Spain and Portugal in the Euro Area: Lessons for Cyprus†
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Abstract
This paper compares the economic performances of Spain and Portugal in the European Monetary Union (EMU) and draws some lessons for economic policy in Cyprus. Although high growth recorded in Spain could be partially attributable to euro entry conditions and a strong population shock, appropriate policy choices have played a paramount role. In particular, on the back of sustained fiscal consolidation, the Spanish public sector partially offset the pervasive effects on the current account of the credit impulse associated with the fall in the risk premium. In contrast, pro-cyclical fiscal policies exacerbated the effects of the credit impulse and led to a boom/bust adjustment process in Portugal, while increasing female participation and strong immigration underpinned wage moderation. Now that Cyprus has adopted the euro, the experiences of Spain and Portugal in EMU pinpoint the importance of an adequate fiscal governance system to ensure fiscal prudence, especially in good times. Across-the-board expenditure rules would ensure wage restraint in the public sector and promote economy-wide wage moderation. In parallel, reforming the education, training and apprenticeship systems, while ensuring an adequate degree of market competition, will support productivity growth in Cyprus.

Keywords: Adjustment in the Euro Area, Fiscal Policy, Structural Reform, Fiscal Governance.

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1. Introduction

In 2008, when we welcome the adoption of the euro by Cyprus and Malta, we also celebrate the 10th anniversary of the third stage of the Economic and Monetary Union (EMU). With the incorporation of those two countries, the number of euro area catching-up Member States amounts to six out of a total of fifteen. Therefore, this year seems to be ideal to take stock of the experiences of catching up countries in the euro area, and to draw some lessons for newcomers. In this vein, this paper focuses on the adjustment processes of Spain and Portugal in EMU and the implications for policy making in Cyprus.

Measured in current purchasing power standards (PPS) the per capita Gross Domestic Products (GDPpc) of Greece, Spain, Cyprus, Malta, Portugal and Slovenia in 2008 are about 91, 95, 83, 70, 67, and 84 per cent of the euro average, respectively. Between 1999 and 2008, Portugal fell behind, with its income relative to the euro area going down by more than 6 percentage points (from around 73%). In contrast, also in terms of the euro area average, the GDPpc of Greece, Spain, Cyprus and Slovenia increased by 20, 11, 9, and 17 percentage points, respectively, while that of Malta stagnated at 70%. Therefore, Portugal represents a disappointing experience in the first EMU decade. In contrast, Spain not only over-performed the euro area in the run up to EMU, but GDP growth actually accelerated since 2001. Although Portugal and Spain had shared a series of institutional and economic features until the dawn of the 21st century, both economies exhibited a different degree of resilience to the downturn that unfolded in 2001. While the slowdown was short lived in Spain, the Portuguese economy has been performing poorly since then and no signs of a firm rebound are yet visible in the near horizon (European Commission, 2008b). Such differences in economic performance do not seem related to different degrees of exposure to the dot-com bubble, but rather appear to be linked to different shocks and policy responses in EMU.

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1 The euro area member states are Belgium, Germany, Ireland, Greece, Spain, France, Italy, Luxembourg, the Netherlands, Portugal, Austria, Finland, together with Slovenia, which joined in 2007, and Cyprus and Malta, which have just adopted the euro. Within the euro area Greece, Spain, Cyprus, Malta, Portugal and Slovenia can be included in the group of catching-up countries. Although Italy’s income is currently below the euro area average, it would be considered strictu sensu as a catching-up country, since it has actually been falling behind during the EMU period.
Within this background, this paper considers policies and institutions that can be useful for Cyprus to establish a national shock-absorption setting to respond to external shocks. Next section presents and compares a series of stylised facts on macroeconomic aspects of Spain, Portugal and Cyprus. Section 3 will examine the role played by EMU shocks, especially the fall in risk premia, as well as competitiveness developments, including the parity at the entry. Section 4 will review the importance of fiscal-policy and the role of fiscal institutions. Section 5 will look at the drivers of growth and competitiveness in the long run, with a particular focus on structural policies. Section 6 concludes.

2. Some stylised facts

Portugal and Spain, two catching-up, neighbouring economies of the euro area, share an almost identical European Union (EU) integration history in chronological terms. Both countries joined the EU in 1986, entered the Exchange-Rate Mechanism of the European Monetary System some years later and adopted the euro on the 1st of January 1999. In the early 1990s, both economies embarked in a strong disinflation process and recorded a sharp and significant fall of risk premia. Since the late eighties or early nineties, at the latest, and in line with general international trends, the financial markets of Spain and Portugal underwent rapid and effective international integration, coupled with strong domestic liberalisation, which significantly eased financial conditions. Moreover, both economies put their budget deficit on a downward path with a view to qualifying in terms of the fiscal Maastricht criteria by 1998. Both countries also shared some expectations associated with their accession to the euro area.

Between 1986 and 1998, growth was consistently higher in Portugal (PT) than in Spain (ES) (Figure 1). Overall, GDP growth averaged about 3¾% in Portugal, compared with just above 3% in Spain. Both countries over-performed the euro area average (EA). The GDPpc (current PPS) of Portugal jumped from 58% of the euro area average in 1986 to 71% in 1998 (from 72% to 81% in Spain). Although employment growth was stronger in Spain (2% per year) than in Portugal (¾%), its unemployment rate was much higher.
FIGURE 1
Annual real GDP growth, 1986-2007 (%)

Source: European Commission (AMECO database).

FIGURE 2
Current account, 1986-2007 (%GDP)

Source: European Commission (AMECO database).

