

L.5.2

RFD 424

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Division of International Finance

REVIEW OF FOREIGN DEVELOPMENTS

June 4, 1963

Recent Economic Developments in Spain,
January 1962 to May 1963 15 pages

Rodney H. Mills, Jr., Economist,
Division of International Finance

This article was prepared primarily for internal circulation, and should not be cited or quoted. The views expressed do not necessarily represent the views of the Board of Governors of the Federal Reserve System.

June 4, 1963

Recent Economic Developments in Spain,
January 1962 to May 1963

Rodney H. Mills, Jr.

Summary

Booming investment demand and easy credit in Spain have caused prices to rise sharply in the period under review, in spite of further rapid output gains and soaring imports, which have been sufficient to eliminate the external surplus. The Spanish authorities have moved in recent weeks to restrict monetary expansion, while continuing the process of liberalization and reform of the economy which began in 1959. 1/

Real gross investment in Spain rose by 24 per cent in 1962, following a slightly greater increase in 1961, according to the first official figures published on Spain's GNP. The gain in over-all output declined to 6.1 per cent in 1962 from 7.7 per cent the year before, mainly because of reduced crops. The increase in total use of resources substantially exceeded the rise in real GNP for the second year in succession.

This rapid rate of domestic expansion has transformed Spain's external position. Imports rose 44 per cent in 1962--after an even bigger increase the previous year--because of the heavy import content of the Spanish investment program. Although tourist receipts and emigrant remittances continued to expand at an extraordinary rate, the balance of payments surplus was eliminated late last year, and a small deficit was recorded in the first quarter of 1963. Current predictions are for balance or a small deficit in 1963. From January to September 1962, official reserves rose by \$169 million; the gold portion rose by \$130 million or from 36 per cent to 41 per cent of total holdings. Between September 1962 and March 1963, official reserves declined by \$21 million but gold holdings continued to rise by \$86 million and comprised 51 per cent of total official reserves at the end of March.

Prices began to rise sharply early in 1962, and continued to do so through the first quarter of this year. By March 1963, year-to-year increases amounted to 10 per cent in wholesale prices and 11 per cent in the cost of living; the rise was especially rapid in the food sector where supply has been less elastic than elsewhere. Behind the rising price level has been a very large expansion of bank credit to the private sector; this increase amounted to 26 per cent in 1962 and produced a 19 per cent increase in the money supply last year.

To slow credit expansion, a compulsory reserve requirement (in the form of a liquidity coefficient) was imposed on the private banks in February of this year, and the coefficient was raised in May. This was one of several steps implementing the 1962 Bank Reform Law; further implementing action in

1/ See "Recent Economic Developments in Spain," November 29, 1962.

this area is awaited. During 1962 and early 1963, restrictions on internal investment in industry were first eased and then removed, while regulations affecting foreign investment in Spain were liberalized. The government seems prepared to delimit the activities of INI, the giant State-owned holding company, and to revise other practices in favor of better resource use.

Further rapid gains in output as investment booms

The strong expansion of economic activity observed in the first half of 1962 continued throughout the remainder of last year. Although statistical data are not available beyond December, continued rising demand apparently stimulated further output increases in the first quarter of 1963.

Spain's first GNP figures, compiled for the Finance Ministry after years of research, place 1962 GNP at constant prices 6.1 per cent higher than in 1961. (See Table 1.) This impressive gain was, however, somewhat less than the increases of 8.1 and 7.7 per cent in 1960 and 1961, respectively. Much poorer crops, and special adverse events affecting the coal and wool industries, explain most of the smaller increase in 1962. 2/

Table 1. Spain: National Accounts, 1959-62
(In millions of dollars at 1961 prices)

	<u>1959</u>	<u>1960</u>	<u>1961</u>	<u>1962</u>
<u>Availabilities</u>	<u>9,867</u>	<u>10,278</u>	<u>11,513</u>	<u>12,743</u>
GNP at market prices	9,835	10,634	11,448	12,145
Net imports of goods and services	32	- 356	65	598
<u>Uses</u>	<u>9,867</u>	<u>10,278</u>	<u>11,513</u>	<u>12,743</u>
Consumption:				
Private	7,171	7,623	8,280	8,913
Public	911	939	1,028	1,097
Gross fixed investment:				
Private	1,496	1,462	1,834	2,352
Public	274	287	372	373
Change in inventories	15	- 33	- 1	8

