THE FUNCTIONS OF THE BANK OF SPAIN

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CHAPTER 1

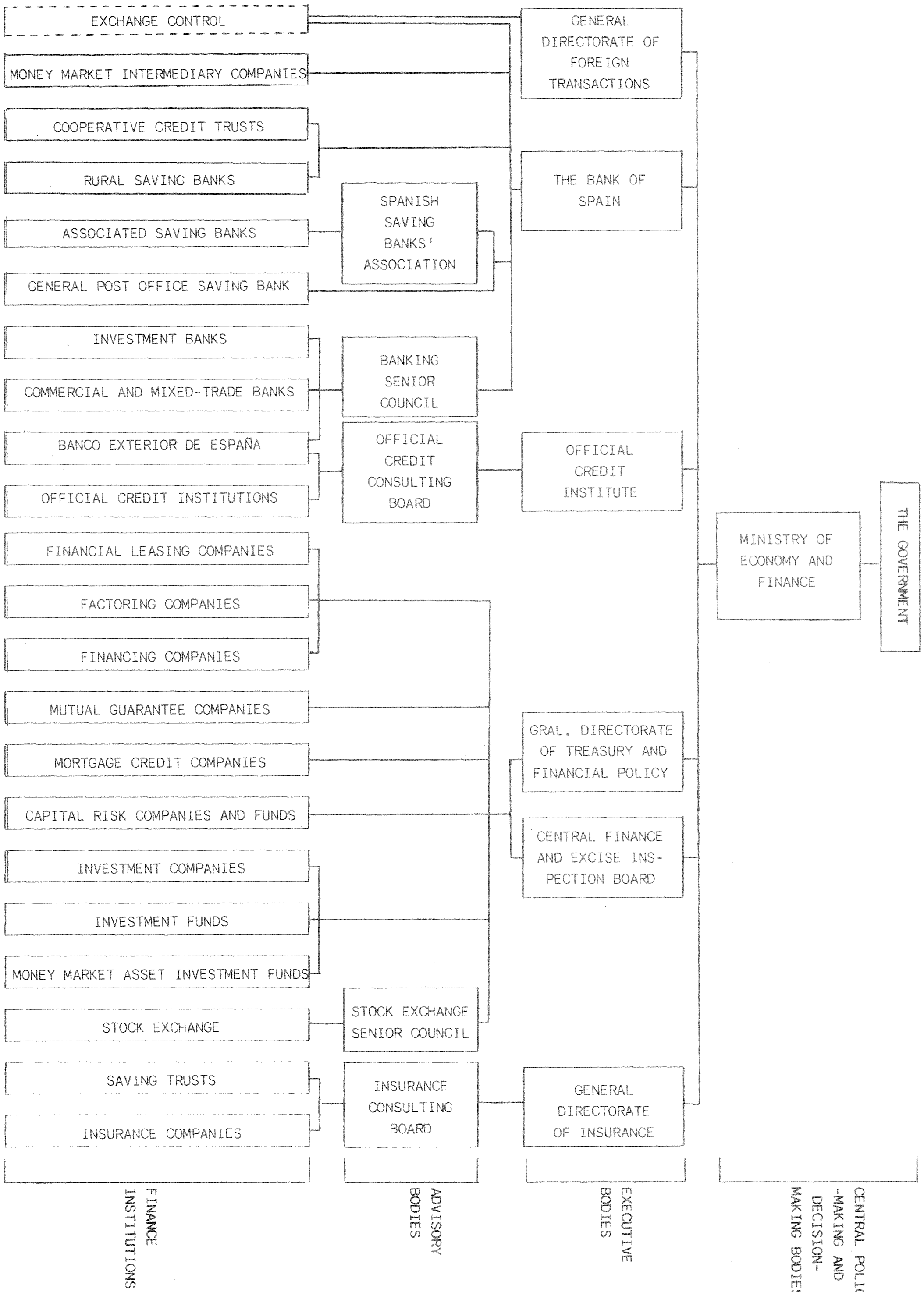
GENERAL FEATURES OF THE SPANISH FINANCIAL SYSTEM

1. Composition of the Spanish Financial System

Monetary authority rests with the Government, who determines the guidelines of monetary policy. The Ministry of Economy and Finance is responsible for all matters concerning the functioning of financial institutions. Chart nº 1 offers a simplified view of the financial network and links among the institution that constitute our financial system.

