

EBS/82/242

CONFIDENTIAL

December 28, 1982

To: Members of the Executive Board
From: The Acting Secretary
Subject: Spain - Change in the Exchange Rate

Attached for the information of the Executive Directors is a paper on a recent change in the exchange rate in Spain.

Att: (1)

INTERNATIONAL MONETARY FUND

SPAIN

Change in the Exchange Rate

Prepared by the European Department

Approved by Brian Rose

December 27, 1982

I. Introduction

On December 4, 1982, the Spanish authorities communicated to the Managing Director, in the attached cable, their decision to devalue the peseta vis-à-vis the U.S. dollar by 8 per cent effective December 6. The immediate occasion for this move was the intense speculative pressure to which the peseta had been subjected over the last two months. In the same cable the Spanish authorities indicated their intention to conduct a managed float which would not run counter to the basic trends in the market and would in no case be used to gain an unfair competitive advantage.

II. Background

During 1982 the Spanish economy continued to be characterized by a relatively depressed level of activity, a high rate of unemployment and the persistence of rapid inflation (Table 1). During the first half of 1982 there was some recovery in activity in response to an easing in monetary policy, but in the second half of the year economic growth virtually came to a halt, as export growth decelerated sharply and as a higher than anticipated rate of inflation reduced disposable income. On balance real GDP is estimated to have increased by 1.2 per cent in 1982 as compared to an average 0.6 per cent over the preceding three years. Despite the continued sluggishness of the economy and the containment of wage growth broadly in line with the tripartite wage guidelines set in June 1981, consumer prices increased by 14 1/2 per cent in 1982 or at a rate similar to that recorded in 1981. Labor market conditions worsened in recent months and the unemployment rate, after stabilizing in the first part of the year, is estimated to have risen to around 16 per cent by year-end.

Over the past three years, there was a considerable depreciation of the peseta. Between the second quarter of 1979 and the third quarter of 1982 the peseta depreciated by 40 per cent with respect to the U.S. dollar and by 25 per cent in effective terms (Table 2). Over the same period the real effective exchange rate (as measured by relative consumer prices adjusted for exchange rate changes) depreciated by 10 per cent.

This depreciation was however not sufficient to offset the 27 per cent real appreciation that took place between the third quarter of 1977 (when competitiveness peaked) and the second quarter of 1979. Vis-à-vis a weighted average of European currencies the peseta depreciated by over 15 per cent between the second quarter of 1979 and the third quarter of 1982. Corrected for inflation differentials, the real depreciation over the same period amounted to only about 5 per cent. Indeed, a small real appreciation against the European currencies was recorded since mid-1980, which may have been partly responsible for a significant redirection of trade flows away from Europe and toward the U.S. dollar area over the last two years.

Following the second "oil shock", Spain's current account balance swung into a significant deficit. During 1980 and 1981 the current account deficit averaged slightly over US\$5 billion or the equivalent of 2 1/2 per cent of GDP. This mainly reflected a deterioration in the terms of trade associated with increased oil prices and a deceleration in export growth stemming from the loss of competitiveness registered in the period up to mid-1979. Since the second half of 1981 there was some improvement in the current account balance resulting from a decline in energy imports and a rebound in export earnings, which however appears to have largely come to a halt in recent months. Preliminary estimates place the current account deficit for 1982 at around US\$4.2 billion or the equivalent of 2 1/4 per cent of GDP.

The capital account of the balance of payments came under considerable pressure in 1982. On a settlements basis the surplus on long-term capital flows narrowed from US\$2.9 billion in the first half of 1981 to US\$1.2 billion in the first half of 1982, mainly reflecting a sharp downturn in private external borrowing. There was also a significant reduction in the external indebtedness of the commercial banks. These developments were partly related to a significant easing of monetary policy and to a narrowing of the uncovered interest rate differential with the Eurodollar in the first half of the year. There are indications that, despite some tightening of monetary and interest rate policies, the capital account remained under pressure in the second half of the year. This reflected increasingly adverse exchange rate expectations as evidenced by a widening of the forward discount on the peseta to around 10 per cent just prior to the recent exchange rate move. On the whole, a loss of reserves of over US\$2.4 billion was recorded in the first nine months of the year. Although no data are available on reserve movements beyond September, there appears to have been further sizable intervention by the Bank of Spain in the foreign exchange markets in the weeks preceding the depreciation.

