Convergence Report presented by the Governor of the Banco de España to the Spanish Parliamentary Committee on Economic Affairs

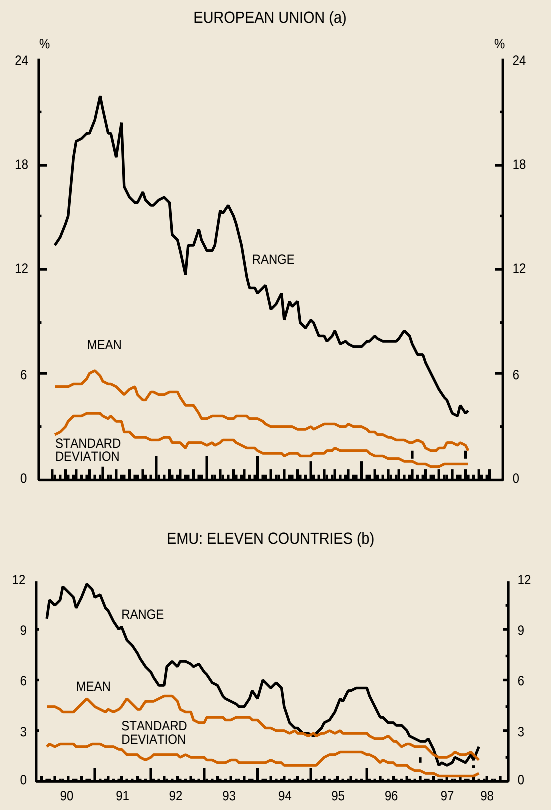
1. SUMMARY AND CONCLUSIONS

Under the Treaty on European Union, the establishment of Economic and Monetary Union (EMU) scheduled for January 1st 1999 requires an analysis of the state of convergence between EU countries to determine which of them are in a position to adopt the euro as a common currency. It is satisfactory to note that, as of the spring of 1998, most of the countries in the area have achieved an extensive degree of convergence, in keeping with the criteria laid down in the Treaty. It might even be said that convergence – considered in its broadest sense – has never in the recent history of Europe been so great as at present. That augurs a solid start for EMU. The euro will be set in place across a broad area which has attained low inflation, whose interest rates are moderate (denoting expectations that the nominal stability attained will be sustained in the future), whose exchange rates have generally held very stable over a prolonged period and whose public finances – which worsened worryingly in the late eighties and early nineties – are in the process of being consolidated. This positive assessment of the starting conditions of EMU should not however mask the fact that there remains work to be done, especially in two respects. First, the EU countries must persevere in restoring health to their public finances. And second, further headway must be made in structural reforms aimed at making EU economies more flexible and adaptable to the changing conditions of what are increasingly integrated world markets.

The convergence criteria were laid down in the Maastricht Treaty to ensure harmonised macroeconomic conditions among the countries that were to adopt the single currency. Such harmony would be conducive to the adoption of common policies and prevent the disequilibria of certain countries from adversely affecting stability in the area, due both to the impact of such imbalances on these countries (since, not having achieved sufficient convergence, they would not be in a position to assume the common monetary policy except by incurring heavy costs) and the risk of contagion to the rest. To this end, demanding and meticulously defined criteria were designed to ensure all the countries were treated equitably. Notwithstanding the exactitude of their definition, some scope for flexibility was built into the Treaty regarding evaluation of compliance with certain criteria, specifically in the fiscal area, so as to accommodate unexpected developments that might require a degree of interpretation. As is widely known, the main variables used to evaluate convergence are the inflation rate, long-term interest rates, the exchange rate and public finances.

CHART 1

Price convergence in the European Union



Source: Banco de España.
(a) Made up of its 15 current members.
(b) The 15 members of the EU, except the UK, Sweden, Greece and Denmark.

Regarding the *inflation* rate, the Treaty stipulates that “the criterion on price stability ... shall mean that a Member State has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed that of at most the three best performing Member States in terms of price stability by more than 1 1/2 percentage points. Inflation shall be measured by means of the consumer price index (CPI) on a comparable basis, taking into account differences in national definitions.”

In recent years the EU countries have, as a whole, had declining inflation rates and, at the same time, the dispersion of their results has diminished. As Chart 1 shows, compared with the situation at the start of the nineties, the average EU inflation rate has dipped from over 5 % to around 2 %, a rate generally considered as compatible with price stability. The indicators of dispersion – such as the range or standard deviation – show an almost continuous declining trend over the course of the decade.

The recent sound performance in terms of price stability is attributable, in most EU countries, to the close pursuit of disciplined and rigorous policies. In particular, as regards monetary policy, the growing independence of central banks, the gearing of their policies to the price stability goal in the medium and long term and the high stability of exchange rates have contributed to moderating increases in costs and prices. And – what is perhaps more important – they have given these policies increasing credibility in the eyes of economic agents, which has translated into lower expectations of price rises. The recent fiscal consolidation has likewise contributed significantly to nominal stability; both directly, via demand, and indirectly, due to its impact on expectations. The price stability attained in most EU countries is not only the outcome of demand-side policies. Also decisive has been the role of the structural reforms undertaken in recent years which, in general, have led to a growing liberalisation of markets and an increase in the competitiveness and external openness of European economies against a background of heightening competition in other world regions.

As a result of the foregoing, most EU countries have attained inflation rates significantly lower than the reference value set in the Treaty, which stands at 2.7 %, the result of adding 1.5 points to the average of the three most stable countries (Austria, France and Ireland). Specifically, a total of 14 EU members (all except Greece) have positioned themselves below this threshold in terms of the relevant indicator for the reference period (the average annual rate between February 1997 and January 1998). Broadly, the 14 members satisfying this criterion have done so comfortably. Spain has achieved an inflation rate of 1.8 %, nine-tenths of a point below the critical threshold.

Turning to *public finances,* the Treaty states that the general government financial position should be sustainable, a condition met when a budgetary position without an “excessive government deficit” is attained. Under Article 104c, there is an excessive deficit if:

a) “the ratio of the planned or actual government deficit to gross domestic product exceeds a reference value (defined in the Protocol on the Excessive Deficit Procedure as 3 % of GDP), unless:

— either the ratio has declined substantially and continuously and reached a level that comes close to the reference value;

— or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;

b) the ratio of government debt to gross domestic product exceeds a reference value (defined in the Protocol on the Excessive Deficit Procedure as 60 % of GDP), unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace."

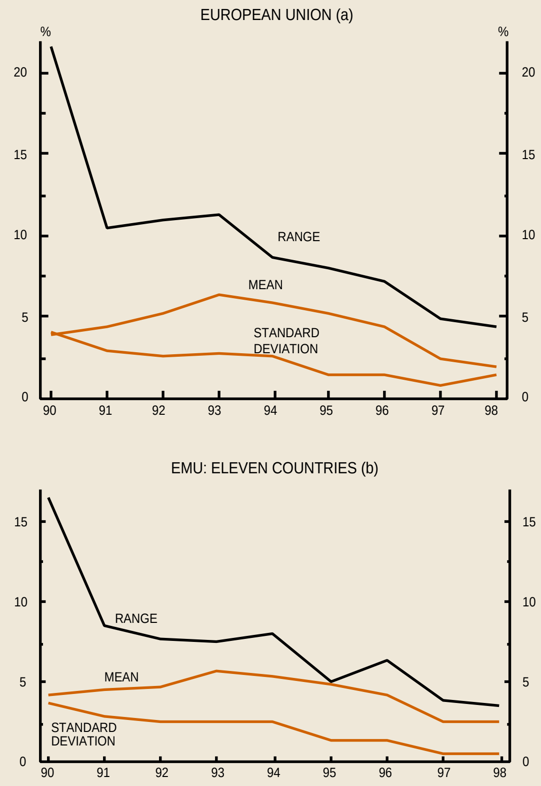
Unlike with the other convergence criteria – compliance with which is to be analysed at the time of the examination by the ECOFIN and the European Council, on the basis of the reports by the European Commission and the European Monetary Institute –, fulfilment of the fiscal criteria depends on the existence or not of a decision qualifying as excessive the deficit of each of the countries, in accordance with Article 104c of the Treaty.

Between 1989 and 1993 there was a marked deterioration in Member States' public finances. The overall EU budget deficit rose from 2.5 % to 6.1 % of GDP, while EU public debt increased over the same period from 35.4 % to 65.9 % of GDP, peaking in 1996 at 73 %. This disconcerting trend, which was common to the whole area and only partly attributable to adverse cyclical conditions, was gradually corrected as from the mid-nineties as European governments progressively pursued fiscal consolidation further to their Convergence Programmes. As a result of these efforts, and thanks in part to more favourable cyclical developments after 1994, the average budget deficit in the EU fell to 2.4 % in 1997, and is expected to stand at 1.9 % this year. Meantime, the debt-to-GDP ratio was 72.1 % in 1997 and is expected to fall to 70.5 % in 1998 (see Charts 2 and 3).

This fiscal consolidation process has meant that in 1997 – the year taken for analysing compliance with the fiscal criteria – all EU countries except Greece have attained deficits equal to or lower than the figure of 3 % set in the Treaty. In Spain, the deficit is 2.6 %, 0.4 percentage points below the reference value and the target set in the Budget and in the Convergence Plan. As to public debt, four countries (France, Luxembourg, Finland and the United Kingdom) stood in 1997 below the reference value; six countries (Denmark, Germany, Spain, Ireland, Austria and Portugal) were between 60 % and 70 %; two countries (the Netherlands and Sweden) between 70 % and 80 %; and three countries (Belgium, Greece and Italy) above 100 %. For countries whose debt-to-GDP ratio is above

CHART 2

Public-deficit convergence in the European Union



Source: European Commission.

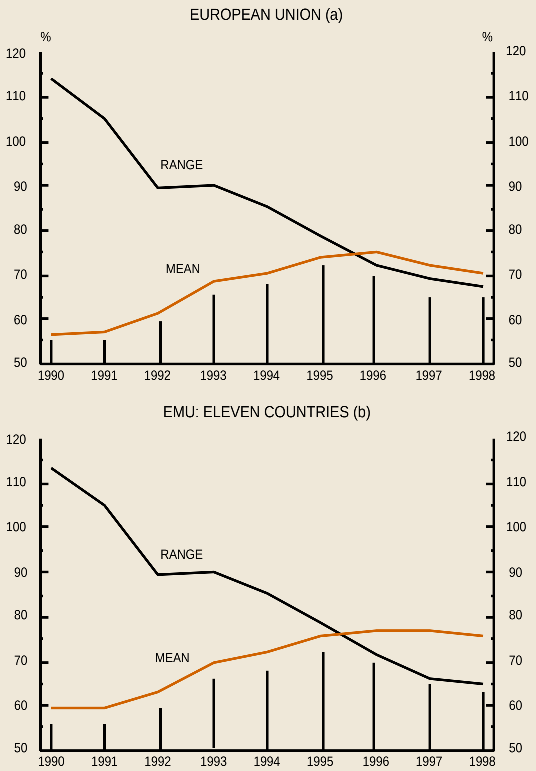
(a) Made up of its 15 current members.
(b) The 15 members of the EU, except the UK, Sweden, Greece and Denmark.

