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Spain and EMU

Isabella Garcia

By joining the EMS on 16 June 1989, the peseta became the first currency to join the European exchange rate mechanism created ten years ago. On this tenth anniversary, the EMS, renowned for promoting non-inflationary growth and accelerating economic convergence, was hailed as a great success. However, in the wake of recent currency turbulence, punctuated in particular by three devaluations of the Spanish currency since September 1992, the European exchange rate system is suddenly accused of a variety of evils: slowing growth, anchoring on Germany, hindering Competitiveness - price of several states, etc. Some comments on the functioning of the ECM are as devastating today as they were laudatory at the end of the last decade.

This radical change of opinion is an opportunity to take an interest in the particular situation of Spain at a crossroads of European monetary integration. After recalling the situation of the Spanish economy on the eve of its accession to the EMS, we will attempt to draw up an initial assessment of the entry of the peseta into the European exchange rate mechanism.

Finally, the prospects offered by the Economic and Monetary Union (EMU) for this country of Southern Europe, which is currently experiencing its deepest recession for thirty years, will be considered.

I - The economic situation of Spain on the eve of its entry into the EMS

Before studying the strengths and weaknesses of the Spanish economy on the eve of its entry into the EMS, we will examine the main lines of the policy implemented by the government from the year 1983.

1.1- The main lines of economic policy

The arrival of a socialist government in December 1982, will mark a break with a long tradition of interventionist government characterized by subsidies to unprofitable enterprises and desire put in place a relatively protected and closed economy. The objective of the new government will be to create the conditions for rapid and sustainable growth, promoting wage moderation and introducing reforms to strengthen the role of market mechanisms.

During this period, the main axes of economic policy are as follows:

- The opening of borders. Liberalization of foreign trade has been rapid since accession to the EEC and has led to the dismantling of trade barriers. Between 1986 and 1989, the gap between Spanish tariffs and the common external tariff fell by almost 40%; a further reduction is made each year until this gap disappears on 1 January 1993. The introduction of VAT 1 in 1986 led to the elimination of several border levies which corresponded to an indirect subsidy to the export or an implicit tax on importation. In addition, non-tariff barriers were significantly reduced in early 1986.
- Liberalization of the economy. This took place in several directions. With entry into the Community, export subsidies were either banned or reduced. Greater flexibility of work was achieved with the introduction in 1984 of fixed-term employment contracts. In the banking and financial sector, several liberalization measures have been taken: deregulation of interest rates, partial liberalization of regulations

requiring banks to distribute part of the loans to certain sectors of the industry. In addition, exchange control has eased gradually (see Kirrane [1993]).

- The reindustrialisation policy. The strategy of the new industrial policy, implemented since 1983, is based on two principles. The first is to improve business productivity by reducing overstaffing, reducing productive overcapacity and increasing the profitability of the main ones. The next step is to help firms that specialize in growth sectors, invest and modernize. This policy of restructuring and financial reorganization also concerns the public sector since the State privatized a certain number of companies after having contributed to the improvement of their profitability (Cussaguet, 1988).

1 VAT replaced the old turnover tax.

SPAIN AND EUROPEAN MONETARY INTEGRATION

- Promoting entrepreneurship and enterprise. In addition to modernizing infrastructure, the government has encouraged companies to create joint ventures and to make more use of modern technologies. Research and development expenditure, which accounted for only 0.5% of GDP in 1984, was to reach 1.3% in 1992. To achieve this objective, a "National Plan for Scientific Research and Technological Development" was adopted. (Scandella, deordolot, 1988).

- The fight against unemployment. To reduce underemployment, the focus has been on increasing productive investment, and geographical and occupational mobility. The limited mobility of the labor force is explained, among other things, by the existence of a labor regulation adopted under the Franco regime, the "ordenanzas laborales", which still applies to about one quarter of SMEs. This regulation, based on a strict compartmentalization by profession, restricts the chances of horizontal and vertical mobility within each firm since the tasks of the workers are defined very precisely.

- The reduction of inequalities. Social spending needs to keep pace with economic growth and reach out to the most disadvantaged social classes first.

The pursuit of these objectives can only be achieved within the framework of a structural adjustment policy aimed at reducing inflation and the budget deficit, if necessary by using monetarist-inspired tools. In the face of inflationary pressures, however, the Spanish authorities will tighten the direction of macroeconomic policy and implement a restrictive monetary policy in 1988. The Bank of Spain's seven-day intervention rate rose steadily between August 1988 and April 1989, reaching 13.25%. The coefficient of reserves, which the banks must obligatorily constitute on the amount of the deposits which they collect, while being raised by 1,5%.

Given the persistence of excessively strong demand growth relative to productive capacity, monetary policy tightened again in mid-1989. In addition to the increase in the rate of intervention and the coefficient of reserve requirements, the Minister of Economy, Carlos Solchaga, instituted a quantitative control of credit, like the one that existed in France until 1986. The increase in domestic credit distributed to the private sector by credit institutions was limited to 17% for 1989.

1.2 - The beneficial effects of accession to the EEC

As mentioned by Kirrane (1994), by joining the EEC in 1986, Spain saw open a nearly unrestricted fifteen times greater than his market in terms of purchasing power. For the other members, the economic advantage of this accession was the obligation on Spain to dismantle its customs barriers. 2.

