico, wherever there is business today."

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An economy built on sand must be rebuilt on education

Guest Column
WILLIAM CHISLETT

Too much of the Spanish economy over the past 30 years has been built, literally, on sand. At their peak in 2006 the housing and tourism sectors accounted for close to 25 per cent of gross domestic product (GDP).

The country needs an economy based much more on exports and direct investment abroad. This would make it more competitive and productive and generate stable employment in a country suffering from a 20 per cent jobless rate.

The spectacular collapse of the construction sector (1m fewer people are working in it than in 2008 and there are about 1m unsold homes) brutally exposed the vulnerability of a lopsided economic model based on bricks and mortar.

Construction and related activities generated hundreds of thousands of jobs (many of them held by immigrants), but contributed little to value added because of low productivity.

Spain's current crisis is almost entirely home-made.

For more than a decade, the political class was happy to encourage phenomenal growth of the property sector without giving thought to the bubble being created or what would happen after it burst.

The housing bubble started during the government of the conservative Popular party (1996-2004) and intensified under the Socialists.

The latter broke their promise to end tax deductions for home purchases – although they have changed their minds again in recent months.

The number of housing starts in 2006 (865,561) was more than France, Germany, the UK and Italy combined.

The explosive growth of the property sector had a big knock-on impact on the rest of the economy and caused corruption among politicians to flourish, particularly as a result of reclassification of land by town halls.

More than half the increase in total tax revenue between 1995 and 2007 came from the property sector.

For many analysts, it was, to borrow the title of a novel by Gabriel García Márquez, a *Chronicle of a Death Foretold*.

The only question was when the slump would happen; the international credit crunch was the trigger.

There is another path to prosperity – through international expansion.

The country has a core of multinationals, such as the Santander financial group, Telefónica (telecommunications) and Iberdrola (renewable energy), and there are also successful medium-sized companies that have expanded abroad.

Geographical diversification enabled them to weather the severe downturn in their domestic market.

Spain's outward investment stock was $602bn at the end of 2008 (the latest figure), 37.5 per cent of GDP, compared with Italy's $517bn (22.5 per cent of GDP).

In GDP terms, outward investment stock was 12 times higher than in 1990.

Most of the investment is in the European Union and Latin America, increasingly in the US and very little in Asia, despite its growing importance in the global economy. There is thus considerable scope for further rises.

William Chislett: there is another path to prosperity – through international expansion

The export sector, however, is lacklustre. Between 1988 and 2009, the contribution of external demand to GDP growth was positive in only six years, two of which were recession years (1993 and 2009), when companies were forced to sell abroad to offset the contraction in their home market.

In "normal" years, buoyant domestic demand sucks in imports and – coupled with the traditionally low level of exports of goods and services (about 25 per cent of GDP) – generates a big trade deficit (7.9 per cent of GDP in 2008) and intensifies the current account deficit (9.5 per cent in 2008).

> Research and development spending, at 1.35 per cent of GDP, is way below most advanced economies

Another indicator of the low export capacity is their amount in per capita terms: $5,355 compared with $8,330 in Italy and $16,175 in Germany, according to the 2009 World Development Indicators.

The cornerstone of a knowledge-based economy – and thus one capable of exporting more – is education.

Spain is going to have to make a Herculean effort to improve its education system.

One of every three people between 18 and 24 does not complete basic secondary education (double the EU average). Results in the OECD's Pisa tests in reading, mathematics and scientific knowledge are poor. It has no university in the world's top 150 in the main rankings (up to 35 per cent of students drop out before graduation and only a third complete their studies on time). Research and development spending at 1.35 per cent of GDP is way below that of the most advanced economies.

It is perhaps not surprising that high-tech products account for only 5 per cent of manufactured exports.

A decade is needed before the positive effects would be felt, and a start has not yet even been made, thanks to the squabbling political class.

The export sector is also hampered by the country's image abroad, which is out of line with reality.

Foreign views are still predominantly forged by stereotypes (fiestas, and bullfighting). This affects consumer's perception of the quality of products. Only one company, Zara, the fashion retailer, is in Interbrand's top 100 global brands.

Fiscal adjustments are necessary to reduce Spain's dependence on the construction sector, but they are not enough. Deep structural reforms are needed for it to become a strong, export-oriented economy.

William Chislett is author of three books about Spain published by the Elcano Royal Institute. www.WilliamChislett.com