60 %, the Treaty stipulates that it should be analysed whether it is "sufficiently diminishing and … approaching the reference value at a satisfactory pace". As will be explained in detail in the third section of this report, it is deduced from the analysis of debt dynamics in the countries exceeding the reference value that those closest to this threshold would, if they persevere with fiscal consolidation, have no difficulty achieving this value within a reasonable period of time. And this all the more so considering that, as from 1999, with the entry into force of the Stability and Growth Pact (SGP), they will have to pursue medium-term targets of budgetary balance or surplus. The countries furthest from the reference value will have to make a more intense and longer-lasting effort; but their recent trends are pointing in the right direction, and the policies announced provide for a continuation of the fiscal consolidation drive.

In view of the overall information at hand, the Convergence Report presented by the Eu-

CHART 3

Public-debt convergence in the European Union



Source: European Commission.

(a) Made up of its 15 current members. Luxembourg is excluded for the range calculation.

(b) The 15 members of the EU, except the UK, Sweden, Greece and Denmark. Luxembourg is excluded for the range calculation.

ropean Commission on March 25th includes the recommendation that the qualification of "excessive deficit" be lifted for all the countries subject thereto, except Greece. These countries are Belgium, Germany, Spain, France, Italy, Portugal, Sweden and the United Kingdom, which are added to the five members already excluded from the excessive-deficit qualification (Denmark, Ireland, Luxembourg, the Netherlands and Finland). The final decision will be taken by the ECOFIN Council at its meeting on May 1st. If, as expected, the ECOFIN Council ratifies the Commission's recommendation, the 14 countries indicated would satisfy the Treaty's fiscal criteria and would thereby be in a position, from that standpoint, to participate in EMU.

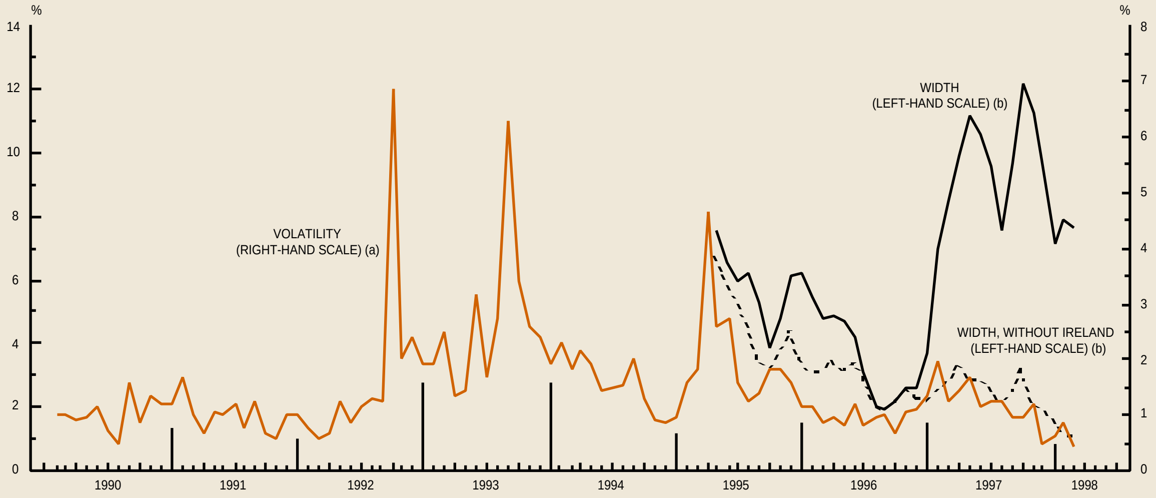
With regard to the *exchange rate,* Article 109j of the Treaty establishes that its stability shall be evaluated by means of Member States' "observance of the normal fluctuation margins provided for by the Exchange Rate Mechanism of the European Monetary System, for at least two years, without devaluing against any other Member State currency". Moreover, the Protocol on the convergence criteria states that the "criterion on participation in the Exchange Rate Mechanism of the European Monetary System ... shall mean that a Member State has respected the normal fluctuation margins provided for by the Exchange Rate Mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular the Member State shall not have devalued its currency's bilateral central rate against any other Member State's currency on its own initiative for the same period".

In the period in question (between March 1996 and February 1998), the currencies participating in the Exchange Rate Mechanism (ERM) of the European Monetary System have sustained a notable and growing credibility. As Chart 4 shows, the volatility of the ERM currencies has diminished markedly since 1995, while the distance between the most appreciated and most depreciated currencies in the grid has narrowed, especially if the autonomous tendency of the Irish pound to appreciate in certain periods is disregarded. With the exception of the latter, all the ERM currencies have held very close to their central parities. Consequently, not only have they remained comfortably within the ERM band of ±15 % without severe tensions, but – in general – they have also held within a margin of ±2.25 % (equivalent to the width of the former narrow band in force prior to August 1993) in relation to the other ERM currencies. In particular, the peseta has, throughout the period in question, traded very close to its central parity against the rest of the currencies, except against the Irish pound, for the reasons outlined above.

The explanation for the notable stability of the ERM currencies lies in the improvement in the related economies' fundamentals; in the ongoing convergence of these fundamentals; in the application of disciplined and congruent economic policies in this group of countries; and in the expectation that these sound fundamentals will be sustained in the future, due in part to the very process of EMU. In sum, it may be concluded from the analysis of exchange rates during the reference period that the ERM members have broadly maintained exchange rate stability that is consistent with the letter and spirit of the Treaty. In particular, the peseta has remained among the group of currencies which, as a result of their performance within the ERM,

CHART 4

ERM volatility and band width



Source: Banco de España.

(a) Volatility: Standard deviation, multiplied by a thousand, of the first difference of the Napierian logarithm of the exchange rates against the D-Mark.

(b) Width: Maximum deviation from the ERM central parities. Calculated as the deviation from the central parity vis-à-vis the D-Mark of the strongest currency, less the deviation of the weakest currency.

comfortably meet the requirements of the Treaty in this respect.

With regard to the *long-term interest rate* criterion, the Treaty states that "the durability of convergence achieved by the Member State and of its participation in the exchange-rate mechanism of the European Monetary System ..[shall be].. reflected in the long-term interest-rate levels". The Protocol stipulates that the "criterion on the convergence of interest rates ... shall mean that observed over a period of one year before the examination a Member State has an average nominal long-term interest rate that does not exceed that of at most the three best performing Member States in terms of price stability by more than two percentage points. Interest rates shall be measured on the basis of long-term Government bonds or comparable securities, taking into account differences in national definitions".

The course of interest rates in the area from 1992 (since when comparable series for most of the countries have been available) shows a general declining trend in yields and their convergence across countries, albeit with certain fluctuations in terms of both average interest rates and their dispersion. Such fluctuations were related to the widespread turbulence on international financial markets, such as the ERM crisis in 1992-93 and the 1994 bond market crisis. The opening months of 1998 have seen the lowest long-term interest rate levels in the period and the greatest convergence thereof (see Chart 5). In the case of Spain, the reduction in long-term bond yields has been particularly steep: the ten-year bond rate fell from 10.8 % at the start of 1992 to 5.2 % in early 1998, while the spread with Germany narrowed, over the same period, from almost 300 basis points to less than 20.

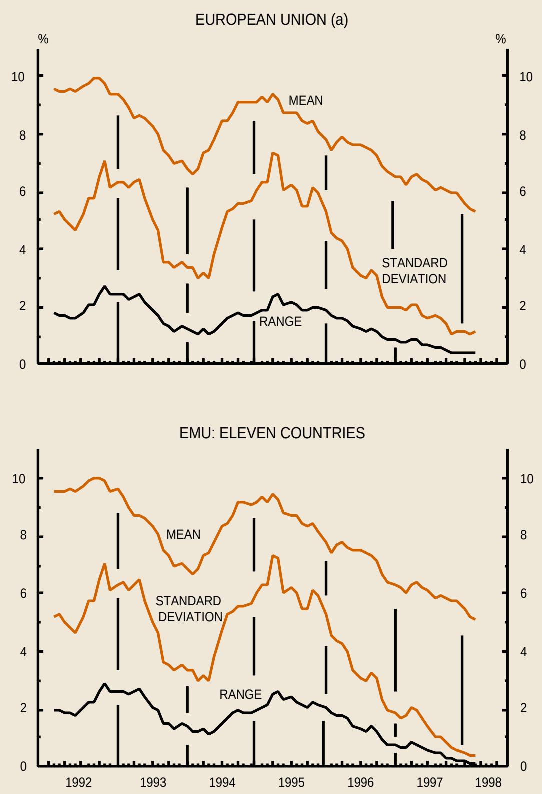
The underlying determinants of this notable approximation of long-term yields to lower levels are the convergence process itself and expectations of sound future fundamentals, which have an obvious influence on expected rates.

As a result of these developments, all EU countries except Greece were positioned comfortably below the reference value (7.8 %) in the relevant period, between February 1997 and January 1998. Spain has achieved an interest rate of 6.3 % in this period, 1.5 points below the critical threshold.

In sum, the headway towards convergence by EU members has enabled most appropriate conditions to be set in place for the start of EMU, especially as far as the inflation, interest rate and exchange rate criteria are concerned. Progress in the fiscal area has been more recent, and the

CHART 5

Long-term interest rate convergence in the European Union

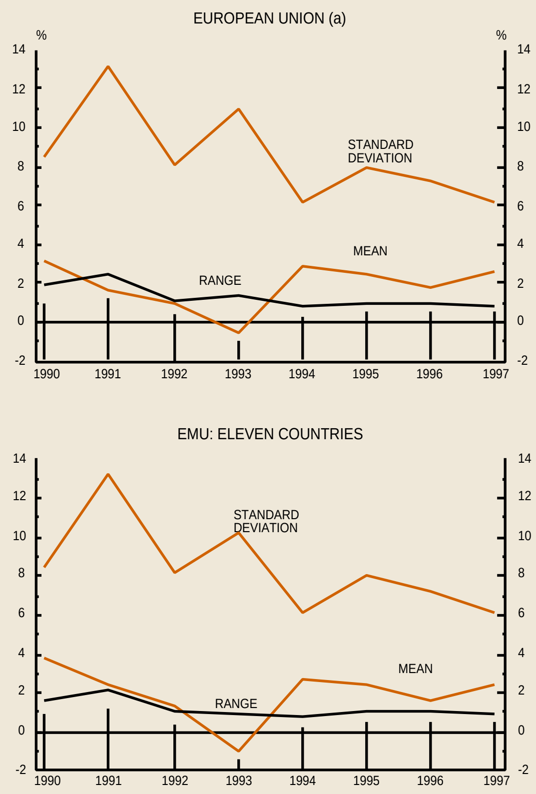


Source: Banco de España.

