Exchange Rate Policy and Disinflation: The Spanish Experience in the ERM

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1. INTRODUCTION

SPAIN is certainly one of the Western European countries that has experienced the most dramatic changes in the past 20 years. In addition to a political shift from dictatorship to democracy in the mid-1970s, the economic structure has been deeply reformed. These changes, including the process of European integration, have been generally beneficial to the nation. However, they have also posed important policy challenges. This has been particularly the case for monetary policy. The Spanish central bank, the Banco de España, has been concerned with two major objectives associated with European monetary integration. The first and most important goal is nominal convergence, i.e. a reduction of inflation to reach German standards. The second objective is exchange rate stabilisation with respect to other currencies in the European Union (EU). The challenge has been to reconcile these aims with a rapidly changing economy affected in particular by trade, financial and capital account liberalisations. A specific problem has been the presence of significant capital inflows in the late 1980s. These inflows were caused by two main factors: first, the various reforms and especially EU membership in 1986; second, a tight monetary policy with high interest rates.

Overall, the monetary policy challenge has been met only with mixed results. A strategy of exchange rate stabilisation was followed between 1987 and 1992, including membership in the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS) after June 1989. This strategy appeared successful in the

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early 1990s, as the inflation and interest differentials with Germany were declining, the credibility of the exchange rate target was increasing and international reserves were at a record high. The EMS crisis in 1992–93 and other turbulences in foreign exchange markets modified dramatically this situation, as the peseta was subsequently formally devalued four times and has depreciated by more than 30 per cent with respect to the DM between 1992 and 1995. Moreover, the inflation differential with Germany in the mid-1990s was similar to the one in 1987.

The collapse of the exchange rate target has probably been influenced by the EMS crisis. However, fundamental domestic disequilibria, reflected in a strongly overvalued peseta, made the exchange rate policy clearly unsustainable. This paper examines the factors that have led to this situation and examines the macroeconomic policies implemented in democratic Spain. In the next section, a brief overview of the main developments in the Spanish economy over the last two decades is presented. Section 3 reviews the evolution of Spanish monetary and exchange rate policy during this period, with an emphasis on the stable exchange rate episode. Section 4 evaluates the policies implemented and attempts to draw lessons from the Spanish experience. It is argued that a superior policy would have been to join the ERM in 1987. Section 5 provides concluding remarks.

2. BASIC FACTS[1]

A period of more than 35 years of dictatorship was concluded by Franco's death in 1975 and was followed by full democracy in 1977 with democratic elections. The Socialist Party remained in power from 1982 to 1996, with absolute parliamentary majority until 1993. One of its main policy objectives has consistently been European integration and Spain adhered to the European Community (EC) in 1986, jointly with Portugal. The actual integration with other EU countries has been progressive. For example, trade liberalisation was phased out from 1986 to 1992. This liberalisation was accompanied by a substantial increase in trade, especially with EU countries.

The capital account liberalisation was also completed by 1992.[2] While foreign direct investment as well as some types of capital inflows were basically free in 1986, the other categories of capital flows had to be liberalised to satisfy the EC Directive on the liberalisation of capital movements (88/361/EEC). Hence, Spanish portfolio investment abroad and various short-term capital flows were

[1] Most of the description given below can be found in more detail in Viñals et al. (1990) and Viñals (1992).
[2] See Bacchetta (1992b) for a discussion of this liberalisation process.

liberalised from 1986 to 1992. At the same time, however, temporary controls on short-term inflows were introduced as a response to large capital inflows. Section 3 examines these measures in more detail. The increase in cross-border flows has been substantial in this period. In the 1980–86 period, capital inflows and outflows represented on average two per cent and 0.7 per cent of GDP, respectively. In 1992–93, they represented 10.3 and 11.1 per cent. In the 1987–91 period, capital inflows were much larger than outflows (6.3 and 1.6 per cent of GDP, respectively). This was reflected by a current account deficit. From a balanced position in 1987, the current account presented an average deficit of 3.5 per cent of GDP in the 1989–92 period. Finally, it is worth mentioning that a large proportion of the increase in capital inflows has taken the form of short-term capital, first with private securities and then, in the early 1990s, with government debt.

The domestic financial sector has also experienced a serious liberalisation process. Until the early 1980s, most financial transactions were going through the banking system, which itself was strongly regulated. In addition to reserve and investment requirements, most interest rates were administered. The liberalisation implemented in Spain was in line with the various regulations and new directives of the EU. The numerous regulatory changes allowed the development of several financial markets, including the stock market and the market for public debt.