Real possibilities appeared to develop the Spanish market for consumer goods and equipment. In fact, the Spanish population is one-eighth of that of the Community and has a lower standard of living than the population of the EEC.

In many areas, the evolution of the Spanish economy until mid-1989 proved to be even more favorable than envisaged by the most loyal advocates of accession. Without denying the role of adjustment policy and the structural reforms described above, we can seek to isolate the role of accession to the EEC in the economic performance of Spain during this period. Entry into the Community has given a real boost to economic growth. The growth rate of GDP was even the highest among the OECD member countries in the second half of the 1980s. In addition to the increase in consumption, it is mainly the investment effort and the acceleration of GDP growth. The diffusion of technical progress that played a key role in this growth process.

The opening of the Spanish market Global competition and the positive impact of high investment rates on firm competitiveness have significantly reduced inflationary pressures. The year 1988 was very satisfactory in this respect, since consumer prices failed to break the 5% barrier.

Since accession, Spain has benefited from assistance under the Community's structural programs. The aim of these programs is to reduce disparities within the UNECE, and in particular to promote the development of backward regions. Between 1986 and 1988, Spain benefited from ECU 3.5 billion from the largest structural funds.³ These transfers from the Community to Spain were mainly earmarked for public infrastructure projects and training programs.

Along with these transfers, Spain has attracted a large influx of foreign private capital were multiplied by 2.8 between 1986 and 1989 (Table 2). While portfolio investment is mainly due to the high level of Spanish interest rates and the rise of the Madrid Stock Exchange, the strong surge in direct investment is largely due to entry into the European Community. In the framework of the reindustrialisation policy, foreign groups have made it possible to overcome the shortcomings of the national productive apparatus by contributing know-how, increasing productivity through the use of high-performance machines and insertion into international distribution network⁴. In addition, certain multinational groups wanted to strengthen their presence in the booming Spanish domestic market and/or to create a profitable base - in terms of production costs - for the 1993 Single Market.

1.3 - Macroeconomic imbalances Persistent

If, in some ways, Spain has benefited from its membership in the Common Market, it has not solved problems such as insufficient savings and high levels of underemployment. In the field of foreign trade, European integration has also contributed to the deterioration of the current account balance. The analysis of the Spanish trade balance shows an increased deficit since entry into the EEC. This deficit has increased four-fold between 1986 and 1989. It thus appears that a phenomenon already observed in 1981 with the entry of Greece has been renewed: the opening up of an economy hitherto relatively protected and closed to stronger international competition leads in the first instance to a deterioration of the trade balance.

In the case of Spain, the gradual abolition of customs barriers and the strong growth in aggregate demand have led to a sharp rise in imports. From a quantitative point of view, the most important factor is the investment effort which has resulted in a rapid increase in imports of capital goods, whose share of total imports has increased from 19.9 in 1983 to 33.1% in 1989. The high level of these imports is mainly due to the modernization of the Spanish economy, revealing the need for catching up of several branches of industry which until then concentrated their activity - in the shelter protectionist measures - for the internal market.

Another explanation is the expansion of private consumption. The increase in domestic consumption seems to have benefited more European trading partners since the share of imports of goods from Current consumption has risen from 8.9% in 1985 to 13% in 1989.

Another factor has swelled imports: the removal of quantitative restrictions on imported products. The appreciation of the real exchange rate of the peseta since 1985 has also contributed to the growth of the import penetration rate.

In addition to the swelling of imports, the deterioration of foreign trade is due to the weak dynamism of exports. Since accession, Spanish exporters have in fact increased their market shares abroad in value, but have suffered a slight loss in volume.

Several reasons explain the weak response of Spanish companies to the opening of the European market. With accession, export subsidies have been reduced or banned in some cases. The rapid expansion of domestic demand has prompted Spanish producers to favor their own market. The relative high level of inflation has led to a loss of international competitiveness. Finally, Spanish products tend to be more competitive than complementary to those of most European countries. Spain's specialization in the automotive and chemical industries and the emergence of an electronic industry can only reinforce this observation. Spanish industry also appears to be in competition with other southern countries, where it has a number of specialties (textiles, shoes, leather, skins). But Spain has higher gross labor costs than countries such as Greece or Portugal, and does not have the degree of innovation from Italy.

The worsening of the trade deficit has weighed more heavily on the deterioration of the current account balance, since the invisible trade balance has remained largely in surplus, despite the decline in tourism receipts in 1989. The importance of net capital inflows to long run, however, resulted in a net positive balance in the basic balance. However, the steady reduction in the basic balance surplus from 1988 shows that the government's room for maneuver to finance the current account deficit narrowed.

In addition to the problem of the current account deficit, the Spanish authorities are confronted with imbalances in the labor market and, first and foremost, with the high level of unemployment, which affected more than a fifth of the active population in 1986. Thanks to strong growth and recovery However, the unemployment rate declined slightly between 1985 and 1989 underemployment in Spain remains high compared all EEC countries.

