

# **SPAIN FACING A SINGLE EUROPEAN CURRENCY**

by

César Medrano Sanz

Approved - J. A. [Signature]

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## **Abstract**

The integration of Europe has proceeded rapidly in historical terms since its formation by the Treaties of Rome in 1957. Despite the proximity of the Economic and Monetary Union (EMU), whose implementation is expected to take place between 1997 and 1999, there are still many uncertain aspects and unanswered questions about the feasibility of this ambitious and unprecedented project. The economic criteria set by the Maastricht Treaty in 1993 is currently met only by one of the twelve member states, Luxembourg. Countries like Greece and Portugal seem unlikely to be able to meet, by the established date, even a modified version of these criteria that is being currently discussed by the European policy makers. Spain's present economic conditions position the country somewhere in the middle of these two extremes, although probably closer to Greece and Portugal. Nevertheless, whether Spain will take part in EMU might, in the end, very well be more of a political issue than an economic one; therefore, three years prior to this historical event, anything written about EMU seems filled with uncertainty and expectation.

## I. INTRODUCTION

Spaniards have never felt as "European" as after the first of January of 1986, when Spain finally became a fully fledged member of the European Community. Despite the fact that Spain has always been a country of strong cultural, economic and political inter-regional differences, it seems evident that the Spanish people clearly share a desire to become part of the European project.

Since 1939, after general Franco's troops eliminated the last vestiges of the previous Republic, Spain underwent a period of international isolation which had a considerable negative impact on the economy. Only in the 1960s and 1970s started the country to show signs of gradual economic convergence with other European countries. Today, in spite of the high and sustained growth of the Spanish economy in the last forty years, Spain still shows many anachronistic features derived from its rapid development (high structural unemployment), mixed with other economic problems of the developed world (e.g., decreasing rate of growth).

In 1991, the Maastricht Treaty set a precise timetable for the achievement of an economic and monetary union in Europe (EMU). This exciting and difficult project established several criteria that the countries integrating EMU have to meet. Between 1997 and 1999 EMU is expected to take place for those countries that meet the criteria. None of these criteria, which involve levels of inflation, public debt, interest rates and exchange rate stability, are at the present met by Spain. So unless something dramatic is done, Spain will not meet the pre-established EMU deadlines. A multi-speed EMU has been proposed to facilitate the integrating process to countries like Spain, Portugal, Greece and Italy. Spain, however is emerging as the most fervent critic of a multi-speed Europe, and is hoping for either a more "flexible" interpretation of the Maastricht criteria (the treaty says that countries can still qualify for EMU if they are approaching the deficit and debt targets at a satisfactory rate) or to put the whole Maastricht timetable back a little to avoid the ignominy of relegation to the duffer's league. Neither option, however, is easily accepted by most other member countries, which seem technically more prepared for EMU.

The purpose of this work is to look at the different economic aspects involving the Spanish integration in EMU. In order to have a better understanding of this topic, it seems useful to review issues on monetary

integration, the history of the international monetary system, and the recent economic history of Spain. The European project of economic and monetary union and its historical developments are also analyzed in order to clarify the context of the Spanish integration in EMU.

## **II. THE INTERNATIONAL MONETARY SYSTEM: HISTORICAL PERSPECTIVE**

International economic transactions require an international monetary system that facilitates an efficient balance-of-payments adjustment mechanism and an adequate supply of international liquidity through internationally acceptable reserve assets. The function of foreign exchange markets is, therefore, that of facilitating trade and investment. This is the reason why foreign exchange systems play a vital role in today's global economy.

Economic history has provided us with the models that allow us to determine the different characteristics and degrees of effectiveness of the various exchange rate systems that have prevailed in the world throughout the present century. By reviewing the world's modern economic history we have the opportunity to look at some examples of the most important exchange rate arrangements.

### **II.A. THE GOLD STANDARD (1880-1914)**

The use of the gold standard implied that every country had to specify a declared par value that reflected the price of gold in terms of the local currency. Likewise, currencies were backed by gold, which constituted the international reserve asset. Stated in other words, under the gold standard the government guarantees the conversion of the country's currency into gold. This willingness to back currencies with gold helped contribute to relatively free trade and payments. In this system, balance of payments adjustment seemed to work smoothly, particularly since it was greatly facilitated by international flows of short-term capital. World War I put an end to this gold standard period.

### **II.B. FLEXIBLE EXCHANGE RATES IN THE 1920s**

After the Great War, countries permitted a great deal of exchange rate flexibility. Despite the extensive fluctuations in exchange rates, purchasing power parity predictions were for the most part consistent with their corresponding exchange rates.

There was a considerable exchange rate volatility between 1919 and 1921, but this, however, could be more a result of the turbulent nature of the postwar years rather than the inherent instability of flexible rates. Nonetheless, after 1921 most floating exchange rates appeared to have followed PPPs very closely, which provides the evidence that support the fact that flexible exchange rates might foster trade under stable circumstances.

## **II.C. FIXED EXCHANGE RATES IN THE 1930s**

In the middle of the 1920s, Britain, which at that time was the financial center of the world, attempted to restore the gold standard, implementing the prewar par value of the pound. This step turned out to be a failure, as this par value of the pound -which ultimately reflects the economic performance of a country based on comparative advantage, productivity indexes, investment, etc...- had considerably changed since the prewar period. This par value greatly overvalued the pound and caused payments difficulties for Britain.

The economic depression of 1930 showed the shortcomings of this exchange rate arrangement as payment difficulties emerged for many countries. International economic policies became considerably more protectionist and inward-looking, which in turn lead to great reductions in the volume and value of international trade, worsening, in this way, the situation created by the infamous Great Depression.

## **II.D. BRETTON WOODS (1944-1971)**

Towards the end of World War II, in 1944, the United Nations Monetary and Financial Conference was held in Bretton Woods, New Hampshire. The International Monetary Fund and the World Bank were given birth as a result of this conference. The World Bank, which back then was known as the International Bank for Reconstruction and Development (IBRD), had as main purpose that of providing long-term loans for the rebuilding of Europe. The World Bank, however, since the 1950s has been primarily involved with the funding of projects and loans in developing countries.

### **II.D.1. THE INTERNATIONAL MONETARY FUND**

The most important goal of the IMF was that of seeking stability in exchange rates. The exchange rate arrangement that the IMF procured

could be labeled as a system of pegged but adjustable exchange rates. Under this system the dollar, which after the war was comparatively stable and strong, was the only currency defined in terms of gold (\$1=1/35 of an ounce of gold<sup>1</sup>). Other countries defined their currencies in terms of the dollar. Also it is important to notice that under this system, the term "adjustable" refers to the fact that, if a country experienced prolonged BOP deficits or surpluses at the pegged exchange rate, a devaluation or upward revaluation of the currency's parity value could be undertaken. The IMF also set up a fund to provide deficit countries with short term loans (3-5 years) with the purposes of giving more autonomy to domestic macro policy instruments and helping preserve relatively free trade and payments in the world economy.