Deep changes also affected the public sector.[3] On the one hand, state interventionism was reduced compared to Franco's era; on the other hand, the government budget expanded rapidly. For example, public expenditure has grown from less than 25 per cent of GDP in 1975 to about 50 per cent in 1994. Public debt has also increased dramatically from 12 per cent of GDP in 1975 to more than 60 per cent in 1994. This debt increase was particularly strong in the early years of democracy, but was stabilised in 1987 only to increase again in the early 1990s. In fact, fiscal policy became more restrictive in the period 1987–89 as the government deficit went down to about three per cent of GDP, compared to a maximum of seven per cent in 1985. While the government's objective was to eliminate the deficit by 1992, it actually increased compared to the late 1980s (4.5 per cent of GDP in 1992 and 7.5 per cent in 1993). In other words, fiscal policy became more expansionary in the early 1990s.

In terms of overall economic performance, the Spanish economy has not been outstanding under democracy and no catching up with richer European countries can be observed. From 1975 to 1994, the Spanish GDP per capita grew slower than the EU average. To assess the actual convergence process is, however, made difficult by the fact that the Spanish business cycle is more pronounced than in other countries (see Dolado, Sebastián and Vallés, 1993). Growth in the late 1980s was much stronger than in the EU, while the recession in the early 1990s

[3] See Bacchetta (1994b) for an analysis of public sector reform after 1975.

was more severe. Consequently, there is convergence in expansions and divergence in recessions.

Another preoccupying aspect of the Spanish economy is its unemployment.[4] Since 1979, the Spanish unemployment rate has consistently been the highest in the EU (to reach 24 per cent in 1994). The difference with other countries has been steadily growing. On the other hand, the inflation differential has been reduced over the two decades. After the first oil shock, inflation increased substantially (reaching 25 per cent in 1977) to progressively decline thereafter. In the 1980s, however, it remained at double-digit levels until 1987, where a restrictive monetary policy was implemented. Between 1987 and 1993, the inflation rate fluctuated around an average of six per cent, which was significantly higher than the average ERM countries. A similar pattern is observed with nominal wages.

3. MONETARY POLICY, EXCHANGE RATE POLICY AND CAPITAL INFLOWS

The most interesting period of Spanish exchange rate policy was probably the one between June 1989 and September 1992, where the peseta remained in a stable ERM. This section provides a description of the main aspects of monetary and exchange rate policy by examining three periods: (i) before June 1989, (ii) June 1989–September 1992, and (iii) after September 1992.[5]

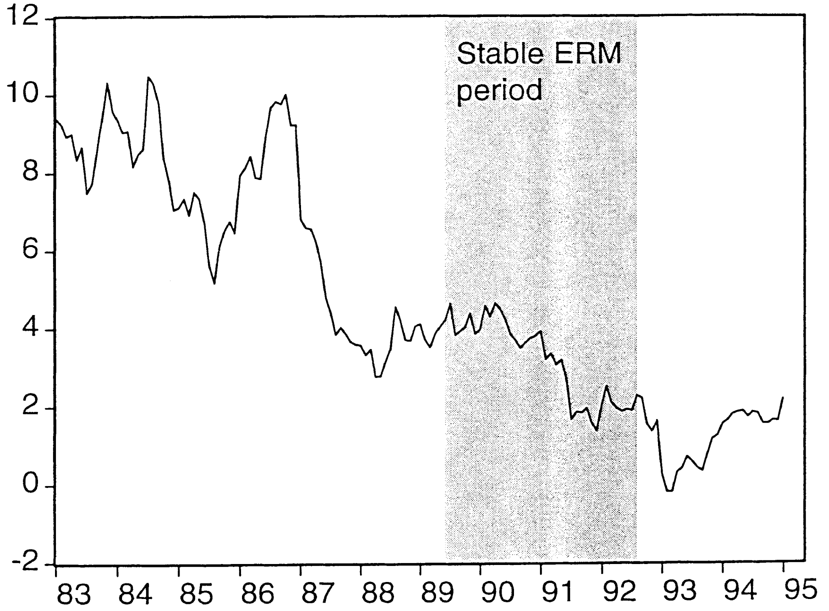
a. The Pre-ERM Period

In the mid-1980s, the Banco de España progressively decreased the attention given to monetary aggregates and started to stabilise short-term interest rates (similar to other OECD countries). At the same time, due to increased economic integration, the exchange rate was acquiring more weight in the determination of monetary policy.[6] From 1986 to 1989, the value of the peseta with respect to other ERM countries was actually maintained in a ± 6 per cent band similar to the one adopted in June 1989.

Monetary policy was quite successful in reducing inflation. Following a first substantial reduction in the late 1970s, inflation was further decreased after 1982. The inflation rate went down from about 14 per cent in 1983 to four per cent in 1988. However, as disinflation also occurred in other OECD countries in the

[4] See Blanchard and Jimeno (1995), and Dolado and Jimeno (1995), for recent analyses.
[5] Ayuso and Escrivá (1993), and Escrivá and Malo de Molina (1991), provide detailed discussions of Spanish monetary policy.
[6] While the central bank first considered an exchange rate index, it focused its attention on the price of DM after 1988.