Source: Ministry of Finance

2/ A different (and older) series of data, relating to national income rather than GNP, shows a 5.7 per cent increase in real national income in 1962. But the national income series, compiled by the National Economic Advisory Council, shows a 6.7 per cent rise in real national income in 1961, compared with the 7.7 per cent increase in real GNP given by the Finance Ministry series. For 1960 the two series exhibit totally different results. The national income series shows a slight drop in real national income in 1960. This result is much more in line with the heretofore prevalent view that 1960 was a year of stagnation in Spain. The GNP series does show a small decline in investment in 1960, but it shows a big increase in consumption.

Output in 1962 was affected by the following main general forces:

- a. Large productivity gains, made possible partly by imported investment goods not available until recently because of Spanish import restrictions;
- b. Strong over-all internal demand which, facilitated by a liberal credit policy, rose faster than aggregate supply and caused prices to rise appreciably; and
- c. Continuation of a remarkable investment boom for the second successive year.

Gross fixed investment in real terms rose 24 per cent in 1962, on the heels of a 28-1/2 per cent rise the year before, according to the new GNP figures. Inventory accumulation was negligible in both 1961 and 1962. Most Spanish investment is in the private sector. The boom has been supported by the ample supply of bank credit, but basically it is a response to enlarged profit possibilities opened up by the much greater freedom to import.

In addition, the climate for investment has improved, largely because of official encouragement. For one thing, the government has moved, and is continuing to move, in the direction of increased freedom for the private sector by dismantling most controls--on prices, on imports and exports, on foreign investment, and on internal investment. For another, rationally-planned economic growth is now a major government objective. The intention announced in 1961 of formulating an ambitious national development program, and the active preparations that have since been made, have doubtless created expectations of strong demand increases over the next several years, with accompanying opportunities for profitable investment. Finally, the prevailing attitude in government has probably made private industry less fearful of further expansion by INI, the State-owned holding company which controls firms in a host of branches of industry and whose activities have come in for strong criticism.

The 1962 increases in real investment (24 per cent) and real consumption (7-1/2 per cent) well exceeded the increase in real output in Spain (6.1 per cent), so that imports of goods and services rose far more rapidly than exports. The increase in net imports of \$533 million in 1962 (at constant prices) equalled no less than 43 per cent of the increase in real total availabilities to the economy. In this respect, the situation was similar to that in 1961, when the shift from export surplus to a modest deficit marked an increase in real availabilities from abroad of just over \$400 million.

Available indicators of over-all industrial activity yield somewhat different results. But most data are consistent in showing an increase in production in 1962 which, while not matching the 1961 gain, was nonetheless of large proportions. The annual industrial production indexes of the National Syndicate Organization are probably the best indicators. These show production increasing 8.2 per cent in 1962 compared with 10.2 per cent in 1961. (See Table 2.) In part, the smaller increase in 1962 was caused by accidental events rather than fundamental changes in the economy. Strikes in the spring and autumn reduced coal production by some 7 per cent, and floods in the Barcelona area in late September destroyed nearly half of Spain's wool industry (on the eve of the period when demand is seasonally the strongest). Tighter labor supply and plant capacity limitations held back expansion in the construction and cement industries. Finally, foreign competition affected some sectors adversely. Reduced production of iron and steel was a direct result of freer imports of those products, while exports of some minerals, metals, and cotton goods declined sharply because of reduced competitiveness or declining foreign demand.