## **II.D.2. EARLY DISRUPTIONS AND THE BREAKING OF THE GOLD/DOLLAR LINK**

The Bretton Woods system performed well in terms of trade creation and exchange rate stability until the mid-1960s. During the 1960s, some important problems emerged in the Bretton Woods system. These problems were basically three:

- Liquidity problem: Reserves in the form of gold were not increasing rapidly enough to deal with larger BOP deficits. This created the problem of having countries pursue trade and payments restrictions to reduce those deficits.
- Confidence problem: The amount of dollars held by foreign banks began to considerably exceed the size of the US. official gold stock. This situation created uneasiness and a loss of confidence in the dollar.
- Adjustment problem: Individual countries began to have persistent BOP deficits or surpluses. That was the case of key countries such as the US (with persistent deficits) and Germany (surpluses). Countries directed monetary and fiscal policies toward internal targets rather than external targets.

Towards the end of the 1960s, the Bretton Woods system started to show the first symptoms of its subsequent collapse. In 1967, the British pound, one of the key currencies in the Bretton Woods system, was devalued. In 1968, several major central banks decided that they would no

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<sup>1</sup> APPLEYARD & FIELD, *International Economics*. Chicago: Richard D. Irwin, Inc, 1995. pp. 592



longer engage in gold transactions with private individuals and firms; central banks would only continue to do so with each other.

Finally, the breaking of the gold/dollar link, that occurred in 1971, signaled the dissolution of the Bretton Woods System. At that time, the Nixon administration undertook several drastic steps in order to try to change the continuing U.S. BOP deficits, the escalating inflation, and the lagging economic growth. The Bretton Woods System was directly affected by the cessation of the willingness to buy and sell gold by the U.S. This action meant that the dollar was no longer backed by gold, and it led to considerable turbulence in the international monetary system.

Despite different attempts, like the Smithsonian Agreement in December of 1971, to restore the previous financial stability in the international monetary markets, in the following years several countries began floating their currencies either freely or in controlled fashion.

## **II.E. THE EUROPEAN MONETARY SYSTEM AND THE EXCHANGE RATE MECHANISM**

In 1972, six European countries, Belgium, France, Italy, Luxembourg, the Netherlands and West Germany, began to float their currencies jointly. Britain, one of the key countries in the Bretton Woods arrangement, also started floating its currencies later that same year. Because of the wave-like movements of these currencies as a unit against other currencies this system was often called the "European Snake"(see figure 1). The EMS, which came into effect in March 1979, of the European Community created a new monetary unit, the ecu (European Currency Unit), whose value was a weighted average of EMS member currencies.

Each currency of the EMS was to be kept within a 2.25 percent<sup>2</sup> of the central rates against other participating currencies. Central banks of the member countries were forced to keep their currencies within this band. The possibility of internal realignment was, however contemplated by the ERM, or Exchange Rate Mechanism, of the EMS. This joint floating system allowed the EMS participating currencies to move as a unit against other currencies, including the U.S. dollar. The European Monetary Cooperation Fund (EMCF) was also created as part of the EMS. The main

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<sup>2</sup> Andrew Britton. Achieving monetary Union in Europe. London: SAGE Publications Ltd., 1992. pp. 9

purpose of the EMCF was that of making loans to members with BOP difficulties.

Since exchange rate stability can only be achieved through the harmonization of macroeconomic policies and inflation rates among member countries, the EMS was originally designed as a regulator of this process. The EMS has been a fundamental element of the transitional period which, in 1997, will lead member states to the accomplishment of EMU.

## **II.F. 1997: ECONOMIC AND MONETARY UNION**

In 1991, the 12 members of the European Community signed in the Dutch city of Maastricht a treaty that set the guidelines of the upcoming monetary union, projected to take place between 1997 and 1999. This extension of the EMS will lead towards the implementation of a full Economic and Monetary Union (EMU) in a three different stages. Another important aspect of this project is the establishment of a European Central Bank.

In the first stage, the member states are expected to work towards the macroeconomic harmonization, which is a sine qua non condition for the implementation of the ecu. This harmonization refers to specific economic indicators like inflation differentials, exchange rate stability, differences in exchange rates, fiscal deficits, and government debt.

In the second stage, which began on January 1st of 1994 and is currently in progress, the EC is expected to conduct exhaustive evaluations of the convergence criteria of the member countries. Member countries are also expected to remove all restrictions in the flow of capitals between them.

Finally, the third stage implies that members irrevocably form the monetary union with the ecu as a common currency. In this way, the European System of Central Banks (ESCB) will then be created as an institution with control over monetary policy and exchange rate stability for the entire European Community.

### **III. MONETARY INTEGRATION**

Monetary integration requires a convergence of the economic performance and policies. This equilibrium is not easily attained, but it is the base of a smooth and stable process towards a successful monetary integration. Internal economic problems demand the use of different macroeconomic tools, and that is why, for instance, it is not easy for countries to give up the advantage of having a flexible exchange rate that operates as an absorber of external shocks. The United Kingdom provided us with a good example of this case as it had to leave the ERM in 1992 in order to prompt a subsequent economic recovery,

#### **III.A. OVERVIEW**

In the last four decades there has been a clear tendency to form economic coalitions among the countries of the world. In this way, we have witnessed the creation of important trading blocks such as NAFTA, EU and EFTA, to name a few of the most significant ones. Even though there is a clear economic benefit for the member countries of a trading block, the gradual loss of domestic control of the economy seems to make politically difficult to integrate the economies of different countries. Economic Integration can be divided into at least four types depending on the degree of involvement of the member countries.

##### **III.A.1. MODELS OF ECONOMIC INTEGRATION**

A free trade area can be considered as the first step towards economic integration. Its acceptance means that all members of the group remove tariffs on each other's products. Individual countries, however, are free to establish their own trading policies with non members, which can lead to what is regarded as transshipment strategy (non member countries may find it profitable to export a product to the member country with the lowest level of outside protection, and then through it this product can be sold in all the other member countries of the free trade area). The most notable example of a free trade area is the European Free Trade Association (EFTA). Some of its member countries, namely Austria, Norway and Finland, have shown an interest in the last few years to become members of the European Union. Austria, Sweden and Finland are, as of 1995, accepted members of the EC.

A customs union is the next level of economic integration. In this case, trading agreements with non member countries are jointly negotiated

by all the members of the customs union. Therefore, the possibility for the implementation of transshipment strategies is eliminated. An example of a customs union was that of the Benelux (Belgium, Netherlands and Luxembourg) before these countries joined the European Community in 1958.

A third level of economic integration is a common market. In addition to the features cited for the previous model, a common market requires a free movement of labor and capital between member countries. A common market would have been the case of the European Community before EMU is implemented (1957-1993).

The highest degree of economic integration is achieved under an economic union. The main characteristic of this scheme is the adoption of a common currency, and the establishment of a common central bank that coordinates the economic policies of the member countries. This monetary union is precisely what makes the formation of an economic union so attractive and politically difficult. The United States of the European Union project for monetary union in 1999 and two clear examples of this type of economic arrangement.

### **III.A.2. EXCHANGE RATE ROLE**

During the last few years, foreign exchange markets have occupied a large part of the world economists' attention, due mainly to its transcendental repercussion in international trade. As international trade between countries has steadily grown not only in absolute terms, but also as percentage of the GDP, currency exchange rate stability has become a target for virtually every country involved in international global trade. Exchange rate arrangements can be roughly divided into three types (see figure 2):

- Pegged currencies (which accounted for 39.9% of world total exchange rate arrangements by end of 1994)<sup>3</sup> The Bretton Woods system provided us with the most significant example of this type of exchange rate arrangement. Under a pegged rate system, governments fix the price of their currency in the foreign exchange market. In order to support their currencies, central banks need a great amount of foreign reserves or/and an acceptable level of international credibility. If that is not the case, speculation and one-sided bets end up undermining the feasibility of the central bank's exchange rate target.