FIGURE 1
Inflation Differential with Germany



CPI inflation rates.
Source: IMF-IFS.

1980s, the inflation differential between Spain and lower inflation countries was initially not reduced. Figure 1 shows the inflation differential with Germany.[7] It shows that in 1986 this differential was still the same as in 1983, at about ten per cent. This was all the more preoccupying as Spain entered the EC in 1986. To reduce the differential, the Banco de España adopted a much more restrictive monetary policy by sharply increasing interest rates. This dramatically increased the interest differential with Germany, as shown in Figure 2. This differential went up to 16.5 per cent in May 1987.

The restrictive monetary policy was accompanied by a more restrictive fiscal policy, as mentioned in Section 2. Hence, 1987 can be considered as the starting point of a small-scale stabilisation programme.[8] This programme was quite successful in reducing the inflation differential with Germany from ten to three per cent, as shown in Figure 1.

The stabilisation programme, however, had unpleasant side effects. Given the significant interest rate differential with other EU countries, combined with a

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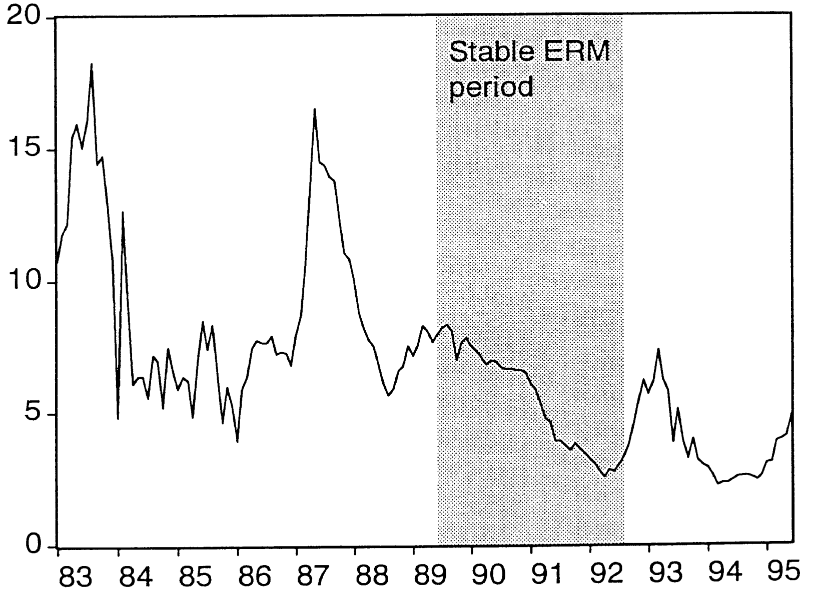
[7] All data presented in graphs are taken from the IMF *International Financial Statistics*.
[8] This programme was modest compared to typical stabilisation programmes in high inflation countries, both by the initial inflation rate and by the magnitude of the measures undertaken.

FIGURE 2
Short Term Interest Differential with Germany

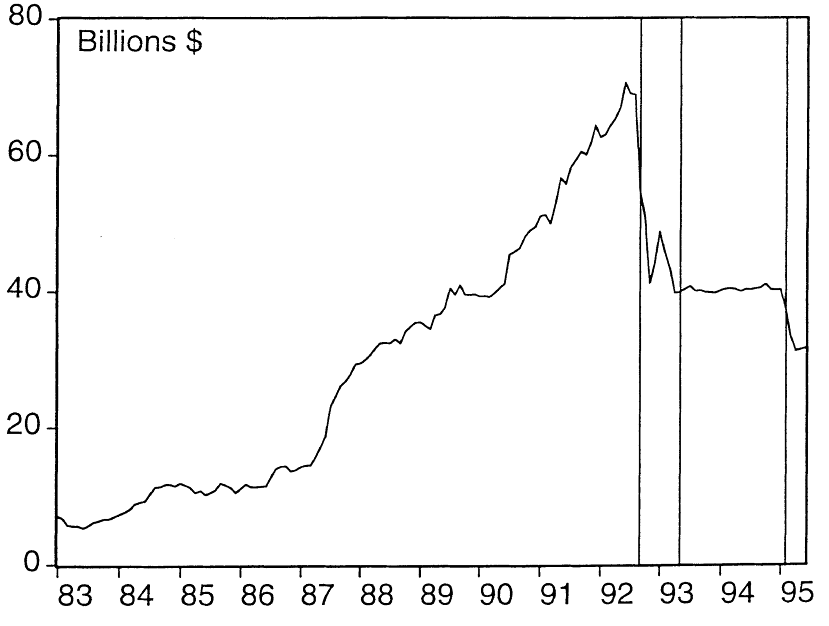


rather stable currency, investment in peseta-denominated assets was very attractive. Consequently, capital inflows increased substantially.[9] Moreover, the large interest differential was combined with various other factors that made investment in Spain more attractive. The main factor may have been the process of trade liberalisation associated with EU membership. Other important factors were the reduction in government deficit and a series of structural reforms, particularly in the financial sector. Consequently, both foreign direct investment and portfolio investment strongly increased after 1986.