Table 2. Spain: Industrial Production Indexes, 1960-62
(1959=100)

	<u>1960</u>	<u>1961</u>	<u>1962</u>
Food	116.2	117.5	121.1
Beverages	103.0	121.2	134.0
Tobacco	102.9	107.3	122.2
Wood and cork	86.0	101.5	115.3
Paper	107.8	114.0	114.7
Leather and shoes	101.0	104.5	107.5
Chemicals	118.0	123.3	145.4
Glass and ceramics	94.8	97.7	112.8
Basic metals	113.4	127.6	134.8
Machinery	75.9	91.0	106.9
Textiles	99.2	108.2	112.9
Coal	91.0	93.1	88.0
Other minerals	99.3	119.9	113.7
Petroleum products and coal derivatives	107.9	109.1	126.4
Cement	108.3	123.1	136.3
Electricity	117.7	130.4	141.2
Transportation equipment	<u>129.0</u>	<u>164.7</u>	<u>201.0</u>
General index	107.9	118.9	128.7

Source: National Syndicate Organization.

Agricultural production as a whole recorded a much smaller gain in 1962 than a year earlier. Although the wheat crop was exceptionally good in 1962 (following two poor harvests), output of nearly all other crops and livestock products expanded at reduced rates in 1962. Overall production of crops and livestock products rose by 4 per cent during 1962 compared with a gain of nearly 9 per cent during 1961. Damage to the citrus crops caused by the freeze in late December last year was a particularly unfavorable development for Spanish agriculture. The loss, estimated at nearly \$60 million in fruit lost or partly damaged, has adversely affected Spain's export earnings in 1963. Fortunately, the trees themselves were spared permanent damage.

Rising prices are again a major problem

Inflationary forces became strong at the start of 1962 and continued into the early months of the present year. Despite many pronouncements on the undesirability of rising prices throughout this period, no significant action to curb them was taken prior to the credit restriction measures applied in February and May of this year. In January, however, a general tariff cut of 5 per cent went into effect.

Although complete price stability was not achieved in 1960-61, upward movements in those years were relatively modest and the situation did not become alarming until 1962. The cost of living index rose 10.6 per cent during 1962, and the continued rise in the first quarter of this year placed the March index at 11.3 per cent above a year earlier. (See Table 3.) The wholesale price index rose 6 per cent during 1962; the rise has speeded up this year, and in March the index stood 10.2 per cent higher than 12 months before. The pressure has been particularly strong in the case of food prices, as shown in Table 4, due at least in part to the smaller increases in food crops than in production elsewhere in the economy, but the behavior of other prices shows clearly that general inflation pressures are operating in the economy.

The monetary statistics show this to be a prima facie case of too much private credit, expanded to feed the investment boom. How large a role has been played by upward wage pressures is impossible to say in view of the absolute dearth of statistics on changes in labor earnings or other incomes. It is known that in 1962 about 40 per cent of Spanish wage earners received substantial wage increases under the collective bargaining system that has been allowed to determine an increasing percentage of all wage rates since 1961. With rising production and a movement of labor to other European countries, the labor market has tightened greatly, so that open unemployment is no longer much of a problem in Spain. For reasons of social justice, the government has been encouraging wage increases for the past year. Spanish workers have also become more aggressive in their wage demands since April-May 1962, when the Asturias coal miners won wage increases after a lengthy strike.

Table 3. Spain: Price Indexes, Selected Months, 1961-63

	General Index	
	Wholesale prices	Cost of living
	<u>1955=100</u>	<u>1958=100</u>
<u>1961</u>		
March	149.0	110.6
June	147.1	109.8
September	148.4	110.5
December	152.2	112.6
<u>1962</u>		
March	153.9	113.8
June	158.2	117.4
September	155.9	118.3
December	161.4	124.5
<u>1963</u>		
January	166.1	124.6
February	166.2	125.8
March	169.6	126.7

Source: National Institute of Statistics (as published by the Bank of Spain).