Against the above background, on December 4, 1982, the newly elected Socialist Government announced an 8 per cent depreciation of the peseta. In support of this move the authorities announced that policies would be geared to securing a scaling down of the growth in the broad money supply (M_3) from around 17 per cent in 1982 to 13 per cent in 1983. As an initial step in this regard, shortly after the depreciation, bank reserve

requirements were raised from 5.75 per cent to 6.75 per cent. At the same time the authorities announced increases in the prices of most petroleum products by around 20 per cent. In the two weeks following the move of December 6, the exchange rate has broadly stabilized at around Ptas 128 per U.S. dollar or about 9 per cent below the level prevailing on December 3. There are indications of a sizable reflow of foreign exchange into Spain during this period.

III. Staff Appraisal

In the staff's view, the depreciation of the peseta has to be viewed against the background of several years of near stagnation in activity and of labor market conditions which are considerably worse than in Spain's main trade partners (Chart 1). During 1981 and 1982 deficits equivalent to about 2 1/2 per cent of GDP were recorded in the current account of the balance of payments although domestic demand continued to be weak and unemployment rose to 16 per cent. It also should be noted that although Spain's debt service ratio, at around 19 per cent, is not a cause for serious concern, it has been rising rapidly. The staff shares the authorities' view that in present circumstances economic policy needs to be geared toward reducing Spain's current account deficit in relation to GDP to a level below that registered over the past two years. Whether the recent depreciation will secure more than a passing improvement of the external position depends crucially on the supporting measures and particularly on the development of real wages in the year ahead. The staff is encouraged by the recent tightening in monetary policy and by the authorities' intention to secure a further significant deceleration of monetary growth in 1983.

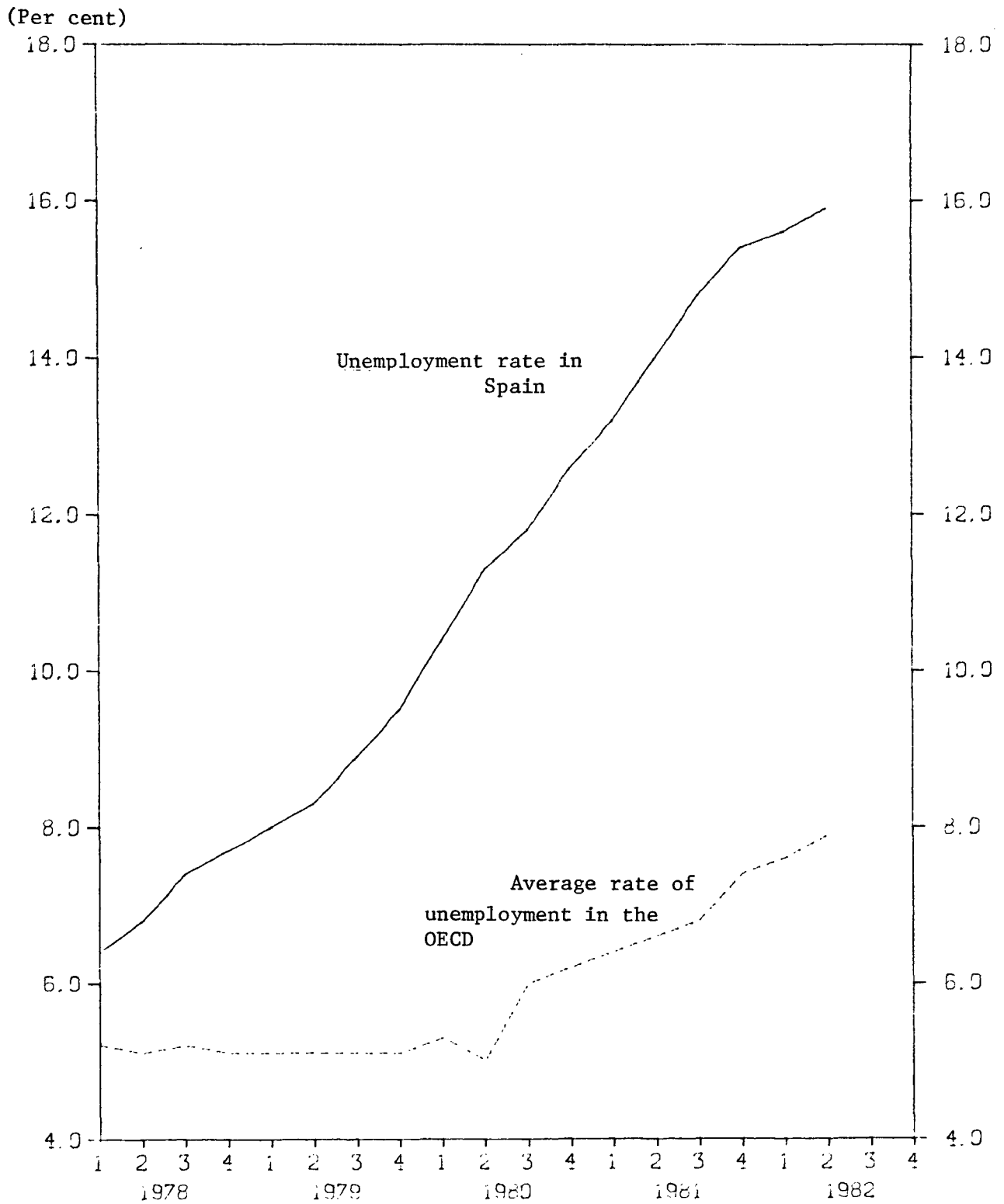
An assessment of the depreciation in terms of the usual indicators of competitiveness is more difficult. The use of the real effective exchange rate for purposes of gauging the appropriateness of the exchange rate depends crucially on the choice of the base period. The staff believes that in mid-1977 the peseta was somewhat undervalued but that the clear overvaluation that followed up to mid-1979 was not fully reversed thereafter (Chart 2). On this basis there would appear to have been a case for a significant depreciation of the exchange rate.

