

## **POLICY MEMO**

### **SPAIN AFTER THE ELECTIONS: THE “GERMANY OF THE SOUTH”?**

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#### **SUMMARY**

As Spain votes, it finds itself at the centre of the two major crises with which the European Union (EU) is currently struggling: the euro crisis and the Arab Spring. Should it fail to resolve the euro crisis, the European project will be politically and economically paralysed for a long time. Should Europe fail to support the Arab revolutions, on the other hand, the EU will be faced with a series of drifting countries on its southern rim. Yet the collapse of the eurozone and failure on the Mediterranean are not inevitable. Spain could play an important role in solving both crises – if the rest of Europe helps it to do so.

First, through Mariano Rajoy’s plan to turn Spain into the “Germany of the South”, Spain can help to heal the divisions between northern and southern Europe. This will in turn give Spain credibility to make sure that, as Germany and others take necessary steps towards political union, they do so in a way that is open and fair and benefits the whole of Europe. Second, by taking the lead on European foreign policy in the Mediterranean and by associating itself with the Weimar Triangle’s defence agenda, Spain can make a contribution to European foreign policy. Such a proactive strategy would be good for both the EU and Spain.

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Spain votes on 20 November. If the opinion polls are right, the election will bring to an end the socialist government of José Luis Rodríguez Zapatero that began in 2004 with the decision to withdraw Spanish troops from Iraq following the Atocha railway bombing and ends with unemployment at 21.5 percent and the abandonment of terrorist

activities by the Basque nationalist group ETA. Little is publicly known about what Mariano Rajoy, the leader of the conservative Partido Popular (PP) – who is likely to win a comfortable majority – aims to do once in government and who he will appoint to the top jobs in government. However, many in Madrid are convinced that his team has prepared a plan to “shock and awe” financial markets and Berlin with a new set of austerity measures, budget cuts and structural reforms, particularly in the labour market.

The plan is credible for two reasons. First, having waited since 2004 to become prime minister, Rajoy will be prepared to do anything to avoid intervention by the troika of the International Monetary Fund, the European Central Bank (ECB) and the European Commission which has taken over Greece and Italy to some extent. Action is even more urgent because the government has not met its target for reducing the budget deficit by 6 percent in 2011 and the markets continue to hit Spain’s risk premium. But, equally important, this strategy has been tried before – with great success. Back in 1996, conservative prime minister José María Aznar stopped Romano Prodi’s attempt to get Spain and Italy to gang up against Germany to stop the clock and get into the euro even if the two countries failed to meet the Economic and Monetary Union (EMU) convergence criteria. That move proved very effective: it won Spain not only entry into the euro but a good reputation among its European partners.

Rajoy and his economic team apparently believe that austerity and structural reforms are the only way to increase productivity, generate growth and bring unemployment down from the current, staggering level of nearly five million in October – in other words, 21.5 percent of the economically active population. So, rather than ganging up with the southern or Mediterranean countries to obtain a better deal or relax austerity measures, they want to move fast and sell Spain as the “Germany of the South”. Rajoy will say his government believes austerity is good for Spain instead of trying to horse trade. The prize for Spain is a place at Europe’s leadership table – from which its dire economic situation has expelled it – if and when a new round of treaty negotiations opens.

Can Rajoy’s plan work? So far, it has proven difficult to convince Angela Merkel and Wolfgang Schäuble, let alone the markets, which have not even been impressed by the appointment of Mario Monti as Italian prime minister at the head of a cabinet of technocrats. But the truth is that Germany could well do with an austerity-oriented partner in the south for four reasons. First, it would put an end to the north-south divide

that has caused so much harm to Berlin. Second, it would provide much-needed political oxygen to the embattled Franco-German axis. Third, it would send long overdue signals to Central and Eastern Europe about how much Germany cares for the periphery. Fourth, it would show the way for other southern countries – especially Greece, Italy and Portugal.

### **Spain's three challenges**

Spain faces three interrelated challenges. The first is economic. Until the crisis, Spain's deficit and debt levels were well below the limits set by the stability pact. Nevertheless, Spain has been hit hard by the financial and debt crises. The financial crisis brought the Spanish economy to a sudden standstill as the real estate bubble which had fuelled an important part of its economic growth collapsed. The debt crisis, produced by the soaring government deficit that resulted from the ensuing decrease of revenues and the increase of expenditure (as the economy shrank by 3.7 percent in 2009, government deficit hit 11.1 percent) put the Spanish economy at the same risk of default and external intervention as Greece, Ireland and Portugal. In other words, Spain's current fiscal problems are the consequence rather than the cause of the crisis.