(a) Excluding Greece, due to lack of data.

CHART 6

Real GDP



Source: Banco de España.

(a) Excluding Greece, due to lack of data.

need for perseverance is greater. That said, the SGP and the Member States' Convergence Programmes should ensure that the fiscal consolidation drive is sustained in the future. Experience in recent years shows that convergence is a process in which good results attained in certain variables induce improvements in others, giving rise to most beneficial feedback effects. Thus, the achievements in price stability and in fiscal consolidation reduce long-term interest rates and contribute to the stability of exchange rates which, in turn, helps improve fiscal results and inflation expectations. This mutually reinforcing chain of beneficial effects in recent years is likely to be strengthened by the creation of a framework of stability in EMU. It is particularly satisfactory to note that while the aforementioned convergence process was unfolding, the EU countries have also tended to follow a more synchronised cyclical pattern, against a background of more vigorous growth (see Chart 6). Convergence achievements in a climate of relative cyclical synchrony will ease the establishment of a common monetary policy.

The high degree of convergence attained augurs a start to EMU on sound foundations. But it should be borne in mind that the success of this ambitious project requires the pursuit of suitable policies by all the countries involved. Budgetary policies should continue to be geared to the restored health and consolidation of public finances. And, as regards structural policies, further action must be taken to achieve efficiency in the markets for goods and services and labour and in the workings of the public sector, as well as in relation to the competitiveness of firms. A rigorous monetary policy, decided within the European System of Central Banks; decentralised fiscal policies, which should be fitted to the needs of each country but subject to the medium-term discipline stemming from the SGP; and, finally, structural policies aimed at ensuring the flexibility of the economies in the euro area, all create an institutional framework conducive to attaining the end-goals of stability, efficiency and welfare that are at the heart of the idea of EMU.

2. CONVERGENCE OF THE SPANISH ECONOMY

2.1. The inflation criterion

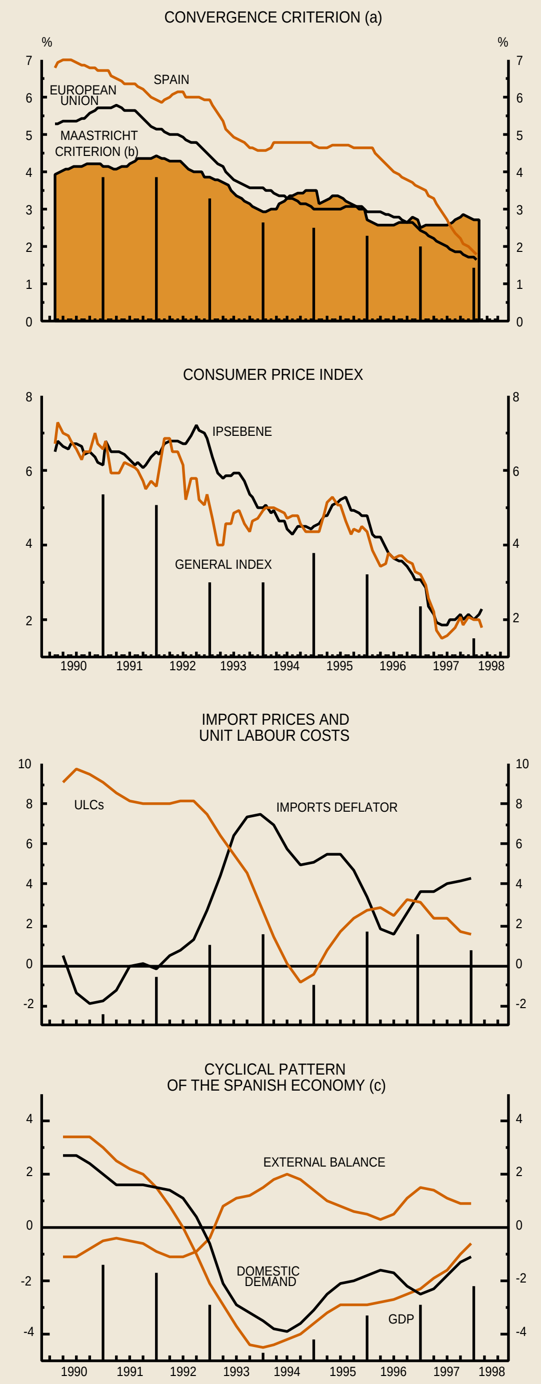
Spain satisfied the inflation convergence criterion laid down in the Maastricht Treaty in July 1997. As of that date, the twelve-month moving average rate of change of the harmonised consumer price index was 2.6 %, one and a half percentage points (the maximum divergence permitted) above the average rate of the three least inflationary EU countries at that time (1.1 %). Since then, the margin of compliance with the criterion has become progressively broader, and in January this year the Spanish inflation rate had fallen to 1.8 %, only six-tenths of a point above the average of the three best performing countries (see Chart 7). This marked the culmination of a long process, not free from difficulties, which has placed the Spanish economy at inflation levels comparable to those of the core EU economies. Such an ambitious goal had appeared difficult to achieve.

At the onset of the nineties, inflationary expectations remained considerably entrenched in the Spanish economy. The inflation rate, measured by the CPI, stood at around 6 %, competitiveness was seriously impaired and the growth of unit labour costs had stabilised at a rate of over 8 %. The imbalances that had built up in the previous upturn prompted, along with the ERM crisis, a serious adjustment in the households and firms sector, whose net worth position had worsened considerably. Notwithstanding, the growth of the CPI did not dip below 4.5 %, a rate considered far removed from the established yardstick, and unit labour costs decelerated rapidly, albeit due only to the increase in apparent productivity caused by the heavy fall in employment.

Against this background it was necessary, in order to place the Spanish economy on the desired path of stability, for both macroeconomic and microeconomic policies to be geared unequivocally to this end. This meant, first, making resolute headway in curbing public spending, the rate of growth and composition of which were markedly inflationary; next, substantially improving the workings of the various markets, giving priority to those for services and productive factors, with special attention in this latter case to the labour market; and finally, setting in place a new monetary policy regime which, based on the independence of the Banco de España and direct inflation targeting, would endow this branch of economic policy with sufficient credibility to check inflationary expectations, restore equilibrium in the foreign ex-

CHART 7

Inflation convergence



Sources: Banco de España, Instituto Nacional de Estadística and OECD.

(a) Twelve-month moving average rate of change of the consumer price index. From December 1995 to November 1996, interim consumer price indices. Since December 1996, harmonised consumer price indices.
(b) Area of compliance with the Maastricht criterion. Limit: average of the three least inflationary countries +1.5%.
(c) Cyclical deviation from trend.

change markets and infuse economic agents' behaviour with the idea that stability was a priority objective and a worthwhile asset.

The progress since made has been considerable. The fiscal convergence drive, analysed below, has acted as a moderating influence on the growth of aggregate spending. Further, various structural reforms have been undertaken. Specifically, in the labour market, the reform of the unemployment benefit system, to do away with some of the aspects deterring job search, was supplemented by greater measures of flexibility. These involved the possibility of new forms of employment contract and the reduction of dismissal costs, with advances also being made in occupational mobility. Nominal wages embarked on a declining path, albeit trailing the ongoing slowdown in the rate of increase of prices, and the growth of unit labour costs tended to stabilise at around 2 %, despite the scant rise in apparent productivity as a result of the pick-up in employment.

The firmness with which the new monetary policy framework was implemented from the outset was rapidly assumed by economic agents, with the prices of financial assets at their different maturities incorporating increasingly more moderate expectations of price increases, at the same time as the exchange rate was stabilising. From January to June 1995, the Banco de España ten-day intervention rate increased by approximately two percentage points from 7.35 % to 9.25 %. As from December that year it began a gradual decline as the domestic and external macroeconomic environment and the economy's liquidity made it advisable and the inflation rate (measured by the twelve-month growth of the CPI) was seen to adjust to its programmed path. The Banco de España laid down successive references for the rise in the CPI to act as a guideline for monetary policy implementation. All were comfortably met, to the extent that, at present, the inflation rate evidences levels of stability on an equal footing with those prevailing in the EU area. As stated, the inflation convergence criterion has been fully satisfied, and sufficiently ahead of schedule.

At present the outlook for short-term price developments is favourable and it is expected that the target set for the current year, which consists of holding the growth rate of the CPI close to the level of 2 % attained, will be met. This is corroborated by the indicators available and the likely behaviour of the main determinants: the external sector is favourable to price stability, the Spanish economy's real GDP growth rate – though running high – is not exceeding its potential and unit labour costs continue to slow. The Spanish economy may thus be confirmed to have attained a high and sustainable degree of inflation convergence, along the lines required by the Treaty. Yet it should not be forgotten that, in order to entrench the measure of stability achieved, economic policy should be firmly committed to controlling inflation. And this all the more so in the new context of EMU, in which the primary aim of the common monetary policy will be to preserve macroeconomic stability throughout the area. In this respect, particular attention should be paid to the continuing differential between the growth rate of services prices in Spain and in most EU countries. This is illustrative of the insufficient competition still characterising certain markets, which hampers greater convergence between the Spanish inflation rate and that of the core EU members. Structural reforms must thus continue to be resolutely pursued, to provide the Spanish economy with levels of efficiency and competitiveness comparable with those of our EU neighbours so that the inflationary patterns previously prevailing in the Spanish economy may be definitively eradicated.

2.2. The public finances criterion

In 1997 the general government deficit stood at 2.6 % of GDP. This figure was some way below the 3 % threshold and also marked an improvement on the target set in the April 1997 Convergence Plan. The fall in the budget deficit has also prompted a reduction in the public debt/GDP ratio. It stood at 68.8 % in 1997, above the 60 % threshold, but was on a declining trend as required by the Treaty for compliance with this convergence criterion in cases where the critical value is exceeded (see Chart 8).