Table 4. Spain: Price Indexes, 1959-62 a/

	Yearly Average				December	
	<u>1959</u>	<u>1960</u>	<u>1961</u>	<u>1962</u>	<u>1961</u>	<u>1962</u>
<u>Wholesale prices (1955=100)</u>						
<u>General index</u>	<u>142</u>	<u>145</u>	<u>149</u>	<u>157</u>	<u>152</u>	<u>161</u>
Foodstuffs, beverages, and tobacco (52.3)	145	149	154	167	160	174
Textiles (13.4)	116	114	123	127	126	127
Metals, metal products, and machinery (9.4)	143	148	148	148	148	149
Fuels, lubricants, and electricity (9.1)	168	174	174	181	175	187
Chemical products (6.0)	129	131	131	129	130	129
Construction materials (3.7)	145	141	135	138	134	141
<u>Cost of living (1958=100)</u>						
<u>General index</u>	<u>107</u>	<u>110</u>	<u>111</u>	<u>117</u>	<u>113</u>	<u>125</u>
Food (52.7)			108	117	111	126
Clothing (13.4)			108	113	110	119
Housing (5.2)			106	114	111	118
Household expenses (8.4)			110	113	111	116
General expenses (20.3)			121	124	121	129

a/ Weights of components are shown in parentheses.

Source: National Institute of Statistics (as published by the Bank of Spain).

Monetary expansion gathers more speed

Monetary expansion gained momentum and attained very large proportions in the past year and one-half. Rising economic activity has required substantial increases in the means of payment, but price developments and the pace of investment suggest that too much purchasing power has been injected into the economy. No change in monetary policy was made throughout 1962. A new instrument of credit control (see below) was introduced in February 1963, and this tool was employed again in May to apply the brakes on the growth of bank credit. These steps should result in a marked slowdown of credit expansion, particularly since the balance of payments is no longer supplying reserves to the banking system and government finances are not inflationary.

Bank credit to the private sector increased 26 per cent during 1962, and money supply rose 19 per cent compared to the 11 per cent rise in the real availability of goods and services to the economy. Allowing for seasonal factors, expansion is said to have continued at about the same pace in the first quarter of 1963.

How fast the monetary scene has changed in the short space of two years can be seen from Table 5. In 1960, despite bank credit expansion and the newly-emerged external surplus--very large in the Spanish context--there were no upward price pressures. Money supply rose only 1-1/2 per cent. Bank of Spain credit to the public sector declined, and there was an extraordinary 36 per cent increase in time and savings deposits caused by the restoration of confidence in the peseta, a climate of hesitation in the business community, and an interbank agreement effective in April 1960 not to pay more than 1/2 of 1 per cent interest on sight deposits. With the revival of investment in 1961 private bank credit rose 23 per cent, while the external surplus was nearly as large as the year before. But money supply rose only 14 per cent, or by little more than the 12 per cent addition to real availabilities to the economy. Again, central bank credit to government contracted, and time and savings deposits rose 21 per cent.

In 1962, external transactions provided far less scope for the generation of inflationary pressures, and once again time and savings deposits registered a big rise (23 per cent). However, Bank of Spain credit to the public sector stopped declining. More importantly, private bank credit rose 26 per cent. While this was not proportionately much greater than in 1961, it had a much bigger effect than the year before because private bank credit had come to be a relatively larger counterpart of money supply. In contrast to the year before, the increase in total money supply substantially exceeded the gain in real availabilities in the Spanish economy.

The ability of the banks to expand credit at these rapid rates has stemmed entirely, or almost entirely, from official reserve accruals. Bank of Spain operations vis-a-vis government reduced bank liquidity in both 1960 and 1961. However, foreign exchange accruals in 1960 were so large in relation to private bank credit expansion that the private banks reduced substantially their rediscounts and advances from the Bank of Spain. As private demand for bank credit grew and foreign exchange accruals diminished and then ceased in late 1962, the banks made more use of Bank of Spain accommodation, but by only relatively small amounts, in 1961-62.