The economic policy U-turn made by Zapatero in May 2010, which envisaged the adoption of major structural reforms in return for continued support from the EU, helped to get the country out of the first line of fire, if only for a while. As the markets seemed to bypass Spain and moved on to question Italy's solvency and credibility, Spain felt temporarily relieved. But it soon found out that it could be brought down by the lack of action of EU leaders on Greece or by the domestic political crisis in Italy or Greece itself. Spain's solvency is not being questioned: in fact, its debt-to-GDP ratio is lower than that of both Germany and France (in 2010, the debt-to-GDP rate was 60 percent in Spain compared to 83 percent in Germany and 82 percent in France). Nevertheless, the crisis is far from solved – especially because Spain is growing at only 0.8 percent and seems to be heading for a recession in 2012, while it is at the same time expected to cut its deficit to 4.4 percent in 2012 and to 3 percent in 2013.<sup>1</sup>

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<sup>1</sup> Inter-annual growth in the third quarter of 2011 was 0.8 percent while quarterly growth in the third quarter of 2011 was 0.0 percent. See Instituto Nacional de Estadística, "Contabilidad Nacional Trimestral de España", 16 November 2011, available at <http://www.ine.es/prensa/cntr0311.pdf>.

Spain's second challenge is political. Zapatero reversed Aznar's European policy, which had turned away from the Franco-German tandem towards the Atlantic during the Iraq war. But Zapatero's bid "to put Spain back at the heart of Europe", as he himself put it in the 2004 electoral campaign, has failed: first, because of the rejection of the European Constitution following the French and Dutch referendums in 2005; and second, because the emergence of Sarkozy and Merkel spelled a conservative Europe in which Zapatero did not fit. For most of his time in office, Zapatero has not been a key player in Europe, despite his good-willed Europeanism and seniority at the Council. Then, starting in 2008, the financial and debt crises further weakened Spain's standing and image.

As Europe gets its act together and figures out the treaty and policy reforms that could allow it to overcome its current crisis, the new Spanish government will have to fight hard to make sure it is not marginalised from the new political and economic integration drive.<sup>2</sup> However, if the fundamentals of its economy do not follow through, it will be hard for Spain to be at the front, and it could even risk being left behind the next wave of political integration which Germany is now setting in motion. The PP is fully aware of this and therefore plans to move very fast after the election to restore Spain's credibility – particularly with Germany – through a new set of structural reforms and austerity measures and to guarantee, in return, that Spain will not be left behind in the two-speed Europe that seems now to be emerging.

Spain's third challenge has to do with national and EU foreign policy. As a medium-sized power with important regional interests in the Middle East and North Africa (MENA) and Latin America, Spain needs an effective EU foreign policy as an amplifier of national interests in these two regions.<sup>3</sup> In the MENA region and in sub-Saharan Africa, EU membership has allowed Spain to build a tight network of overlapping interests and policies that have helped it to deal in a proactive way with problems such as immigration, terrorism, crime and trafficking, lack of democracy and economic backwardness. Thanks to the EU, the divide created by the Strait of Gibraltar has turned into a cushion of interests and positive-sum games.

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<sup>2</sup> See Thomas Klau and François Godement with José Ignacio Torreblanca, "Beyond Maastricht: A new deal for the eurozone", 16 December 2010, European Council on Foreign Relations, available at [http://www.ecfr.eu/page/-/ECFR26\\_BEYOND\\_MAASTRICHT\\_AW%282%29.pdf](http://www.ecfr.eu/page/-/ECFR26_BEYOND_MAASTRICHT_AW%282%29.pdf).

<sup>3</sup> See Richard Youngs, "The EU and the Arab spring: from munificence to geo-strategy", FRIDE, October 2011, available at <http://www.fride.org/publication/950/the-eu-and-the-arab-spring:-from-munificence-to-geo-strategy>.

Thanks to the euro and the backing of the largest and richest world market, the Spanish economy has been deeply internationalised. Through its Latin American connections, its firms have also been able to turn themselves into large multinationals with a global presence, from China to the United States. For example, Brazil contributes a quarter of Santander's profits. Latin America's economic dynamism offers an extraordinary opportunity for Europe to grow its way out of the crisis through trade and investment opportunities. Spain can thus help Europe to reconnect to the new Latin America, which is also proving to be a much promising back-gate to Asia.

However, as crisis-hit Europe struggles to rise to the challenge of developing a coherent foreign policy, Spain's interests suffer. Because it believed that Europe was about to develop a strong and effective diplomacy, Spain has not invested in further developing its own foreign policy apparatus and has not devoted much time to thinking about its place in the world. While France and Britain might still see their interests and their global clout safeguarded by their presence in the Security Council and the G8, Spain has had to fight hard to sit at the G20 and to be visible in other international forums. Now, as it makes cuts to its foreign service, army and development, it needs to rethink how to rebalance the reality of its global presence with more realistic ambitions. MENA is a good case in point: the success of democratic reform is of huge importance to Spain, but the crisis means it risks missing a once-in-a-generation opportunity to fulfil the Mediterranean vision laid out at Barcelona in 1995.

