LETTER AND ENCLOSURE
FROM ALBIN PFEIFER

[RELATED PAPERS (2)

Bethesda, Md, June 29, 1989

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Dear Phil,

Following your telephone call last week, I searched my "Odds and Ends from a Fund Career" file and did find a paper on the Spanish stabilisation program of 1959. I wrote it for a Fund trainees' seminar in January 1960, half a year afterwards.

As you can see-- I enclose a copy-- the paper deals with the economic and political background as well as the objectives and content of the program. Unfortunately, it sheds but little light on matters that are of interest in the context of the historical evolution of the Fund's stand-by policies. Specifically, it fails to explain:

1. why the program provided for a relatively large up-front drawing of $ 50 million (gold tranche plus first credit trnche plus $ 15 million of second credit tranche) and a stand-by arrangement for only $ 25 million (covering the remainder of the second credit tramche and part of the third), and

2. why drawings under the standby (which in the event was never used) were not made conditional on the fulfillment of specific performance criteria.

On these questions I have some recollections to offer, but--after 30 years -- they are a little vague and may not be entirely reliable.

As for the first question, both our mission (Ferras, Sacchetti and myself) and the Spaniards on the other side were keenly aware of the large risks of this radical program in terms of foreign exchange and, hence, of the necessity that it be both strong and credible. Given the low level of available foreign exchange reserves, that meant that considerable resources might be needed right away; and at the time cold cash was seen as even more helpful in this respect than drawing rights under a standby arrangement. In my recollection Per Jacobsson strongly felt that way. It was he who made the final decisions on the amount and form of Fund support when he came to Madrid in the last stage of the negociations and closed the deal.

As for the absence of formal conditionality and performance criteria, I recall some controversy at the time between ourselves in the European Department and others in the Fund (specifically Western Hemisphere people and, I believe, Irving Friedman). These latter advocated setting targets that would quantify policy and serve as performance criteria on which continued eligibility to draw under the stand-by would depend. We were in favor of setting quantitative targets, but as guidelines for policy and not performance criteria. Our Spanish friends actually welcomed such quantitative policy targets because they promised to strengthen the hand of those implementing the new policies internally against the strong vested interests that could be expected to oppose them. In the event, a number of such targets were set in the Letter of Intent, notably ceilings on total public sector expenditure and on total credit (with sub-ceilings for the public and the private sectors). We believed that the Fund should underwrite a Spanish stabilisation program only if it were a fully adequate one and we could be confident that it would be implemented substantially as promised. Setting meaningful performance criteria was difficult and linking disbursement of the Fund's money to the fulfillment of such criteria seemed unnecessary and infra dignitate. We were strongly supported in these views by Per Jacobsson who in the end was to lend his personal prestige to the success of the program.

With best regards,

Sincerely yours,

Albin Pfeifer

Outline of lecture given to the Fund's trainees in January 1960.

The Fund and the Spanish Stabilization Program - A Case Study

A. PFEIFER

Mr. Dirks has asked us in the European Department whether we could not take a concrete example from our operational work and try to explain in some detail how we go about solving our problems so that you people could have a look in our kitchen, so to speak. I am not sure that I will succeed, but I am quite willing to try to use the "case-study" approach with respect to our operations with Spain last year.

The basic data of the "case" have been given to you in the form of our Consultations Report of April 1959. Let us start from those, and then see how a stabilization program was worked out on the basis of these data, what problems arose and how these were met. After that we will see how the program was put into effect and how effective it has been. And then finally you will have an opportunity to ask questions, so that any aspects that particularly interest you can be given special attention.

First let me try to place the data in their historical perspective and pick out the most salient features of the situation as described in detail in the consultations paper that you have before you.