The surge in capital inflows was creating a strong appreciating pressure on the peseta in early 1987. This clearly conflicted with the objective of a stable currency. In response to this appreciation, the Banco de España intervened heavily in the foreign exchange market. Figure 3 shows the rapid increase in foreign exchange reserves in 1987. Since the central bank also aimed at limiting the growth of monetary aggregates, it sterilised the interventions and reduced credit to the private sector by increasing interest rates. This policy response, typical in the first stage of a capital inflow episode, was obviously creating a vicious cycle, as the increasing interest rate was attracting even more capital inflows.

[9] Schadler et al. (1993) provide a detailed analysis of the large capital inflows episode in Spain and in five other countries in the late 1980s and early 1990s.

FIGURE 3
Foreign Exchange Reserves

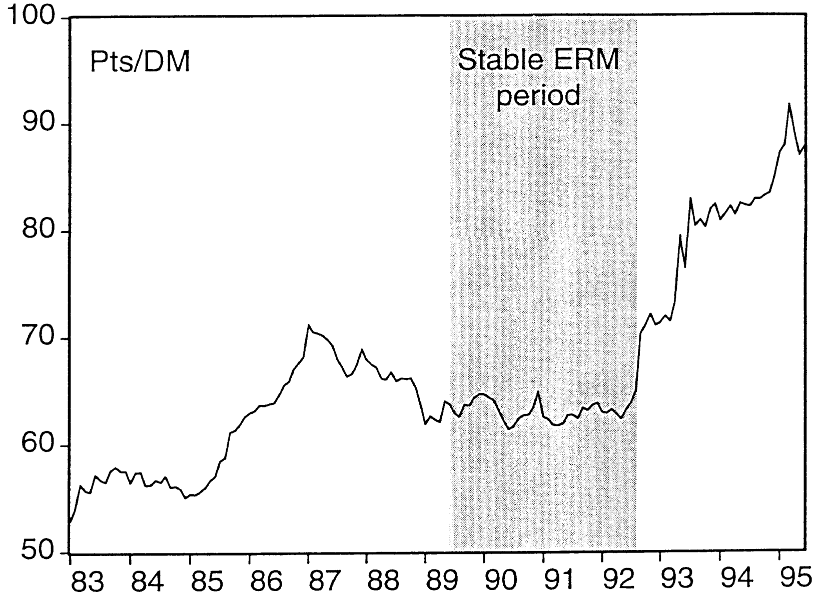


As an attempt to break this cycle, the Banco de España resorted to temporary controls on capital inflows in Spring 1987. Successive measures were adopted from March to July, in particular by prohibiting interest payments on non-residents' accounts in pesetas (superior to 10 million pesetas).[10] This measure was successful in reducing the use of these accounts, but international investors found other ways to benefit from the large interest rate differential. First, they engaged in currency swap agreements with Spanish banks. The central bank reacted by imposing restrictions on short positions in foreign currency by banks. Second, investors purchased Spanish public debt bearing an interest lower than the one on swaps, but still attractive. Again, the central bank had to impose new restrictions, this time on the purchase of government debt by non-residents. Other restrictions on capital inflows were introduced in 1988 and 1989. This evolution shows that the controls were not very effective as investors quickly found new ways to arbitrage between domestic and foreign interest rates.

Examining the differential between Madrid and London peseta interest rates shows that controls on capital inflows were binding from April 1987 to April 1991. This implies that interest rates in Spain could be higher than with full international capital mobility. Nevertheless, this differential (equivalent to the deviation from covered interest parity) was on average small, and increases were

[10] Residents were still constrained in many ways on their capital movements.

FIGURE 4
Nominal Exchange Rate



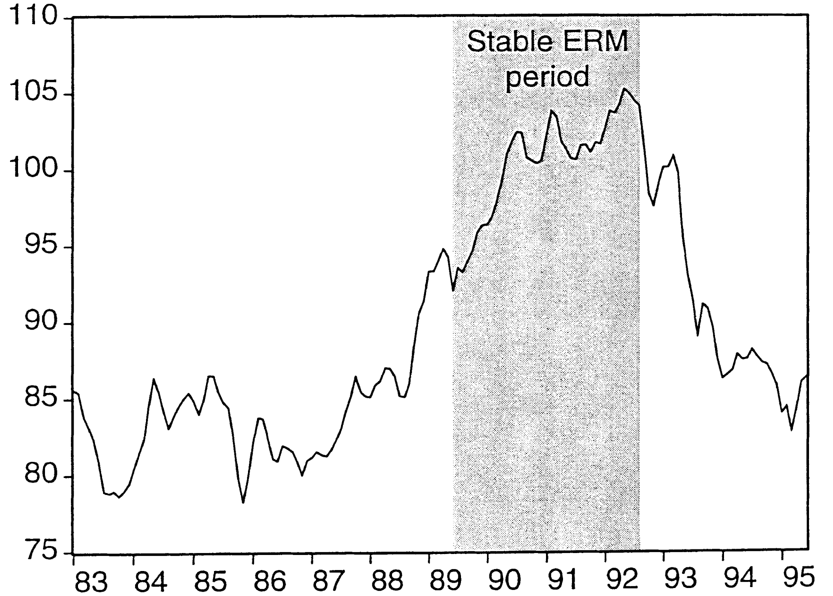
Source: IMF-IFS.