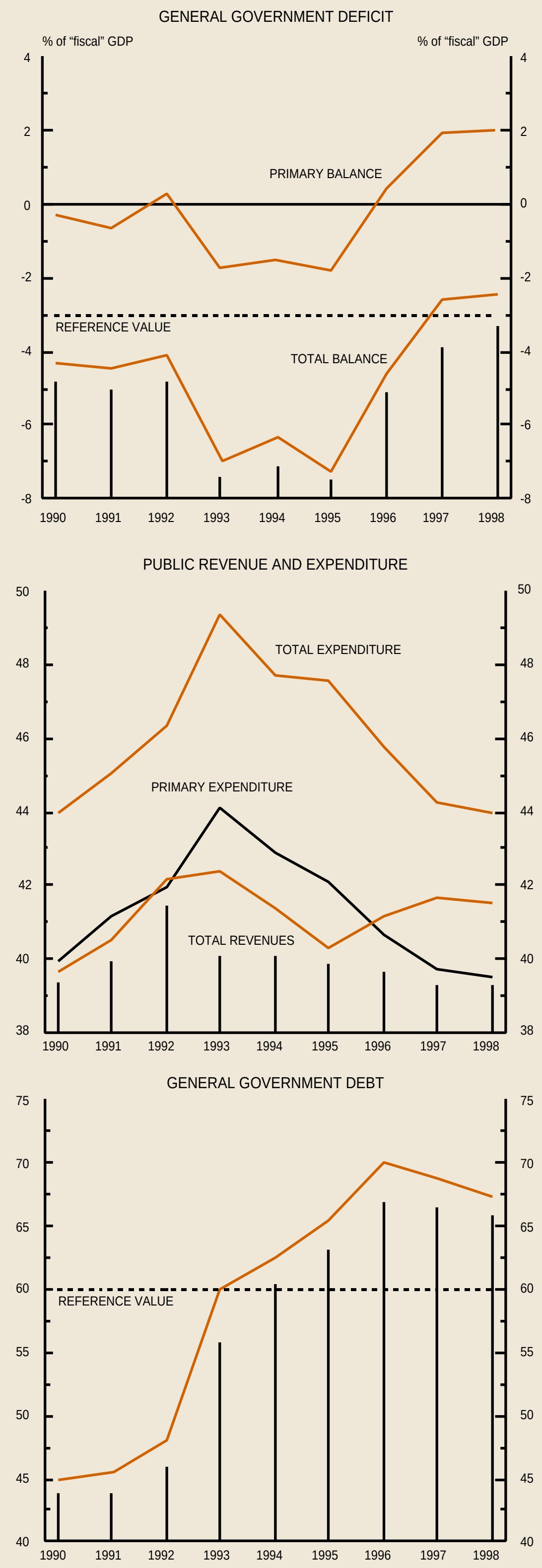
When the Maastricht Treaty was signed, the deficit criteria was seen as one of the most demanding in terms of the adjustment the Spanish economy would have to make. Throughout the eighties there had been rapid growth in public spending which could not be sufficiently covered by revenue, despite the successive tax reforms that progressively increased the tax burden. This imbalance in public finances was masked in part by the sharp cyclical improvement in the deficit in the second half of the decade and in the early nineties; but it revealed itself in full force when the Spanish economy went into recession in mid-1992. There was thus a pressing need then to alter substantially the nature of fiscal policy. The signing and ratification of the Treaty on European Union increased the urgency of such a change in fiscal policy stance since it made it necessary to make the adjustment in a period of time limited by the date of the convergence examination.

The process of fiscal consolidation was obstructed by the scale of the 1993 recession and by the sluggishness of the subsequent recovery, which did not gather notable steam until 1997. Nonetheless, the efforts to contain spending and enforce budgetary discipline in recent years have succeeded in substantially redressing the state of public finances. The importance of the adjustment made can be measured by the significant cut in public spending as a proportion of GDP since 1993 (see Chart 8). This result has extended, to a greater or lesser extent, to the main spending headings. But particular mention should be made of the measures aimed at reducing the advance of general government final demand (through the control of personnel expenses, goods and services acquisitions and investment), and those geared to moderating the growth of transfers to other sectors (particularly unemployment benefits). In addition, steps have been taken to control spending on pensions. Interest payments have behaved more steadily (their considerable fall in 1997 aside), and the reduction in spending has been centred mainly on the primary component, giving rise to a primary surplus as from 1996. The share of public revenue in GDP has, for its part, held stable, albeit with significant fluctuations in some years.

Turning to the debt/GDP ratio, the increases seen between 1993 and 1996 mark the end of a lengthy growth process dating back to the eighties. The process was the reflection of the deficits built up at that time and of a gradual shift towards debt financing by market procedures, against a background of high interest rates. In recent years, the re-gearing of fiscal policy towards budgetary consolidation (to ensure the sustainability of public finances in the medium and long term) and the culmination of the reform of deficit financing (with the express prohibition of financial support by the Banco de España to the public sector, as from 1994) have substantially modified the set of factors that determine how the debt ratio changes. The drive to contain spending has already translated into a primary surplus of 1.9 % of GDP in 1997. And this, along with the notable cut in interest payments derived from the decline in rates to which the fiscal process itself contributed, has allowed for the rising trend of the debt ratio to be curtailed and for a decrease therein to begin, on sound foundations. In this respect, the design of fiscal policy for the coming years and the stepping up of recovery in the economy provide an appropriate context in which the trends observed in 1997 may take root. That would give rise to bigger primary surpluses and would,

CHART 8

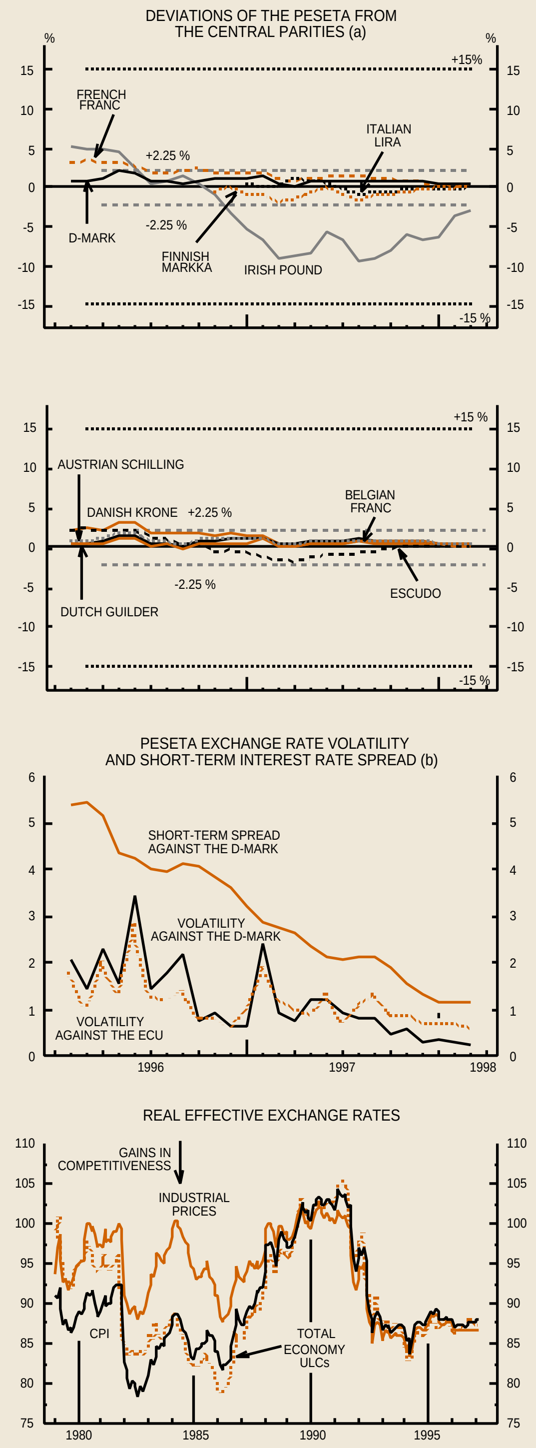
Public-finance convergence



Sources: Intervención General de la Administración del Estado and Banco de España.

CHART 9

Exchange rate stability convergence



Source: Banco de España.

(a) Appreciation (+) or depreciation (–) with respect to the bilateral central parities against the currencies shown.

(b) Standard deviation, multiplied by a thousand, of the first difference of the Napierian logarithm of the peseta exchange rates against the D-Mark and the ecu. The interest-rate spread is for three-month interbank rates.

along with the low interest rates prevailing, provide for a rapid decline in the debt ratio, which might fall below the 60 % threshold within a reasonable time frame.

In sum, the current upturn the Spanish economy is experiencing is a favourable setting for the continuing consolidation of public finances. If budgetary austerity and discipline are maintained, rapid improvements in the deficit and debt ratios may be achieved in the coming years. Such improvements are vital since, once in EMU, the participating countries' public finances will be obliged to comply with the SGP. That involves not only maintaining the standards defined under the Maastricht Treaty on fiscal convergence criteria, but also the rapid move towards budgetary balance.

2.3. The exchange rate stability criterion

The peseta has been participating in the ERM since June 19th 1989. It therefore comfortably meets the convergence criterion requirement of having belonged to the ERM during the reference period, namely the two years from March 1996 to February 1998. Moreover, the central parity of the peseta has not been devalued against any of the other ERM currencies over this period.

During the two years in question, the peseta traded at close to its central bilateral rates against the rest of the ERM currencies. This disregards its position vis-à-vis the Irish pound which, for much of the reference period, followed an autonomous tendency to appreciate. Since October 1996, the peseta has generally moved in a range of ±2.25 % in relation to its central parity, without significant tensions. The maximum deviation, calculated on a monthly average basis, was an appreciation of 3.4 % against the French franc in February 1996, which was subsequently corrected (see Chart 9). In February 1998, the peseta was fluctuating at maximum distances of between –0.2 % and 0.4 % from the central parities with the rest of the ERM currencies, excepting the Irish pound.

The volatility of the peseta exchange rate, measured against both the D-Mark and the ecu, progressively decreased to the point of recently reaching historical lows. Moreover, the short-term interest rate spread with the core ERM currencies has likewise narrowed sustainedly. Specifically, the three-month interest rate differential between Spain and Germany fell from 5.1 percentage points in March 1995 to 1.1 points in February this year (see Chart 9).

From a longer-term perspective, the peseta has been highly stable since mid-1995. Its exchange rate has held at around its equilibrium level, according to the customary competitiveness indicators, based on various calculations of the real effective exchange rate (see Chart 9). Indeed, throughout the reference period (from March 1997 to February 1998) the competitiveness levels of the peseta have remained virtually unchanged in general terms. And, at the same time, there has been a substantial improvement in current-account balances, which have been positive as from 1995, since when the net external debit position has also declined.

Among the factors behind the high stability of the peseta are the intensification of the nominal convergence process, successfully completed in 1997, the appropriate economic (fiscal/monetary) policy mix and, consequently, the sizable and growing confidence about accession to EMU in January 1999.