For Bentolila and Blanchard (1990), the causes of this high unemployment are due to the following structural handicaps:

- inadequate supply and demand of work in terms of qualification;
- specialization in industries with a high proportion of labor, leading to a production deficit for most capital goods;

- rationalization movement in weakly competitive industries leading to massive layoffs;
- low intervention of the unemployed in the formation of wages (phenomena of "insiders").

The last point concerns the financing capacity of households. This declined by almost 4% between 1985 and 1988 to 1.4%. Except for British households with a 1988 financing gap, the financing capacity of Spanish households is the lowest in comparison with other OECD countries.

This phenomenon is explained by the combination of a decrease in savings and an increase in consumption. While the rise in residential investment is due in part to tax benefits, the low savings rate is mainly due to higher consumption, higher income expectations⁵ and higher investment in housing. The aging of the salaried working-age population has been rejuvenated, as the low and declining savings rate of Spanish households has led to an increase in their indebtedness. This expectation can be explained by the high level of economic growth and positive effects of wealth that resulted.

Beyond the political and economic reasons, the decision to participate in the European exchange rate mechanism has not failed to influence the functioning of the Spanish economy.

2.1 - Motivations for joining the EMS

As we have previously emphasized, the situation of the Spanish economy at the beginning of 1989 is relatively satisfactory in several areas. Despite the weight of unemployment, the weakness of household savings, the high level of real interest rates and the current account deficit, the Spanish authorities have several sources of satisfaction such as the high growth rate, the slowdown in inflation, the surplus of the basic balance and the steady increase in foreign exchange reserves.

The Spanish authorities will then take advantage of this favorable situation to join the European Exchange Rate Mechanism on June 16, 1989 with a fluctuation margin extended to plus or minus 6%, such as the Italian lira⁶. This date of entry caused, at the time, a surprise effect since Carlos Solchaga, Minister of Economy and Finance, announced on June 6 before the bankers and governors of central banks gathered for the International Monetary Conference (IMC) that Spain wanted to join the EMS before July 1990.

Beyond the purely economic motives, the decision to accede earlier to the EMS was also politically motivated (Kirrane 1996). Spain thus radically completed its first European presidency, reaffirming its attachment to the Community. Similarly, the success of the government of Felipe Gonzalez in the European elections showed that the Spaniards had not sanctioned its policy of rigor, yet hardly favorable to their purchasing power. As the Spanish government had sufficient credibility and popular support, it could make the decision to join the EMS, which, on the occasion of its tenth anniversary, confirmed its dynamism and evolution.

From the economic point of view, the adherence of the peseta had several objectives: to mitigate the impact of real shocks, put an end to speculation on the Spanish currency and fight against inflation by reinforcing the credibility of economic policy. Work carried out by Ungerer, Evans, Nyberg (1986) on the first participants in the EMS show that the objectives of limiting the effects of real shocks and slowing down inflation are generally achieved.

The gradual liberalization of capital movements, transfers received under the Community's structural programs and the attraction of high real interest rates have led to a massive influx of

capital, mainly in the form of direct investment and investment portfolio. These private foreign investments will contribute to the appreciation of the peseta, whose exchange rate against the DM has depreciated for years.

The situation reverses in the first quarter of 1987. Since then and until the beginning of 1989, there has been a steady increase in the peseta against DM (Chart 1). From the autumn of 1988, the Spanish monetary authorities have to face a strong speculation on their currency. Foreign operators, anticipating a steady rise in the peseta, make important acquisitions, leading to a strong appreciation of the Spanish currency.

In this context of destabilizing anticipation, the announcement of the accession of the Spanish currency to the European exchange rate mechanism aimed, by its unexpectedness, on the one hand to stop speculation and on the other hand to strengthen the credibility of the authorities as regards their monetary policy commitment. As in the case of Italy with the abandonment in January 1990 of the fluctuation band of the enlarged reading of 6%, the resident agents were as much the target of the message as the community partners. To bring the peseta into the EMS was to commit to stabilizing its price and thus to reducing the inflation differential with the other countries participating in the system; this reduction goes through a fight against the internal sources of price increases.

2.2 - The paradox of the peseta

The evolution of the peseta following its entry into the SME has been paradoxical. While inflation remained higher in Spain than in the Community and the trade deficit worsened, the Spanish currency tended to appreciate against other European currencies.

This appreciation of the peseta despite deep internal imbalances can be explained by the asymmetrical functioning of the EMS (see Kirrane [1995]). The asymmetry stems from the fact that Germany, a country with weak inflation and having a perfectly substitutable currency against the dollar and the yen, determines the exchange rate of the area by the choice of its monetary policy. Under these conditions, the other EMS countries are obliged to control the parity of their currency vis-à-vis the Czech mark through their own monetary policy if they know of disturbances, these countries must stabilize their exchange rates without the German authorities to intervene. The asymmetry of the system entails as Artus (1990) points out, the performance of the French and German economies has become closer. Asymmetry also has the advantage of enhancing the credibility of the anti-inflationary policies put in place by governments other than Germany. The latter country with structurally weak inflation, the announcement of the research of a stable parity with the mark implies indeed that the private economic agents anticipate rigorous policies on the part of the central banks (Giavazzi-Pagano (1988)).