short-lived. Analysing daily matched data, Bacchetta (1996) shows that 95 per cent of a shock to the differential disappeared after two months. In spite of intervention and capital controls, the peseta appreciated in early 1987, as shown in Figure 4.

Given that capital controls were not very effective and that the increase in interest rates was also affecting long rates, and consequently investment decisions, the central bank decided to relax somewhat its monetary policy by letting the short-term interest rate decline (see Figure 2) and the monetary aggregate expand more than planned. This change was also made possible by the decline in inflation. However, tensions due to capital inflows continued in 1988 and became strong in early 1989. Moreover, the inflation rate was increasing again (see Figure 1) and a general strike in December 1988 augured strong pressure on wages and public spending.

As the Spanish economy was opening up (and could not be isolated by temporary capital controls), it was becoming clear that the authorities would find it extremely difficult to reduce inflation and maintain a stable exchange rate at the same time with the policies implemented in the late 1980s. Therefore, it seemed necessary to opt for a new strategy. The alternative considered was the use of the exchange rate as a nominal anchor by joining the ERM. This strategy, by

FIGURE 5
Real Effective Exchange Rate



Based on relative normalized unit labor costs.
Source: IMF-IFS.

definition, would stabilise the nominal exchange rate. Moreover, there was the conviction at the time that this strategy would also help reduce inflation by importing credibility from low inflation countries, particularly Germany.[11] Hence, this strategy would allow the attainment of two main monetary objectives. Consequently, Spain decided to join the ERM in June 1989, adopting a ±6 per cent fluctuation band (most ERM countries had a ±2.25 per cent band).

Overall, the Spanish economy was in a good condition on the eve of the ERM membership. In the few years before 1989, a phase of convergence took place both in real terms, with output and employment growing faster than other EC countries, and in nominal terms, with a significant reduction in inflation. This inflation differential with Germany was actually as high as in some other ERM countries, e.g. Italy. The substantial reduction in the public deficit and the

[11] See, for example, Viñals (1990) for a discussion in the case of the Spanish peseta, and Giavazzi and Giovannini (1989) for the ERM in general.

stabilisation of the public debt were also positive elements. The only relatively preoccupying aspect was that of the somewhat ‘overvalued’ level of the peseta chosen as the central parity in the ERM. Figure 5 shows the evolution of the real exchange rate. Compared to its 1987 level, the real exchange rate index had increased by about 15 per cent in June 1989.

b. The Stable ERM Period

As the Banco de España had already stabilised the peseta in the previous two years, the initial impact of ERM membership was not too large. Nevertheless, it stabilised exchange rate expectations and made investment in pesetas even more attractive. As interest rates were initially kept at a high level (see Figure 2), this led to larger capital inflows that were reflected in an appreciation of the peseta, an increase in foreign exchange reserves and an increase in the deviation from covered interest parity (i.e. the controls on capital inflows became more binding).

In an effort to further reduce the inflation differential, the monetary authority wanted to maintain a very restrictive monetary policy. However, the level of interest rates was limited by the exchange rate commitment. Even though the exchange rate constraint was somewhat relaxed by capital controls, the desired tightness of monetary policy was inconsistent with the exchange rate band. Consequently, the Banco de España used other instruments to directly affect credit expansion. First, reserve requirements on banks were increased and then credit controls were implemented through moral suasion. These controls had a short-lived effect as firms found alternative financing through the commercial paper market.

Given the lack of effectiveness of the controls on credit and on capital movements, both were abandoned in early 1991. Subsequently, monetary policy had to follow strictly the exchange rate rule, even though monetary aggregate targets (ALP) were still formulated. As can be seen in Figure 2, the interest rate declined while leaving the exchange rate relatively stable. From early 1991 to the Spring of 1992, the peseta actually fluctuated in a small range (less than three per cent) at the top of the fluctuation band. This stability was also due in part to foreign exchange market intervention and the central bank reserves continuously increased during this period (see Figure 3). Both the exchange rate stability and the increase in reserves had a positive impact on exchange rate expectations by increasing the credibility of the exchange rate commitment.[12] This was reflected in a larger decrease in the interest rate.