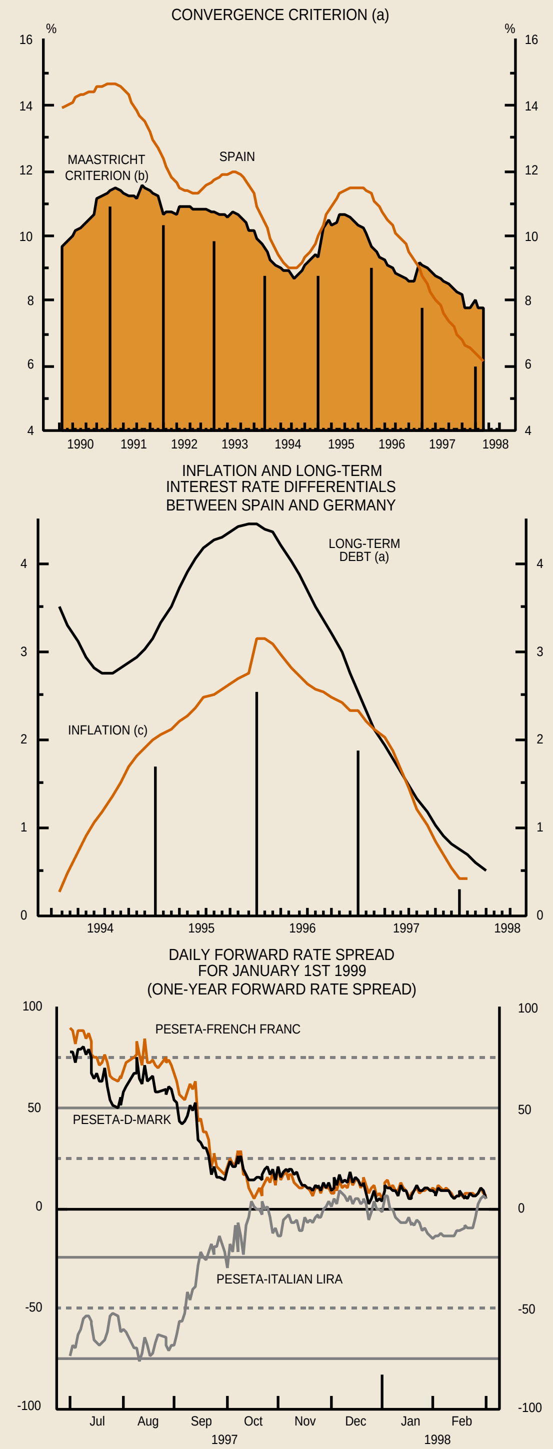
In short, the recent course of the exchange rate of the peseta has been characterised by the complete absence of pressures. This has been reflected in the reduction of volatility to historically low levels; in the sustained narrowing of short-term interest rate spreads with the traditionally more stable currencies; and in the outlook for the financial markets which, in mid-March, are discounting the elimination of the short- and long-term spread vis-à-vis the D-Mark by January 1999. This absence of pressures likewise derives from the consideration of the current levels of the exchange rate as close, in effective terms, to equilibrium, bearing in mind the competitiveness of the Spanish economy.

2.4. The interest rate criterion

For most of the nineties there has been a progressive approximation by Spanish long rates to those in EU countries with lower bond yields. Notwithstanding, the ERM crisis, for one thing, and the spread of the US bond market crisis to Europe, for another, affected Spanish financial markets particularly adversely. This took place against an insufficient correction of Spanish macroeconomic disequilibria, prompting a significant – but temporary – widening of the distance of long rates from the convergence threshold. Subsequently, the gradual improvement in domestic conditions (exchange rate stability and the reduction of inflation and the budget deficit), and the resumption of relative normality on international financial markets, enabled the long-term interest rate convergence gap to close gradually as from mid-1995 until it disappeared at end-1996 (see Chart 10). On

CHART 10

Long-term interest rate convergence



Source: Banco de España.

(a) Twelve-month moving average of long-term interest rates.
(b) Average of the three least inflationary economies plus two percentage points. In January 1998, Austria, France and Ireland.
(c) Until 1996, average twelve-month CPI rates; since 1996, harmonised CPIs.

the data available at the time of this report going to press (i.e. January data, the latest figure for the harmonised CPI), long-term interest rates were 1.5 percentage points below the Maastricht criterion.

The strong reduction in long-term interest rates should be seen against the background of the most significant corrections to inflation and the improved outlook for the future behaviour of prices (see Chart 10). Both developments have come about as a consequence, first, of the implementation of a clearly counter-inflationary monetary policy during the episodes in which the risks of overshooting price forecasts were greatest; and further, of the budgetary consolidation drive made since 1995. Moreover, the formalisation of fiscal discipline undertakings by the EU countries further to the signing of the SGP in December 1996 has strengthened the idea of a euro area firmly committed to an ongoing correction of fiscal disequilibria. That has meant a reduction in the risk premium built into the long-term interest rates of all EU countries, and especially in those, such as Spain, in which initial interest rates had been higher.

As of the closing date of this report, the market expectations incorporated into forward rates indicate that Spain will continue to meet this convergence criterion in the coming months. According to these expectations, long-term rates (the average over the past twelve months) will continue to fall to close to two percentage points below the convergence threshold in April 1998, the reference date for the purposes of the EMU entry examination. In turn, as the expected short-term interest rate spreads with the EU countries show (they will be close to zero at the start of 1999), there appear to be no doubts at present about the starting date of the third stage of EMU and Spain's participation therein (see bottom part of Chart 10).

2.5. Assessment

The Spanish economy has satisfactorily met the criteria laid down by the Maastricht Treaty in 1993 as a prerequisite for forming part of the group of countries that will set in train the third and final phase of EMU on January 1st 1999. The effort expended in recent years has been considerable. And it demonstrates well how the effects of economic policies are reinforced when they are geared unequivocally towards the same goal of convergence with the macroeconomic stability proper to an efficient, competitive area, and when they are underpinned by sufficiently broad social consensus about the aims to be achieved.

As seen in the foregoing sections, Spain's starting position entailed certain elements of uncertainty that might have hampered achievement of the goals pursued. In 1993, the Spanish economy was engrossed in a far-reaching adjustment, as a result of the disequilibria that had built up in the previous upswing and the deep-seated ERM crisis. Instability was the keynote on the foreign exchange markets, the inflation rate was high and the budget deficit was widening as the rate of output fell.

In these circumstances, the economic policy response was aimed at attacking the causes that had generated these disequilibria and at seeking to lay the foundations for emerging from recession as soon as possible, so as to combat the high levels of unemployment prevailing. For this, confidence had to be restored in the disciplined orientation of macroeconomic policies and a favourable impression had to be made on the expectations of economic agents and the financial markets.

The foregoing has analysed the policies applied and the way in which the Spanish economy has gradually settled into a phase of economic expansion, while in turn managing to comply satisfactorily with the convergence requirements governing EMU membership. That culminates an historic trajectory the maximum ambition of which was to integrate the Spanish economy into the core of the founding members of EMU. Now that this long sought-after goal is to be achieved, it should not be forgotten that the greatest benefits from the new situation may only be gained by persevering with the policies that have made it possible, maintaining their stability-oriented stance and undertaking the reforms needed to ensure the continuity of these results. In this way the Spanish economy will be able to deploy its competitive potential in the new setting of a fully integrated market and the single EU currency.

3. CONVERGENCE IN THE EU

3.1. The inflation criterion

In January 1998 (the last month of reference for examining compliance with this criterion), all EU countries, except Greece, recorded an inflation rate – measured in accordance with the criteria explained in section 1 of this Report – substantially below the convergence threshold. France, Ireland and Austria were the three countries with the lowest inflation rates (1.2 % in the first two cases, and 1.1 % in the third); their average rate, plus 1.5 percentage points, gives a reference value of 2.7 %. The rest of the countries satisfied this criterion by a considerable margin, ranging from a minimum of 0.8 percentage points, in the case of Denmark (the country with the highest inflation rate, at 1.9 %), to a maximum of 1.4 percentage points, in the case of Finland (the country with the lowest inflation rate, at 1.3 %, excluding the three which determine the critical value). In Greece, despite the sharp slowdown in the rate of price growth during the nineties, the average rate of inflation was 5.2 % in January 1998, 2.5 percentage points above the convergence threshold.

These results reflect the marked price convergence achieved by the EU countries in recent years. As seen in Chart 11, in 1993 only seven of the fifteen EU countries would have complied with this criterion, the convergence threshold then being 2.9 %. In subsequent years, the progressive slowdown in the rate of growth of prices in all countries of the area, especially in those starting from higher levels, enabled inflation differentials to narrow. From the viewpoint of fulfilment of the criterion this convergence resulted in a gradual increase in the number of countries with inflation rates below the threshold: ten in 1995, eleven in 1996 and fourteen since July 1997.

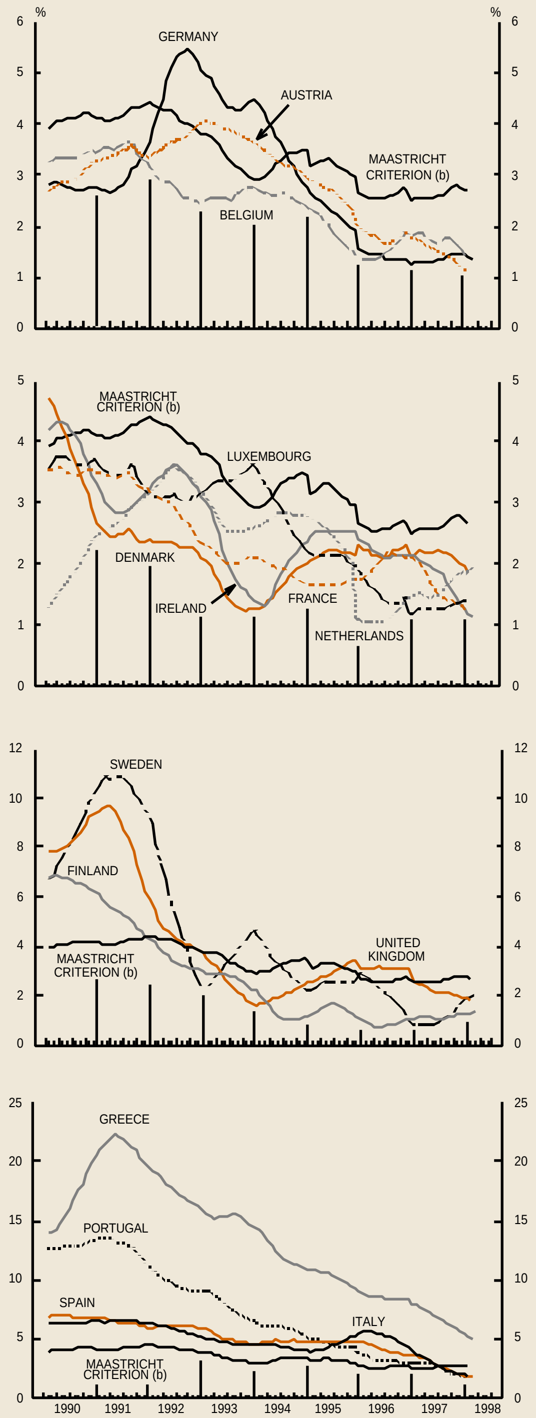
The drive to moderate prices in countries with less tradition of stability has been very notable. Portugal's inflation rate fell from over 10 % in 1991 and 1992 to a low of 1.7 % in July 1997, since when it has edged up slightly. In Italy, the twelve-month increase in the CPI fell from 7 % in the second half of 1990, to 1.6 % in January 1998. And the notable decline in inflation in Spain has already been commented on in the previous section.