However, the economic performance of Portugal during the first decade of EMU has significantly worsened. Its GDP has been growing at an annual average rate of 1¾%, which compares with 3¾% in Spain. In parallel, the unemployment rate in Portugal rose from 4½% to 8%, while it fell in Spain
from 15% to just above 8%. These figures actually reveal very different degrees of resilience and adjustment to the 2001 crisis. In 2002, GDP grew by a sluggish ¾% in Portugal, compared with 2¾% in Spain. Moreover, Portugal was in recession the year after, and growth remains below 2% nowadays. Activity quickly recovered in Spain and it has steadily accelerated until very recently.

On the demand side, growth has been generally driven by domestic components in the two countries. The exceptions are Spain in the first half of the 1990s and Portugal during the last five years, when the growth contributions of net exports were positive. Fixed capital formation played an important role, especially investment in infrastructure and housing. In the early 2000s, investment collapsed in Portugal, in particular in construction, but has kept a brisk pace in Spain until very recently.

Negative contributions of net exports, coupled with the deterioration of the primary incomes and transfers balances since 1986, led to the accumulation of external deficits in both countries, although at very different speeds (Figure 2). Starting from a surplus position, the current account of Spain and, to a lesser extent, Portugal deteriorated until the early nineties. The Spanish external deficit was assessed by markets to be unsustainable, which triggered a succession of devaluations of the peseta, leading to a substantial improvement of the current account, from a deficit of 4% of GDP in 1992 to a balanced position in 1997. Since then, the external position of Spain has steadily worsened to reach a deficit of around 10% of GDP. The current account of Portugal steadily deteriorated during the nineties to attain the 10% of GDP already in 2001. Although, consistent with the recession that followed the burst of the dot-com bubble, the external position of Portugal improved somewhat, the relief was short lived and the Portuguese current account resumed its downward path already in 2003, and nowadays the external deficit has gone back close to the level recorded in 2001.3

2 The deterioration of the primary incomes balance is the consequence of large foreign direct investment inflows in the past, as well as the fast accumulation of external debt (see section 3). The deterioration of the current transfers account reflects the dramatic changes in migratory flows that have taken place in the Iberian countries over the last two decades. On the one hand, the large migratory outflows recorded since the fifties significantly slowed down or even stopped altogether in the eighties and nineties. As a result, incoming transfers declined. In parallel, during the last decade, Spain has become net receptor of migratory flows (see section 5).

3 For more detailed analyses of the economic performance in Spain and Portugal see Abreu (2006), Ayuso, de Castro, Gomez and Martinez-Mongay (2005), Cabrero and Yaniz (2007),
In terms of real GDP growth, Cyprus (CY) has over-performed Spain, Portugal and, indeed, the euro area since the early 1990s (Figure 1). Between 1991 and 1998, GDP grew at an annual average rate of 4½%, which pushed the per capita GDP (PPS) of the country up from 66% to 74% of the euro area average. Cyprus exhibited quite strong resilience to the slowdown of the early 2000s and the pace of economic activity has remained remarkably stable, at close to 4% since its accession to the EU. As a result, income per capita increased by 9 percentage points compared to the euro area average. Albeit not as high as in Spain, at 2½% per year, employment growth has also been buoyant since the late nineties, especially when assessed against an unemployment rate hovering around 4%. In parallel, the current account has been in the red, fluctuating close to -5½% of GDP, thus smaller than in Spain and in Portugal (Figure 2).

The economic performance of catching up economies in the euro area, especially the implications of widening external imbalances, has attracted the attention of scholars and commentators, generating an abundant literature (see, among others, Blanchard, 2001, Blanchard and Giavazzi, 2002, Blanchard, 2006ab, or Gaspar and St. Aubyn, 2008). In their report EMU@10, the services of the European Commission (see European Commission 2008a) present evidence that the catching-up patterns observed during the first decade of the third stage of EMU broadly follow the predictions of extended neoclassical growth models (see Barro, 1997, and the references therein). Based on the principle of conditional convergence, these models predict that long-run growth is inversely proportional to the income of the country and directly proportional to its steady-state income. This latter income is determined by the household behaviour with respect to savings, work and fertility, which in turn largely depends on economic policies. In addition, Regling and Watson (2008) have highlighted the paramount role of financial integration in supporting growth, adjustment and convergence in the euro area.

Overall, the main factors behind the different performances in Spain and Portugal can be divided into three groups. First, the conditions at entry, including not only the irrevocable euro conversion rates but also the way the two economies reacted to similar shocks in their run up to EMU. Second, the role played by fiscal policies. The third group of factors includes supply-side determinants of long-run growth. However, in spite of this broad consensus, the jury is still out on, among other things, the

extent to which such different performances are of a permanent, long run nature or, on the contrary, they represent a temporary deviation from secular trends. It is probably too early to provide a conclusive judgement. Consequently, this paper does not aim at saying the last word on the issue. Rather, by focusing on the potential impacts of specific policies on the economic performance and the adjustment processes of Spain and Portugal in EMU, this paper tries to identify benchmark policies, which may be particularly relevant in Cyprus.

3. EMU shocks and competitiveness at the entry

Like other catching-up countries in the euro area, Spain and Portugal have traditionally recorded high and persistent inflation. However, in the road to EMU, between 1993 and 1998, inflation fell from 5% to 1.8% in Spain and from 6% to 2.2% in Portugal. With a view to complying with the Maastricht criteria, the fight against inflation during the nineties led to a steady reduction of nominal and real interest rates (Figure 3). Nominal interest rates fell from a peak of about 18% and 15% in Portugal and Spain, respectively, in the early nineties to below 3% in the 2000s. As a result, ex-post real interest rates fell in Spain by some 600 basis points (bp), from about 8% at the beginning of the decade to around 2% in 1998 and, then, by more than 200bp between 1999 to 2006. During the EMU decade, consistently with more moderate inflation rates in Portugal, real interest rates also kept on falling but to a much lesser extent than in Spain.