The four main institutional groups of our financial system -banks, savings banks, official credit institutions and cooperatives- are controlled and regulated at an intermediate level by the Bank of Spain and the Official Credit Institute. Table 1 shows the number of institutions in each group and their branches.

Subject to guidelines set by the Ministry of Economy and Finance, the Bank of Spain is responsible for all matters concerning private banks, savings banks, cooperatives and money market intermediary companies. All the functions regarding the regulatory activity, inspecting the above mentioned institutions, as well as implementing the monetary policy, are carried out by the Bank of Spain. Its competence in both these fields was determined by the Decree-Law of 1962, by which the Bank was nationalized and reorganized. The Decree-Law was in part modified in mid-1980 by a new law regulating the Bank of Spain's governing bodies and providing the Bank with a greater autonomy in implementing the monetary policy always within the general guidelines issued by the Government. The new law states that the Bank of Spain is to implement the monetary policy in the way it considers most appropriate to attain the desired goals and particularly to safeguard the value of money. The chart below shows the structure of the Bank of Spain's governing bodies.


EXCHANGE CONTROL
MONEY MARKET INTERMEDIARY COMPANIES
COOPERATIVE CREDIT TRUSTS
RURAL SAVING BANKS
ASSOCIATED SAVING BANKS
GENERAL POST OFFICE SAVING BANK
INVESTMENT BANKS
COMMERCIAL AND MIXED-TRADE BANKS
BANCO EXTERIOR DE ESPAÑA
OFFICIAL CREDIT INSTITUTIONS
FINANCIAL LEASING COMPANIES
FACTORING COMPANIES
FINANCING COMPANIES
MUTUAL GUARANTEE COMPANIES
MORTGAGE CREDIT COMPANIES
CAPITAL RISK COMPANIES AND FUNDS
INVESTMENT COMPANIES
INVESTMENT FUNDS
MONEY MARKET ASSET INVESTMENT FUNDS
STOCK EXCHANGE
SAVING TRUSTS
INSURANCE COMPANIES
SPANISH SAVING BANKS' ASSOCIATION
BANKING SENIOR COUNCIL
OFFICIAL CREDIT CONSULTING BOARD
STOCK EXCHANGE SENIOR COUNCIL
INSURANCE CONSULTING BOARD
GENERAL DIRECTORATE OF FOREIGN TRANSACTIONS
THE BANK OF SPAIN
OFFICIAL CREDIT INSTITUTE
GRAL. DIRECTORATE OF TREASURY AND FINANCIAL POLICY
CENTRAL FINANCE AND EXCISE INSPECTION BOARD
GENERAL DIRECTORATE OF INSURANCE
MINISTRY OF ECONOMY AND FINANCE
THE GOVERNMENT
FINANCE INSTITUTIONS
ADVISORY BODIES
EXECUTIVE BODIES
CENTRAL POLICY -MAKING AND DECISION-MAKING BODIES