The favourable behaviour of consumer prices in the fourteen countries fulfilling the criterion has also been observed in other price indicators, such as the GDP and private consumption deflators. By way of illustration, the range of variation in the annual increases in these two deflators in the fourteen countries was 12.5 and 9 percentage points, respectively, in 1992; in 1997, the ranges had narrowed to 2.3 percentage points for the GDP deflator and 1.4 percentage points in the case of the private consumption deflator. In that latter year, Portugal (2.9 %) and Spain (2.5 %) recorded the highest growth in GDP and private consumption deflators, respectively, while the lowest growth in these indices was in Germany (0.6 %) and in France (1.1 %).

A wide range of factors has made it possible for the current situation of these fourteen countries to be generally considered compatible with price stability. Among them, a fundamental role has been played by certain economic policy de-

CHART 11

Inflation in the EU (a)



Source: Banco de España.

(a) Twelve-month moving average rate of change of the consumer price index. From December 1995 to November 1996, interim consumer price indices. Since December 1996, harmonised consumer price indices.

(b) Average of the three least inflationary economies plus 1.5 %. In January 1998, Austria, France and Ireland.

cisions: the gearing of monetary policy to the achievement of price stability; fiscal consolidation; and reforms in labour, goods and services markets.

In the mid-nineties, the economic cycle also contributed, to some extent, to the containment of upward pressures on prices. The 1993 recession gave rise, in most countries, to a negative output gap, which generally has not completely closed yet, despite the significant recovery in economic activity in recent years. The United Kingdom is an exception: its more advanced cyclical position has been accompanied by a certain upturn in inflation, which has led the Bank of England to increase its reference interest rates since the final quarter of 1996. Nonetheless, the latest data show a further moderation in the rate of price growth in the UK.

Wages and unit labour costs (ULCs) have also had a moderating impact on prices. The most marked slowdowns in ULCs have been in Spain, Portugal and Italy. In 1997, ULC increases in the fourteen countries were about 3 % or less. The moderation in inflation forecasts has also been seen in industrial and import prices, although the volatility of the latter has been more marked, basically as a consequence of the swings in the dollar. In this respect, the marked decline in the prices of energy and non-energy commodities since mid-1997 is helping to sustain a low-inflation environment, not only in EU countries, but also in the industrialised countries as a whole, and it is expected to continue to do so throughout 1998.

As regards the latest inflation developments, there are some countries (principally Ireland, Finland and Portugal) which have recorded slight upturns in recent months in their twelve-month consumer-price growth rates, although these remain close to 2 %. Yet the medium-term prospects for maintaining price stability are very favourable, despite the firming of the expansionary phase of the cycle expected in most EU countries.

3.2. The public finances criterion

According to the latest deficit and public debt data released by the European Commission, fourteen countries recorded a public deficit of 3 % of GDP or less in 1997 and would therefore have fulfilled the deficit criterion. Greece is the sole exception, with a general government net borrowing requirement that year of 4 % of GDP. As to debt, four countries – France, Luxembourg, Finland and the United Kingdom – ended 1997 with debt ratios below 60 % of GDP, while the rest of the countries had public debt above this level. This means, as commented in section 1, that examination of compliance with the debt criterion by these countries requires analysis of all the considerations defined in the Treaty to be applied when the debt exceeds the 60 % threshold. In any case, as the Treaty establishes, compliance with the fiscal criteria depends on whether there are excessive deficits, according to Article 104c. A general summary is given below of the situation of the EU countries in relation to the fiscal criteria.

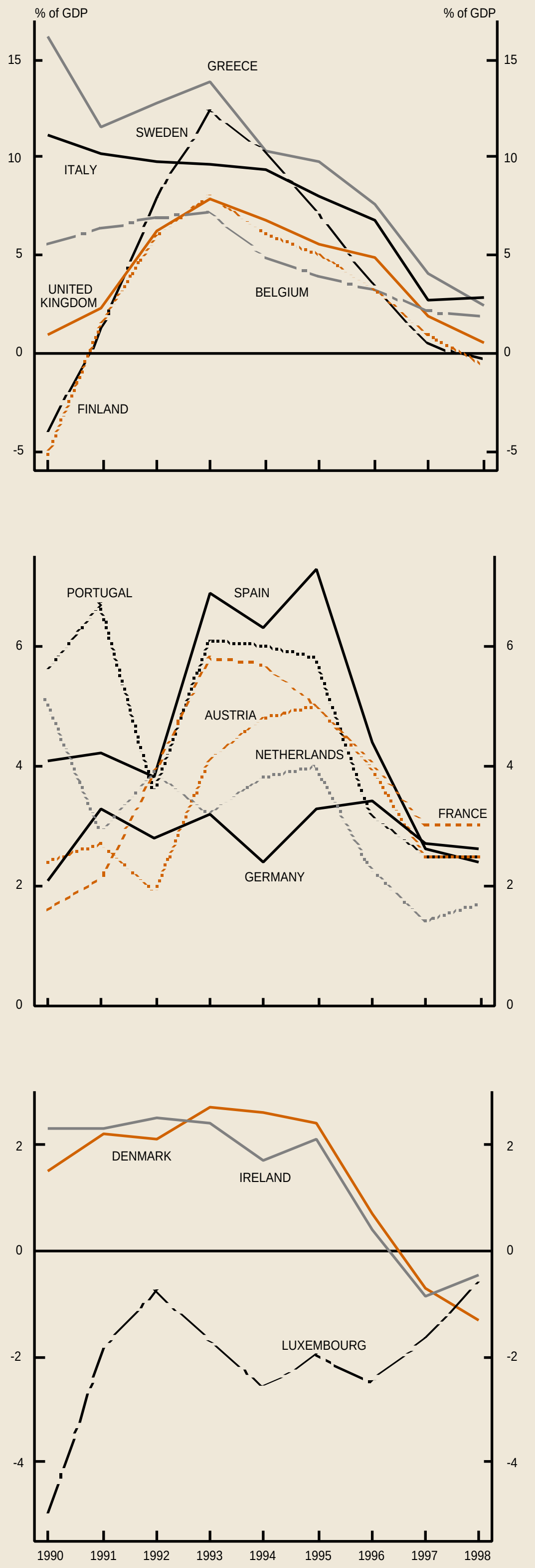
Among the countries which complied in 1997 with the deficit criterion, Luxembourg, Ireland and Denmark achieved surpluses of some significance, while the other eleven countries posted deficits ranging from 0.8 % of GDP in the case of Sweden to 3 % of GDP in that of France. Specifically, Finland's net borrowing requirement was 0.9 % of GDP, the Dutch and UK deficits were below 2 % of GDP (1.4 % and 1.9 %, respectively) and the other countries posted deficits of between 2 % and 3 % of GDP.

Comparing these results with previous years gives an idea of the progress in fiscal consolidation. As seen in Chart 12, the reduction in the public deficits of the EU countries during the nineties has been notable. In 1993, the year in which most countries experienced a sharp fiscal deterioration (largely of cyclical origin), Italy, Belgium, Greece, Finland, Sweden and the United Kingdom had net borrowing requirements of more than 7 % of GDP; in the cases of Spain, France and Portugal, the deficit stood at between 5 % and 7 %; in Austria, the Netherlands and Germany it stood at between 3 % and 5 %; two countries, Ireland and Denmark, had deficits below 3 % of GDP, and only the public finances of Luxembourg were in surplus.

Thereafter, fiscal consolidation drives were stepped up in most countries, in conformity with the targets regularly presented in their Convergence Programmes. In 1994, when the Excessive Deficit Procedure (EDP) was put into operation for the first time, the Council decided that there were excessive deficits in ten of the then twelve EU countries: the exceptions were Luxembourg and Ireland. The following year, Germany joined the group of countries complying with the fiscal convergence requirements, while the three countries which joined the EU in January 1995 – Austria, Finland and Sweden – swelled the ranks of the non-compliers, making a total of twelve. In 1996, the number of countries with excessive deficits (twelve) remained the same, Denmark leaving the group and Germany rejoining it. In the Council's 1997 decision, the Netherlands and Finland joined Luxembourg, Ireland and Denmark as countries ex-

CHART 12

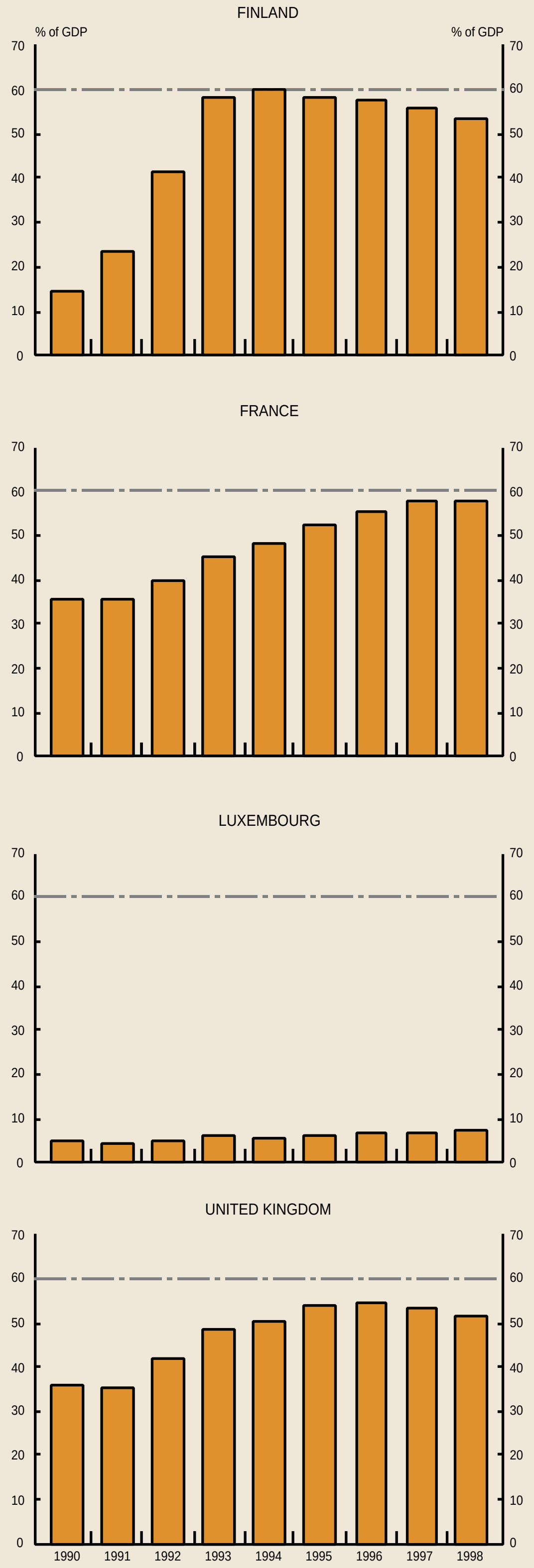
Public deficit (–) or surplus (+) in EU countries



Source: European Commission.