The Spanish economy suffered terrible losses in the Civil War in the years 1936-39 and the reconstruction after that war was difficult and slow. At first because the raw materials and capital goods needed could not be obtained while the rest of the world was still fighting World War II. And, when that was over, there was still no quick recovery. Other countries were not particularly anxious to help Spain on its feet again. Also in Spain itself there were many people who felt that the country could and should practice a large degree of autarchy. Furthermore, Spain did not, like the other Western European countries, receive large amounts of U.S. aid. So Spain went it alone with a minimum of foreign trade, and that mostly of the bilateral variety. It was already a protectionist country from way back, but after the Civil War it closed itself up more than ever. In a climate of inflation and continuous shortages it took till 1950 or 1951 to restore the national income level of before the Civil War. And in agriculture, where for a long time there was a serious lack of fertilizers, it took until 1955 to get back to the pre-Civil War level of production. Priority was given to industrialization. It is true that a large number of new plants were opened, many of them with the help of the governmental Instituto Nacional de Industria, but it was all done in the hot-house atmosphere of heavy protectionism and monopolistic conditions. International costs were often disregarded in the investment decisions and a good part of the investment was uneconomic. Moreover, hostile legislation practically barred foreign capital from entering Spain, and the country, thus, failed to profit from most of the advances in technology abroad. The traditional export industries in which Spain has a real comparative advantage, oranges and certain mining operations, were relatively neglected. And then: the investment effort was excessive even though Spain received large sums of U.S. aid since 1953. Unfortunately a country cannot invest beyond its own savings and those which it can obtain from abroad and the result was a new heavy inflation since 1955. Despite the maintenance of severe exchange restrictions the balance of payments showed a big deficit and by the end of 1958 Spain had lost most of its international reserves. Meanwhile, as you see from the paper, the inflation caused the exchange rate to get out of line and this in turn was remedied by the authorities by introducing a whole lot of multiple rates. That was in itself a bad thing for the Spanish economy, but the special rates never caught up with the inflation and the currency became more and more overvalued and that, of course, gave rise to a continuous tendency towards capital flight and black market dealings.

It was against this background of hot-house economic growth, scarcities, inflation, neglected foreign trade, protectionism, exchange restrictions, bilateralism, multiple exchange rates, non-repatriation of export receipts etc., and attempts in the Spanish Government to alter the course that the Fund came into the picture.

Spain joined the Fund and the International Bank in September 1958 and at that time had already indicated that it also wished to join the OEEC. This joining of international organizations in itself was already an indication that there were important forces in Spain that had come to the conclusion that the country would have to change its economic course toward greater liberalism. Then shortly after they became members, Spain asked the Fund to see what it could do for them. These forces, notably the Ministers of Finance and Commerce and quite a few of the more modern economists, obviously wanted to enlist the technical help of the Fund and, maybe more important, its moral support and prestige to put through a real stabilization program. So in late February we sent some of our people there,
1959 formally for routine Article XIV Consultations, but in fact also to study the Spanish problem and discuss with the Spanish authorities what might be done.

We studied the situation and laid down our diagnosis in the Consultations Report, particularly Part I. This diagnosis was quite unequivocal and the conclusions were simple. We found that to make the Spanish economy viable again and to fit it in into the economy of the Western world it would be necessary to do the following five things:

(1) to stop the current inflation so as to create honest money again, and thereby stimulate savings and create the basic condition for balanced further growth of the economy and restoration of balance of payments equilibrium;

(2) to relax restrictions on foreign trade and payments. To open the door, restore competition, let in fresh air, even if it might mean a temporary cold and even if the chilly fresh air might kill some of the weaker marginal enterprises which so far had been protected not only by high tariffs, but also by very strict quotas;

(3) to do away with all kind of stifling dirigist controls and interventions such as price controls and job protection laws which, by making it practically impossible to fire anybody, stood in the way of flexibility in the economy.

(4) to stop the xenophobia: give foreign capital a better break and thereby enlist its help in obtaining capital and know-how;

(5) to do away with the system of multiple exchange rates which helps the weak and punishes the strong; and have one good viable exchange rate at which the peseta would be cheap enough for exports to be profitable again, and for foreign tourists and other people wanting to remit money to Spain to obtain their pesetas through the official channels rather than in the free markets abroad. By the same token a good exchange rate would help to reduce the need for import restrictions and to stop the capital flight.

These conclusions were not only laid down in the Consultations Report, but we also gave them to the Spanish Government when we left Madrid in early March. We told the Government that in our opinion, the Executive Board would not underwrite any stabilization program unless adequate measures were taken in all the five areas which I just enumerated. The Spanish ministers agreed that something along these lines should be done and said that they were going to see what they could do politically.

Let me stress that it was not easy for them to take action quickly. First of all many of the measures took a great deal of study, but secondly there were great political difficulties to overcome. By no means the whole government was as yet ready to take radical measures, and the measures needed would have to be radical. Some people and some groups were sure to be hurt if inflation was to be stopped, or foreign competition was to be admitted again, or credit was to be curbed, or people could again loose their jobs.

At the request of the Spanish Ministers a Fund team went to Madrid for discussions in May, and again in June, to advise whether certain solutions would be acceptable or not, make suggestions, and to help supply arguments with which those in favor of the stabilisation program might defend the measures against opponents in Spain; in short: to negotiate and help the Government to push the program through.