The stable ERM period allowed Spain to reduce its inflation differential with Germany somewhat further (see Figure 1). This was made easier by the fact that inflation increased in Germany after the reunification shock (this shock also

[12] See Ayuso, Jurado and Restoy (1993) for various measures of credibility.

explains a proportion of the reduction in interest differential in Figure 2). However, the differential still remained positive, which implies that Spain was losing competitiveness. Figure 5 shows clearly that the real exchange rate continued appreciating from 1989 to 1992.[13]

In addition to the loss in competitiveness, there are two important negative developments during this period. First, as seen before, fiscal policy became more expansionary with a significant increase in the public deficit. Second, wage increases became larger after 1989. While there was a wage moderation in 1987 and 1988, wages increased in real terms after 1990. During the same period, wages increased less rapidly in other EU countries. In the 1989–92 period, compensation per employee increased on average by 7.9 per cent in Spain, compared to 4.8 per cent in Germany. The reasons for this increase are found in changes in the structure of the labour market (see Bacchetta, 1994a, and the references therein for a description of these changes). These developments, jointly with the increased current account deficit, would eventually conflict with the exchange rate target.

c. *The Crisis and its Aftermath*

The negative outcome of the Danish referendum on the Maastricht Treaty in June 1992 started a period of turbulence for the ERM. It also started the depreciation of the peseta and the decline in the credibility of the exchange rate target. This was accompanied by a loss in foreign exchange reserves as the Banco de España intervened to support the peseta. The general evolution of the ERM in the summer of 1992 made it clear that the parity of the peseta could not resist speculation. The speculation was all the larger as all capital controls had been completely removed in early 1992. Thus, the peseta was devalued by five per cent on 17 September, while the pound and the lire exited the system altogether. The adjustment of the central parity, however, was considered to be small and speculation against the peseta continued. The Banco de España had to intervene heavily, again losing a substantial amount of reserves (see Figure 3). Moreover, it introduced temporary controls on capital outflows. These measures may have limited the loss in foreign exchange reserves, but they could not prevent a new devaluation of six per cent on 23 November.[14] The temporary capital controls were also removed at this time.

A third devaluation (eight per cent) took place in May 1993 in an atmosphere of political uncertainty (anticipated general elections with expected loss of absolute majority by the Socialist party) and negative economic performance.

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[13] For an analysis of the real exchange rate during this period, see Bacchetta (1994a).
[14] Notice that the measures imposed were of the kind advocated by Eichengreen and Wyplosz (1993) to prevent speculative attacks.

The devaluation was preceded by a sharp increase in interest rates and a loss of foreign exchange reserves. In July 1993, the fluctuation band in the ERM was increased to ±15 per cent. The fourth devaluation (seven per cent) occurred in March 1995, in a period of turbulence in foreign exchange markets, in particular with a strong depreciation of the dollar. While the interest rate declined after the third devaluation, it increased after the fourth as inflationary pressures were feared in a period of recovery.

After 1992, and even though the peseta remained in the ERM, the exchange rate was becoming less important in the implementation of monetary policy. In June 1994, the Law of Autonomy of the Banco de España was approved. The objective of this institutional change was to provide more independence to the monetary authority. After this change, the central bank decided to abandon the targeting of monetary aggregate and to adopt an inflation target of three per cent by 1997.

4. WHAT CAN BE LEARNT FROM THE SPANISH CASE?

The developments in international financial markets and the EMS crisis in 1992–93 have certainly played an important role in the various devaluations of the peseta. However, the main impact of these external events was to determine the timing of the collapse of the exchange rate target, but not the need for it. The nominal exchange rate was clearly not sustainable because of purely domestic factors, as the Spanish economy was experiencing several macroeconomic disequilibria. Therefore, the adoption of an exchange rate target in the late 1980s in Spain can probably be considered *ex post* as a mistake, as it involved high costs without producing a sustainable reduction in the inflation differential. In particular, it has implied a long period of very high real interest rates and of real exchange rate appreciation which have certainly affected the economy in a negative way.[15] Moreover, the successive devaluations and the associated speculation episodes have introduced a climate of uncertainty, especially given the political importance attached to exchange rate stability in the early 1990s. Nevertheless, criticising past economic policies is useful only to the extent that lessons can be drawn for the future or for other countries. This section briefly analyses the causes for the failure of exchange rate policy to deliver its expected benefits. It also attempts to determine which of these failures could have been anticipated when the policy was implemented.

