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## Appearance by the Governor of the Banco de España before the Spanish Parliamentary Committee on Economic, Trade and Finance Affairs

Mr Chairman, ladies and gentlemen:

I appear once more before this Economic, Trade and Finance Affairs Committee observing the four-monthly term established by you to monitor the monetary policy implemented by the Banco de España in accordance with the responsibilities and powers attributed to it under the 1994 Law on Autonomy. Under these arrangements, the first two appearances of the year analysed the degree of compliance, in the specific circumstances then prevailing, with the statutory mandate of pursuing price stability, for which the Banco de España had devised a direct inflation targeting strategy. These first two appearances were structured around the half-yearly inflation report that the Banco de España was obliged to publish to make the measures taken in relation to the ends pursued comprehensible and transparent. The last appearance at the end of the year was to take stock of monetary policy conduct and to announce the inflation targets proposed by the Bank for the new year from a medium-term perspective.

On this occasion, the start of Monetary Union in a little over two weeks substantially changes the nature of my appearance. January 1st will see the entry into force of the recently approved reform of the Banco de España Law on Autonomy, which adapts its legislative and statutory framework to the requirements arising from Spanish EMU membership and from the incorporation of the Banco de España into the European System of Central Banks (ESCB). It will then be for this system, steered by the Governing Council of the European Central Bank (ECB), to define the monetary policy strategy and objectives for the euro area as a whole. Further to this significant change, the Banco de España shall cease to announce monetary targets and, consequently, to publish its inflation reports which, as you know, were designed as an instrument to monitor such targets. The last such report was published in September. Nonetheless, the Banco de España will continue to participate actively in the performance of the functions of the ESCB, contributing to shape the opinion of its governing bodies and to decision-making, which shall perforce be centralised. Our central bank will be entrusted with implementing such decisions in national markets, in keeping with the strongly decentralised operational framework that has been adopted.

Under these terms, the Banco de España will be responsible for monitoring the Spanish economy within the framework of the single monetary policy set by the ECB and for its implementation in our money and financial markets. In this regard, the Banco de España will continue to publish, inter alia, the quarterly

short-term reports and the monthly notes on the Spanish economic and monetary situation. In my appearances before this Committee, I shall continue to monitor the Spanish economy and our financial system within Monetary Union in the manner and as regularly as you should require. I shall be pleased to attend to your requirements, logically observing the confidentiality to which I am bound as a member of the governing council of the ECB. In this way, and within the specific characteristics of the new framework, we may continue with a tradition which has proven most fruitful as regards understanding and effectiveness of the ends of monetary policy in Spain.

With this in mind, I shall focus today on Spanish monetary policy in 1998. The close of this year marks the discontinuation of a direct inflation targeting strategy and the end of a stage in which the convergence of interest rates with the level to prevail at the start of Monetary Union has been achieved. I shall also tackle certain matters relating to the monetary policy strategy defined by the ECB, the implementation framework that is to be followed and the preparations needed for the organisation of markets and payment systems.

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A year ago, I appeared before you to present the monetary policy objectives for 1998. These specifically involved maintaining the 12-month growth rate of prices, measured by the consumer price index, at close to 2 % over the year. Since then, inflation has declined by over half a point in relation to the level of 2 % as of December 1997, and the inflation targets set for the present year have been comfortably met. Indeed, last spring already we had met the requirements set in this connection for entry into Monetary Union, and our current inflation rate is in step with that of the euro-area members.

The recently released November figure has placed the 12-month growth rate of the CPI at 1.4 %, and the year-end figure may well be the same. Energy prices, which have fallen by close to 6 %, have contributed decisively to this favourable result. And food and non-energy industrial goods have also increased moderately, by around 0.5 % and 1.5 %, respectively. It is thus in services where the greatest price pressures are concentrated, as reflected by the fact that the latest-month rate of 3.6 % is well above the values prevailing in most euro-area countries. These levels testify to the lack of competition still characterising many branches in the services sector.

The sound overall performance of prices during the present year has been enhanced by the conditions prevailing abroad and at home. Abroad, the marked fall in commodity and oil prices and the absence of inflationary pressures in the main economies (particularly in Europe) have, against a background of dimmer prospects due to the disturbances and uncertainty caused by the Asian and Russian crises and their influence in other areas of the world, made import prices dip.

On the domestic front, a sustained pattern of balanced growth in 1998 has allowed a notable expansion in economic activity (GDP increased by around 3.8 % on average during the year) to co-exist with very low inflation rates. As the Spanish economy reached a more advanced position in the cycle, domestic demand progressively replaced the external sector as the driving force, with net external demand contributing slightly negatively to GDP growth. Thus, while the strength of domestic demand has been mainly driven by the momentum of investment and by the pick-up in private consumption, the external sector has flagged increasingly, owing both to the slower pace of exports, against the background of a deceleration in world demand, and to the greater impetus of imports, associated with the strength of national demand. Confidence indicators have confirmed favourable consumer expectations about the economy and only business confidence surveys show any uncertainty over the influence of the international crisis and its impact on foreign markets.