BODIES GOVERNING THE BANK OF SPAIN

	NAME OF OFFICE & SUBORDINATE DIVISION	APPOINTED BY:	TERM OF OFFICE	TERMINATION	REQUIREMENTS	INCOMPATIBLE WITH THE POSITION OF	MAIN COMMITMENTS
PERSONAL APPOINTMENTS	THE GOVERNOR	THE CROWN (ON SUBMISSION BY THE GOVERNMENT)	4 YEARS, REPEATABLE	. END OF TERM OF OFFICE . ACCEPTED RESIGNATION . DISMISSAL BY A GOVERNMENT DECREE FOLLOWING A PROSECUTION BY THE MINISTRY OF ECONOMY AND FINANCE	TO BE AN ADULT SPANIARD ENJOYING RENOWN FOR COMPETENCE IN ECONOMY	. DEPUTEE OR SENATOR . ANY OTHER ACTIVITY CONNECTED WITH THIS OFFICE . MAY NOT WORK IN ANY PRIVATE CREDIT OR SAVING INSTITUTIONS BEFORE TWO YEARS AFTER LEAVING OFFICE	. TO REPRESENT THE BANK OF SPAIN . TO CONDUCT THE BANK'S ADMINISTRATION . TO UNDERTAKE AND DECIDE ON THE EXECUTION OF THE BANK'S TRANSACTIONS, HAVING OBTAINED THE EXECUTIVE BOARD'S CONSENT IF APPROPRIATE . TO SETTLE THE GENERAL COUNCIL'S AND THE EXECUTIVE BOARD'S DECISIONS BY EXERCISING THE CASTING VOTE
	THE DEPUTY GOVERNOR	THE GOVERNMENT (ON SUBMISSION BY THE MINISTRY OF ECONOMY AND FINANCE)	SAME AS THE GOVERNOR	SAME AS THE GOVERNOR	SAME AS THE GOVERNOR	SAME AS THE GOVERNOR	. TO SUBSTITUTE FOR THE GOVERNOR IN HIS ABSENCE . TO UNDERTAKE DUTIES DELEGATED BY THE GOVERNOR AND THE ONES SPECIFIED IN THE BANK'S REGULATIONS
CORPORATE BODIES	THE GENERAL COUNCIL (INCL.): . THE GOVERNOR (CHAIRMAN) . THE DEPUTY GOVERNOR	ALL MEMBERS, BY A GOVERNMENT DECREE					. TO DECIDE ON THE OUTLINE OF THE BANK OF SPAIN'S POLICY . TO MAKE THE BANK'S REGULATIONS AND TO PUBLISH ITS RULINGS . TO APPROVE BUDGETS, GENERAL ACCOUNTS AND ANNUAL REPORTS . TO ADVISE THE GOVERNMENT AND TO APPROVE GENERAL REPORTS FOR SUBMISSION . TO SUBMIT PENALIZING MOTIONS IN VERY SERIOUS CASES . TO ASSIST THE GOVERNOR . TO HOLD MEETINGS - ONCE A MONTH - ON THE GOVERNOR'S CALL - ON HALF OF ITS MEMBERS' MOTION
	. SIX COUNCILLORS	THE GOVERNMENT	3 YEARS, REPEATABLE	SAME AS THE GOVERNOR		. ANY POSITION IN PRIVATE FINANCE INSTITUTIONS	
	. ONE COUNCILLOR	THE BANK OF SPAIN'S STAFF (BY BALLOT)			10 YEARS' SERVICE		
	. GENERAL MANAGERS OF THE BANK OF SPAIN (max. 4)	THE GOVERNOR					
	. GENERAL MANAGER OF THE TREASURY AND FINANCE POLICY . GENERAL MANAGER OF BUDGETTING			UPON LOSING THE POSITION THE OFFICER ORIGINALLY HELD WHEN HE WAS APPOINTED			
	NON-VOTING OFFICIALS: . THE SECRETARY GENERAL OF THE BANK OF SPAIN . GENERAL MANAGERS OF ALL OTHER BANK OF SPAIN'S DIVISIONS						
	EXECUTIVE BOARD: (INCL.): . THE GOVERNOR . THE DEPUTY GOVERNOR						. TO EXECUTE THE GENERAL COUNCIL'S INSTRUCTIONS . TO PREPARE REPORTS FOR THE GOVERNMENT . TO PREPARE BUDGETS, GENERAL ACCOUNTS AND ANNUAL REPORTS . TO DRAW THE BANK'S REGULATIONS . TO APPOINT THE BANK'S SENIOR STAFF . TO MAKE DECISIONS ON ADMINISTRATIVE AUTHORIZATIONS . TO EXERCISE SANCTIONING AUTHORITY
	. THREE OF THE SIX COUNCILLORS APPOINTED BY THE GOVERNMENT	ELECTED BY THE GENERAL COUNCIL			ADEQUATE PARTICIPATION		
	. ONE OF THE BANK OF SPAIN'S GENERAL MANAGERS . NON-VOTING MEMBER: THE SECRETARY GENERAL OF THE BANK OF SPAIN		1 YEAR				

NUMBER OF ENTITIES AND AGENCIES

(31-III-87)

	Entities	Agencies
Bank of Spain	1	53
Banks	95	16.391
Saving Banks	79	11.115
Cooperative Credit Institutions	135	3.396
Official Credit Institutions	5	55
Foreign Banks	42	126
Spanish Bank's agencies abroad	-	146

Official credit institutions, who are also under the authority of the Ministry of Economy and Finance, are grouped under the control of the Official Credit Institute, which coordinates, controls, supervises conduct their activities, and is responsible for their funding. Such financial structure counts also with some organizations that play an advisory role, such as the Banking Senior Council, the Spanish Savings Banks Confederation, the Official Credit Consulting Board, Insurance Consulting Board and the Senior Council for the Stocks Exchange.

There is a second, less important, group made up of institutions for hire-purchase, factoring, financial leasing, mutual guarantee companies, investment trusts, mortgage credit companies, capital risk companies and money market asset investment fund. All these institutions, as well as the Stock Exchange, come under the authority of the Treasury and Financial Policy General Directorate. The Finance and Tax Inspection Office is in charge of inspecting and supervising these entities.