Using the exchange rate as a nominal anchor was considered as a way to import credibility from Germany. This credibility gain was estimated to be larger

[15] Dolado and Jimeno (1995) provide evidence consistent with this view.

than the loss incurred by giving up the exchange rate as an instrument. This was especially the case as the ERM was still giving some flexibility with a ±6 per cent band and with the possibility to devalue (although not unilaterally). The basic thinking behind the credibility argument is based on the literature on rules versus discretion (see Giavazzi and Giovannini, 1989, ch. 5, for a discussion of the fixed exchange rate rule). The fundamental idea behind this line of reasoning is that there is a game between the authorities and the private sector. If the authorities set policies on a discretionary basis, they often have an incentive to 'cheat' the private sector, for example, with surprise inflation or devaluation. On the other hand, if the government or the central bank can adhere to a credible rule, the private sector will adapt its behaviour to that rule.[16] By pegging the exchange rate with Germany, the Spanish authorities were trying to convince the private sector that it would adopt policies similar to Germany and that the inflation rate would converge to the German one. The authorities were hoping to change the private sector's behaviour on two fronts. First, in the wage-setting process and, second, in the attitude towards fiscal policy. The first aspect is clear in the sense that nominal wage increases were expected to be lower since workers would have lower inflationary expectations. The impact on fiscal policy is less obvious since its determination depends on various political factors. It was believed that fiscal restraint would be easier if the country adopted a system that made large fiscal deficits more costly.

Unfortunately, the credibility effect did not work. As described in Section 3, both wage increases and the fiscal deficit became larger, instead of smaller, in the ERM. Hence, the policy mix in Spain was inadequate and the wage pressure, combined with strong rigidities in the non-traded goods sector, made it impossible to eliminate the inflation differential in a stable currency system. The reasons why the credibility effect did not work are complex. First, it might be that the exchange rate commitment was not credible. This explanation, however, is not convincing since financial markets found it credible. Another explanation is that economic agents are not behaving as rational, fully informed, maximising agents as simple models typically assume. They could be backward-looking instead of forward-looking. Or there might be a learning process so that it takes time to adjust to a new rule. The various rigidities in the labour and goods markets make this process longer. A third type of explanation is that the private sector is not behaving as one entity, but is made of agents behaving non-cooperatively. The aggregate response of the private sector obviously depends on the institutional set-up. Although it is difficult to determine the precise elements influencing this aggregate behaviour, it seems that various changes in the 1980s worsened the situation. In the labour market in particular, the nationwide wage-bargaining process involving the government, firms and trade unions was

[16] It should be noted that no systematic empirical evidence supports this theory.

abandoned in 1987 in favour of a more decentralised process. With this type of bargaining process, workers do not internalise the impact of wage increases. Regarding the fiscal sector, a decentralisation has also taken place, with a larger role given to the regions (*Autonomías*). This change has been partly responsible for the increase in the fiscal deficit (see Bacchetta, 1994b).

The absence of a significant credibility effect, however, is not specific to Spain.[17] The failure of other exchange-rate-based disinflation programmes (e.g. the recent case of Mexico), as well as the EMS crisis, have made analysts more sceptical about the virtues of a nominal anchor (see Svensson, 1994). It is not impossible that with current thinking, and in the same conditions as in 1989, Spain would not have found ERM membership in its interest.

In any case, with the state of thinking in the late 1980s, and to the extent that the developments in the labour market and on the fiscal side could not be anticipated, joining the ERM may not necessarily be considered as a mistake *ex ante*. However, there are two aspects where the exchange rate policy was faulty: the initial level of the exchange rate and the stubbornness in keeping the exchange rate target. As mentioned above, Spain entered the ERM after a period of appreciation of the peseta.[18] The experience of other exchange-rate-based stabilisation programmes has shown that a real appreciation typically occurs after pegging the exchange rate. As depreciation expectations are stabilised, capital inflows increase, putting a pressure both on the exchange rate and on inflation. Consequently, it is advisable to peg the exchange rate in a situation of undervaluation (e.g. see World Bank, 1993, p. 52).[19] The Banco de España attempted to prevent the negative effects of increased capital inflows by introducing controls on these inflows and on domestic credit. As described above, however, these measures were not effective.

Even without the increase in capital inflows, a real appreciation is to be anticipated, since the inflation differential would not disappear immediately. Consider the following thought experiment. The initial differential was four per cent in 1989. An optimistic guess at that time would have been that this differential could be reduced after the first year by one per cent each year. For a constant nominal exchange rate, this implies a real appreciation of ten per cent after four years (as the differential was reduced more progressively and the peseta appreciated in nominal terms, the actual real appreciation has been larger). This would imply a 25 per cent real appreciation of the peseta compared to 1987. To

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[17] See, for example, Edwards (1995) for an analysis of Latin American experiences.

[18] There has, of course, been a discussion about the right level of the central rate in the ERM band. Entering with a lower value for the peseta would not have been easy given its appreciating trend and would have probably required a strong fiscal adjustment.