Attaining sound growth without inflationary pressures has proven possible thanks to sustaining an economic policy firmly geared towards stability and wage moderation. In this respect, progress in correcting budgetary imbalances has been noteworthy. The budget deficit has been lowered from 2.6 % of GDP at end-1997 to a forecast level of 1.9 % at end-1998, a substantial improvement on the initial target.

Given the favourable climate prevailing for price developments and inflation prospects throughout 1998, the Banco de España has continued progressively to lower its intervention rate, in line with the inflation target set. It has also sought to draw Spanish monetary conditions closer to those that might prevail at the onset of the euro.

In 1998, the Banco de España cut its intervention rate on five occasions. The last of these, at the start of December, was in concert with the other central banks of the countries that will initially make up the European mone-

tary area. Hence the intervention rate of the Banco de España and that of the rest of these central banks, with the temporary exception of the Bank of Italy, stands at 3 %. In our case, that amounts to a fall of 1.75 percentage points since the beginning of the year.

With this decision, the opening interest rate for Monetary Union that the ECB intends to maintain in the foreseeable future has, de facto, been set. Any continuing uncertainty over this process has thus been dispelled, smoothing the complex transition in store in the opening days of 1999.

Setting the euro-area interest-rate at 3 % responds, logically, to considerations relating to the new monetary area as a whole. In particular, it counters concerns that the climate of moderate recovery might be adversely affected by the factors of uncertainty prevailing in the international environment. Admittedly, such factors appear to have abated in recent weeks. But they continue to entail a risk that growth will weaken, given the slowdown in world growth, the persistence of serious economic problems in Russia and Japan and significant doubts concerning developments in most emerging economies and those in transition. Fortunately, the present situation across the euro area (price growth is running slightly below 1 %) and the favourable monetary and price outlook in the future Monetary Union meant that a preventive interest rate cut could be made, so clearing the horizon and alleviating the potential risks detected.

During the present year, expectations about interest-rate convergence have progressively limited the Banco de España's scope to influence the yield curve in financial markets in its shortest-dated segments.

In the prevailing climate of nominal stability and convergence, the easing of monetary conditions in 1998 has passed through, with more or less intensity, to the term structure of rates on different financial markets, placing such rates at historically low nominal and real levels. In turn, these financial conditions have helped improve both the general government and private-sector balance-sheet and financial positions, with the subsequent beneficial effects for public finances, economic activity and employment.

The reductions in interest rates on all markets and at all terms have drawn rates closer to those in other countries in the area and, in certain cases, this has meant lower interest rates for Spanish borrowers than for those in other European countries. The 10-year government

bond spread over Germany is currently very narrow and the convergence of interest rates has been accompanied by the high stability of the peseta in the ERM, where it has constantly traded very close to its central parity.

Turning to the monetary aggregates, ALP (liquid assets held by the public) has slowed during 1998, and currently stands at a growth rate of close to zero. This deceleration cannot be accounted for by the overall performance of nominal expenditure and of interest rates, since it is closely related to the ongoing shifts in the public's holdings towards shares in mutual funds. Hence, on considering the overall course of liquidity, bearing in mind the increase in shares in mutual funds, its year-on-year growth is higher (specifically, ALPF is growing at 6 %) and, consequently, more consistent with the trend of the basic determinants of the demand for liquidity. In contrast to ALP, the narrow monetary aggregates – such as M1, which only includes cash and sight deposits, and M2, which further includes savings deposits – have been on a more expansionary course (of around 10 %), which is logical given the intense growth of economic activity. The growth rate of credit extended to households and firms has accelerated in 1998 in step with the economy's expansion and the decline in the cost of financing. In October, it reached a year-on-year rate of almost 15 %, in contrast to the moderate growth of general government net borrowing, which was influenced by the headway made in fiscal consolidation.

The Spanish economy is moving into the euro area with the appropriate levels of stability and the prospect of maintaining high output and employment growth rates. That said, such rates may be tempered as the effects of the international crisis on the euro area and on economic agents' confidence become more tangible. Low interest rates and the rapid growth of lending to the private sector point to certain risks of lax initial monetary conditions. That obliges me to stress what I said on previous appearances about the role in these new circumstances of the economic policy components that remain under national sovereignty.

The loss of autonomy in the management of interest and exchange rates arising from Spanish membership of the euro area means non-monetary policies must be pursued more stringently than in the past so as to ensure the compatibility of Spanish macroeconomic conditions with the rest of the area and with the single monetary policy. It is thus vital that budgetary policy should continue on the path set under the 1999 Budget. Hence, the shortfall in public finances should be reduced, first, via measures

that contain and cut expenditure on those items which least contribute to the economy's productive potential or to social well-being; and further, via improving the tax system's efficiency and revenue-raising capacity. Of no less importance is the deepening and widening of the structural reforms undertaken in recent years. These should aim at improving the working of those goods and services markets which have so far been sheltered from competition, and at adding greater efficiency and flexibility to the labour market.