I am told that what interests you particularly is how exactly the Fund does its work and may be I should now try to give you a sort of blow-~~of~~ by-blow account of the discussions and the negotiations. But I am afraid that a precise account of all the little battles and all the little frustrations, and all the negotiations would be rather tedious. It may be better to go back to the five-point conclusions which I summed up before, to review the substance of what was discussed and negotiated, and see what was done in the final stabilization program with respect to each of these points.

Let us start with the first conclusion: "Current inflation should be stopped."

You will recall from your reading of the consultations paper that the inflation in Spain was caused largely by overinvestment, and that the money that fed the inflation came from the Central Bank. It came basically in two ways: while the current expenditures of the central government were more than covered by taxes, the expenditures of all kinds of autonomous and semi-autonomous public agencies were not and it was these agencies, and especially the Instituto Nacional de Industria, which financed a large part of the public investment effort. To the extent that these agencies could not cover their financing needs in the rather limited capital market, the Bank of Spain was forced to help them with direct advances, the so-called "creditos personales". But that was not all. There was also a large investment demand on the part of private enterprise, who relied on credit ~~from~~ from the commercial banks. These banks saw their deposits increased by the money put into circulation by the Central Bank, and so their lending capacity was increased. But on top of that, they could always obtain further reserves from the Bank of Spain, either by rediscounting commercial bills at relatively low interest rates or by pledging (the so-called "pignoracion") of their Treasury bills. In Spain, namely, all public securities can at all times serve as collateral for central bank loans to the banks, a device that obviously frustrates any monetary policy worth speaking of.

When the Fund was confronted with the Spanish situation, the Government was already tightening up the budget system by gradually bringing the various autonomous agencies under its control. But it was clear from the start that the Government would have to go further and that the first thing that would have to be done was to limit the call on resources of the public sector as a whole, including the investment expenditures of autonomous agencies, to the available domestic savings. If that could be accomplished, there would no longer be any need for the public sector to borrow from the central bank. This undertaking implied that revenue be raised or expenditure cut or both. Both things obviously were difficult politically, but in the end it was agreed that a number of taxes would be increased and that a a cut would be made in public investment. Secondly, we expressed the opinion that it was absolutely necessary that the authorities should establish some sort of control on credit. Every modern State has such a credit control system; no modern State with a market economy can afford not to keep credit under the control of the monetary authorities. The only question was what sort of controls were best in this given case. After rather lengthy talks and negotiations we agreed that, given the historical situation, and particularly with all those government securities around which were autonatically eligible for "pignoracion" at the central bank, the more refined techniques of monetary policy, such as minimum reserve requirements, were not suitable in this case, at least not for the time being. We agreed that the best solution would be to have an absolute ceiling on all credit to the private sector fixed in such a way that the increase in credit over a given period would not exceed a certain tolerable amount. So a credit ceiling was fixed, giving a little margin above the existing volume of credit, but basically on the basis of the status quo. Finally, we also reached agreement with the Spanish Government--again after rather long discussions--that the classical instrument of interest rate changes, long despised as a dirty bankers' trick, would be used again. All discount rates of the Central Bank would be increased as part of the stabilization program. It was hoped that this would make credit more expensive and that the higher costs would then effect a natural selection of investment projects.

Now let us go to the second field of action, that of restrictions on imports. We insisted from the beginning that there should be a big cut in restrictions. This was the only way to make the economy internationally competitive ~~rate~~. But we also insisted that the restrictions should be lifted in a nondiscriminatory way. We not only pointed out the virtues, but but also the real advantages for Spain of having as large as possible a free list for imports without discrimination as to origin. Finally we insisted that, as a minimum, the most important raw materials, fuel and spare parts should be placed on a free list, and that a beginning should also be made with the freeing of consumer goods by instituting global quotas for such goods, again irrespective of origin. Although there still remained some considerable restrictions, the relaxation of restrictions on imports was sufficient for Spain to satisfy the OEEC requirements in regard to import liberalization.

These proposals were of course revolutionary. They meant that in essence the bilateral trading system would be liquidated almost overnight and that the economy would be reincorporated in the main stream of the world economy. Seen against the background of the past twenty years, these certainly were large steps on the road to free trade and, as you will imagine, the Government had a great deal of trouble in putting all this through against the determined opposition of many vested interest, but they finally succeeded.