Finally, it should be noted that the exchange rate move took place against the background of intense speculative pressure in the exchange market. This pressure was initially countered by heavy intervention in the foreign exchange markets by the Bank of Spain, resulting in a substantial loss of foreign exchange reserves. In these circumstances the authorities felt that they had little alternative but to move the exchange rate to a level that would appear more sustainable. The Spanish authorities have indicated the intention to manage the float of the peseta in a way that will not run counter to the basic trends in the market. The staff welcomes this intention.

The staff's tentative assessment of the recent exchange rate move on the basis of the available information is that a depreciation on the order of that undertaken would appear to have been appropriate. However, a more thorough evaluation would require up to date information on recent balance of payments developments as well as a more detailed knowledge of the economic policy intentions of the new Government. The staff expects to obtain such information on the occasion of the Article IV consultation discussion with Spain scheduled for early 1983.

SPAIN

Chart 1. Unemployment in Spain and in the OECD



SPAIN

Chart 2. Effective Exchange Rate

(1975 = 100)

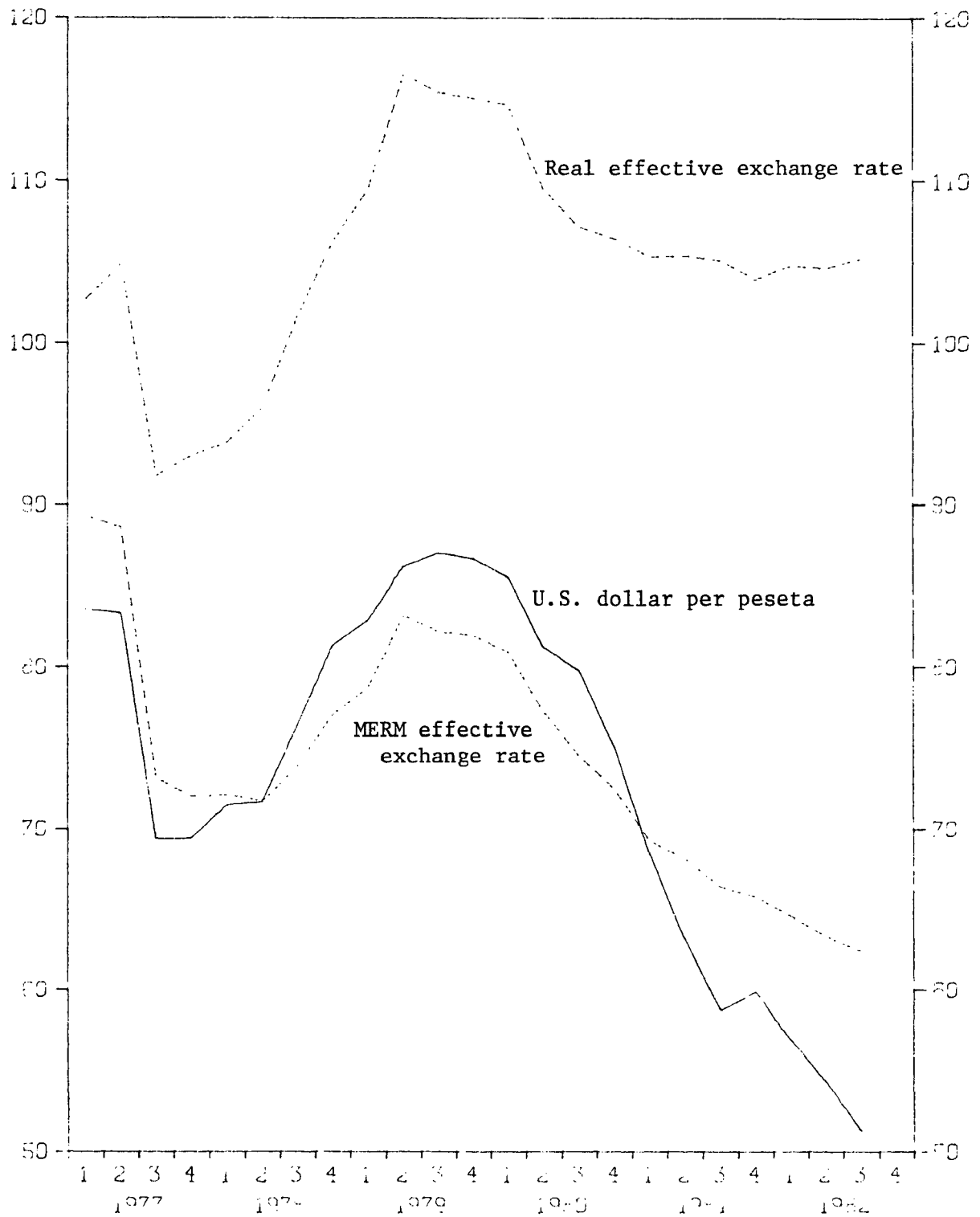


Table 1. Spain: Selected Economic Indicators

	1979	1980	1981	<u>1982</u> Estimated
	<u>(Percentage change)</u>			
Domestic economy				
Real GDP	0.4	1.2	0.3	1.2
Real domestic demand	0.7	1.0	-0.3	0.3
Consumer prices	15.7	15.5	14.6	14.5
Employment	-2.1	-3.3	-3.2	-1.2
Unemployment (in per cent)	8.7	11.5	14.3	15.6
	<u>(In billions of U.S. dollars)</u>			
Balance of payments				
Current account deficit	1.11	-5.19	-5.04	-4.20
(As per cent of GDP)	(0.6)	(-2.4)	(-2.6)	(-2.3)
External medium- and long-term debt (at end of period)	19.46	23.69	27.02	28.34
End of period foreign exchange reserves (excluding gold)	11.89	11.12	10.24	7.83 <u>1/</u>
	<u>(Percentage change)</u>			
Financial indicators				
M3 growth (end of period)	18.0	16.7	15.8	17.0
Domestic credit	17.2	20.3	20.2	21.0
Credit to the public sector	35.2	38.2	40.9	40.0
Public sector deficit (as per cent of GDP) <u>2/</u>	-2.5	-3.1	-4.7	-5.4

Sources: Bank of Spain; and staff estimates.