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<sup>3</sup> THE ECONOMIST, April 1st 1995, pp.64

- Independently floating (32.6% of world total by end of 1994): The advantage of this system is that countries using this arrangement do not have to use monetary policy to adjust their exchange rate. In this way, monetary policy can be used to pursue other macroeconomic objectives. In theory, independently floating exchange rates help to reduce the impact of external shocks in the economy, provided that domestic wages and prices do not immediately adjust to offset any exchange rate move. However, the two risks of using this type of exchange rate arrangement are high inflation, provoked by a loose monetary policy, and the problem of exchange rate volatility, which results in a reduction of trade. Fixed exchange rates reduce the problem of exchange rate volatility and risk of high inflation, at the cost, however, of making it harder for countries to adjust to external shocks.

- Managed floating (18.0% of world total by end of 1994). This system can be considered a hybrid of fixed and flexible exchange rates. Under this system, a country might intervene when it judges it might be well served by doing so. An example of a managed float is what is called a dirty float, in which countries use intervention to pursue particular goals at the expense of other countries. An example of this economic behavior was the efforts of the Japanese government in the 1980s to keep the value of the yen down to promote Japanese exports.

At the present, evidence seems to suggest that any system based on a explicit exchange-rate target (pegged currencies, managed floats within small bands) will, eventually, fail. The main reason for this is the increasing amount of capital flows that is traded everyday in international currency markets. Financial innovations such as derivatives and cross-border investment makes capital controls very difficult to enforce. It is reasonable to think that, due to these latest developments, speculation will be on the rise if individual governments try to set exchange-rate targets. Political pressure to use the exchange rate to cope with economic shocks will also contribute to undermine a pegged systems credibility. This set of circumstances will encourage opportunities for speculation based on "one-sided bets", which international financial specialists will not have many difficulties to spot and promote.

Setting bands for the targeted exchange rate has been suggested as an alternative to provide an exchange rate without much volatility and an acceptable performance as shock-absorbent. The problem with this option is that, first of all, it is not easy to determine the "real" value of that currency, and not assessing this value correctly could lead to significant

economic distortions. Also, it is important to realize that, if the proposed band is wide enough, this exchange rate arrangement will work as if it were a floating exchange rate. On the other hand, if the band is too narrow, we will have an arrangement that resembles a fixed exchange rate.

Another alternative is macroeconomic coordination among countries, which can be pursued by setting common targets on inflation rates, interest rates, public deficit, etc... Although there is no doubt that macroeconomic coordination can be determinant to promote exchange rate stability, the feasibility of this endeavor is highly questionable. Individual countries face problems of their own, and for which they need to pursue different macroeconomic policies. Pursuing a common macroeconomic policy could lead some countries into a recession, reducing or even impeding, in this way, their economic growth.

Evidence seems to suggest that the two most effective exchange-rate arrangements are floating-exchange rate systems or the implementation of a monetary union, which eliminates the currency-exchange market among member countries and, therefore, its negative repercussions.

### **III.B OPTIMUM CURRENCY AREAS**

An optimum currency area can be defined as an area that has fixed exchange rates among its integrating units (states or countries), and flexible exchange rates with trading partners outside the area.

Robert Mundell (1961) pointed out that the factor mobility between countries and their economic structure are two determinant factors in establishing the domain of an optimum currency area. According to Mundell's view, countries integrating an optimum currency area must be economically similar and have an optimal degree of factor mobility between them. If this is not the case, economic adjustment through monetary and/or fiscal policy will be more difficult to implement due to varying economic conditions that might require government intervention of opposite nature.

Ronald McKinnon (1963) also contributed to the theory of optimum currency areas arguing that, open economies, or those economies that have a greater potential to become comparatively more export-oriented, are more likely to succeed forming a currency area than close economies. Apparently, BOP adjustment is thereby more effectively achieved.

### III.B.1. ECONOMIC GROWTH AND INTERNATIONAL TRADE

The Treaties of Rome of 1957 established the European Economic Community whose ultimate formation was the formation "of an integrated market for the free movement of goods, services, capital, and people", which are the so-called "four freedoms". These treaties promoted trade among the member countries to a much greater extent than it had been promoted previously. This promotion of trade has been argued by many economists as a determinant cause of the high rate of economic growth for the Community as a whole from 1961 to 1970. During these years, the average annual growth rate of real GNP was 4.8 percent<sup>4</sup>.

In the 1970s and 1980s, however, GNP growth fell and unemployment grew considerably. The combination of these two economic trends gave birth to the term "Eurosclerosis". This economic slowdown was not only attributed to the oil crisis of 1973-74 and 1979-81, but also to the continued existence of internal barriers that retarded a better European performance. As a result, in February 1986 the Council of Ministers adopted the Single European Act to implement the reduction of trade barriers among member states. The date that was set for the removal of those barriers was December 31, 1992; and as time has shown the EC has indeed a considerably higher degree of market liberalization,

What this gradual development of more open trade policies among the countries of the EC shows is that there is a clear consensus among EC policy makers on the benefits of international trade as a determinant factor in the promotion of economic growth. Growth comes about by means of change in technology or through increases in the levels of factors of production like labor and capital.

Technological change results in a larger amount of output being generated from a fixed amount of inputs. Likewise, a larger amount of output can be generated through an increase of capital and/or labor. Labor can be increased through a positive rate of population growth or through immigration. The level of capital can be increased through domestic or foreign investment; foreign investment, in turn, can be divided into foreign direct investment and foreign portfolio investment.

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<sup>4</sup> Central Intelligence Agency, Directorate of Intelligence, *Handbook of Economics Statistics, 1990: A Reference Aid* (Washington D.C: CIA, 1990), pp. 39-40

### **III.B.2. INTERNATIONAL FACTOR MOVEMENTS**

In an economic union, free movement of capital and labor implies that these factors of production will move in response to the expectation of a higher rate of return in the new location. Some of the reasons for the movement of capital, for instance, are: the access to a growing market for the product, a higher per capita income of the recipient country, assurance of access to mineral or raw material deposits, avoidance of tariffs and non tariffs barriers, etc. U.S. investment in EC countries grew considerably in the 1960s possibly with the intention of avoiding the EEC common external tariff on imports from the outside world.

Likewise, labor movements within the EC are to be expected, since economic theory predicts an equalization of wages across member countries. The fact that wages do not equalize with trade leaves open the possibility that labor may have an incentive to move from one country to another.

It is, therefore, to be expected that countries with a relatively large labor force and comparatively lower wages, like Spain, will have migrational movements towards other member states where wages are higher and labor is relatively less abundant. Capital investment will, in the same way, tend to flow from countries that are well endowed with it to countries, like Spain, where capital is relatively more scarce. Economic theory on capital and labor market equilibrium shows that there are substantial potential positive effects derived from such international factor movements.