**FIGURE 3**

*Nominal short-term interest rates, 1986-2007*

![Graph showing nominal short-term interest rates from 1986 to 2007 for Spain (ES), Portugal (PT), European Average (EA), and Cyprus (CY).]

*Source: European Commission (AMECO database).*
This process coincided with an intense domestic liberalisation of the financial sector across the euro area, particularly in Spain, where intermediation rates significantly fell. Figure 4 plots the reduction in the mortgage interest rates, which could be interpreted as an indicator of the changes in risk premia, and the reduction in the difference between inter-bank interest rates and the mortgage interest rates, which could be interpreted as an indicator of the changes in bank margins, both measured over the period 1995-2006. Spain, together with Portugal and Italy, would be among the countries where the risk premia would have fallen by more within the euro area. Spain would also be the country where domestic liberalisation would have been more important, while Portugal would be close to the average in the euro area. All in all, Spain and Portugal would be among the euro area members in which the combined effects of financial integration and domestic liberalisation would have been more intense.

The liberalisation of the credit market and the concomitant credit expansion, fed asset markets, especially real estate, which played a paramount role in underpinning domestic demand (see Martinez-Mongay, Maza and Yaniz, 2007). As predicted by intertemporal models (see, for instance, Fagan and Gaspar, 2007, and Gaspar and St. Aubyn, 2008), output strongly reacted in both countries to the reduction of risk premia in a context of financial market integration and domestic liberalisation.
Financial integration and domestic liberalisation brought capital costs down, and, consequently, investment played an important role in sustaining domestic demand, with construction in general, but especially housing, being particularly buoyant (European Commission, 2008a). However, the expansion of credit in the second part of the nineties was sharper in Portugal than in Spain (Figure 5). These developments have led to unprecedented increases in the external debt ratios, albeit more moderate in Spain (Figure 6). Although section 4 below highlights the role of fiscal consolidation behind such a more moderate deterioration of private balance sheets in Spain, the role of supply factors, especially those of regulatory nature, should not be undermined. For instance, aiming to better account of ex-ante credit risk, the Bank of Spain decided in 2000 to introduce a so-called statistical provision, which help restrain credit growth during the first half of the 2000s.

**FIGURE 5**

Credit growth to non-financial sectors, 1996-2007 (%)

Sources: ECB and Eurostat.
The demand expansion was sustained by the pro-cyclical behaviour of real interest rates in EMU (European Commission, 2006b). In the euro area, where the nominal interest rate is set in the context of the average inflation rate, idiosyncratic demand shocks feed inflation and induce a fall in real interest rates, which, through the credit channel, push demand and inflation further up, thus lowering real interest rates in a self-reinforcing manner. In addition, asset markets amplify real interest rate effects through changes in wealth (Regling and Watson, 2008). These expansions may induce overheating, thus triggering a real appreciation of the effective exchange rate relative to the euro area, thereby for a given productivity growth rate, weighing on competitiveness, the channel of which acts in the opposite direction to the real interest rate. Eventually, the initial equilibrium is restored. However, in the real world, where productivity growth tends to respond to structural policies only slowly and nominal rigidities prevail, in the absence of national exchange rate policies, the working of the competitiveness channel may be slower than that of the real interest rate. As a result, while asset-led expansions may be exuberant, the

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4 The demand shock can start, among other things, by a credit impulse associated to the fall in risk premium.
restoration of competitiveness may take longer, resulting in a protracted slow down period.

The interaction of the fast and pro-cyclical real interest channel and the slow and counter-cyclical competitiveness channel is largely reflected in the current account developments displayed in Figure 2. As indicated above, the credit impulse, which started in the early 1990s, went hand in hand with a steady worsening of current accounts in both countries (Figure 2). Measured in terms of the relative change of nominal unit labour costs, the real effective exchange rate (REER) of Portugal vis-à-vis other euro area countries appreciated by more than 40% over the pre-EMU period, 1986-1999, with the bulk of this appreciation (about 35%) taking place until 1992 (Figures 7 and 8). Although at a slower pace, the same trends were in motion during the first years of EMU, when the Portuguese REER further appreciated by 8% between 1999 and 2002. This cumulated 50% appreciation, combined with the credit-led domestic demand, resulted in a two-digit current account deficit and the halt of the expansion by 2002. Since then, the REER has increased only marginally and the current account has temporarily improved on the back of a sluggish demand for imports.

The profile of competitiveness developments was substantially different in Spain, especially during the 1990s (Figures 7 and 8). The REER vis-à-vis the euro area appreciated in Spain between 1986 and 1992 (31%). In contrast, between 1992 and 1999, the Spanish REER depreciated by about 12%. During the first decade of the euro area, the competitiveness gains of the 1990s were fully offset and the level of the REER recorded last year was comparable to that of the early nineties. Interestingly, behind the competitiveness gains recorded during the central part of the nineties lies a competitive devaluation (triggered by an external deficit judged unsustainable) instead of productivity gains or wage moderation. By the early nineties, 128 Spanish pesetas were equivalent to 1 euro. The irrevocable conversion rate was fixed at about 166 pesetas per euro on the last day of 1998, representing a devaluation of about 30%. On the other hand, the conversion rate of the Portuguese escudo was fixed at about 200, which compares with the nominal exchange rate of 179 escudos per euro prevailing in 1991, and therefore represents a devaluation of around 12%. The rapid and strong REER depreciation in Spain would largely explain why its current account improved from a deficit of 4% of GDP in the early nineties to a balanced position in 1997.
FIGURE 7
Real effective exchange rates (1986-2007)

Source: European Commission (AMECO databank).