Table 5. Spain: Selected Monetary Statistics, 1959-62
(in billions of pesetas; end of year)

	1959	1960	1961	1962
<u>MONEY SUPPLY</u>	<u>201</u>	<u>204</u>	<u>232</u>	<u>276</u>
Currency	70	75	84	98
Sight deposits	132	129	149	178
<u>COUNTERPARTS OF MONEY SUPPLY</u>				
<u>Credit to public sector a/</u>	<u>110</u>	<u>104</u>	<u>95</u>	<u>96</u>
Bank of Spain	41	36	26	27
Private banks b/ :				
Long-term bonds	61	61	61	59
Other	6	4	4	6
Treasury coin	2	3	4	4
<u>Credit to private sector</u>	<u>187</u>	<u>208</u>	<u>254</u>	<u>318</u>
Bank of Spain	5	4	4	4
Private banks b/ :				
Loans and other credits	162	183	228	291
Securities	20	21	22	23
Foreign sector	0	23	45	59
<u>Gross official reserves</u>	<u>13</u>	<u>35</u>	<u>52</u>	<u>62</u>
Balance in U.S. aid peseta deposits	- 11	- 12	- 11	- 7
Other (net)	- 3	0	3	5
<u>Time and savings deposits in private banks b/</u>	<u>- 75</u>	<u>-111</u>	<u>-135</u>	<u>-165</u>
<u>Bank capital and all other (net)</u>	<u>- 21</u>	<u>- 20</u>	<u>- 27</u>	<u>- 32</u>
<u>TIME AND SAVINGS DEPOSITS</u>	<u>136</u>	<u>185</u>	<u>224</u>	<u>275</u>
In private banks b/	75	111	135	165
In savings banks	61	75	90	110
<u>BANK OF SPAIN CREDIT TO PRIVATE BANKS b/c/</u>	<u>35</u>	<u>22</u>	<u>20</u>	<u>25</u>
Advances against government securities	25	14	16	18
Rediscounts	9	7	5	7
Other credits	2	2	1	1
Banks' balances with Bank of Spain	- 1	- 1	- 2	- 1

a/ Central administration, autonomous organizations, state enterprises, municipal and provincial authorities, and the official credit institutions.

b/ Deposit money banks, as distinct from the savings banks and the Bank of Spain.

c/ Excluding advances against government securities extended but not drawn on. These totalled 21 billion at the end of 1962, and nearly the same at the end of 1960 and 1961.

Source: Data in Bank of Spain, Boletín Estadístico.

With prices and bank credit still rising swiftly in early 1963, the authorities moved to halt the trend. Under the powers provided under the Bank Reform Law of April 1962, the Finance Minister imposed a compulsory liquidity coefficient on the private banks. This coefficient relates total deposit liabilities to the sum of cash on hand, balances with the Bank of Spain, the unutilized portion of the holdings of government securities pledgeable for Bank of Spain advances (now granted automatically), and certain minor categories of public-sector paper eligible for automatic rediscount at the Bank of Spain. By order of the Finance Minister, the Bank of Spain may fix this percentage between 10 and 20 per cent. The coefficient was established at 12 per cent effective February 15 and was raised to 13 per cent on May 6. The May action is thought to have immobilized all of the hitherto-existing base for further credit expansion.

Adoption of the reserve requirement instrument, and the disappearance for at least some time to come of the balance of payments surplus, seem likely to usher in a new period in Spanish monetary experience. If Bank of Spain credit to the public sector is not increased the resources of the private banks seemingly can now increase only through resort to Bank of Spain credit. In this situation, the monetary authorities have scope to regulate monetary expansion by controlling the rediscounts and advances of the Bank of Spain to the private banks.

Balance of payments surplus vanishes

The succession of Spanish external surpluses has come to an end, and there is no reason to expect any sizeable surplus in the external position for the foreseeable future. Official reserves fell \$9 million in the last quarter of 1962, and \$12 million in the first quarter of 1963 (partly because of reduced exports of citrus fruits as a result of the December freeze). (See Table 6.) Current opinions on the balance of payment out-turn for 1963 as a whole range between estimates of equilibrium and of a "modest" deficit. Over the longer term, the long-awaited 4-year development plan now scheduled to begin in January 1964 will call, according to recent official statements, for outside assistance.

Table 6. Spain: Official Reserves, 1959-63
(In millions of dollars)

Year	Amount, end of period			Increase in Period
	Gold	Foreign Exchange	Total	
1959	68	150	218	152
1960	178	412	590	372
1961	316	553	869	270
1962	446	583	1,029	160
<u>Quarter</u>				
1961 - I	205	394	599	9
II	217	475	692	93
III	277	522	799	107
IV	316	553	869	72
1962 - I	351	579	930	61
II	409	583	992	62
III	428	609	1,038	46
IV	446	583	1,029	- 9
1963 - I	514	503	1,017	-12

Source: International Monetary Fund.