An outflow of labor and/or an inflow of capital investment in Spain can potentially reduce the currently high unemployment rate and foster economic growth. Because of its potential effects, perfect factor mobility is, without a doubt, one of the most appealing features of an economic union.

### **III.B.3. SPAIN WITHIN THE EUROPEAN CONTEXT**

According to the previously discussed theory about optimum currency areas, Spain can potentially face substantial economic difficulties as a result of its imminent participation in EMU. By comparing the economic indicators of Spain to those of other member states of the EC, one can quickly realize that the Spanish economic conditions are clearly differing from those of most of the other member states. Particularly the



high unemployment and inflation rates seem to pose a big question mark upon the potential success of EMU in Spain.

In addition, due to the rigid labor conditions and the limited liberalization of the financial and communication sectors, Spain lacks the factor-mobility conditions that a successful currency area requires. Despite the doubling of the Spanish exports as a percentage of GDP in the last 20 years (see figure 15), Spain has also traditionally been an inward-looking country that resembles more the definition provided by McKinnon of a close economy than most other EC member states.

Nevertheless, Spain has also some elements in his favor. According to classical economic theory, trade is potentially more beneficial if it takes place between countries that hold a comparative advantage in the production of different potential exports. Spain's comparative advantage in sectors like tourism, fishing, and agriculture (vegetables, citrus fruits) represents, in terms of potential gains from trade, a positive addition to the European market. Likewise, Spain seems to hold a comparative advantage in the manufacturing of transport equipment. Spain's exports of transport equipment totaled 1,575.38 billions of ptas. in 1991<sup>5</sup>. Spain is currently the fourth largest automobile manufacturer in Europe after Germany, France, and Italy.

By the same token, more than half of Spain's imports come from other EC countries. Countries like Germany and France provide Spain with a great percentage of imported commodities, like machinery and chemicals. Therefore, given the characteristics of the Spanish production spectrum, the EC seems to offer the ideal setting to establish mutually beneficial commercial relations.

### **III.C. EUROPEAN UNION: A PROJECT FOR 1997**

The Treaties of Rome in 1957 established a common market within the European Community. During the last decade, however, there has been a clear determination among most members of the European Community to undertake the project of achieving a fully implemented monetary union by 1999. Nevertheless, in practice, individual countries seem to be rather reluctant to give up the domestic sovereignty which the scheme requires.

According to the interventionist view, domestic macroeconomic policy allows countries to individually design their plans to foster economic

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<sup>5</sup> OECD Economic Surveys: Spain (1992-1993) pp. 118

growth by means of adjusting their economies to particular circumstances and economic cycles. Obviously, under the case of an economic union, this domestic economic control would be automatically resigned to a common central bank, at least in terms of monetary policy. The only alternative that member countries would still keep would be that of using fiscal policy.

On the other hand, however, an economic union entails important benefits for the member countries. The potential increase in trade, along with the virtual elimination of currency speculation which involves the currencies of the member countries seem to be the most appealing reasons in favor of the implementation of an economic union. There might still be speculation between the common currency of the economic union and other external currencies, but at least trade within the economic union will be fostered to the highest degree since exchange rate instability is no longer present. In addition to this, central banks of member countries will not need to use their reserves to support a stable currency.

The argument for Economic Union has been recently reinforced as this form of economic integration would be an effective way to neutralize the growing speculation forces which in the last few years have undermined the credibility of the effectiveness of central bank interventionism. Also, it is reasonable to think that a common central bank will pursue more stable economic policies than separate central banks. Having a common central bank theoretically free from political pressure should make foreign exchange rates, among the common currency and other external currencies, more stable. In this way, trade will be promoted, which is the ultimate goal of an economic union.

Whereas the United States presents itself as a stable and successful example of complete economic integration, the European Union is a case in the making that currently portrays the difficulties of undertaking this objective. Even though the European project poses some serious questions upon the economic feasibility of this endeavor, the idea of a political union among the member states seems to be even more problematic. The fact is that an economic union entails a political consensus. In the case of Europe, due to the extreme diversification of the social and economic conditions throughout the continent, a political union seems far more controversial than that of a relatively more homogeneous and young country like the USA.

### **III.C.1. A COMMON CURRENCY**

The completion of the single market in goods, capital, people and services can only be achieved through the implementation of the European currency unit or ecu. The ecu is currently a "basket currency" composed of all EC member-state currencies. The percentage weighting of currencies in the ecu is determined by the economic strength of each one of the member states (see figure 3).

At the present time, the ecu is only used by the EC to quantify issues like its annual budget, external tariffs, subsidies, loans, agricultural prices, aids to developing countries, etc. It is still not possible to carry ecus around as legal tender, although it is possible to have ecu-denominated accounts or have Eurocheques issued in ecus.

The ecu is expected to become legal tender in Europe between 1997 and 1999, upon the implementation of EMU. The European Monetary Institute (forunner of the European Union's central bank) recently announced that the largest coin in the currency supposed to replace national ones should be worth 2 ecus (\$2.60)<sup>6</sup>; notes will range from 5 to 500 ecus.

### **III.C.2. THE EUROPEAN CENTRAL BANK**

The economic and monetary union envisioned in Europe will have a European central bank which will operate as a coordinator of the member states macroeconomic policies. In 1997, the European Monetary Institute will be replaced for the European Union's central bank. With the implementation of the European central bank and the ecu two significant related ends will be achieved. First, inflation will be kept under control. Member states sill not have the possibility to inflate their currencies in order to render high public debts more manageable. Second, a single currency will eliminate the swings in prices that occur with floating exchange rates and deter trade and investment and imposing, thereby, costs.

The elimination of the member countries' central banks poses the question of whether unemployment, which is a particularly problematic issue for countries like Spain, will be kept at acceptable levels if EMU takes away from member states the monetary and fiscal tools traditionally used to fight these problems. The lesson of the past 25 years is that the use of the right to devalue or borrow excessively has been part of the problem

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<sup>6</sup> As of April 8th, 1995

itself. Therefore, this loss of macroeconomic operability imposed by EMU on member states seem to bring about more benefits than costs, at least in the long run.

#### **IV. THE CONVERGENCE CRITERIA SET BY THE MAASTRICHT TREATY**

The Process of monetary and economic union in Europe consists of three stages, which set the criteria for the implementation of the ECU as a common currency and the convergence of the different European central banks into one independent central bank. In order to achieve this purpose, it is essential that certain macroeconomic conditions that cover relative rates of inflation, exchange rate stability, the debts and the borrowing of governments and relative rates of interest be met.

The main objectives of the first stage are the convergence of macroeconomic indicators, the creation of an internal market with common financial regulations, and the inclusion of all the currencies of the countries of the European Community in the European Monetary System (EMS). This is viewed as a first step towards the installment of the ECU through a gradual process of independence of the central banks of the different countries of the European Community.

The second stage formalizes the original goals through the creation of the European System of Central Banks (ESCB), the development of appropriate tools whose purpose is that of achieving a common monetary policy, and the development and reinforcement of the ECU.

In the third stage, after the established in the previous stages have been met, the ECU would be implemented as a common currency.