There was one aspect of the liberalization of trade which was somewhat disquieting to both the Spaniards and us and that was the question to what extent the public would rush to buy imports once they were liberalized. Apart from the exchange rate the answer depended, of course, on how badly they needed the imports and how many pesetas they would have to spend on imports. How badly the imports were needed was difficult to say. Everybody had a suspicion that there were considerable stocks in the economy, but nobody knew. And how much money people would have was also difficult t to predict. In an inflation the public tends to borrow as much as possible and put the money into goods of all kinds, but it is difficult to say how much they borrowed in excess of their normal needs and how large their stocks were. So it was decided to play it safe and require importers to put up a 25 per cent advance deposit when applying for an import license; this deposit to be held in a blocked account at the Bank of Spain. As we will see, it turned out later that the stocks were much larger than expected and that, once confidence was restored, there was no rush at all to buy the liberalized imports. But the 25 per cent deposit requirements was a bit of shock treatment that acted as a check on possible speculative imports by sterilizing a certain amount of money. Its psychological effect was considerable and as such it undoubtedly helped to turn the tide, together with the other measures of the stabilization program.

The third field of action was that of the abolition of harmful controls and of measures to enhance the <u>flexibility</u> of the economy. Here again we had quite a bit of discussion and the Spaniards had quite of bit of political trouble. For an economy which has been dirigistic, bureaucratic, protectionist and monopolistic for a long time it is not easy to make sudden vital changes without great shock effects. But, of course, these changes are necessary. To change the direction of an economy you need flexibility so that the available resources can move to new more productive occupations. Any controls that stand in the way of such movement are harmful, at least in principle. Take the case of lay-offs of labor. In Spain the existing legislation makes it practically impossible ever to lay-off employees. How is labor to go to the new industries under these circumstances? Or take the case of cartels and price controls. Obviously they also stand in the way of changes. Of course, all these things are highly political and they are farther removed from the immediate sphere of interest of the Fund than, say, credit policy or restrictions policy. So in this field the Fund finally had to contend itself with a number of rather vague undertakings on the part of Spain, except for the abolition of all price controls. Since July Spain has been abolishing all kind of superflous agencies and controls, but little has in fact been done on the things that count, namely monopolistic practices and the excessive-job-security which we thought should be replaced by a good unemployment insurance scheme.

The fourth area of action was that of foreign investment. On enlisting the help of foreign investment we were very insistent. We gave the government our frank opinion that foreign capital just could not be expected to come in in any substantial amounts as long as foreign participations in Spanish enterprises were limited to 25% of capital and transfer of income and principal were not guaranteed. Here, of course, there was a lot of opposition too, particularly from groups fearing foreign competition and wishing to perpetuate the old autarchic regime. We advocated a foreign investment regime on the pattern of the Law in Italy which has been very successful and the final outcome actually was a fairly liberal Investment Law on the Italian model. It limits participations to 50 per cent as a general rule, but allows for exceptions and also guarantees fairly satisfactory repatriation and income transfers. At the same time it maintains certain safeguards for vital Spanish interests, for instance with respect to defense industries and public utilities, but that does not prejudice the issue.

Finally the exchange rate. Here we insisted, of course, on (a) the unification of the terribly complicated multiple exchange rate system that had grown up in the years before; (b) the adoption of a good unitary exchange rate. You saw from the paper that the Spanish multiple exchange rate system was pretty bad. Export rates ranged from 31 pesetas to the dollar to 52.5. Import rates from 25 to 125 pesetas per dollar. The "official rate" of 42 had became rather meaningless; the black market rate at the time was somewhere between 57 and 60 pesetas per dollar. To unify such a system is not easy. It hurts quite a few people by doing away with their special privileges; it gives unexpected favors to others. And whatever the new unitary rate, exporters will claim that it is too high and importers that is too low. Furthermore, there is the question of the impact of the new exchange rate on the domestic prixe level. However, that may be, the Spanish government in the end agreed to a unification of the rates, a major political decision. Minor import subsidies on strategic cost of living items were introduced to limit price rises and also some taxes on exports, but these were no longer part of the exchange system and altogether did not amount to much.

On the approximate level of the new uniform rate there had agreement from the start. If one took into account the price relationahips and the necessity of setting a rate in which everybody could believe, while not going too far and risking too large a price increase, it was clear that one would have to go to the range of 58-60 pesetas per dollar. The new unitary rate of 60 pesetas per dollar was finally fixed by the government with Mr. Jacobsson, who helped arrange the last important details in Madrid in June.