CHART 13

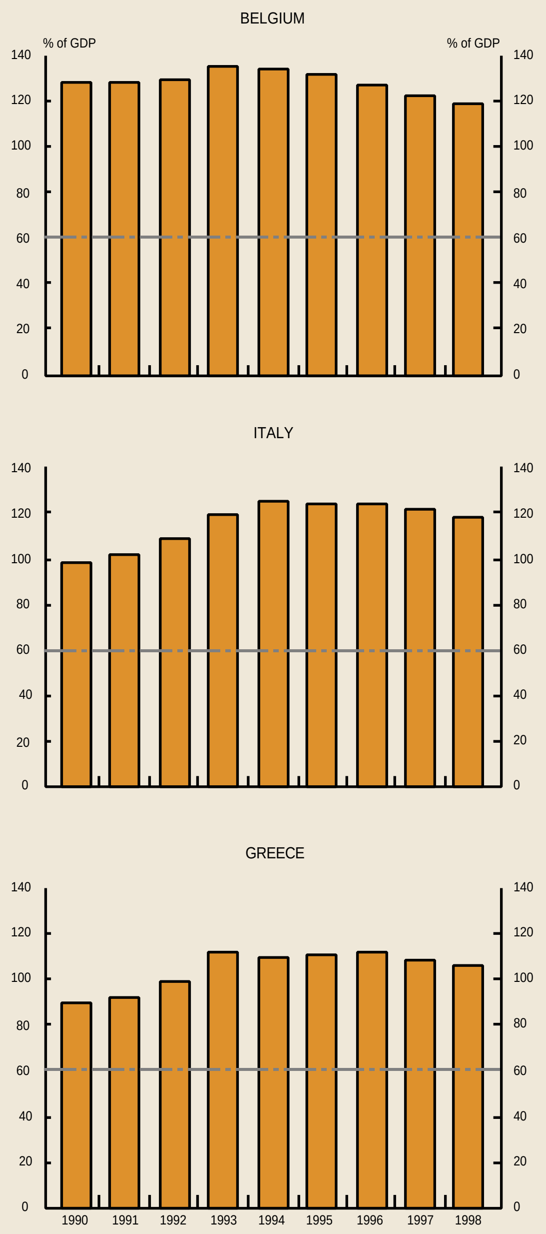
Public debt (a)



Source: European Commission.
(a) Countries with debt ratio below 60 % of GDP in 1997.

CHART 14

Public debt (a)



Source: European Commission.
(a) Countries with debt ratio above 100% of GDP in 1997.

empt from the EDP, while the other ten countries continued to be classified as having excessive deficits. Finally, as mentioned above, it is likely that at the next EDP the Council will accept the Commission's recommendation that all the EU countries be excluded from the Procedure, except for Greece.

Breaking down the deficits into their cyclical and structural components shows that in practically all the countries fiscal adjustment has been in the right direction, to the extent that it has mostly fallen on the structural component. Broadly, since 1990, the structural deficit has been significantly corrected and, in all countries, has tended towards balance.

As regards public revenue and expenditure, it can be seen that, in the last few years, most countries have tended to stabilise their public revenue in relation to GDP. On the expenditure side, there has been a decline practically across the board. The portion of expenditure used to cover debt servicing has been significantly reduced in most countries, especially in the last two years, as a consequence of the general decline in interest rates.

Lastly, in 1997, in all countries except for Belgium, Germany, Greece, France, Italy and the United Kingdom, the deficit was less than public investment (the so-called "golden rule"). This result is a further indication of the fiscal adjustment made, and represents progress on the situation in 1996, when this condition was only met by Denmark, the Netherlands, Ireland, Luxembourg and Portugal. The outlook for 1998 indicates that the number of countries complying with the "golden rule" will increase.

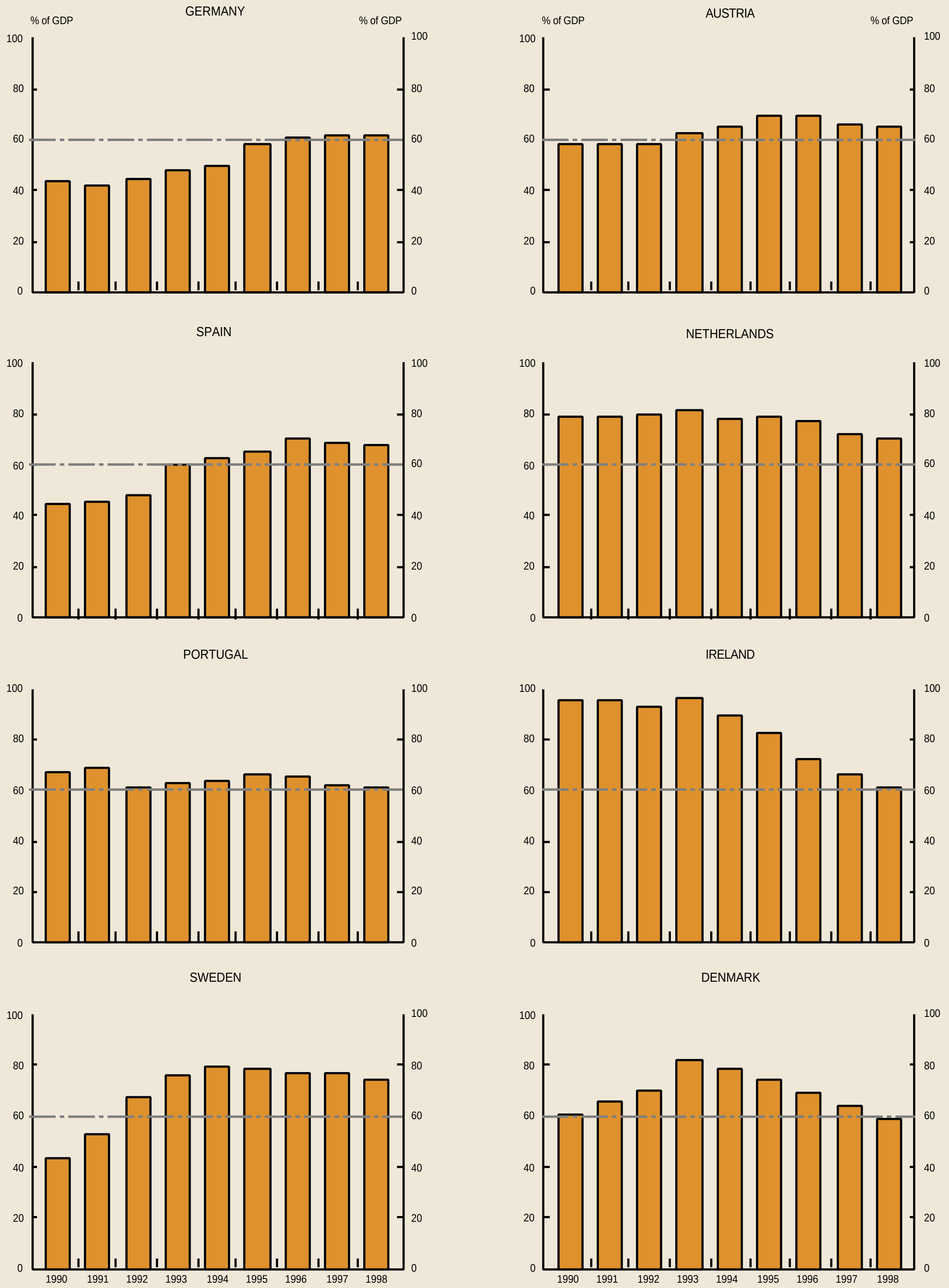
As for the debt criterion, as mentioned above, only four countries would have ended 1997 with a ratio below 60 % of GDP. In Belgium, Italy and Greece it is still more than 100 % of GDP (122.2 %, 121.6 % and 108.7 %, respectively), while for the rest it is within a range defined by that of Germany (61.3 % of GDP) and Sweden (76.6 % of GDP).

In general, the developments described in relation to deficits are repeated when the pattern followed by the debt ratios in most countries is analysed. Thus, the deterioration of fiscal balances in 1993 also involved a practically EU-wide upturn of public debt that same year and, in some cases, in subsequent years too. The strengthening of the fiscal adjustment programmes since then has led to a reduction in debt growth rates and, more recently, to a tendency for them to fall progressively.

France, Luxembourg, Finland and the United Kingdom, the four countries whose debt was below 60 % of GDP in 1997 did not exceed this threshold in any year of the period analysed (see Chart 13). At the other extreme are Belgium, Italy and Greece, whose public-debt ratios were already above 100 % of GDP in 1990. Nonetheless, as from 1994 the debt ratio stabilised and began to fall in these three countries, most markedly in the case of Belgium, which had the highest level of debt in 1993 at 135 % of GDP (see Chart 14).

CHART 15

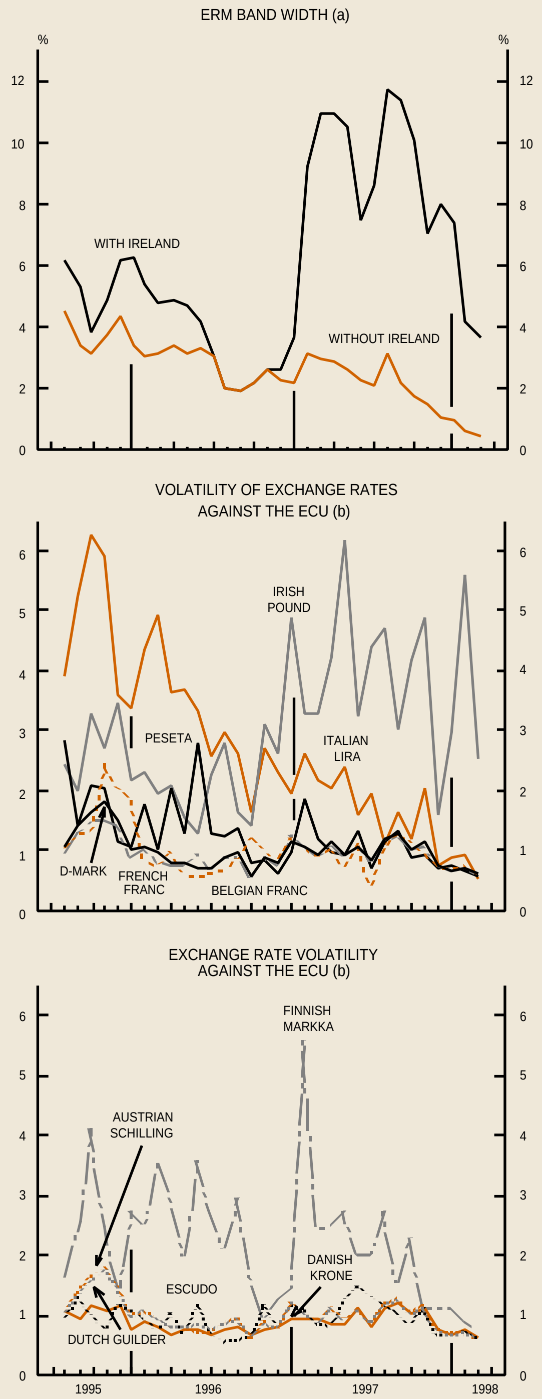
Public debt (a)



Source: European Commission.
(a) Countries with debt ratio between 60 % and 80 % of GDP in 1997.