The Maastricht criteria sets a precise timetable for EMU: it will be achieved by 1999 if "a majority of members fulfill the necessary conditions". In the absence of that majority, those countries that do fulfill the conditions will enter a single-currency union on their own on January 1st 1999. At the moment only Luxembourg meets those requirements, so it is quite likely that there will be a somewhat more flexible interpretation of the Maastricht criteria in order to make feasible EMU on the established dateline.

## **IV.A. THE MAASTRICHT TREATY**

The Treaty on European Union was signed at Maastricht on 7 February, 1992. The implications of the Maastricht Treaty for the future of Europe are of great magnitude and importance, since the main goal is that of achieving by the end of this decade an economic and monetary union among the member states. The successful operation of the European Monetary System and the implementation of the Single Market program provide a secure foundation on which EMU can be built.

The constitution of the central bank system is one of the most challenging features demanded by EMU. Nevertheless, if an European central bank system is successfully implemented, independence from political pressure will be the catalyst which will bring about stable prices, which, in turn will have a considerably positive effect on the markets.

There is a timetable with 1997 as the earliest date for the implementation of the EMU, and 1999 as the latest. This will be followed by the replacement of existing currencies by a single European currency, the ecu. After the establishment of EMU, the low inflation rates of countries like Germany and France will be extended to all states that participate in EMU. There will be a common currency and monetary policy set by the European central bank. Interest rates, under control of this European central bank, will be the same in all member states.

It is also expected that it will not be possible to pursue an exchange-rate policy for the ecu which is not consistent with the aim of price stability in Europe to which the European central bank will be committed. Nevertheless, the main downfall of pursuing a policy of price stability will be the potential danger of recession and high unemployment. The restoration of full employment will depend on better national policies towards training and labor mobility. The governments of the member states will basically be left with just the option of using fiscal policies to stabilize the economies during the economic cycles. Taxation and spending will then require a more careful planning and execution by the member states, since monetary policy will no longer be available to them.

It is also important to point out that most of the member countries that have furthest to go in meeting the convergence criteria of the treaty, also have regimes with some of the lowest levels of income per head in the EC. Thus, the economic implications of the treaty tend to be frequently linked together in political practice. There is an inherent need to raise the living standards of the poorest people in Europe if the transition to EMU is

to succeed. In the Maastricht summit it was also established a new cohesion fund that should help to overcome this problem of economic inequality.

The enlargement of the Community will also pose an additional challenge for the state members. There are three countries that are expected to join the Community in the near future are Austria, Sweden and Finland. These countries, and in particular Austria, could all take part in the imminent EMU with no more difficulty than the existing members of the EC.

Other countries that might potentially join the Community in the future might face a very different situation. Countries like Turkey, Malta, Poland, Hungary and the Czech Republic. The time scale for their membership of the Community, if they apply will be longer than that of the transition to EMU. Upon becoming members of the EC they might not be able to participate in EMU until their economies show a gradual transformation towards the integration criteria. Some of the present members of the EC, presumably Greece and Portugal, may also be in that position for some years.

The real test will come in 1996, when the European Monetary Institute (forerunner of the European Union's Central Bank) is expected to assess each of its members one by one.

## **IV.B. MAASTRICHT CRITERIA**

The conditions that the countries applying for EMU must meet basically aim at the achievement of a macroeconomic harmonization among the member states in order to assure a smooth economic and monetary integration. These convergence criteria requires low inflation and interest rate levels, low levels of government deficit and public debt, and a stable currency.

### **IV.B.1. GOVERNMENT DEBT AND PUBLIC DEFICIT**

There are at least four reasons to worry about high levels of public sector debt:

- Crowding out: Government borrowing will increase the demand for money, which in turn will put upward pressure on interest rates, displacing private investment.

- Inflation: Governments might be tempted to print more money in order to erode the real value of their debt.

- Fiscal elbow room: Excessive debt can constrain government's ability to use fiscal policy to support demand in a recession.

- The debt trap: If real interest rates are higher than a country's growth rate, debt will rise indefinitely unless the government is running a big enough surplus on its primary budget (i.e., excluding interest payments). It is also important to notice that a higher debt also pushes up interest rates, making this circle even more vicious.

According to the Maastricht treaty, budget deficits must remain under 3% of GDP. At the present, only Germany, Ireland and Luxembourg meet this condition. Similarly, the public debt of each member state measured as a proportion of GDP is in most member states well above the 60% the treaty suggests. Because deficits are so high, it is expected that the ratio of debt to GDP will grow in the future (see figure 4).

Countries like Italy and Belgium have a severe gross public debt problem. Italy needs to run a primary debt surplus of at least 5% of GDP simply to stabilize its debt ratio; in 1994 it had a surplus of only 1%. Italy seems to be already snared in the debt trap, and, at some stage, the risk of default will loom. Of the three ways to break free from the trap (raise taxes and slash spending, let inflation rip, or default), a rising inflation rate seems the most likely for obvious reasons (fiscal contractionary policy does not seem very likely considering the political instability of this country, and defaulting would have drastic consequences). Therefore, this increase of the price level rate combined with the high public debt will make it more difficult for Italy to meet the Maastricht criteria. Belgium, on the other hand, despite having the highest debt ratio (138.7%) in the European Union, thanks to a large primary surplus, seems to have stabilized its debt ratio. This makes the risk of inflation somewhat less likely.

In the last few years, most EC countries have experienced rising levels of public debt and negative budget balances (see figure 5). The 1993-1994 recession has, without doubt, aggravated these deficits, and it will be necessary an extraordinary effort from each member state in order to meet these two convergence criteria.

## **IV.B.2. INTEREST RATES**

According to the Maastricht criteria, the long-term interest rate of a country should be within two percentage points of the average of the best three performers. At the present, this sets this upper limit at approximately 10% (long-term government bonds).

## **IV.B.3. INFLATION**

Under the Maastricht Treaty, the inflation rate of a country should be within 1.5 points of the best three performers. Therefore, the price level of the member states should at present be no higher than 3.3%. Spain with a current 4.8% inflation rate, Italy (4.3%), Portugal (4.5%), and Greece (14%) are the countries that have the greatest difficulties to meet this criterion.

## **IV.B.4. EXCHANGE RATE STABILITY**

According to exchange rate performance, there seem to be two different families in the EC: a D-mark block (formed by Germany, Benelux and Austria) and the rest of currencies, which seem to operate in a more volatile manner (see figure 6). Under the Maastricht treaty, the exchange rate of a country applying for EMU should have been stable for two years before hand. In August of 1993, member countries shifted to wider 15% bands. The present adverse international conditions, however, like the instability of the US dollar make exchange rate stability a difficult challenge for most member states. In addition, it is important to remember that since 1992 the British pound and the Italian lira are no longer members of the exchange-rate mechanism.

## **IV.C. A MULTISPEED SYSTEM**

It is quite probable that the Maastricht criteria will not be met by most of the member states before the established deadline (1997). It is important to realize, that these stringent criteria, that include interest and inflation rates, public debt, government deficit and exchange rate stability, were as of 1992 only met by three countries: Denmark, Luxembourg and France. As of April of 1995, however, only Luxembourg meets all the criteria. In order to contemplate the present situation with its inherent consequences, the concept of creating a multispeed system that would



integrate countries in EMU in different stages is starting to gain weight, especially among countries that are likely to meet the Maastricht criteria.