In contrast, this asymmetric system is a source of instability. A weak dollar on the foreign exchange market leads to a transfer of floating capital to the mark, an appreciation of the latter and tensions between European currencies. Moreover, the fact that countries other than Germany must control the parity of their own currency with respect to the mark means a loss of autonomy.

Over the last decade, the convergence of economies and the credibility of anti-inflationary policies seem to have outweighed the risks of instability. The evolution of southern European countries in the early 1990s, however, has changed the nature of EMS representation. To use the terminology of Giavazzi and Spaventa (1990), the beginning of this decade was characterized by the appearance of a "new SME".

In this "new EMS", the least rigorous countries at the macroeconomic level were also the hard currency countries. This paradox stems from the fact that new members immediately benefit from the credibility of the system, which eliminates expectations of currency depreciation. However, if for internal reasons (financing of the public debt, control of domestic demand, etc.), they lead at the same time a policy of high interest rates, resulting in capital inflows that lead to appreciation of their currency (Vinals (1990) for Spain). As Artus and Dupuy (1990) demonstrate, there was a "new SME" phenomenon in Spain and Italy: high domestic interest rates and appreciation of the exchange rate despite deep internal imbalances. In the case of Spain, interest rates have been kept high to counteract inflationary pressures. The rapid rise in unit labor costs, the buoyancy of domestic demand and the rise in prices in the services sector explain in the main the inflation propensity of the Spanish economy. The high level of Spanish rates played a key role in the appreciation of the peseta; in 1991, the Spanish currency was considered the strongest currency of the European exchange rate mechanism.

2.3 - A technical success

From a point of view, the accession of the Iberian currency has undoubtedly been a success. Firstly because the suddenness of the decision has slowed speculative tensions. Then, from the first quotations, the Spanish currency has appreciated beyond its central rate, forcing the Bank of Spain to daily interventions on the foreign exchange market.

Beyond this technical success, the entry of the peseta initially provoked greater monetary stability. The variability of the exchange rate of the peseta against the mark thus greatly diminished between the date of entry into the EMS and the summer of 1992 (Minda, 1993) - during this period the exchange rate of the peseta per For example, the mark has always been pegged between its central rate (65 pesetas) and its floor rate (61.2 pesetas). It should be noted that this less fluctuation in the exchange rate was accompanied by a parallel decrease in the variability of interest rates.

While this monetary stability can also be explained by the tightening of monetary policy in mid-1989, the decision to join the EMS exchange rate mechanism played a decisive role since speculative movements due to the anticipation of a rise have faded. The convergence of interest rates with other EMS countries has at the same time accelerated.

Although Spanish short-term rates have remained high for several years, the differential with countries such as Germany and France narrowed until the summer of 1992 (Chart 2). The difference in nominal interest rates thus fell from 8% to 2.7% in three years (June 1989 - June 1992) between Spain and Germany and from 5.7% to 2.4% in respect of France.

The anchor on German monetary policy is probably not as strong in Spain as in France, but it nevertheless served to further discipline Spanish monetary policy.

2.4 - The emergence of new constraints in the decision to participate fully in European monetary integration has, however, posed several problems:

- the appreciation of the peseta, combined with a rapid rise in wages and uncontrolled inflation, has contributed to degrade the balance of the trade balance;
- the high level of interest rates has slowed down investment demand
- Seigniorage receipts as a source of finance for the fiscal deficit have been abandoned;
- The influx of foreign capital has fueled domestic demand, thus slowing down the disinflationary process.

Could the paradox of the peseta persist with the emergence of these new constraints? In the light of the evolution of the peseta in 1992, it appears that the phenomenon of the "new EMS" could only be transitory. This tendency to appreciation of the exchange rate in an economy characterized by imbalances is possible, but only if some. The income from the investment is measured by the cash flow: at M / Y , with M the monetary base and Y the real GDP Gros (1989) shows that under the effect of the EMS and the financial integration in Europe, Seigniorage incomes, which accounted for 2.34% of GDP during the period 1982-1987, were expected to be negative in 1992.

These conditions are met only in the short term (Artus, Dupuy, 1990). These conditions for shifting to a monetary policy aiming at internal rather than external objectives are twofold: the imperfect mobility of capital and the use of currency reserves to stabilize the exchange rate. under the first condition, if the imperfect mobility of capital offers the advantage of not aligning domestic interest rates with international rates, it has the disadvantage of running up against the current globalization of capital markets. the use of foreign exchange reserves by the central bank, it cannot be practiced indefinitely.

The appreciation of the peseta was also accompanied by a relatively unstable short-term equilibrium, since the current account deficit that occurred as early as 1988 was financed mainly by the entry of foreign capital. However, there are among these movements of portfolio capital particularly unstable.

Under these conditions, there was a risk of a break in the equilibrium in the short term. For Artus (1991), the factors behind this break-up could be:

- a fall in interest rates to boost investment and / or] 86 to reduce internal pressures in the EMS;
- saturation of international portfolios, as investors no longer want to increase the peseta's share;
- an exogenous movement of mistrust, leading to the appearance of anticipation of depreciation;
- the willingness of public authorities to restore the balance of foreign trade;
- a too rapid increase in labor costs, implying a slowdown in direct investment;
- competition from Eastern European markets for the reception of investments and foreign capital.