[19] It is sometimes argued that an initially overvalued currency signals the toughness of the central bank, and therefore should strengthen its credibility. This argument, however, does not consider how to correct the loss in competitiveness.

correct this loss in competitiveness by maintaining a constant nominal exchange rate, Spain would have needed a long period of low inflation or high productivity growth compared to Germany (for example, 25 years with inflation one per cent lower than the German one!). Most scenarios that could lead to this correction are obviously wishful thinking. While this thought exercise is very simplistic, it shows that the problems ahead could have easily been anticipated. In addition, policy makers seemed to have neglected the fact that capital inflows might be temporary, as they were caused by structural reforms that are temporary by nature. It could easily be expected that once the best investment opportunities are exploited, capital inflows would decline and could even be substituted by net inflows as Spanish investors look for new investment opportunities.[20]

The other mistake has been to maintain the same policies for too long. Soon after ERM membership, the developments in wage setting and fiscal policy made it clear that the policy was not sustainable.[21] It was clear that a strong adjustment was needed either in fiscal and income policies or in exchange rate policy. However, European integration was an important item on the political agenda and ERM membership could not be questioned, particularly in the process towards a European Monetary Union. As for fiscal or income policies, the government was unable to implement any change, even though it still had the absolute majority in Parliament.[22] Consequently, the disequilibria in the Spanish economy were growing and made it a good target for speculators.

In a sense, the problem with the actual policies was to sequence the disinflationary measures. First, from 1987 to 1989, disinflation relied mainly on the fiscal policy mix. When these instruments ran out of steam, the formal exchange rate policy was adopted. A superior strategy would have been to use all the instruments together and to join the ERM early in 1987. Since the peseta/DM parity was relatively stable from 1987 to 1989, this commitment would not have significantly affected the exchange rate, although this may have exacerbated the capital inflows problem for a while. On the other hand, targeting the exchange rate at that time would have had many advantages. First, it would have been accompanied by the right policy mix, between 1987 and 1989, and would be part of a full stabilisation programme (particularly with a restrictive fiscal policy). Second, the inflation reduction would also have been substantial within the ERM. Consequently, the nominal convergence in 1987–89 could have been attributed to the exchange rate policy, which would have considerably enhanced the central bank's credibility. Therefore, it would have been easier to lock in this inflation convergence than by entering the system in 1989. Third, the extent of real

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[20] See Bacchetta (1992a) for a formalisation of this idea.

[21] See, for example, Bacchetta and Caminal (1990), Bacchetta (1992c) and Dornbusch (*El País*, 3 January, 1991) for early warnings.

[22] It proposed a 'pact of competitiveness' in 1991, but it had little effect.

appreciation would have been much smaller, since the nominal appreciation would have been limited. Thus, the sustainability of the exchange rate policy would have been greater. Moreover, any adjustment in case of speculative attacks would have been smaller, and probably less dramatic, than what happened in 1992–93. The damage to the central bank's credibility would then have been smaller.

5. CONCLUSIONS

This paper has examined Spanish exchange rate policy in recent years. While exchange rate stabilisation started in late 1986, it is the formal ERM membership in 1989 that created the problem and made the peseta the target of speculative attacks. The exchange-rate-based disinflation programme has failed in reducing the inflation differential and has probably exacerbated the business cycle, in particular the recession in the early 1990s.[23] This has probably damaged the real catching-up process that took place in the late 1980s. The failure obviously did not come from exchange rate policy *per se*, but from the overall policy mix. The Spanish experience has shown that little success in reducing inflation can be expected from exchange rate policy alone.

A more rigorous discussion of the costs associated with this policy would require the specification and analysis of alternative policy strategies during this period. At least two natural alternatives should be considered. The first is non-ERM membership, giving more flexibility to the exchange rate. This would have allowed lower interest rates and would have avoided the costs of formal devaluations. The second alternative, mentioned in the previous section, would have been to join the ERM earlier, in 1987.

The structure of the Spanish economy is obviously different from many other countries considering exchange rate stabilisation. In particular, the breakdown of the stabilisation policy occurred in a framework of high capital mobility. The Spanish experience has shown that neither massive foreign exchange intervention nor temporary controls can resist speculative attacks. Moreover, with volatile financial markets, the timing of the attack can hardly be predicted. Another important feature of the Spanish disinflation experiment is the relatively low level of initial inflation. It is well known from other stabilisation programmes that reducing inflation in the one-digit range is much more difficult than with higher levels, especially with hyperinflation.

Finally, the paper has taken a purely 'short-run' economic perspective. The

[23] See Svensson (1994) for a discussion of the procyclical effect of the ERM. Kiguel and Liviatan (1992) provide evidence of the business cycle impact of exchange rate stabilisation in other countries, and Rebelo and Végh (1995) examine alternative theoretical explanations.

evaluation of the Spanish experience, however, might require a broader discussion. From a political viewpoint, ERM membership might have been useful in confirming Spain as a full member of the EU. The period from 1986 to 1992 was crucial in establishing Spanish political credibility in Europe. Even though the credibility of monetary policy has been seriously damaged in recent years, the position of Spain on the European political map might not have suffered so much from the crisis. An evaluation of this hypothesis obviously goes beyond the scope of this paper.

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