In 1997, there are several countries that will almost for sure take part in EMU. These countries are: France, Belgium, Germany, Holland, Luxembourg, Denmark, and Austria. Other countries that are also probable to take part in the EMU in 1997, but with a less likelihood are: Ireland, Spain, Italy, Sweden, and the United Kingdom. Finally, Portugal, Finland, and Greece might join EMU some time thereafter, since these three countries might need some additional time to adjust to the convergence criteria.

## **V. AN OVERVIEW OF THE SPANISH ECONOMIC HISTORY**

The most significant aspect of the Spanish economy in its recent history has been its rapid growth in the 1960s and 1970s that led to the current high unemployment rate. This structural unemployment makes it extremely difficult for the Spanish government to keep inflation low, since this would require the implementation of contractionary economic policies that would worsen the situation in the Spanish labor market. The "cost-ratio" for reducing the unemployment and/or the inflation rate seems exceptionally high in Spain.

In the past few years, Spain has been particularly affected by the international economic crisis, mainly because Spain has heavily relied on foreign investment in the last few decades. This economic slowdown has made the Spanish public debt increase above the 60% level required by the Maastricht treaty. Speeding up privatization and private financing of major infrastructure projects would help to reduce public sector debt and deficits, thereby avoiding public investment cuts that would worsen the employment situation. Nevertheless, the irony is that the most pressing problem of the Spanish economy, the high unemployment rate, can only be solved thorough a flexibilization of the labor market that, according to the Spanish workers' unions, will make the workers more vulnerable and worsen the overall working conditions. In any event, the socialist government, which has been in power since 1982, has not yet undertaken this task and, therefore, now finds the Maastricht convergence criteria quite arduous to meet.

## V.A. SPAIN UNDER THE RULE OF FRANCO (1939-1975)

In 1939, after the Spanish Civil War was won by the *Frente Nacional* commanded by Franco, the country was totally devastated. The post-war years were extremely hard. There were shortages of all kinds of primary products like food, clothing, etc.

Due to the totalitarian nature of the Spanish government, in the 1940s and 1950s, Spain underwent a period of political isolation and autarky in industrial and agricultural practices. During these years, the economy was strongly planned by the central government, and a series of programs of industrialization were gradually designed and executed. The government of Franco created a system of socialist totalitarianism. Some of the features of this regime like universal education, free health care, and a pension system were implemented as economic conditions improved. It has been noted by some economic historians that the problem of labor rigidity that Spain currently faces was, to a great extent, inherited from the years of Franco's rule.

Between 1939 and 1959, the autarkic-oriented Spanish government put into practice a policy of import substitution that resulted in an overvalued exchange rate. Towards the end of this period, an extremely serious balance of payments crisis and rising inflation made a change in orientation necessary.

In 1958, Spain became an associate of OEEC (later called the OECD) and a full member of the IBRD and the IMF. The new outward orientation of the economic policy permitted an acceleration of the rate of growth of the economy that resulted mainly in a considerable industrial push. Spain ranked second, during the 1960s, among the OECD countries in terms of her performance in terms of real GDP growth rates. Between 1963 and 1971, Spain grew at an average annual rate of 7.3% in real terms. During this period, there were significant changes in the sectoral distribution of jobs (see table below). This pattern portrays the typical transitional process that most countries undergo before reaching the status of "developed economy". Similar percentage figures could be shown for the recent cases of "graduated" countries of Korea or Taiwan.

Structure of the active population (percentage population in relation to total population)

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	1960	1970	1975
Agriculture	41.7	29.1	22.2
Industry	24.7	28.7	27.3
Construction	7.1	8.6	10.3
Services	26.5	33.6	40.2

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One of the most significant features of the Spanish economic picture in the sixties and seventies was the strong internal and external migrational flows. During this period, in which the population on average was roughly 33 million, a massive outflow from the countryside took place (nearly 4.5 million people moved on a permanent basis within Spain)<sup>7</sup>. There was also a significant number of Spaniards who sought work abroad. Between 1960 and 1973 over 1 million Spaniards were given official assistance in seeking work elsewhere in Europe<sup>8</sup>.

During the last years of the ruling of Franco, the country underwent the so-called "Spanish miracle". The spectacular GNP growth over the 1960s and early 1970s, the doubling of *per capita* income from \$594 in 1965 to \$1160 in 1972 and rising levels of consumption all point to a far more affluent society. There are several reasons that, depending on the source consulted, might have contributed to a greater or lesser extent to the so called "Spanish miracle". Some of these reasons are the larger influx of receipts sent by emigrants, the "pay-off" of the industrialization plans of previous decades, the larger number of tourists, the lack of any account of political developments since 1959, or simply the fact that the starting point was low and, therefore, GNP growth in relative terms seems more spectacular.

Over the whole decade of the 1960s exports grew very strongly in an atmosphere of a good European economic conjuncture and will come to

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<sup>7</sup> Fundación Foessa, *Estudios Sociológicos sobre la Situación Social de España, 1975* (Madrid, 1976)

<sup>8</sup> Fundación Foessa, *Estudios Sociológicos sobre la Situación Social de España, 1975* (Madrid, 1976)

play a driving role in Spanish economic development as is clearly seen in 1984 (see figure 7).

In 1974, however, Spain was particularly hard hit by the international oil crisis. Other European countries were able to resist the blows because of their advantageous position and their ability to transfer resources from unprofitable sectors to more profitable ones. Spain was saddled with an outdated, over-bureaucratic, protectionist and paternalistic economy which had grown up in isolation over 40 years; and was, thereby, unable to properly react to this crisis.

The death of Franco in 1975 and the transition towards a democratic system can be considered as the landmark of a new economic and political era for Spain and, to some extent for Europe. Franco's death signaled the collapse of the last Fascist regime in Europe.

## **V.B. THE DEMOCRATIC PERIOD (1975-PRESENT)**

In December 1976 Spaniards participated in the first democratic poll since the Civil War ended in 1936. The "Political Reform Referendum" was overwhelmingly approved. In 1978, Spanish voters approved the new constitution. Spain underwent not only a period of drastic political changes but also of economic restructuring that is at the present still in progress.

By far the most serious problem facing Spanish society during its recent history has been unemployment. The restructuring of key industries in the early 1980s caused the loss of more than 65,000 jobs. By the early 1990s unemployment reached 3 million people, or 22% of the work force.

Without a doubt, joining the EC can be considered the most important economic and political achievement of the Spanish diplomacy since the restoration of the democratic system. Spain had tried on and off over a 20-year period to join the EC, but its violations of democratic principles impeded its entry. Once the constitutional governments were in power after 1978, however, negotiations were intensified, and Spain finally became a fully fledged member on 1 January 1986. The transitional period of integration, however, did not end until 1992.

The integration of Spain in the European Community meant the adoption of the Common External Tariff and the assumption of the commercial agreements prevailing between the EEC and the rest of the world. Spain was then pushed towards specialization in order to allow the

appearance of beneficial effects of trade creation and of the economies of scale. After the integration of Spain in the EEC, a worsening of the Spanish trade deficit, which persists nowadays, took place. Apparently, the Spanish authorities did not implement needed extensive programs of export promotion placed on solid economic basis (promotion of technological change, specialization in areas in which Spain holds a comparative advantage, etc...).