For 1962, the Spanish surplus was \$184 million compared with \$371 million in 1961 and \$460 million in 1960.^{3/} The reduction was caused for the most part by a doubling of the trade deficit to \$835 million (based on customs data with imports on a c.i.f. basis). Even though net receipts from tourism soared to \$427 million and net inward private remittances to \$175 million, they could not match the widening of the trade gap. Net private capital inflow remained large at about \$200 million in 1962, although it did not change greatly in over-all magnitude from the \$191 million figure in 1961. (Other details of the 1962 balance of payments are not available.)

Imports in 1962 were 44 per cent higher than in 1961; this followed a rise of 51 per cent in 1961. (See Table 7.) Seasonally-adjusted imports rose 9 per cent in the first quarter of 1962, 13 per cent in the second, 2 per cent in the third and 18 per cent in the final quarter. Three factors making for the growth of imports were (1) the increase in consumption; (2) rising prices in Spain; and (3) import liberalization (both in 1962 and in earlier years).

^{3/} Measured by the net change in short-term foreign assets and liabilities of the monetary institutions. Increases in Spain's IMF position totalling \$128 million in 1960-62 supplemented increases in official reserves.

Table 7. Spain: Foreign Trade, 1959-62
(In millions of dollars)

<u>Year</u>	<u>Imports, c.i.f.</u>	<u>Exports</u>	<u>Balance</u>
1959	795	501	-294
1960	722	725	+ 4
1961	1,092	709	-383
1962	1,569	734	-835
<u>Quarters, seasonally-adjusted, at annual rates</u>			
1961 - I	1,044	744	-300
II	960	648	-312
III	1,152	684	-468
IV	1,236	720	-516
1962 - I	1,344	768	-576
II	1,524	672	-852
III	1,560	756	-804
IV	1,848	696	-1,152

Source: National Institute of Statistics (annual data) and OECD (quarterly adjusted figures).

However, the most important single factor has been the private investment boom and its heavy import content. Private fixed investment in Spain rose an estimated 34 per cent (at current prices) in 1962. Bank of Spain figures show increases last year of 67 per cent in imports of "investment goods" (machinery, precision instruments, and transport material) and of 71 per cent in imports of other manufactured products, (largely of metals and chemicals). (See Table 8.) Considerably smaller increases were recorded in other groups (19 per cent for foodstuffs, 30 per cent for raw materials, and 39 per cent for fuels and lubricants).

Table 8. Spain: Trade by Commodity Groups, 1961-62 a/
(In millions of dollars)

	Imports		Exports	
	1961	1962	1961	1962
Foodstuffs	189	226	315	363
Fuels and lubricants	178	246	42	45
Raw materials	260	336	131	106
Manufactures:				
Machinery	167	286	22	25
Precision instruments	12	21	1	1
Transport equipment	73	112	4	28
Other	213	342	194	166
Total manufactures	<u>465</u>	<u>761</u>	<u>221</u>	<u>220</u>
Total imports or exports	1,092	1,569	709	734

a/ Comparable data are not available for earlier years.
Source: National Institute of Statistics.

Exports rose 3.5 per cent in 1962, due entirely to higher exports of foodstuffs, which made up nearly half of total exports. But this increase did little more than make up for a drop in exports in 1961, so that last year's exports were only 1 per cent above the level of two years earlier. This virtual stagnation in exports for the past two years reflects the pull of strong internal demand, as well as rising domestic prices and reduced competitiveness in some export markets. Moreover, according to the report of the IBRD Mission to Spain, an "export mentality" has yet to be created in Spain, and further measures by the government to promote exports are in order.

More moves toward a freer economy

The dismantling of government controls on economic activity has been an important part of the Spanish story since the basic decision in 1959 to move towards a freer economy. In recent months this process has continued. In addition, reforms are "in the mill" concerning the role of state enterprises and certain other aspects of government policy which have been criticized as detrimental to private initiative and efficient resource allocation.