The attacks on the peseta during the second half of 1992 and the recent turbulence of the EMS show that these fears of a break-up were not unjustified.

III - From SME to EMU: what perspectives for the Spanish economy?

The Economic and Monetary Component of the Maastricht Treaty provides that EMU will be carried out in stages to enable member states to control the liberalization of capital movements. However, the Spanish bank abolished the exchange control measures on 1 February 1992. To gradually adapt their economic policies to the requirements of the changeover to a single currency (see Kirrane [1994]). The analysis of the potential benefits and costs of the transition phase in Spain will allow us to see how the peseta behaves in the period of monetary turbulence that has been shaking Europe since autumn 1992.

31- peseta and the monetary crisis of autumn 1992

The EMS, which entered into force on 13 March 1979, aimed at establishing more stable exchange rate relations between European currencies in the context of increased economic

convergence. From 1979 to 1987, the divergence in economic performance - particularly in inflation - will be accompanied by multiple realignments of parity. In fact, it will take until January 1987 to see the EMS operate as a relatively fixed exchange rate system.

Since then, not only have the participating currencies overcome the crises (1987 stock market crash, dollar depreciation, economic recession) but other currencies have joined the European exchange rate mechanism: the Spanish peseta in June 1989, then the pound in October 1990 and finally the Portuguese escudo in April 1992. In January 1990, the Italian Government announced the reduction of the fluctuation band of the lira from 6 to 2.25% on both sides of the central rate. The European exchange rate mechanism, which is known to foster non-inflationary growth and accelerate the convergence of the economic performance of the majority of members, has gradually been considered a success. However, thanks to the monetary turmoil that has shaken Europe since the autumn of 1992, the SME is suddenly accused of the most various evils: slowing growth, anchoring on Germany, hindering the competitiveness of several states. Some comments on how the EMS works are as devastating today as they were laudatory at the end of the last decade.

It is true that in mid-September 1992 the fixity of the currencies which prevailed since the last readjustment of January 1987 was abruptly put in question. European central banks have not been able to stem market forces which, on the occasion of the Danish 'no' vote and the French referendum, have begun to doubt the irreversibility of the march towards the single currency and the fixed exchange rate at within the Community. These doubts have led operators and speculators to re-examine the strengths and weaknesses of different countries. From a monetary point of view, this review led to two observations: first, the lira and the peseta were widely overvalued, on the other hand, keeping the book at his level required the continuation of an austerity policy which was hardly compatible with Britain's strongest recession since the 1930s.

This situation will exacerbate the tensions on the foreign exchange markets and trigger a redevelopment within the EMS. This readjustment started in September 1992 with devaluations of the lira of 3.5% and the peseta of 5% continued in November with a further devaluation of 6% of the Spanish currency and the Portuguese escudo. The floating of the lira and the pound and the restoration or strengthening of exchange controls in some countries (Spain, Ireland, Portugal) will also mark this period of turbulence.

This realignment of parities conceals, however, a deeper monetary crisis. The introduction of new currencies has accelerated first the cleavage within the Community. Around the mark, a hard core seems to have formed, bringing together currencies with relatively low fluctuations as the florin, the Danish krone and the Belgian franc or relatively moderate as the French franc. On the other hand, the last arrivals know a greater volatility of the prices of their currency (read, pound sterling, peseta, escudo). The lira and the peseta have always been considered as the currencies or the strongest or the weakest of the European exchange rate mechanism.

The slowdown in economic activity, which has been very pronounced in Europe since autumn 1991, has also delayed economic convergence and created new tensions. The lack of rapid convergence of inflation rates has led to a real appreciation of weak currencies such as the lira and the peseta, leading to a loss of competitiveness compared to the most virtuous countries. In countries where the primacy of the protected sector in the wage bargaining process and where the indexation principle has not been questioned, the use of the ERM as a tool to combat inflation proven to be perilous as it has led to slow convergence in price, while putting the cost of this policy on the sector exposed to foreign competition.

German reunification, which took place in July 1990, naturally amplified the crisis of the system since the high level of German rates is in contradiction with the needs of other European countries. The restrictive monetary policy pursued in Germany has, however, further hampered low-inflation countries and the asymmetry of the EMS has intensified as it began to be used as an instrument of convergence.

The peseta could not withstand the turmoil that shook the European exchange markets. At the end of summer 1992, several observers estimated that the Spanish currency was overvalued by at least 15%. Such a level of the exchange rate proved to be less and less compatible with the difficulties faced by the Spanish economy. In fact, Spain's lack of competitiveness, linked to the overvaluation of its currency, has led to a further increase in the trade deficit, which reached Pta 3 600 billion in 1992, compared to Pta 3 446 billion in 1991, or 6.2% of GDP. In addition, foreign capital inflows into Spain were on the brink of drying up. The improvement in the tourism surplus due to the World Expo and the Olympic Games did not slow the deterioration of the current account deficit, the first devaluation of 5% in September was inevitable.