2. Development of the Financial System

Even though it is difficult to pinpoint a precise date for the starting of a given process of financial evolution, 1973-74 can be generally accepted as the date in which our current system took the first steps. It was only after these years that our financial system has undergone important transformations, both in its operational and structural nature, that changed a good number of its traditional features. The process, though spaced out in time and subject to several contingencies, has always had the constant tendency to endow the system with increasing flexibility and to allow for greater competition among the institutions operating within it.

Before embarking on a brief chronological survey of these transformations, it might be useful to outline a few general points that will help to understand the process and its peculiarities.

First of all, we must necessarily bear in mind that the transformations of our financial system is part of a more general process that has been taking place in all the neighbours industrialized countries. This process, affecting us all, is embodied in various lines of reform, which, though interwined at times, can be clearly distinguished.

Lets focus our attention on the chronology of events. During the second half of the 1960s and the beginning of the 1970s, all industrialized countries introduced a number of reforms and changes in an attempt to allow for greater freedom in the institutions' activity within the sectors familiarized with. This did not mean that specialization was to disappear but rather that it had stopped being a legal requirement. This new attittude brought about changes in the regulations that the authorities imposed on the institutions becoming the authorities' control more homogeneous, more flexible and simpler.

Beginning with the early 1970s, the implementation of new possibilities of action that the new regulations offered to banking institutions coincided with substantial changes in general economic conditions -and thus, in economic policy- and banking crises ensued in some countries. In the face of these crises, monetary authorities reacted by introducing a number of measures to secure protection to the depositors. In all cases, these measures included reinforcing financial institutions' control mechanisms and a new approach to their control procedures.

The current evolution of the system -since the early 1980s- shows how innovations in financial instruments have developed considerably, how all financial activities are increasingly internationally involved and how the authorities have created new means of levelling up with financial institutions' operations. At the same time they attempt to safeguard their capacity to innovate as a vital element for developing more sophysticated systems, and finally, the guarantee the safety of the system as a whole.

In the second place, our development has been different from other countries' in so far as the economic conditions in which these transformations were undertaken in Spain differed from the ones prevailing in these countries. In fact, the transformation process abroad had been taking place over a longer period of time so that, when an economic crisis arose in 1973-74, most foreign countries were already well advanced in reforming the basic aspects of their systems and could embark with greater ease upon the reforms to increase the security of each system. Spain, on the other hand, was envisaged with the need to carry out its reforms on all fronts at the same time and in the midst of an economic crisis. Thus, since 1973, a number of measures have been brought into action with the aim of improving the functioning of financial institutions and of perfectioning the implementation of the monetary policy. At the same time attempts to secure their soundness and solvency were being made, together with more rigorous inspection methods that were introduced. The conditions in which our banking crisis came about and the way it developed is a clear reflection of the prevailing situation those days. Actually, perhaps with the exception of solvency ratio and risk limits, all the legal system evolved at the same time as the crisis was developing.

Once pointed out the facts mentioned above, we should look into the measures relative to the process of liberalizing the system, to giving banking institutions an uniform legal status, and the implementation of the monetary policy, as well as into all such measures bearing effect on the soundness and solvency in the functioning of the system as a whole.

The summer of 1974 can be considered as a significant date for the transformation process of our financial system. It was at this time that a number of measures were undertaken. Such measures brought about increasing liberalization for the system also contributing to a greater degree of uniformity in the legal status of the financial institutions, and to a tighter interaction between them. Some of these measures were: a regulation on setting up and expanding banks and savings banks, provide with greater scope for attracting resources through certificates of deposit, liberalization of interest rate on long-term forward deposits, the introduction of an uniform solvency ratio, reserve requirements and investment requirements.

From then on, further regulations have shown a clear tendency to broaden and go deeper into the lines of the 1974 reform. In this regard, the finance authorities aimed at a three-fold goal, which was announced after the Moncloa Accords (1977), namely at strengthening monetary policy instruments in order to make them more efficient in future applications, at bringing interest rates more into line with free market conditions as an essencial requirement for greater efficiency in the working of financial markets and, furthermore, at modifying the structural and operational features of financial institutions.

With regard to the reinforcement of monetary policy instruments, is worth to mention the introduction of the following measures: the reserve requirements for savings banks was set at the same level as for commercial banks, savings banks were incorporated into the monetary control mechanisms, and short-term rates of the Bank of Spain were adapted to those of the monetary market, while a system of awarding monetary control loans by auction was introduced.