A battery of sweeping objectives, designed largely to liberalize the internal economy, was adopted by the Spanish Government in a decree of November 29, 1962. Some of these announced intentions have been acted on; others await fulfillment. Only some of the more important of them are considered here.

First, in January and May of 1963 all restrictions on the establishment, expansion, and transfer of plants and factories were wiped out (except for public utilities, shipbuilding, and certain industries of negligible economic importance). This was a sequel to actions last August and September which reduced the scope for governmental delay or prohibition of private investment plans, as a result of widespread dissatisfaction with the pre-existing need for government approval of every investment decision.

Second, in April of this year the permissible share of foreign participation in Spanish firms was raised from 50 to 100 per cent in a wide number of industries (including iron and steel, non-ferrous metals, chemicals, textiles, electronics, machine tools, leather and shoes, and hotels), which together account for a major portion of Spanish industrial output. All restrictions on the repatriation of foreign capital and on earnings were removed in the spring of 1962.

Third, some of the remaining impediments to production in the form of allocations of goods and price ceilings were done away with in April, and others are slated to go by January 1964.

Fourth, the future role of state-owned enterprises was defined in the November pronouncement as being restricted to one of "complementing private initiative and combating monopolistic practices." Annual investment programs of these enterprises will also be published. These pronouncements concern the National Institute of Industry (INI), the state-owned holding company whose investments in over 60 firms in twelve broadly-defined sectors of industry and commerce were valued at 60 billion pesetas (\$1.0 billion) in 1960. It was the opinion of the IBRD Mission that, especially in the light of past INI activities, its existence would be a strong potential discouragement to private initiative unless its field of operations were clearly staked out and its intentions publicly known. Details of the future role of INI have apparently not yet been released. 4/

4/ In addition, nothing has yet been said officially about possible changes in another facet of INI operations. It was the IBRD Mission's view that, insofar as possible, INI should operate on terms of equality with private industry. At present, INI bonds carry a government guarantee, the interest on them is tax exempt, and savings bank regulations provide them with a captive market. Bond issues have been the prime source of INI expansion since cash grants from the government budget were ended in 1957.

Finally, a review has been promised of two practices that date from 1939. These are the "Buy Spanish" provisions on public sector procurement, and the many special benefits still accorded to some industries which are a holdover from the defense needs of 25 years ago and the former policies of autarky.

Implementation of the Bank Reform Law is affecting Spanish banks

The Basic Law on the Organization of Credit and Banking of April 14, 1962 affected in greater or less degree all the financial institutions in Spain. Its language is mostly general, so that it has been necessary to see how it would be implemented. Since the nationalization last summer of the Bank of Spain and three of the six official medium- and long-term credit institutions (the other three were already 100 per cent government owned), several more implementing decree-laws have been promulgated. However, some questions of great interest--especially relating to monetary policy--are still undecided.

The Finance Minister received power to establish four types of reserve or liquidity requirements for the private banks by the decree-law of December 6, 1962. Three of these requirements relate total outstanding deposits to: (1) cash on hand, balances with the Bank of Spain, and the unutilized portion of government securities deposited with the Bank of Spain as collateral for advances; (2) the items above, plus other public sector securities that are eligible as collateral for advances from the Bank of Spain or which are eligible for automatic rediscount with the Bank of Spain;^{5/} and (3) capital and reserves. The fourth requirement which the Finance Minister may impose is a marginal reserve requirement, relating increases in total deposits to additions to balances with the Bank of Spain. This last requirement is in addition to the power already granted in 1960 (and not yet exercised) to require banks to keep balances with the Bank of Spain up to 10 per cent of total deposits. The liquidity requirement imposed on the banks in February 1963 conforms to the second of these variants.