The actual depreciation of the peseta against the mark was even stronger because the Spanish currency, which was at the head of the EMS, was in last place, well below its central rates. This readjustment of the peseta, however, did not stop the mistrust of it. Since the release of the lira and the EMS pound, the differences in inflation as well as the greater or lesser control of fiscal deficits have caused a lack of credibility with respect to the less virtuous countries of the system. This is why the peseta suffered a second devaluation of 6% on 21 November 1992.

3.2 - Expected benefits of EMU

If the introduction of EMU will have repercussions for all Member States it is still too early to know precisely the geographical breakdown of the advantages and disadvantages that will result. In addition to the difficulty of predicting in the long term, the project to create a single currency leaves many gray areas unclear about its implementation.

Subject to transitional adjustments, one can nevertheless try to consider the expected benefits of strengthening monetary integration. Excluding micro-economic impacts, the existence of a single currency could provide the following macro-economic benefits:

- the removal of customs barriers and the opening of public markets are likely to exert size of markets and competitive effects;
- the liberalization of capital movements and financial services is expected to decrease the cost of intermediation, resulting in a positive effect on investment;
- the emergence of a capital market at European level will favor the convergence of interest rates and rates of return on financial assets as well as a better allocation of savings within the Community;
- strengthening economic convergence will require an extension of monetary and fiscal discipline to the less virtuous countries.

Will the favorable effects reverberate in the same way in all countries? It is permissible to doubt it. Indeed, the diversity of the economic and social structures within the Community, as well as the uneven stage of development in which the countries of the Community have arrived, make the idea of a distribution unlikely naturally equitable for European monetary integration. Aware of this diversity, the European Commission has also adopted convergence indicators relating to

the economic policy of states and not to the structure of their economies. Consideration of the structural variables would undoubtedly have prevented the accession of the least developed countries.

For the latter, the first step towards integration, which consists in the free movement of capital, implies an alignment of interest rates. As the smaller development of these countries leads to a relatively large investment demand, interest rates are currently at a high level. Therefore, financial integration can only accentuate a fall in these same rates, which has beneficial effects on investment and growth.

This expected drop in interest rates should favor Spain and Italy, which have a particularly high level of interest rates. Nominal short-term interest rates in Spain are thus much higher than those prevailing in the other major nations of the Community. After a slight easing started in mid-1991, Spanish short-term rates again crossed the 15% mark in 1992. In comparison, Spanish interbank lending rates in March 1993 were 7.5% higher than in Germany (15.8% against 8.3%).

In order to benefit from this foreseeable fall in rates, Spain will need however, to release a level of savings capable of adjusting to an increase in investment. If not, the call for foreign savings may widen the current account deficit and thus delay convergence. The inadequacy of domestic private savings can, however, be offset by an increase in public savings through adequate tax policy (Artus, 1991b).

The structural weakness of savings could be partially mitigated by the continuation of redistributive actions at Community level. The Spanish government has therefore recommended aid from the most advanced countries to EMU to countries or regions that are lagging behind during the transition phase (Bruno, Le Cacheux, Mathieu, 1991). This assistance would in turn require the creation of a Compensation Fund whose objective would be to stimulate tangible and intangible investment in countries where GNP per capita does not exceed 90% of the average GDP per capita of the Community.

In their wake, the Spaniards have even proposed that the contribution of the least developed countries to community projects be revised downwards, so that these countries can strengthen their convergence program. The Spanish proposals have received a favorable response from the European authorities since, under the Maastricht Treaty, the Twelve have planned a "Cohesion Fund" which will be responsible for a large part of the public expenditure of the least prosperous countries in two particular sectors: transport infrastructure and the protection of the environment. At the Edinburgh Summit of December 1992, the Twelve decided that the Cohesion Fund will have about ECU 15 billion for the period 1993-1999, more than half of which is earmarked for Spain.

This Cohesion Fund, however, represents only a small part of the ECU 176 billion planned by the Community to reduce regional and social disparities within the Europe of the Twelve over the period 1993-1999. In all, the regions and the poorest social categories will receive during these six years, almost double the aid paid from 1988 to 1992.

The convergence indicators adopted as well as the prohibition to finance the deficits of the public finances by "the billboards" should also require the Spanish authorities to more discipline, particularly in terms of budget and salary. The sharp deterioration of public finances in 1992 forced the Spanish government to vote a budget collective in order to limit certain expenses and to obtain additional revenues. The measures adopted include a reduction in social transfers, higher marginal tax rate from 0.5% to 3% depending on income levels, decreased tax deductions

and an increase in rates average of 13 to 15% VAT. This budgetary rigor must continue since the 1993 budget has been described as the "most restrictive of the last twenty years" by Carlos Solchaga.

The government has understood the need to be rigorous so that Spain can enter the final phase of EMU. This rigor will be all the more useful as the slowdown in activity in 1992 was not accompanied by a decline in price increases comparable to that recorded in the major industrialized countries. Inflation, which reached 5.9% in 1992, was mainly fueled by service prices (+ 10.2%) and wage growth (+ 8.5%); the raising of the VAT rate and the rise in energy costs being offset by the small increase in food prices.

3.3 - The potential costs of the transition period In parallel with the creation of the European Monetary Institute (EMI), the second stage of EMU, which will open on 1 January 1994, aims to ensure closer coordination of economic policies and sustained convergence of the economic performance of the Member States. The introduction of a single currency and a European Central Bank imply irrevocably fixed conversion rates between the currencies of the member countries. However, fixed exchange rates require a strengthening of economic and monetary cohesion.