1/ End of September 1982.

2/ Cash balance on a national account basis.

Table 2. Spain: Exchange Rate Indicators, 1976-82

(1975 = 100)

	Nominal Exchange Rates			Real Exchange Rates			
	Index of U.S. Dollar Rate	Index of MERM Weighted Effective Exchange Rate	Index of Effective Rate Vis- à-vis EC Currencies	Relative CPI	Relative Wholesale Prices	Relative Unit Labor Costs	Real Exchange Rate Vis- à-vis EC 1/
1976	86.0	91.4	95.8	97.9	96.7	102.9	100.2
1977	76.4	80.7	84.0	98.1 2/	94.8	101.2	99.7
1978	75.2	73.7	74.4	99.4	95.7	102.8	98.8
1979							
I	82.9	78.7	77.4	109.5	103.9	...	100.7
II	86.2	83.2	81.6	116.5	109.6	...	114.7
III	87.0	82.1	79.0	115.4	109.3	...	112.4
IV	86.6	81.9	77.9	115.0	109.1	...	118.6
Year	85.7	81.5	79.0	114.1	108.0	121.5	111.6
1980							
I	85.5	80.9	76.5	114.7	109.6	...	110.1
II	81.2	77.2	73.6	109.5	105.8	...	106.4
III	79.7	74.5	70.8	107.1	104.3	...	104.0
IV	75.1	72.4	70.7	106.5	103.5	...	104.8
Year	80.4	76.3	72.9	109.4	105.8	116.4	106.6
1981							
I	68.4	69.2	70.1	105.3	100.9	...	105.5
II	63.1	68.1	71.6	105.4	102.7	...	107.5
III	58.7	66.4	72.0	105.1	101.7	...	109.9
IV	59.9	65.7	70.0	103.9	101.0	...	106.6
Year	62.5	67.4	70.9	104.9	101.6	110.6	107.2
1982							
I	56.8	64.5	69.7	104.8	...	...	108.2
II	54.3	63.3	68.9	104.6	...	...	108.5
III	51.3	62.4	69.0	105.2	...	...	...
IV	49.9 3/	61.9 3/	...	...	...	...	...

Sources: IMF, International Financial Statistics; Bank of Spain, Statistical Bulletin; and staff calculations.

1/ As measured by relative consumer prices.

2/ The peak in competitiveness was reached in the third quarter of 1977 when the index stood at 91.8.

3/ November 1982.

Communication Received by the Managing Director from
the Spanish Authorities on December 4, 1982

The following communication to the Managing Director was received on December 4, 1982 from the Spanish authorities.

When the exchange market opens Monday morning December 6, 1982 the Bank of Spain will observe intervention rates of pesetas 127.50/70 per U.S. dollar, which represents an 8 per cent devaluation of the peseta with respect to the December 3 fixing of the peseta at 117.450 per U.S. dollar.

This decision was reached owing to intense speculative pressure on the peseta during the last two months which has increased in recent weeks and forced the Bank of Spain to intervene heavily in the market. The decline in the rate of exchange has been maintained within limits which appear compatible with a situation of approximate equilibrium in accordance with the basic trends in the markets and the Spanish economy.

The Government has announced that its monetary policy targets in 1983, defined in terms of M3, will be situated in a band established around a 13 per cent growth rate (16 per cent in 1982). These monetary targets are considered compatible with a reduction of the inflation rate measured in terms of consumer prices to 12 per cent in 1983 (14.5 per cent in 1982) and with an increase of real GDP in the neighborhood of 2 to 2.5 per cent in the coming year (an estimated 1 to 1.5 per cent in the current year). The Government intends to make an effort to contain the budget deficit and begin to reduce it as a percentage of GDP and is confident that the current account balance of payments deficit will be on the order of US\$3 billion in 1983 (US\$4.2 billion in 1982). The Bank of Spain intends to introduce a controlled flotation policy in the exchange market in the near future. It will respect the basic trends of the market and refrain from any operation involving competitive depreciation.

We trust that the International Monetary Fund will view favorably the decision adopted which seeks to help restore balance to the Spanish economy.