FIGURE 8
Nominal exchange rates of the peseta and escudo with respect to the euro (1986-1998)

Note: 1 From 1999 onwards the irrevocable conversion rates fixed in 1998 apply.
Source: European Commission (AMECO databank).

Turning to the Cypriot economy, the interaction between the interest rate and the competitiveness channels during the first few years in the euro area seems to be somewhat less important than in Spain and Portugal.
Leaving aside a hike in 2003, which appears linked to the implementation of indirect tax reforms, in line with the Community acquis, inflation has remained stable at about 2-2.5% over most of the 2000s. In parallel, nominal interest rates have hovered around 4% since the early 2000s. A main exception is 2004, when the central bank increased policy rates in a move to pre-empt possible pressures on the foreign exchange market related to the completion of the capital account liberalisation process. Consequently, the changes in the risk premium were relatively moderate. In addition, according to European Commission (2007a), Cyprus is a regional financial centre and is substantially integrated in the financial systems of the euro area in terms of branches and subsidiaries of foreign banks operating in the country. Therefore, a significant idiosyncratic reduction in risk premium should not be expected. Moreover, the nominal exchange rate of the Cyprus Pound (CYP) vis-à-vis the euro also remained stable since the late eighties at about CYP 0.57-0.59 per euro and, therefore, remarkably close to the irrevocable parity fixed by the Council on 10 July 2007, at CYP 0.585274 per euro. The REER vis-à-vis the euro area has also been relatively stable since 2003.

Overall, since Cyprus, unlike Spain and Portugal, has not relied in the past on the exchange rate to gain competitiveness, and the conversion rate is close to the market rates that prevailed for several years, the exchange-rate conditions at the entry might be relatively neutral. However, recent developments suggest that the existence of an asset boom in the island should not be ruled out. Although credit to the private sector has expanded on average at 10% in recent years, it is accelerating nowadays, especially reflecting strong activity in housing. The loans for housing purchase purposes are increasing at about 30%. This, together with unprecedentedly high extraordinary profits from financial corporations, provides additional evidence on a relatively strong credit impulse and an asset boom in the country. The Portuguese experience of the early 2000s, as well as current developments in Spain, point to the need of close monitoring of asset markets in Cyprus.

4. The role of fiscal policy and fiscal institutions

It is interesting to note that between 1997, year in which the competitiveness gains of the devaluations faded out, and 2004, the current account balance has deteriorated at a slower pace in Spain than in Portugal. However, private domestic demand has been more buoyant and the drag of the external sector has been larger in Spain over most of the period. The role of fiscal policies and institutions seems paramount for
explaining the different speeds in the worsening of the external position of the two Iberian countries.

Spain and Portugal embarked in a sustained process of fiscal consolidation between the early 1990s and the dawn of EMU (Table 1). The process was apparently stronger in Portugal, where the cyclically-adjusted balance (CAB) fell by $3\frac{1}{2}\%$ of GDP, than in Spain, where the CAB was reduced by $2\frac{3}{4}\%$ of GDP. However, developments in interest payments indicate that the fiscal position of Portugal actually worsened in terms of the cyclically-adjusted primary balance (CAPB), while that of Spain significantly improved. Moreover, fiscal consolidation continued in Spain over the EMU decade. After posting a deficit of just $\frac{1}{2}$ point of GDP by 2001, the government balance attained a surplus over $2\%$ of GDP in 2007. However, the fiscal adjustment stopped after 1999 in Portugal and the deficit has remained close to $3\%$ of GDP during most of the current decade, sometimes thanks to deficit-reducing one-offs, which amounted to more than $2\%$ of GDP in some years (2003, 2004).

**TABLE 1**

*The fiscal adjustment in Spain and Portugal, 1993-2007 (% of GDP)*

<table>
<thead>
<tr>
<th></th>
<th>SPAIN</th>
<th></th>
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<tr>
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<td>3.0</td>
<td>2.4</td>
<td>2.2</td>
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<tr>
<td>CAB</td>
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<td>2.8</td>
<td>2.7</td>
<td>2.4</td>
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<tr>
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<td>-1.8</td>
<td>-0.8</td>
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<tr>
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<td>-14.5</td>
<td>-12.5</td>
<td>36.2</td>
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<td>Investment</td>
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<td>3.7</td>
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<td>37.6</td>
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<tr>
<td>Debt</td>
<td>56.1</td>
<td>-4.0</td>
<td>4.8</td>
<td>6.7</td>
<td>63.6</td>
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*Note:* Change over the period of reference as a % of GDP.

*Sources:* European Commission (AMECO databank) and own calculations.
As measured by the changes in the cyclically-adjusted primary balance net of one-offs, the fiscal policy stance was pro-cyclical in Portugal between 1998 and 2001, while it was neutral overall in Spain. This had implications for the accumulation of imbalances during the credit impulse in both countries. Specifically, fiscal consolidation helps explain why, in spite of comparable credit growth, the current account and the external debt grew faster in Portugal than in Spain. By reducing the borrowing needs of the public sector, sustained and credible fiscal consolidation in Spain provided some room for the private sector, especially non-financial corporations, to increase their borrowing needs without overburdening the current account (Figures 9 and 10). In contrast, fiscal profligacy in Portugal actually added to the steady reduction of household savings and to the widening savings-investment gap of the corporate sector, thus exacerbating the pro-cyclical effects of financial integration and liberalisation.