In order to invigorate the economy, the Spanish authorities developed policies tending to increase the level of flexibility of the economy. Some of these measures, which, according to the opinion of most economic experts, should have been implemented considerably earlier, are the flexibilization of the labor market through the Workers Statute approved in August of 1984, and the attempt to increase competition in the financial system accepting foreign banks and liberalizing the previously very segmented internal financial market.

In Spain it seems to be the case that economic measures are often implemented late, allowing, in this way, international crisis to hit relatively hard the Spanish Economy. Spain did not make an Energy Plan which faced up the problems arising from the price increase of crude oil products until July 1979. However, in spite of the lateness, the approach adopted by the Spanish economic authorities on themes like those previously mentioned (reform of the labor market and of the financial system, energy policies) was consistent with the target of increasing the flexibility and efficiency of relocating production resources -a condition necessary for the success of an outward looking policy, which was positively evaluated toward the integration in the EEC. Also, part of the limited effectiveness of those measures have to be attributed to the forty years of political and economic isolation which made the economic restructuring particularly difficult.

The restructuring process was particularly intense in some sectors. The sectors of car manufacture, materials for construction, chemicals and food products had the highest rates of growth during the 70s and 80s. On the other hand, textiles, leather, clothing, footwear, and basic metals decreased its share in the composition of the Gross Industrial Product.

## **VI. THE ECONOMY OF SPAIN IN THE EUROPEAN CONTEXT**

Despite the support shown by the Spanish public opinion and the members of all main political parties to take part in the EMU and

implement the ecu as a common currency in 1997, it does not seem technically feasible at the present.

Spain currently fails to meet any of the criteria in the Maastricht treaty for EMU: it has neither stable exchange rates, nor a modest budget deficit, nor low rates of interest and inflation. At the present, it does not seem likely that Spain will approach the public debt target at a satisfactory rate either. If the Spanish economy had been satisfactorily approaching this rate, there would have been a better chance for Spain to take part in EMU. Spain's interest rates and levels of public debt were acceptable in 1993 but have since moved beyond the criteria set by the treaty (see figures 8, 9 and 10).

One of the main problems that the Spanish economy faces today is the high level of unemployment, which is not one of the criteria set at Maastricht, but is directly related with them. The Spanish government pursuit of the terms established by the Maastricht criteria is aggravating the unemployment problem, since these criteria require the implementation of austere economic policies.

The high unemployment rate that Spain currently faces is a problem of difficult implications. The Spanish employment situation demands political measures that because of its unpopular nature have been avoided by the socialist party, which has been in power since 1982. Since it is not politically appealing to undertake the industrial restructuring, Spain's endemic and abnormal unemployment has been the highest among those of the OECD countries. Unfortunately, in this aspect, Spain is a victim of the political cycles that embedded in every democracy. The consequences can be costly: Spain will most likely be relegated to the "division two" of the Maastricht treaty.

## **VI.A. UNEMPLOYMENT**

As pointed out in the previous section, unemployment is, without a doubt, one of the most pressing economic and social problems that Spain faces nowadays. Spain has, by far, the highest unemployment rate among developed countries and, therefore, among member states of the EU (see figure 11).

One of the most difficult challenges for Spain in the future will be that of reducing the rate of inflation (currently 4.8%)<sup>9</sup> without rising the

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<sup>9</sup> THE ECONOMIST, April 8th 1995

already excessive rate of unemployment (23.9%)<sup>10</sup>. After the establishment of the economic and monetary union, the balance between member states will be maintained by the adjustment of relative costs and prices, a process that requires the kind of labor flexibility in labor markets as well as the markets for goods and services. Spain, however, is far from reaching the optimal level of labor flexibility that the implementation of economic and monetary union demands. Part of the legacy left by the Franco regime was a rigid labor system, that the two main workers unions in Spain, UGT and CCOO have preserved and invigorated after union activity was legalized in 1976. Another important cause of unemployment is the fact that the Spanish economy is/has been in the process of rapid structure change and development.

Economic experts often times blame this labor rigidity for the high level of unemployment in Spain (23.9%)<sup>11</sup>. The Workers Statute, approved in August of 1984, favored forms of temporary and part-time contracts to improve the workings of the labor market. Likewise, in 1994, the socialist government undertook a series of reforms, whose goal was to liberalize the evidently rigid conditions of the labor market. The most significant of these reforms was the implementation of apprenticeship contracts for people under 30 years of age. The results of these policies were positively reflected on a relative decrease in the rate of unemployment, taking into account the negative effects of the crisis of 1994. These measures, besides having the objective of promoting employment, are also aimed at the reduction of the volume of the underground economy, which considerably diminishes the fiscal collections of the government.

Spain's labor market also faces a relative high number of strikes, (see figure 12). Many factors can be cited as possible causes for this, but the most consistent ones refer to the poor relations between unions and employment organizations, drastic and painful structural changes in the Spanish economy, and the ineffective management of this issue by the socialist government. Needless to say, that this situation deters foreign investment and therefore, weakens the Spanish economy.

## **VI.B. PRICE LEVEL**

The Maastricht treaty established that a country's inflation rate of consumer prices cannot be greater than 1.5 percentage points above the average of the three lowest -inflation EC countries. At the present, this

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<sup>10</sup> THE ECONOMIST, April 8th 1995

<sup>11</sup> THE ECONOMIST, April 8th 1995

average seems to be roughly 2%, which is three percentage points lower than Spain's current inflation rate (4.9%)<sup>12</sup> (see graph EC march 4th)

Even though Spain's inflation rate has been declining since 1992, it seems to be again on the rise, after the recovery from the economic crisis of 1994. *The Economist's* poll of forecasters of April (1995) predicts a consumer price % increase of 5.2% for 1996.<sup>13</sup> The reduction of the inflation rate seems a difficult challenge for the Spanish governments, specially considering the extremely high unemployment rate (see figures 11 and 14).

### **VI.C. INTEREST RATES**

Only in 1993, since the second stage of the Maastricht treaty was implemented, met Spain the Interest rate criterion, which establishes that a country's long term government bond interest rate must not be more than two percentage points above that interest rate average in the three lowest-inflation countries. This upper limit is roughly 10%, which was Spain's average long term government interest rate in 1993. Nevertheless, this rate is currently 11.7%.<sup>14</sup>, which is approximately two point above the acceptable level established by the Maastricht treaty (see figure 10).

### **VI.D. BUDGET DEFICIT AND PUBLIC DEBT**

Although Spain's budget deficit does not meet the Maastricht criterion (3 % of GDP), it seems to be approaching this target at a satisfactory rate (see figure 5).

The gross public debt of Spain, however, seems to have gradually worsened in the past few years. The public debt in 1995 will be 65.8% of GDP, and it is expected to slightly rise in 1996 to 66.1%. The treaty suggests a maximum government debt of 60% of GDP. Nevertheless, this is a criterion that has not been easily met by other countries of the European Union. Belgium's public debt in 1995, although showing a decreasing tendency, is 138.7%, and Italy's 126.8% (see figure 8).

