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Journal of Policy Modeling 34 (2012) 16–34

Journal of Policy Modeling

www.elsevier.com/locate/jpm

The single monetary policy and domestic macro-fundamentals: Evidence from Spain

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Received 13 February 2011; received in revised form 6 May 2011; accepted 25 August 2011
Available online 10 September 2011

Abstract

We model pre-euro Spanish monetary policy and use our findings to assess the compatibility of the interest rates set by the ECB since 1999 with Spanish macro-fundamentals. We find that in the 1990s Spain implemented successfully a monetary strategy tailored to its own domestic fundamentals; and by abolishing it to join the euro she has paid a cost in the form of a sub-optimal monetary policy. Our findings suggest that the present turmoil in the market for Spanish government bonds is symptomatic of the risks involved in participating in a monetary union highlighted by the theory of optimum currency areas. We argue in favour of structural reforms increasing Spanish competitiveness, and a cautious approach with respect to the timing of further EMU enlargement.

JEL classification: C51; C52; E43; E58; F37

Keywords: Spain; ECB; Monetary policy; Domestic fundamentals; Compatibility

1. Introduction

In recent months the eurozone has been experiencing a major sovereign debt crisis. Starting from Greece in late 2009 this has since spread to other periphery EMU countries raising doubts about EMU's sustainability and prompting calls for a major overhaul of its institutional framework. Arghyrou and Tsoukalas (2011) offer a first theoretical treatment of the crisis attributing it to a background of deteriorating macro-fundamentals and shifting market expectations. Arghyrou and

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doi:10.1016/j.jpolmod.2011.09.002

Kontonikas (2011) tested that model's empirical validity finding strong supporting evidence. Their findings are consistent with those of other recent studies showing that since 2007 markets have been imposing significantly heavier penalties on macro and fiscal imbalances (see e.g., Attinasi, Checherita, & Nickel, 2009; Barrios, Iversen, Lewandowska, & Setzer, 2009).

These studies focus on the second aspect of the EMU crisis, i.e., changes in markets' pricing behaviour. By contrast, the crisis' original underlying factor, i.e., accumulated macro-imbalances, has received much less attention. This is rather surprising for two reasons: first, because it is precisely such macro-imbalances that were highlighted by the Theory of Optimum Currency Areas (TOCA) as the primary threat to the sustainability of a monetary union. Second, because well before the onset of the EMU crisis economic research had highlighted growing intra-EMU imbalances (Arghyrou & Chortareas, 2008; Campa & Mínguez, 2006; European Central Bank, 2003) and divergence between the single monetary policy (SMP) and national fiscal policies (Hugh Hallett & Lewis, 2008). Therefore, it was possible to infer that the risks highlighted by the TOCA were in place. Without estimates of monetary-policy incompatibility the theoretical debate on the optimal SMP was largely taking place within an empirical vacuum and systemic EMU-specific risks were underestimated.

Two studies testing the compatibility of the SMP with national macro-fundamental are those by Hayo and Hofmann (2006) on Germany and Arghyrou (2009) on Greece. The latter finds that the interest rates set by the ECB were lower than those compatible with Greek fundamentals by a factor ranging between 2 and 3. In light of subsequent events, it can now be plausibly argued that the estimated size of monetary policy incompatibility was a valid proxy for accumulated macro-imbalances and a valid lead indicator for the crisis subsequently hitting the market for Greek government bonds.

In this paper we address the question of monetary-policy incompatibility for the largest of the EMU-periphery economies, Spain. Being the EMU's fourth largest economy producing 12% of the EMU's total output, Spain was always regarded to have enough bargaining power to exercise potentially significant leverage on the ECB on her own and by leading coalitions of countries sharing its asymmetries against the EMU average (see e.g., Di Bartolomeo, Engwerda, Plasmans, & van Aarle, 2006). Following the Greek crisis, the significance of Spain has increased further. According to ECB data, Spain's share in total outstanding long-term EMU sovereign debt is 9%, as opposed to Greece's 5% and Portugal's 2%. Furthermore, the total foreign-bank exposure to Spanish investments was estimated by the Bank of International Settlements in September 2009 at 781 billion US Dollars, as opposed to 167 billion in Greece and 134 billion in Portugal (see also Darvas, Pisani-Ferry, & Sapir, 2011). These have prompted observers to comment that the comparison between a Greek and Spanish debt crisis is analogous to the one between the collapses of Bear Stearns and Lehman Brothers. Therefore, research on risks idiosyncratic to Spain is both timely and of general interest.

The question of monetary-policy compatibility had been raised for Spain before her accession to the EMU in 1999 (see Gali, 1998). At the time there was plenty of room for optimism as the 1990s had seen a significant improvement in Spanish macroeconomic performance reflected in all leading macro-indicators (see Fig. 1). During 2009–2007 Spain continued outgrowing the EMU's average, however, its overall macroeconomic outlook deteriorated. Most notably, Spanish inflation relative to the EMU increased causing real effective exchange appreciation and negative real interest rates. These were followed by a record current account deficit and very significant price increases in the Spanish real estate market. The source of these adverse developments is debatable. One possibility is Balassa (1964)–Samuelson (1964) effects caused by high Spanish growth rates. This argument, however, is rather unconvincing given the post-1999 low growth of