### **A third wave of Europeanisation**

The Spanish election coincides with the thirty-sixth anniversary of Franco's death. This may tempt foreign commentators to continue talking about "post-Franco Spain". However, if anything, this election will prove that there is actually very little about contemporary Spain that can be explained by looking at the Franco era. Actually, the problems which Spaniards face today and would want to see solved by those taking office after 20 November derive not from Spain's past but from the thoroughgoing process of Europeanisation that Spain has witnessed as a result of its accession to the EU in 1986.

Spain's Europeanisation has come in two waves, both including deep structural reforms. The first, under Socialist leader Felipe González (1982–1996), sought to bring the country into the EU and adapt it to the challenges posed by the Single European Act (SEA) and the full liberalisation of the single market envisaged for 1993. This entailed the opening-up of the Spanish economy to EU trade, the break-up of state monopolies and the end of state aid to heavy industry. The second round of Europeanisation took place under Prime Minister Aznar (1996–2004) and its main aim was to ensure that Spain would meet the convergence criteria which would qualify it as a full member of the monetary union. To the surprise of Italy and, to a certain extent, Germany, Aznar's administration passed all the tests. Now, 25 years after having proudly rejoined Europe, Spain must embark on a further round of deep Europeanisation, this time including accepting very tight fiscal and financial controls from abroad.

Rajoy's aspiration to make Spain the "Germany of the South" is the necessary precondition for this third wave of Europeanisation to work. But as well as taking new austerity measures and seeking to establish a strategic alliance with Germany, Spain should also take the lead in at least one area of EU foreign policy in order to signal its commitment. Leadership is most badly needed in MENA, which fits well with Spain's recent policy history, ambitions and national interests. Zapatero has already begun to signal Spain's willingness to take a lead in MENA. He succeeded in appointing his former advisor, Bernardino León, as the EU's special envoy for the region.

However, Spain must go beyond rhetoric and do more than just supporting Mr. León. In particular, it must lead by example in its bilateral relationships in the region. Specifically, it must avoid any contradiction between its own action at the national level and what it asks Brussels to do at the EU level – for example, in terms of opening markets (especially to agricultural products from MENA countries), the granting of financial aid (especially aimed at promoting foreign investment and local SMEs, which create most jobs) and the improving of labour mobility schemes with the region. Wisely managed, the "money, markets, and mobility" framework offered by the EU can prove immensely beneficial to Mediterranean countries such as Spain that have much to gain from interdependence.

Spain's new government needs to rediscover the leadership and entrepreneurship it showed in the 1995 Barcelona Process, which then languished and ultimately was

replaced by support for the status quo during the 2010 Spanish EU Presidency. Spain could carve out a new position as the intellectual leader of a new EU approach. This would require a strategic alignment between Spain and France which overcomes the rivalries between the Barcelona Process and the Union for the Mediterranean. But rather than offering an anaemic and underfunded copy of the enlargement process minus the benefit of membership, the EU must develop a more political and differentiated approach to its southern neighbourhood. This means moving away from the bureaucratic approach adopted by the Commission, which tends to transpose the same rigid and lengthy action plans from country to country. Instead, the EU should develop differentiated strategies for countries in the region that are flexible, effective and well-resourced.<sup>4</sup>

Similarly, Spain could also help revive European defence integration, which would serve both the Atlanticist and the European orientation of the PP. In the past, some Spanish conservatives saw the Common Security and Defence Policy (CSDP) as an anti-American strategy that was aimed at weakening NATO and the transatlantic alliance. But now, as the US focuses on Asia and encourages European defence integration, it would be a safe and quick win for Spain that would not only impress Washington but also help Spain to catch up with Poland – a key US ally that needs to compensate its lack of membership in the euro with political measures like this. Spain should begin by associating itself with the Weimar Triangle (Germany, France and Poland).<sup>5</sup> It could also push two specific ideas: a European Defence Review and close co-ordination of defence cuts in order to maintain collective defence capacity. This proactive approach to MENA and the CSDP could be quite helpful in domestic terms when reframing the budgets and priorities of the three pillars of Spanish external action (diplomacy, defence and development co-operation).