The continued fiscal consolidation in Spain led to a fall in the debt ratio of about 30% of GDP between 1998 and 2007, while public debt increased in Portugal by more than 10% of GDP over the same period. Consequently, in the same way that part of the increase in private borrowing needs in Spain were compensated by the improvement in the lending position of the public sector, part of the additional private debt was offset by the fall in public debt.

**FIGURE 9**

*Sectoral balance of Spain, 1995-2007*

Source: European Commission (AMECO databank).
Different fiscal governance frameworks seem to be behind the higher deficit bias observed in Portugal and the more neutral behaviour of fiscal policy in Spain. There is a broad consensus that the magnitude of the deficit bias depends on the budgetary process, the discretion of policymakers and the independence of budget institutions (see European Commission, 2006a, Part III, and the references therein). A high degree of centralisation of the budgetary processes is considered to result in lower deficit biases. In addition, numerical rules, which guide or impose constraints on the discretion of policymakers, are meant to ensure the implementation of time-consistent policies.

Already since the mid-nineties, Spain had implemented substantial changes in the budgetary process and put in place fiscal institutions to tackle the deficit bias and avoid pro-cyclical fiscal behaviour. This is mirrored by differences in the budgetary planning in the medium-term (Figures 11 and 12). An assessment of the degree of achievement of the adjustment paths put forward in the successive updates of the Portuguese stability programme reveals that medium-term budgetary plans have become a moving target, instead of providing anchors for the budgetary process across years (European Commission, 2008d). In contrast, medium-term targets were consistently achieved and even over achieved in Spain (European Commission, 2008e).
According to European Commission (2006a), Spain is considered to have made stronger progress than Portugal in terms of fiscal governance, including the commitment capacity and power of the Minister of Finances, as well as the introduction of a rules-based budgetary process and control, in line with the reformed Stability and Growth Pact. In contrast, Portugal has not yet taken decisive steps to centralise the budget process (European Commission, 2006a). Moreover, while deficit rules at central and local governments were introduced in the early 2000s, Figure 12 suggests that Portugal scores low in terms of enforcing such rules.

The experience of Portugal also illustrates the importance of setting realistic macroeconomic scenarios in the process of medium-term budgetary planning, which calls for a proper identification of the shocks that an economy is facing. Budgetary slippages displayed in Figure 12 do not only reflect lack of centralisation or weak enforcement of rules, but also clearly optimistic assumptions for GDP growth. As a rule, GDP has been projected to grow by 3% over the medium term in the successive stability programmes of Portugal, while actual growth rates have remained below 2%. The temporary nature of the effects of the fall in the risk premium was neglected, and consequently the severity of the adjustment that followed was underestimated. While this may not be an easy task, the Portuguese experience highlights the importance of ensuring that budgetary projections are based on realistic and cautious macroeconomic forecasts.

FIGURE 11

*Government balance projections in successive programmes: SPAIN*

*Source: European Commission (2008d).*
The relationships between the conduct of fiscal policy and economic performance in Spain and Portugal may be particularly relevant for Cyprus, which shares specific features with each one of the two Iberian Member States. Like Spain, Cyprus significantly improved the budget balance by about 8% of GDP between 2003 and 2007 (Table 2). In addition, the debt ratio fell consistently with deficit developments and reached the 60% of GDP threshold already in 2007. Also like Spain, the medium-term adjustment paths, as set up in the successive updates of the convergence programme of May 2004, seems to have acted as effective anchor for the budgetary process and the targets were consistently overachieved (European Commission, 2006c).

Tax revenues from real state and corporate profits in 2007, especially in the financial sector, have been 5¼% of GDP higher than initially budgeted by the Cypriot government. Albeit at a much slower pace, Spain has also recorded a significant increase of tax revenues from real state and corporate profits in the recent past. Interestingly, this increase in tax revenues has taken place in spite of significant reforms aimed at lowering direct taxation. As shown in Martinez-Mongay, Maza and Yaniz (2007), the recorded increase in the tax burden during the recent expansion of the Spanish economy has been partially driven by a particularly tax-friendly growth composition, which reflects booming asset markets. Therefore, as in Spain, exceptionally high tax revenues in Cyprus provide additional evidence of a strong credit impulse in the island. Consequently, while the

additional tax revenues do not come from revenue-enhancing tax reforms and, therefore, do not add to economic distortions, they may disappear along with the end of the asset boom, as it could already be happening in Spain (see European Commission, 2008b). Consolidation has been revenue driven in Cyprus, while no sizeable retrenchment can be observed in primary current expenditures. In this context, Cyprus is similar to Portugal. In addition, deficit-reducing one-offs have also been sizeable, especially between 2003 and 2005. Nevertheless, the tax amnesty launched during those years, together with improvements in tax administration, might have led to a broadening of the tax bases and, thus, to a permanent increase of tax revenues.