In order to enter the final stage of EMU, which will start no later than 1 January 1999, the candidate countries will therefore have to jointly pursue an orthodox monetary policy and a rigorous fiscal policy. The "good European student", to use an expression of La Bruslerie (1992), will have to control its inflation, limit its indebtedness and reinforce the strength of its currency on the European exchange market.

The Monetary Union will impose an economic convergence effort on the Twelve, particularly severe for the less virtuous. If the deadline seems still distant, a comparison with the current situation is however not without interest. Only two countries (France and Luxembourg) fulfilled the conditions of transition to the third stage of EMU in 1992. The situations in the other ten countries are very contrasting. Denmark, apart from the increase in its public debt, is very close to France and Luxembourg; the slight recovery in inflation and the budget deficit observed in Germany are probably only transitory.

The Netherlands, Ireland and above all Belgium have difficulties in managing their public finances but also have relatively stable currencies and satisfactory inflation rates. On the basis of the criteria mentioned above, the single currency could therefore only be constituted today by a core group of four countries; the Netherlands, Ireland and Belgium needing a derogation to clean up their public finances.

With the exception of the United Kingdom, whose membership is more dependent on political will than on the satisfaction of economic indicators, the situation facing the countries of Southern Europe is more worrying. . It is hard to imagine Greece, Portugal and Italy succeeding in the next two years or even four years. 15 Especially the Dutch guilder and the Belgian franc (Cfla devaluation of the Irish pound by 10% on 31 January 1993). All convergence indicators. In this group of countries, Spain occupies a special place insofar as it is the only nation in Southern Europe to meet today a criterion of convergence.

However, in order to be able to quickly get closer to the European average, Spain will have to impose a severe austerity cure. This cure has already begun since the measures initially planned to reduce the budget and external deficits have been made even more urgent by the first two devaluations of the peseta. The Finance Act for 1993 thus provides for an increase in non-

financial receipts of 6.9% and an increase in expenditure of 3.7%, a decline in real terms. The temporary increase of the income tax for 1992 is maintained in 1993. In addition to the freezing of the purchasing power of civil servants, certain ministries such as those of Defense, Transport and Housing have had their budgets particularly affected. The finance law initially voted aims to reduce the budget deficit to 3.9% of GDP in 1993 against 4.6% in 1992. The scenario of the Ministry of Economy seems optimistic because it is based on an assumption of growth of GDP for 1993 of 1.1%. However, according to the latest forecasts of Spanish banks, the growth rate should be less than 0.5%, 194 against 1.1% in 1992.

Here we measure the difficulty for the countries of Southern Europe to get closer to convergence criteria. The objective of the Monetary Union requires them to implement remediation plans at a time when Europe is experiencing a severe economic slowdown. The problem of EMU is that it forces the less prosperous countries to accentuate the slowdown in activity, whereas the economic situation should encourage them to oppose it (Clerc, 1992).

Spain in particular is preparing to experience in 1993 the biggest recession in thirty years. Domestic demand, the main driver of growth in the late 1980s, decelerated sharply in 1992. Household consumption, which was still growing at an annual rate of 3% in 1991, is expected to increase modestly by 1% in 1993. Despite substantial increases in nominal wages, the trend in disposable income has been affected by the tightening of household taxation and rising unemployment. The weakness of private consumption is likely to have repercussions on investment, the decline of which could continue with the end of the major works of the Olympic Games in Barcelona and the Seville World Expo. The stimulus MINIPLAN adopted at the end of February cannot seem to avoid a decline in GDP in 1993-

However, the slowdown in domestic demand has encouraged slight decrease in the trade deficit in the last quarter of 1992. The worsening of the current account deficit in 1992 reflects the deterioration of the trade balance but also a reduction of surpluses in services and transfers. The entry of the economy into recession should be accompanied by a fall in inflation as the impact of the double devaluation of the peseta could be offset by weak domestic demand. This sudden contraction of the economy is due to external as well as internal reasons. Spain, like other European countries, is suffering the negative effects of the slowdown in the global economy and recent uncertainties about monetary developments in Europe. Added to this is a restrictive monetary policy stance and a tightening of fiscal policies in most countries of the Community. Internally, the main factor is the decline in the flow of foreign direct investment. Foreign capital in industry and real estate accounted for about 3% of GDP in the late 1980s. This ratio fell to 2% in 1992 and is expected to continue to decline. This decline in foreign investors is a consequence of the maturity reached by the Spanish economy, which offers as much as in the past an attractive comparative advantage.

3.4- The "cold" readjustment of the peseta in May 1993

The deterioration of the economic situation has had repercussions on the foreign exchange market as evidenced by the fragility of the peseta at the end of February 1993. A further weakening was not to be ruled out because the Spanish currency, which was the most overvalued of the EMS, was less depreciated than reading it or the pound. The risks of depreciation persisted all the more since the double devaluation of 1992 brought as many damages as benefits to the Spanish economy. While foreign tourists and exporting companies are in principle the main beneficiaries of these devaluations, they generate imported inflation at the same time, while increasing the amount of foreign currency denominated loans.