The Basic Law of April 1962 states that monetary and credit authority rests with the government, and implementing measures give the Minister of Finance primary responsibility for the formulation of monetary policy. When the Bank of Spain was nationalized in June 1962, the pertinent decree-law gave the Finance Minister the power to determine the general policies to be followed by the Bank, to set interest charged or paid by it and to approve its open market operations. Bank reserve requirements are established directly by the Finance Minister, although the Bank of Spain was asked to determine the precise percentage to be imposed this year.

^{5/} Advances are made up to only 80-90 per cent of the nominal value of the securities. When securities are actually deposited with the Bank of Spain, they are valued at 80-90 per cent of their nominal value, or less than when they are still retained by the banks. This accounts for the distinction in the requirements between deposited and undeposited securities.

The significance of the nationalization of the Bank of Spain is probably largely psychological and administrative. On the other hand, the nationalization of the three official medium- and long-term credit institutions which were partly in private ownership will undoubtedly produce important changes in their lending policies. The six official credit institutions, with resources of about 80 billion pesetas, are a major source of finance for the private sector. Formerly dependent on bond issues, they have recently obtained nearly all additions to their resources from the government budget.

Crucial matters of monetary policy still remain to be decided. The article of the Basic Law closely related to the instruments of monetary policy states that "rules will be established to govern open market operations as well as rediscounting and pledging of government securities for Bank of Spain advances/ by private banks and the establishment of compulsory reserves of the private banks to be held in the Bank of Spain, and any other control instruments."

Future decisions taken in regard to Bank of Spain advances to banks against pledge of government securities will be of great importance. Practically all securities issued by the government over a long period of years are eligible for automatic advances from the central bank. The only control over the volume of such advances has been the rate charged for this accommodation. Although the government securities issued since 1959 have not borne this privilege, nearly all government securities now held by the banks enjoy the privilege of automatic eligibility.^{6/} As the IBRD Mission to Spain pointed out, "this privilege has been recognized as a very serious impediment to control of the liquidity of the economy." The IBRD Mission suggested that a conversion operation (or a series of them) be carried out to exchange these securities for securities without the automatic pledge feature. Since the control of bank credit expansion has in recent months become of central importance to the economy, this matter would appear to be urgent.

Since there is as yet no Spanish money market, it is impossible to foresee what open market operations the Bank of Spain might undertake. To get a market started, the IBRD Mission has suggested that Bank of Spain credit to the government in the form of overdrafts on the government's account be replaced (at least in part) by the issuance of securities on the open market. Another recommended change was abrogation of the requirement that savings banks put 75 per cent of the increase in their deposits into new issues of government or other public-sector (e.g., INI) securities if the volume of such issues reaches that level.

Initial steps were taken in November and December 1962 to accomplish the eventual separation of commercial and investment banking. The present system of mixed banks has been criticized as causing, inter alia, undue

^{6/} The private banks held 59 billion pesetas of government bonds at the end of 1962, of which 18 billion pesetas had been actively used for such advances. Advances had also been made against another 21 billion pesetas, but these funds had not been drawn.

control of large-scale industry by banks as well as discrimination in bank lending. Since forced divestiture of corporate securities by the mixed banks could be highly disruptive, action in this area has to be cautious.

Two measures have been introduced:

- a. A decree-law of December 6, 1962 provides that
- (1) banks as presently organized cannot make new purchases of corporate securities if their holdings of such securities plus real estate exceeds the sum of their capital and reserves; and
 - (2) in five years, banks as presently organized must divest themselves of corporate securities and real estate in excess of capital and reserves. Exceptions may be granted, but sales of securities bought or retained through exceptions will not carry the exemption from capital gains tax that will apply to sales made to comply with the provisions.

b. A decree-law of November 29, 1962 established regulations under which investment banks may be set up and operated, and present mixed banks may opt to become investment banks. To ensure that they do so in fact and not just in name, investment banks will not be permitted to have more than three branches or to engage in commercial bank operations except with firms in which they have a "major interest" (a term apparently still to be defined).

Most of the larger banks now hold corporate securities in excess of capital and reserves, and for some banks the excess is large. They will have to shed some of them or reorganize as investment banks. But Spain will continue to have some degree of mixed banking for an indefinite period, and some critics feel the actions to date do not go far enough.