It is important to observe the fact that persistent budget deficits tend to worsen the public deficit of a country. Spain currently has a considerable financial burden as a consequence of the socialist reforms

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<sup>12</sup> THE ECONOMIST, April 22nd 1995

<sup>13</sup> THE ECONOMIST, April 8th 1995

<sup>14</sup> THE ECONOMIST, April 8th 1995



implemented in the last decades. It was evident during the last international crisis (1993-1994) that Spain economic position is not strong enough to support the current welfare system; the budget deficit and public debt figures rose considerable during this crisis. It seems obvious that the system will have to be reformed if it is intended to meet the criteria.

## **VI.E. BALANCE OF PAYMENTS**

The programs to encourage exports in the last few years have also meant a considerable effort to increase the degree of openness in the Spanish economy. Given the secular character, centuries old, of the commercial deficit of the Spanish Balance of Payments whose automatic settlement has rarely occurred, and given that the compensating items of this balance have not always been sufficient to clear it, this can justify, partially at least, public intervention in a suitable policy to promote exports. In order to reduce the trade deficit, growth in sectors in which the Spanish economy holds a comparative advantage, like tourism and the manufacturing of certain products like automobiles, has been promoted considerably by the Spanish government during the last two decades. (see figure 15).

As it can be seen in this graph, Spain has doubled their exports as a percentage of GDP between 1960 and 1994. Despite this increase in exports, Spain faces a current account deficit of approximately 2.7 \$bn per year.<sup>15</sup>

## **VI.F. GDP GROWTH**

As a consequence of the strong initial trade creation effects after joining the EC in 1986 (34% rise in the terms of trade), Spain experienced a remarkable GNP growth between 1985 and 1990. During these five years, Spain ranked first in the OECD in terms of per capita GDP growth and employment creation<sup>16</sup>. This strong growth attracted a large amount of foreign investment that offset the rising external deficit. The end of this expansion in 1991 brought to the surface the intrinsic macroeconomic imbalances and structural deficiencies of the Spanish economy. From 1990 to 1994 the annual average of GDP growth was a modest 1.6% (see figure 16)

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<sup>15</sup> THE ECONOMIST, April 22nd 1995

<sup>16</sup> OECD Economic Surveys: Spain (1992-1993)

The forecast for the Spanish GDP growth rate in 1995 and 1996, according to *The Economist*, is 3.3%<sup>17</sup>. This forecast is the highest GDP growth rate given by The Economist to any OECD country for 1996, and it will be a determinant factor to reduce the current public debt and meet, in this way, one of the, at the present, most difficult criteria for Spain.

## **VI.G. EXCHANGE RATE STABILITY**

Since 1992, when the British pound and the Italian lira were forced out of the exchange rate mechanism, the Spanish peseta has experienced four devaluations (see figure 18). Since September of 1992, the peseta has stumbled by 22%<sup>18</sup>. The most recent devaluation by 7% (March 6th) set the Spanish peseta at a record-low exchange-rate against the German mark. Despite the fact that Spain joined the ERM in 1989 of the EMS with wider exchange bands (6% instead of 2.5%), these bands had to be widened in August of 1993 to 15%. There are significant reasons for these frequent devaluations. It is important to consider on one hand the strength of the German mark, which was primarily promoted by the low interest rates implemented by the German Bundesbank in order to keep under control the potential inflation which could have been caused by the German reunification. On the other hand, the disturbingly rapid rise in the Spanish budget deficit and the associated external deficit made the peseta vulnerable to speculative attacks. Also, the persistent high inflation rate produced a decrease in the demand of the Spanish currency and its price in terms of other currencies. In the last few years, several important political scandals have also been a contributing factor to this exchange rate instability of the Spanish peseta.

The most crucial test for the Spanish peseta, however, begins in 1995, since under the Maastricht treaty the exchange rate of a country applying for EMU should have been stable for two years beforehand. The exchange rate forecast of *The Economist's* issue of April 22nd suggests that, at least in terms of dollars, it is not expected to change (see figure 19), but the Spanish currency has been increasingly unstable in the last few years. Only the currencies forming the so-called D-mark block (Belgian Franc, Dutch Guilder and Austrian Schilling) have seemed to maintain an acceptable degree of stability since the beginning of this year (see figure 6).

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<sup>17</sup> THE ECONOMIST, April 22nd 1995

<sup>18</sup> THE ECONOMIST, March 11th 1995

## **VII. Conclusion**

The Economic and Monetary Union projected for 1997 will, without a doubt, become a crucial event in the history of the world. Fifteen countries of the old Europe, a continent that has played a key role in the development of human history, will then take part in a process of economic and, subsequently, political convergence. The implementation of a common currency, the ecu, and a central European bank are two of the key features of this economic union. Member countries will, once they take part in EMU, give up a considerable amount of political and economic independence with the purpose of creating a unified Europe. This Europe in the process of rejuvenation has, from an economic point of view, the purpose of promoting trade and the benefits originated thereby. The unification of these fifteen (counting the recent additions of Austria, Sweden and Finland), or some day even more, European states constitutes something unique in world history for which there are no past experiences to draw on.

Monetary integration, however, requires a great deal of planning and joint-decision making that is not easily accomplished when the area of integration is highly heterogeneous and polarized, which is the case of the European Community. According to the theory of optimum currency areas, it is technically very hard to integrate regions that are economically dissimilar and have little factor mobility between them. Unfortunately, this seems to be the case of countries like Greece, Portugal, and, to a great extent, Spain, which will presumably not find it easy, according to the theoretical grounds of optimum currency areas, to participate in the EMU projected for 1997.

Fundamental to guarantee the success of this delicate project is the economic convergence of the member countries. The Maastricht treaty established different criteria which will have to be met prior to EMU. This macroeconomic harmonization has not been easily pursued by the member states, since it often conflicted with domestic economic goals. These stringent criteria, that embrace interest and inflation rates, public debt, government deficit and exchange rate stability, were as of 1992 only met by three countries: Denmark, Luxembourg and France, and as of 1995 only Luxembourg met the Maastricht criteria.

Nevertheless, there are several almost definite candidates for the 1997 deadline. These countries are: France, Belgium, Germany, Holland, Luxembourg, Denmark, and Austria. There are other countries that are likely to take part in the EMU in 1997, but in these cases there is some

qualification over the likelihood. These countries are: Ireland, Spain, Italy, Sweden, and the United Kingdom. Finally, Portugal, Finland, and Greece might join EMU some time afterwards, since these three countries seem to need a longer period to meet the convergence criteria.

Spanish politicians have repeatedly declared that it is in Spain's best interest to join EMU in 1997. The obvious risk in Spanish eyes is that their country will be left behind, with all the subsequent negative consequences that this relegation will originate: deterioration of the external economic image of Spain, reduction in foreign investment, disillusion of the Spanish people, etc. At the present, Spain fails to meet any of the criteria of the Maastricht treaty, and recent developments of the economic indicators show no tendency to change this.

Three possible outcomes for this problem are currently being contemplated. The so-called multi-speed Europe, against which Spain and Italy are emerging as the most fervent critics, would allow countries that by 1997 do not meet the convergence criteria to have an extended transitional period and join EMU thereafter. Spain is clearly more receptive to either having a more "flexible" interpretation of the Maastricht criteria or to delaying the whole Maastricht timetable. At this point, it seems that only time can tell whether the ecu will replace the peseta in 1997. However, since politics have frequently driven economics in the European Union, it might well be the case that, in the end, in 1997, the Spanish peseta will become a currency of interest only for numismatic purposes.

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