## **What Europe can do for Spain**

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<sup>4</sup> See Susi Dennison and Anthony Dworkin, “Europe and the Arab revolutions: a new vision for democracy and human rights”, European Council on Foreign Relations, November 2011, available at [http://www.ecfr.eu/page/-/ECFR41\\_HUMAN\\_RIGHTS\\_BRIEF\\_AW.pdf](http://www.ecfr.eu/page/-/ECFR41_HUMAN_RIGHTS_BRIEF_AW.pdf).

<sup>5</sup> See Nick Witney, “How to Stop the Demilitarisation of Europe”, European Council on Foreign Relations, November 2011, available at [http://www.ecfr.eu/page/-/ECFR40\\_DEMILITARISATION\\_BRIEF\\_AW.pdf](http://www.ecfr.eu/page/-/ECFR40_DEMILITARISATION_BRIEF_AW.pdf).

There is a lot that the new Spanish government can offer its European partners. The three key challenges it will face are also challenges for the EU. Addressing them in a satisfactory way will therefore not only be good for Spain but also for Europe as a whole. It is therefore in the interest of Europe to support them. One key point is that Spain should not be trading its actions in these three fields in return for other things. Fixing its own economy, providing political leadership to help the EU advance towards political union and helping MENA countries succeed is in its own interest and therefore should be done irrespective of what others think or do. However, there are a number of things that the rest of Europe could do to help Spain to take these steps.

First, Spain needs financial breathing space in order for structural reforms and budgetary cuts to yield results. This means an active role of the ECB on the financial markets, both in providing liquidity to the private sector and intervening with purchases to calm bond markets. Second, Spain should not be left out of discussions on treaty reform leading to further economic and political union. This is essential if economic reforms are to be sustained and successful. Third, Spain needs a “quick win” on either MENA or the CSDP – two fields in which Spain can well reconcile its ambitions with its resources and its geographical position – in order to demonstrate that it has returned to the centre of Europe.

The last few months have made it clear that domestic reforms are a necessary but not sufficient condition to calm the markets and get Spain on a growth path. Although its debt-to-GDP ratio is still lower than that of Germany and France and it is reducing its deficit, Spain’s risk premium has continued to soar. In fact, it is now being forced to borrow at 7.0 percent for its 10-year yields – with its risk premium vis-à-vis Germany going up to 499 basis points, a euro-era high. Spain is in effect suffering from Italy’s political instability and lack of credibility. At this point, the solution of the crisis is to be found not at the national but at the European level.

An adequate response to the debt crisis should, at a minimum, avoid aggravating debt problems and turning liquidity problems into insolvency. But, in the longer term, low growth and high unemployment are unsustainable. So, while in the present context austerity measures, structural reforms and fiscal consolidation are unavoidable, growth- and jobs-related productivity gains will not be realised in the absence of both external and domestic demand. The ECB, the European Financial Stability Facility (EFSF) and



the European Stability Mechanism (ESM), and other EU instruments (such as the EU budget) are therefore crucial to ensure that credit flows from the private sector to companies and that growth is resumed. In other words, as vital as it is that Spain does not falter on fiscal consolidation and reforms, it is essential that financial markets do not suffocate the Spanish economy while it is healing and eventually recovering. This entails a continuation of the ECB's special measures to provide liquidity to the private sector and support on the secondary bond market to keep risk premiums under control.

Long-term political and institutional reforms should be approached in an inclusive and non-discriminatory way. If a two-speed Europe emerges at the end of the process that is now underway, it should be because some countries are not willing or not able to join a new core group rather than because the process leaves countries out. Just as the eurozone functions today, membership of the core should be open to those who can and want to join at a later stage. Thus, whether the new economic and political governance mechanisms are included in the present treaties (by way of the available strengthened co-operation clauses) or outside the treaties (as was previously the case with the Schengen or Prüm Treaties), the basic principles of openness and non-discrimination should be respected. Participation in an eventual two-speed Europe should be under the same principles as the euro: it should not be prohibited and not be compulsory.

## **Conclusion**

With the prospect of a new government, there is a chance to bring Spain back to the forefront of European politics. By helping itself, Spain can help Europe to get out of the crises. But Europe can also help Spain. If austerity does not lead to growth, the crisis will deepen and Europe will fragment and eventually break in two. Spain is willing to become the "Germany of the South". This would help the EU as a whole and the Merkel government in particular. But structural reforms at the national level have to be followed by structural reforms at the EU level. Austerity for austerity's sake does not make political sense: it might eventually lead Spain to growth and jobs, but in the absence of any common political project it might damage the EU's image in Spain and weaken Europe as a whole. A seat at the table as the EU moves towards political union can provide much needed legitimacy and political oxygen to governments struggling to succeed upon markets and electorates. For both Europe and Spain, there is light at the end of the tunnel.

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