**TABLE 2**

*The fiscal adjustment in Cyprus, 1998-2007 (% of GDP)*

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>Budget Balance</td>
<td>-4.1</td>
<td>-2.4</td>
<td>9.8</td>
<td>3.3</td>
</tr>
<tr>
<td>CAB</td>
<td>-3.8</td>
<td>-2.6</td>
<td>9.9</td>
<td>3.5</td>
</tr>
<tr>
<td>Total Expenditures</td>
<td>36.7</td>
<td>8.3</td>
<td>-1.1</td>
<td>43.9</td>
</tr>
<tr>
<td>Interest</td>
<td>3.1</td>
<td>0.3</td>
<td>-0.2</td>
<td>3.2</td>
</tr>
<tr>
<td>Investment</td>
<td>2.9</td>
<td>0.5</td>
<td>-0.3</td>
<td>3.1</td>
</tr>
<tr>
<td>Total Revenues</td>
<td>32.6</td>
<td>5.9</td>
<td>8.7</td>
<td>47.2</td>
</tr>
<tr>
<td>Tax Revenues</td>
<td>27.6</td>
<td>5.3</td>
<td>9.3</td>
<td>42.2</td>
</tr>
<tr>
<td>Debt</td>
<td>58.4</td>
<td>10.6</td>
<td>-9.1</td>
<td>59.8</td>
</tr>
</tbody>
</table>

*Note:* 1 Change over the period of reference in % of GDP. 2 2007 data from the December 2007 Stability programme of Cyprus and Commission services calculations (European Commission, 2008c).

*Sources:* European Commission (AMECO databank) and own calculations.

Fiscal developments in the late 1990s and early 2000s also bring Cyprus closer to Portugal than to Spain. Between 1998, the first year for which comparable ESA95 data exist, and 2003, the increase in government receipts was more than offset by the increase recorded in expenditures, especially primary current spending items. The bulk of the concomitant worsening in the budget balance was permanent, so that fiscal policy was pro-cyclical over the whole period. Moreover, Cyprus lacked adequate fiscal rules and institutions before joining the EU. After 2004, and having as a goal the euro area membership, the country imported fiscal discipline from the Stability and Growth Pact. Overall, the past record of pro-cyclical fiscal policies, coupled with current credit developments and buoyant asset markets, calls for prudence when assessing the implementation of unfunded tax cuts and/or expenditure increases, which can be difficult to reverse in bad times. A lesson to be learned from the Portuguese
experience is that fiscal profligacy in good times may contribute to demand-led boom/bust expansions.

The Cypriot fiscal authorities have taken some steps in the right direction to preserve fiscal discipline. The budgetary process presents a reasonable degree of centralisation. The Ministry of Finance (MoF) seems to have quite strong agenda-setting powers. The MoF provides the other Ministries with guidelines for the budget formulation for the forthcoming year concerning expenditures. Also important, the MoF takes into account the Stability and the National Reform Programmes in preparing the so-called budget circular, which is sent to the government-spending agencies outlining the fundamental parameters for budget preparation.

In spite of such progress in fiscal governance, further institutional reforms appear necessary to secure fiscal prudence. Fiscal rules do not appear well developed in Cyprus, where, given past spending outcomes, they do not seem fully biding. Spending ceilings on the nominal growth rate of some primary expenditure items of the central government were introduced since 2005. However, such ceilings do not cover wages and salaries, which are determined by sectoral collective agreements and a backward-looking indexation system based on a Cost of Living Allowance (COLA). Under COLA, wages, including those of the public sector, are adjusted twice a year to inflation recorded in the preceding six months. The existence of this backward-looking indexation system may jeopardise the effectiveness of the expenditure control mechanism. Although the use of ceilings seems to have restrained expenditure growth, adopting supplementary budgets during the course of the year has remained a usual practice, not only to reallocate expenditures across budget lines, which should be their primary function, but also to approve additional spending programmes.

Since 2007, Cyprus has introduced a new three-year budgeting process, based on the so-called Medium Term Budgeting Framework (MTBF) and the Program-Performance Budgeting (PPB) methods. The objective is to have the full 2011 budget in the new MTBF/PPB format. Although this represents a move in the right direction, as it provides more transparency and a more efficient spending control, the new system retains the existing expenditure rule. In particular, the rule sets a ceiling on the annual growth rate of primary expenditure, excluding wages and salaries. Therefore, it still leaves the budgetary framework exposed to the slippages associated with the COLA wage-setting mechanism.
5. Structural factors

While it seems clear that fiscal policy has played a role in prompting the boom-bust adjustment process in Portugal, simulations by Gaspar and St. Aubyn (2008) suggest that fiscal mistakes can explain just a fraction of the differences between both countries in terms of economic performance in EMU. Although such simulations might not take full account of negative effects of large deficits on agents’ expectations, the findings in Gaspar and St. Aubyn (2008) point to the need to consider other structural determinants of potential growth to better understand the different performances of Spain and Portugal in EMU.

Table 3 presents a standard decomposition of real GDP growth into total factor productivity growth (TFP), the change in the capital-to-labour ratio (capital deepening) and the change in the labour input. The latter is further decomposed into the contributions of average hours worked per occupied person, the growth rate of the working-age population, and the changes in the participation and unemployment rates. The table shows that the main drivers of growth in both Spain and Portugal have undergone significant changes since their accession to the EU. Until the recession of the early 1990s, a much higher TFP contribution in Portugal largely explained the recorded growth differential with Spain of 1¼ percentage points. In the run up to EMU, when both countries grew at comparable rates, growth in Spain was driven by factor accumulation, while, in the case of Portugal, growth was fully based on capital deepening and technical progress.