The fragility of the peseta required the maintenance of interest rates at a high level. At the end of March, interbank lending rates were close to 16%, compared to 12% before the tensions caused by the first Danish referendum of June 1992. With real interest rates of around 10%, it was unrealistic to wait for a recovery in investment or to consider improving the profitability of companies. On the other hand, while the peseta's rise against the mark or the franc has been almost fully offset, some European countries have made 296 competitive devaluations, which have caused Spain to lose the benefits of devaluations in terms of competitiveness (BNP, 1993) due to insufficient control over wage increases and the rigidity of the Spanish social system.

The attacks against the Spanish currency have however intensified since April 12 exactly, date of the announcement of early parliamentary elections. Political uncertainty over the outcome of the June 6 poll, speculation has cost almost \$ 4 billion in April alone to the Bank of Spain, whose reserves at the end of April 44.4 billion dollars, compared to 72.2 billion in June 1992. As a result, the entry of the economy into recession, with GDP declining by 0.3% in the fourth quarter of 1992, made it untenable to maintain the highest interest rates. of the Community, which are essential to support the Spanish currency, but which are socially damaging, as evidenced by the surge in unemployment. Last year, the number of jobseekers increased by 668,000. In March 1993, the Ministry of the Economy had 253,000 more, which brought to 3,300,000 victims of unemployment, a record rate of 21.7%. 17 Following the double devaluation of the peseta in 1992, Spanish exports gained price-competitiveness, only in Belgium (Caisses des Deposits et Consignations, 1993).

By accepting a devaluation of 8% of the peseta on May 13, the Spanish government wanted to stop speculation fueled by the rapid deterioration of the economy and the approach of legislative elections. This third devaluation in less than eight months was accompanied by a drop in the Bank of Spain's key interest rate from 13 to 11.5%, allowing Spain to start the process of lowering interest rates. Europe and also satisfy the Spanish employers who had long called for a reduction in the rent of money.

The devaluation of the peseta, which led in its wake that of the Portuguese escudo of 6.5%, was made "cold" 18 in a concerted and without dramatization. This is the first time since the monetary turmoil of the autumn of 1992, and since the revaluation of the mark in January 1987, that a devaluation is thus decided, by surprise and in the middle of the week, at a meeting of support of the European Monetary Committee. This readjustment reminds us in passing that the EMS was originally designed as a system operating with "fixed but adjustable" parities. A "cold" management of future readjustments would no doubt allow the EMS to regain its credibility and avoid wild and competitive devaluations such as the Pound and the Lira, currencies that are clearly undervalued relative to purchasing power parity estimates. Two recent reports, one from the Committee of Governors of the Central Banks of Customs and the other from the Monetary Committee, acknowledged that a return to the effective functioning of the EMS involved "cold" and "more" parity changes to take account of the competitiveness differentials accumulated by each Member State.

The entry of the Spanish economy into a period of recession may make the cost of the transition phase to EMU more painful. The decline in inflation - which remains the Achille heel of the economy - and the reduction of fiscal deficits are not without consequences. They lead to pressures on the purchasing power of households and loss of business opportunities, which inevitably aggravates unemployment.

Apart from a recovery in the world economy and structural reforms such as those aimed at stimulating domestic competition in services (see the rise in prices in this sector), would not other means exist to mitigate the constraints? of the transition? Clerc proposes three ways that can better spread the cost of the transition : longer convergence times, greater financial solidarity within the Community and a more equitable distribution within each country. The first solution would have the disadvantage of delaying economic convergence and further strengthening the existence of a multi-speed Europe, but it would offer the advantage of spreading the social cost of the monetary union over a longer period, and thus more bearable because less intense. The Maastricht Treaty has provided for a derogation, ie a longer transition period to the third phase, for those countries that request it.

The organization of financial solidarity around the Cohesion Fund is undoubtedly an excellent way to mitigate the disparities of development within the Europe of the Twelve. Will the funds released be sufficient to make the transition more sustainable, given that the Community budget currently accounts for around 1% of Community GDP?

The third way, which is to better distribute the social impact of convergence programs, refers to choices of economic and social policy. Such a policy of support is undoubtedly desirable but its implementation is made difficult by the current economic situation. It is easier to fight inequalities in prosperity than in recession.

While the downturn in economic activity in Europe may complicate the transition from the EMS to EMU, it is clear that a correction of the asymmetry of the costs and benefits over time of the monetary union will require similar initiatives. national rather than European. The task of Spain, which is moving towards a painful period of adjustment, would no doubt have been facilitated by a broader conception of economic convergence. In view of all these elements, it remains to be hoped that the application of the Maastricht Treaty will be more flexible than its elaboration.

The march towards the European Union will require, in the process, a reform of the mode of operation of the EMS. A unified market in which goods and capital circulate freely needs relative monetary stability. The decision taken last summer to widen the margins of fluctuation to 15% around the central rates is more a means of curbing the ardor of speculators than a solution to the structural problems of the monetary Europe. Pending a redesign of the EMS, the temporary floating of European currencies has been accompanied by a decline in interest rates, including in Spain, which should ultimately promote a recovery in growth.

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