Before the stabilization program could be put into effect there was, of course, the matter of financing. The Spanish Government and we were both convinced that the program which I just outlined was a strong one and that in the end it would succeed in making the Spanish economy viable again. By eliminating inflation and having a good exchange rate it would be possible to stimulate exports and restrain imports and the total program could be expected also to attract foreign capital. Thus there was every prospext for the eventual restoration of balance of payments equilibrium and the emergence of a balance of payments surplus later. But we were all impressed with the fact that the first effect of the program might be a big surge in imports once the exchange restrictions were relaxed, particularly in view of the fact that so many commodities had been scarce for a long time. Therefore, there was a need for large foreign credits: to tie Spain over this initial period while equilibrium is being restored, and to inspire confidence in the new rate of the peseta.

Once the Fund and the OEEC accepted the program in July 1959 they also put their resources at the disposal of Spain. The Fund approved a drawing of $50 million (i.e., the gold tranche of $10 million plus 40% of the quota). One half of the $50 million was in U.S. dollars and the other half in sterling and French francs. In addition the Fund made available a stand-by credit of $25 million. The OEEC, through the European Fund, put up $100 million. U.S. banks advanced nearly $70 million altogether once the Fund had given its approval of the plan, and to round out the package, the U.S. Government was listed as contributing $140 million, but that was really part of the close to $200 million a year that the U.S. had been contributing to Spain for some years.

In July most of the measures of the Stabilization Program such as the devaluation, the new taxes, the credit ceilings and the new Law on Foreign Investment, were put into effect. Other measures such as the slow-down in public investment and the liberalization have been put into effect gradually since July and the various measures to abolish controls, cut red tape and introduce flexibility have still not all been taken.

It may still be a little early for an appraisal of the ultimate effects of the program, but the results of the first six months have been most encouraging.

Psychologically the stabilization treatment has been very effective. Even those who had their doubts about its ultimate success stopped buying to see how things would be going and that turned the trick. People and business enterprises did not rush out to buy imports, but for the time being were living off the stocks that they had built up in the inflationary period before. The demand for credit went down instead of up. The credit ceilings were never reached. Exports developed nicely, imports rose only very gradually, tourist and emigrant remittances flowed again into the official channels. The result was that the foreign credits were either not touched at all or to the extent that they had been drawn, like the $50 million from the Fund, were added to reserves. Internally there was a temporary slump. The weaker industries were forced to reform and become more productive or go broke; some did go broke. There was a reduction in profits and in many industries overtime was cut out, but on the whole there has not been large unemployment; ironically, largely because of the same job security legislation that we criticized, and still criticise, so much. In the last few months, however, things seem to have been going better again. The trouble is that you cannot come out of a bad inflation without a period of slump and that you cannot have healthy development before the inflation-mess has been cleared up. In Italy in 1947 they had a very successful stabilization which in many respects is comparable to the present one in Spain and there it took a year before production had again reached the pre-stabilization level. There will still be much to be done before the Spanish economy has been truly modernized, but we are confident that by next summer it will be in a much healthier state than it has been for a long time.

Now, if you have any questions, I shall be glad to answer them.

7/5/89

Talk with Pfeifer on Spanish Standby of 1959

I called ~~Albert~~ Albin Pfeifer to thank him for his letter of 6/29 enclosing the text of his 1960 memo on the Spanish case. I noted he had not indicated why Messrs Jacobsson and Ferras had not wanted to apply specific targets as conditions for continuing drawings under the standby. Was it because they felt a gentlemens' agreement would be more appropriate in the case of a relatively sophisticated European country like Spain?

Albin replied that he thought that may have been a significant consideration in Ferras' and Jacobsson's minds. They were both products of the European central banking fraternity. The mission had gone to Spain with no specific instructions on how they should deal with the case, although they were well aware that

Western Hemisphere Dept. was applying specific conditions and ceilings. France had not indicated that such tests would be applied as conditions for drawings, even though the national authorities wanted concrete targets in the letter of intent. When Jacobsson came at the end of the negotiation he fully endorsed that approach and continued to maintain it vis-a-vis such countries.

Pfeifer noted that subsequently P.J. took a good deal of personal pride in the Spanish stand-by and how it turned out.

Jack Polak told me, incidentally, that a Mr. Munz, who was an ED in the Fd representing Spain & other countries, wrote quite a detailed book on the subject of Spain and the IMF.

Phil Thomson