Compared with the second half of the 1980s, the contribution of TFP significantly declined in both countries in the central years of the 1990s. The negative TFP shock, which was especially relevant for non-tradable sectors, was even more accentuated since the late nineties, especially in Portugal. Overall, during the first decade of the euro area, the growth contribution of TFP has been negligible in Spain and marginally negative in Portugal.\(^5\)

The average contribution of capital has been roughly comparable in both countries over 1999-2007. However, the trends are very different. The capital contribution has been on a declining path in Portugal, reflecting the contraction of the construction sector and sluggish investment activity in equipment. In Spain, the growth contribution of capital accelerated since the late nineties, reflecting the expansion of housing investment, which

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\(^5\) See European Commission (2006b) chapter VII.
accounts for half the almost 10% of GDP increase recorded by the investment ratio since the mid-nineties, as well as the more recent surge in equipment investment.

### TABLE 3

The composition of growth, 1986-2007 (%)

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td><strong>SPAIN</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real GDP Growth</td>
<td>3.7</td>
<td>2.5</td>
<td>3.8</td>
<td>3.6</td>
</tr>
<tr>
<td>TFP</td>
<td>0.8</td>
<td>0.5</td>
<td>0.1</td>
<td>0.1</td>
</tr>
<tr>
<td>Capital</td>
<td>0.6</td>
<td>0.7</td>
<td>0.4</td>
<td>0.7</td>
</tr>
<tr>
<td>Labour</td>
<td>2.4</td>
<td>1.2</td>
<td>3.4</td>
<td>2.8</td>
</tr>
<tr>
<td>Hours</td>
<td>-0.2</td>
<td>-0.1</td>
<td>-0.3</td>
<td>-0.7</td>
</tr>
<tr>
<td>Working Age Pop.</td>
<td>0.8</td>
<td>0.5</td>
<td>1.2</td>
<td>1.4</td>
</tr>
<tr>
<td>Participation</td>
<td>1.2</td>
<td>0.9</td>
<td>1.6</td>
<td>1.3</td>
</tr>
<tr>
<td>Unemployment</td>
<td>0.6</td>
<td>-0.1</td>
<td>0.9</td>
<td>0.8</td>
</tr>
<tr>
<td><strong>PORTUGAL</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real GDP growth</td>
<td>4.9</td>
<td>2.6</td>
<td>2.0</td>
<td>1.3</td>
</tr>
<tr>
<td>TFP</td>
<td>2.2</td>
<td>1.3</td>
<td>-0.3</td>
<td>-0.2</td>
</tr>
<tr>
<td>Capital</td>
<td>0.8</td>
<td>1.3</td>
<td>1.0</td>
<td>0.3</td>
</tr>
<tr>
<td>Labour</td>
<td>2.0</td>
<td>-0.1</td>
<td>1.3</td>
<td>1.1</td>
</tr>
<tr>
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<td>-0.4</td>
<td>0.2</td>
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</tr>
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<td>0.3</td>
</tr>
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<td>0.0</td>
<td>0.8</td>
<td>0.4</td>
</tr>
<tr>
<td>Unemployment</td>
<td>0.8</td>
<td>-0.2</td>
<td>-0.2</td>
<td>-0.4</td>
</tr>
</tbody>
</table>

**Note:** 1 Assuming a Cobb-Douglas production function \( Y = A(L \cdot H)^\alpha K^{1-\alpha} \), where \( Y \) denotes the level of GDP, \( A \) measures the technical progress, \( L \) employment, \( H \) the average hours worked per person employed, \( K \) the capital stock and \( \alpha \) the labour share in income, real GDP can be written as

\[
Y = \frac{Y}{H \cdot L} = A \cdot \left(\frac{K}{H \cdot L}\right)^{1-\alpha} H \cdot WP \cdot PART \cdot (1 - ur)
\]

where \( WP \) stands for working age population, \( PART \) denotes the participation ratio as a share of \( WP \) and \( ur \) the rate of unemployment. In terms of growth rates \( g' \):

\[
g_Y = g_A + (1 - \alpha)(g_K - g_L - g_H) + g_H + g_{WP} + g_{PART} - g_{ur} \frac{ur}{1 - ur}.
\]

The expression \((g_K - g_L - g_H)\) is referred to as capital deepening (capital), i.e. the increase in the capital labour ratio, while \( g_A \) is the total factor productivity growth (TFP), and the rest is the labour input (labour).  

**Sources:** European Commission (AMECO databank) and own calculations.

Overall, the growth differential between Spain and Portugal over the period 1999-2007 is largely explained by the different contributions of
labour. Specifically, the high contribution of labour in Spain is explained by an unprecedented population shock, an increase in the participation rate and a steady and strong fall in the proportion of the jobless. This is mirrored by an increase in the employment rate of 10 percentage points since 1998, to 67% in 2007. Working-age population growth averaged 1.4% per year in Spain during the EMU decade. This is twice the rate recorded between 1986 and 1998 and, mainly reflects an overwhelming acceleration of immigration flows, which jumped from about 130,000 people in 1999 to over 800,000 in 2007 (Figures 13 and 14). All in all, about five million people migrated to Spain during the EMU decade. This, together with a massive participation of women into the labour market, led to an increase in the participation rate from 64% in 1999 to above 72% in 2007. Interestingly, the participation of women rose by more than 10 percentage points.

FIGURE 13

*Demographic trends in Spain*

![Graph showing demographic trends in Spain](image)

*Sources: European Commission (AMECO databank and Eurostat).*
While the high contributions of population and labour force participation to growth in Spain can be attributed to an external shock (immigration) and/or to socioeconomic trends of a rather long run nature (incorporation of women to the labour market), the fall in unemployment seems to be largely policy-induced. The unemployment rate fell by about 7 percentage points during the EMU decade, from 15% in 1998 to 8% in 2007, and, according to the calculations in European Commission (2008e), the Spanish NAIRU fell by more than 6 percentage points during the same period. According to Ayuso, de Castro, Gomez and Martinez-Mongay (2005), the fall of the Spanish unemployment rate is likely to be the result of a series of labour market reforms implemented since the late eighties. As shown by the OECD’s synthetic indicators of stringency of employment protection legislation (EPL), such reforms have lowered EPL stringency in Spain, especially for temporary contracts (see Scarpetta, 2007).