CHART 16

Band width and volatility of the exchange rates in the ERM



Source: Banco de España.

(a) Maximum deviation from the ERM parity. Calculated as the deviation from the central parity against the D-Mark of the strongest currency, less the deviation of the weakest currency.

(b) Standard deviation, multiplied by a thousand, of the first difference of the Napierian logarithm of the exchange rates against the ecu.

The sharp correction of Ireland's and Denmark's high debt ratios is also notable. After amounting in 1993 to 96.3 % of GDP and 81.6 % of GDP, respectively, they stood close to the reference level in 1997 (66.3 % of GDP in Ireland and 65.1 % of GDP in Denmark). This pattern of reduction has led the Council to exclude these countries from the EDP, since 1994 in the case of Ireland, and since 1996 in that of Denmark.

Among the other countries, Germany and Portugal are closest to achieving a level of public debt of 60 % of GDP (see Chart 15). German debt has increased by 13 percentage points since 1993, primarily due to the impact of reunification. In the rest of the countries (the Netherlands, Austria and Sweden, as well as Spain) debt ratios have embarked on a downward trajectory in recent years. This may, within a relatively short-time frame, allow them to achieve levels of public debt of around 60 % of GDP, as long as they continue to pursue fiscal consolidation, in line with the obligation to make progress towards budget balance or surplus, pursuant to the terms of the Stability and Growth Pact (SGP).

These results show that, although the correction of the fiscal disequilibria has been significant and in the right direction, it is necessary to make further headway, especially to be in a position to comply with the medium-term SGP target, due to come into force in January 1999. On these premises, the right conditions will be created to ensure that the pattern of debt reduction continues in the coming years, although those countries which are still very far from 60 % will have to make additional efforts to approach this threshold as quickly as possible. The fiscal targets contained in the Convergence Programmes of all the EU countries point in that direction. Indeed, all of them envisage further progress in fiscal consolidation for 1998.

3.3. The exchange rate stability criterion

As established in the Treaty, the reference period for evaluating the exchange rate stability criterion shall be the two years preceding the examination, i.e. March 1996 to February 1998. The Treaty requires, in the first place, membership of the ERM. All EU countries are members, except Greece (1), the United Kingdom and Sweden.

(1) Greece joined the ERM on March 14th 1998, outside the reference period.

The currencies belonging to the ERM have, during the reference period, been characterised by increasing stability. All of them have respected the current fluctuation margins of ±15 % with room to spare and there has been no devaluation of the central rate of any country's currency, at its own initiative. With the exception of the Irish pound, the other currencies have held at levels close to their respective bilateral central rates, generally not moving by more than ±2.25 % from them, except temporarily on specific occasions. Special mention should be made of the behaviour of the Irish pound. From late 1996, the Irish pound followed an autonomous path of appreciation which, in the central months of 1997, took it to almost 12 % above the weakest currency. In the first few months of 1998 this trend was reversed so that the Irish currency gradually approached its central rates, to stand at a distance of 2.5-3 % (2).

The Finnish markka and the Italian lira joined the ERM on October 14th and November 25th 1996, respectively. If the previous period is counted, from March 1996, their exchange rates against the ERM currencies have been at all times within what would subsequently be their fluctuation margins. Since their ERM entry both currencies have moved at levels close to their central parities, with a maximum deviation of 3 % in the case of the Finnish markka and of –2.8 % in that of the lira, excluding their positions vis-à-vis the Irish pound.

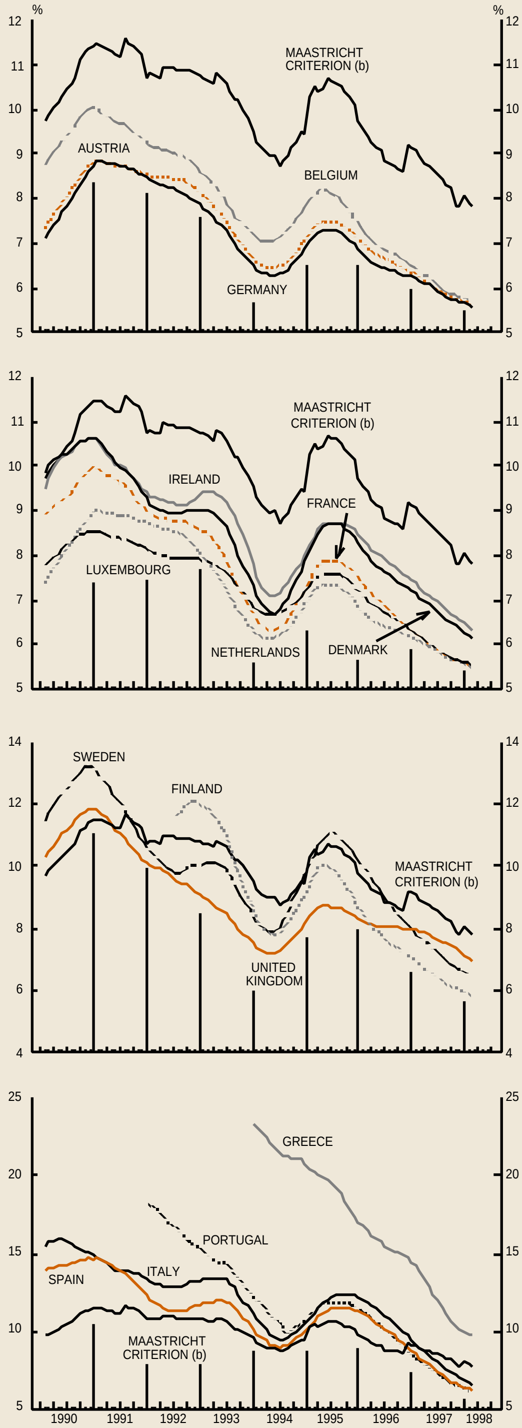
The growing stability within the ERM of all these currencies and their progressive convergence towards the central parities has been reflected in a notable narrowing of the width of the grid. If the Irish pound is excluded, at end-1995 the distance between the strongest and the weakest currency was around four percentage points, while in February 1998 this distance was one percentage point. In Chart 16 it can be seen how the position of the Irish pound increased the width of the grid to twelve percentage points in September 1997 and how, despite its subsequent correction, it was still around four percentage points in February 1998.

The stability of the ERM currencies has been accompanied by a notable decline in the volatility of their exchange rates vis-à-vis the

(2) The situation described for the Irish pound, as a currency persistently appreciated with respect to the other ERM currencies, led to the Irish authorities requesting a 3 % revaluation of its central rates with respect to the ERM currencies. The petition was accepted. It is worth pointing out that this change in parities does not breach the exchange-rate stability requirements laid down in the Treaty, since this was an "own-initiative revaluation" not a devaluation.

CHART 17

Long-term interest rates in EU countries (a)



Source: Banco de España.

(a) Twelve-month moving average of long-term interest rates.

(b) Average of the interest rates of the three least inflationary economies plus two percentage points. In January 1998, Austria, France and Ireland.

ecu. Except in the case of the Irish pound, such volatility has been at historically low levels. Likewise, there has been a high degree of convergence between the short-term interest rates of the ERM currencies; the three-month interest rate spreads over the currencies with the lowest interest rates have narrowed considerably, especially in the cases of Spain, Portugal and Italy, which started from higher levels.

Finally, it should be pointed out that the various indicators of competitiveness, calculated on the basis of real effective exchange rates using different relative prices, suggest that the EU currencies are reasonably close to the historic averages, which may be considered consistent with equilibrium levels. The current-account balances – generally in equilibrium or showing moderate surpluses – corroborate this conclusion.

3.4. The interest rate criterion

In the reference period, from February 1997 to January 1998, all the EU Member States, with the exception of Greece, recorded annual average (as specified by the Treaty) long-term interest rates below the convergence threshold (see Chart 17). This value was 7.8 % in January, the arithmetic mean, plus two percentage points, of the interest rates of Austria (5.6 %), France (5.5 %) and Ireland (6.2 %). In that month, leaving aside the case of Greece, the distance between the highest long-term yields (United Kingdom, 7 %) and the lowest (the Netherlands, 5.5 %) was less than two percentage points, so that all the countries were in a position to satisfy the criterion, irrespective of which three determine the reference level. Greece, the only non-complier, saw a major general decline in its long-term interest rates to mid-1997, after which there was a slight upturn. In January 1998, the annual average yield on Greek bonds stood at 9.8 %, i.e. 200 basis points above the reference value.

During the nineties, the long-term interest rates of the countries most closely associated with the D-Mark area (Germany, Austria, Belgium, the Netherlands and Luxembourg) and of France have displayed a high degree of synchrony, and have stood at very similar levels since mid-1996. Ten-year yields in this group of countries generally trended downwards, interrupted only by the international bond-market crisis in 1994. The long-term rates of the area have generally fallen sharply since November 1997, reaching historic lows in early 1998.

In Spain, Italy, Portugal and Finland, long-term rates, which remained relatively high during the first half of the decade, fell sharply from mid-1995, gradually approaching the yields of the traditionally most stable EU countries. In the four countries mentioned, long-term spreads over the D-Mark have recorded historic lows; 20 basis points in Spain's case in March this year.

In Ireland and Denmark long-term interest rates fell from 1995, albeit at a slower rate than in the countries mentioned above. The spreads over the D-Mark also narrowed in the period considered, although they are currently larger than those of Spanish, Portuguese, Italian and Finnish bonds. The United Kingdom, partly as a result of its different cyclical position with respect to the rest of the EU countries, also recorded smaller declines in its long-term yields, so that currently it has the highest rates in the area.

Among the factors which have driven the general descent of long-term interest rates in the EU as a whole would be the decline in inflation rates and the consolidation of public finances, as well as confidence that this consolidation will be sustained in stage three of EMU.

31.3.1998.