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As I mentioned at the beginning of my address, it is for the ESCB and, in particular, the ECB to formulate the monetary objectives for the euro area as a whole. And these must be fully assumed by the Banco de España as a member of the system. Let me now move on to discuss the elements or basic pillars underpinning the framework which will govern monetary policy decisions in the euro area.

As decided by the governing council of the ECB, the basic elements of the single monetary policy framework are as follows.

First, price stability, which will be pursued over a medium-term horizon, has been quantified as «a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2 %». In this respect, the current course of inflation in the area may be considered to be in line with this definition.

Second, a notable role is assigned to the money supply in monetary policy decision-making, establishing a reference value for the growth of the relevant monetary aggregate. This ensures that there will be a degree of continuity with the practices successfully pursued by some of the central banks shortly to make up Monetary Union. Nonetheless, so as to avoid a mechanistic reaction to short-term deviations from the reference value, price developments and the associated outlook in the euro area will be assessed on the basis of the information provided by a broad set of economic and financial indicators. Accordingly, single monetary policy decisions will not be tied more or less automatically to how a particular monetary variable fares, but will reside on an overall analysis of the economic situation and the inflation outlook in the euro area as a whole. Under these co-ordinates, the Governing Council of the ECB agreed to establish an initial annual growth reference of 4.5 % for the monetary aggregate M3, leaving itself the possibility of revising this value in December 1999. M3 is defined as the sum of euro-area residents' holdings of cash, deposits

and other bank liabilities maturing at less than two years, and money-market fund shares. The reference value, for its part, has been derived in keeping with the definition of price stability and its medium-term horizon, bearing in mind the trend of GDP and the velocity of circulation of money in the euro area as a whole.

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Allow me now to refer to certain matters linked to the implementation of the single monetary policy and the introduction of the euro as from January 1st next year. Here, the most important decision adopted has probably been to establish a minimum reserve system with which credit institutions in the euro area must comply. These institutions will, moreover, act as counterparties to the ESCB in its monetary policy operations, and the fact that the reserve assets required are to be remunerated at market interest rates will mean that the cost arising for them from compliance with this requirement will be very small and, for Spanish banks, considerably less than at present. Recently, the ESCB has also made public the list of financial and monetary institutions which make up the money-creating sector in the euro area, and the statistical information that these institutions must supply to the central banks of their respective countries has been specified.

Also, during the second half of the year, the central banks of the participating countries have undertaken a series of trials to test the working procedures for the decentralised implementation of the single monetary policy. The results have demonstrated the suitability of these procedures for effective monetary policy conduct. The Banco de España, too, has continued the ongoing adaptation of its monetary policy instruments and procedures so as to approximate them progressively to those that will be in place as from January 1999. The transition towards a real-time gross settlement payment system, the extension of the assets that will be accepted as collateral for monetary policy loans and the introduction of new liquidity-regulating instruments are some of the changes which were already begun in 1997. During 1998, this process has been drawing to its culmination. Risk control measures in the taking of guarantees have been harmonised; a deposit facility similar to that which will be in force in 1999 has been introduced; and the frequency with which regular liquidity-injection tenders will be held has been altered from a thrice-monthly to a weekly basis. Furthermore, arrangements for compliance with the minimum reserve requirement were modified in November and December, on the basis of a new harmonised accounting reporting

framework, and its maintenance period has been extended to one month.

The introduction of the euro will require a major effort by financial-market agents in terms of learning and adaptation. The first business day of 1999 will see a mass conversion into euros affecting the listing and wholesale trading of securities and the clearing and settlement thereof. Consequently, given that euro notes and coins will not be in circulation until January 2002, the effects of this mass conversion will, first and foremost, fall on financial intermediaries.

I would not wish to conclude here without pointing out that the adaptation of Spanish financial markets to the requirements of the single currency will be smoothed by the entry into force of the legislation covering the introduction of the euro, also known as the «umbrella law», recently approved by this Parliament. This legislation, which provides the legal framework in which the transition shall unfold, establishes a series of clear, accurate operational procedures for conversion to the new currency, along with simple, orderly methods for the redenomination of accounts and securities into euros. These methods and procedures have been designed to prevent the conversion into euros hindering

the sound workings of markets, to minimise the costs associated with the process and, ultimately, to secure its rapid acceptance by Spanish society. The Banco de España will ensure that the supply of new euro-denominated financial products and services by credit institutions is conducted with due transparency, avoiding any confusion that might erode the public's confidence in the new currency.

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To conclude I should like to stress, as I have on previous occasions, that, more than an end in itself, Spanish membership of Monetary Union involves new opportunities to improve standards of living and well-being in Spanish society as a whole. However, full benefit may only be had from these opportunities if the fiscal consolidation drive adheres to the balanced-budget rules established in the Stability and Growth Pact; if the markets for goods and services and for labour operate more flexibly and efficiently; and if economic and social agents adopt behaviour in keeping with the Spanish economy's participation in the common area of monetary stability.

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