The combination of a more flexible EPL and a large positive supply shock in the labour market seems to be behind the unprecedented wage moderation recorded in Spain in the 2000s, where, overall, real wages have not only increased below productivity but by less than the norm in the euro area (Figure15). Wage moderation would have help to preserve for a longer time the competitive gains achieved with the devaluations of the first half of the nineties. However, in spite of this unprecedented wage moderation, sluggish productivity growth has steadily been taking its toll, which, together with a strong domestic demand and higher energy prices,
is behind the 2-digit current account deficit in Spain. On the other hand, compared with productivity growth, real wages have increased in Portugal by more than in the euro area average. Inadequate wage behaviour would, explain the faster deterioration of competitiveness and the concomitant widening of the current account deficit in Portugal. According to European Commission (2008b), there might be some evidence of an impact of the government wage policy, especially the decreed annual wage increases, on private-sector wages.

**FIGURE 15**

*Wage behaviour in the euro area 1995-2007 (difference with the euro area)*

Sources: European Commission (AMECO databank) and own calculations.

Although the average growth rate in Cyprus since the late nineties compares well with the 3¾% recorded in Spain, its composition appears much more balanced (Figure 16). TFP and capital deepening have each contributed by about ¾ percentage points. Moreover, where the labour input is concerned, it has been fully driven by raising working-age population. As in Spain, average hours worked has contributed negatively to GDP growth, but unlike this country, higher participation and lower unemployment posted marginal contributions. All in all, population has contributed with 2½ percentage points to growth in Cyprus. Working-age population has been growing as an annual average rate of about 4%. Also like Spain, the increase in working age population has been significantly underpinned by immigration. Net immigration flows averaged about 10,000 people per year since the early 2000s. This can be considered quite high for a country with a total population of just ¾ of a million inhabitants.
Overall, as suggested by employment and unemployment rates, job creation in Cyprus has been sufficient to systematically absorb the additional labour supply. While the unemployment rate has fluctuated between 4 and 5%, thus close to full employment, the employment rate has increased only slightly from 68½% in the late nineties to the current 69%. Although migratory flows could have been, in turn, paramount for underpinning wage moderation, wage pressures in Cyprus have been associated in the past with the public sector (European Commission, 2008c). The share of the public wage bill in total compensation of employees has been traditionally large in Cyprus (around 30% compared to 20% in the EU), which might point to a leading role of the public sector in wage setting. For instance, public sector wages experienced a notable pick up during 2002 and 2003, outpacing wage increases in the private sector. Afterwards, wage setting in the public sector acted as a guide for private sector wage negotiations. As an important element of the fiscal consolidation strategy for 2004 and 2005, the government reached an agreement with public sector unions not to increase contractual salaries. The example of the government was followed by the banking sector, which had a moderating impact on wage settlements in the private sector at large. As a result, wage moderation contributed to a sharp deceleration in unit labour costs from an average of about 5% during the early 2000s to the current 1½%.

FIGURE 16
Real GDP growth and its components in Cyprus (1999-2007)

Source: European Commission (AMECO databank) and own calculations.
Together with public-wage control, and given the tight labour market conditions, a sustained supply of labour would appear to be paramount for ensuring wage moderation in Cyprus. However, several gender and age imbalances across occupations and qualifications might put a brake on labour supply. According to European Commission (2007b), the challenge of maintaining fast-growing labour-market inflows could be addressed by reducing the currently high gender pay gap, further promoting part-time work, enhancing vocational training and increasing employment and training opportunities for young people by reforming the education, training and apprenticeship systems. In addition, although measures have been taken to strengthen the enforcement capacity of the Competition Authority and improve competition conditions in the energy, postal and telecom markets, further efforts are needed to reduce administrative burdens and develop a better regulatory strategy. A timely implementation of the Services Directive needs to be ensured, which is crucial in an economy where services account for 77% of GDP and 71% of employment. Finally, given the importance of business services as beneficiaries of foreign capital, improving competition in the area of professional services would also enhance the flexibility and resilience of the Cypriot economy.

6. Conclusions

The comparison between Spain and Portugal provides useful lessons for policymaking in EMU. Specifically, this comparison draws the attention of the Cypriot authorities to the need to monitor closely the asset boom currently underway in the island. Asset booms not only amplify real interest rate effects through changes in wealth, but also have sizeable, non-permanent effects on budgets. This pinpoints the importance of an adequate fiscal governance system to ensure fiscal prudence, especially in good times. The fiscal discipline imported from the reformed Stability and Growth Pact could be strengthened further by effective and credible expenditure rules and by a prudent assessment of composition effects linked to a tax-rich growth model. Across-the-board expenditure rules would ensure wage restraint in the public sector, which would be supportive for economy-wide wage moderation. Making a realistic assessment of the nature of the adjustments underway and avoiding optimistic forecasting biases appear to be particularly relevant in the cases of Spain, where the asset boom is coming to an end, as well as in Cyprus, where it may end at some point. In addition, the challenge of maintaining fast-growing labour-market inflows needs to be addressed, while ensuring
an adequate degree of competition in product markets in order to enhance productivity.

References