As regards the provisions for achieving an uniform treatment and flexible interest rates on financial markets, the steps mainly consisted in increasing the basic interest rate, liberalizing interest rates on banks' and saving banks' lending operations for one year or more, reviewing and leveling the interest rates on these institutions' and Official Credit institutions' special investment operations, and increasing the interest rates on investment bonds and securities subject to saving banks' public fund coefficient. Likewise, the State introduced public debt issues at the interest rates quoted on the market.

Finally, it should be pointed out that concerning the functioning, the structure and the organization of financial markets, attempts were made to reduce a number of investment requirements which were intended to enhance an artificial demand for various public and private financial assets from banking institutions. The main steps in this direction consisted in reducing the public debt and special investment coefficient which was compulsory for savings banks, as well as reducing the special credit coefficient which was compulsory for private banks. Time schedules were established to make these reductions gradual. Furthermore, savings banks were authorized to undertake all kinds of banking operations, including discounting bills and dealing in foreign exchange commercial transactions. The regulation for these banks' governing bodies was adjusted as well, likewise, important changes in the functioning of credit cooperatives were introduced, establishing minimum requirements and specific coefficients.

In January 1981, a number of changes were introduced along the same line mentioned above. These changes catered for three fundamental aspects -namely: interest rates, compulsory investment coefficients and medium and long-term financing.

All interest rates on lending operations not included in the coefficient requirements were fully liberalized. Maximum limits to commissions for banking services were set while some other price lists were left free. All institutions were ordered to make their prime rate public. Maximum limits were also set to interest rate and commission charges on loans subject to investment coefficient, as well as to charges on credit operations under one of the binding saving schemes currently in force. Interest rates on six-month to one-year deposits of one million pesetas or over were liberalized. The regulation on amounts and minimum maturities for the issue of CD's was also changed, while a new rule was issued to secure firm fulfilment of subscribed maturity terms.

The investment coefficient requirements were gradually reduced following a new, shorter, time schedule.

At the same time and in an attempt to increase medium and long-term financing, a deposit to be held by banks and savings banks at the Bank of Spain was made compulsory, though it could be recovered if the depositing banks granted loans (or purchased bonds issued by non-financial companies) to mature within a period of time exceeding three years. These deposits did not bear interest and were not eligible for reserve requirement obligations. At the same time, interest rates on loans funded with them were free, and such loans could be granted to anyone. However, the interest rate charges on these loans were to fluctuate within a band span that each bank or saving bank publishes on a quarterly basis specifically for this kind of operations.

The reform also affected all the measures connected with solvency and soundness of banking operations. In the Spanish financial system, the Bank of Spain is responsible for supervising banking institutions. In fulfilment of the 1942 and 1962 Laws, the Bank of Spain receives submissions of balance sheets from banking institutions and is responsible for regular and special inspections at banks whenever it deems necessary. During these inspections, the Bank of Spain can request all kinds of data related to the institution being inspected in order to examine its performance. Depending on the seriousness of the inspection, it can reach the point in which the board of directors is asked to answer for any anomaly. The Bank of Spain has the competence to propose to the Ministry of Economy and Finance what sanctions be imposed.

Apart from this supervision, which the Bank of Spain carries out by inspecting all the banking institutions, there are also measures, enforced by a general and objective regulation -which will be dealt with further below- for diversifying the risk of credit institutions, for limiting personal credit grants to these institutions' own board members, for ensuring that a minimum ratio between the entities' own resources and their risk assets is maintained (solvency ratio), etc. All this is supplemented by the Credit Information Exchange System run by the Bank of Spain. At present, all deposit institutions must report all loans exceeding four million pesetas to this Credit Information Exchange System.

A whole set of regulations designed following the same criteria have been established during recent years to strengthen the soundness of deposit institutions. These measures seek to ensure sound provisioning policies by promoting realistic distribution practices.

No matter how good the regulations and inspection systems may be, they cannot prevent critical situations in individual banking institutions from appearing. Events in recent years have shown that the Spanish legislation on banking supervision had become outdated in ruling the alternatives that the Bank of Spain has in dealing with extreme situations as well as on the sanctions it could apply or submit for application.

As a consequence of the banking problems that had been ocurring in recent times, the Bank of Spain's powers of inspection have been reinforced and so has been its authority to suspend or change the governing bodies of banking institutions in dangerous situation. At the same time and in order both to lessen the effects of such crises on the banking sector and to protect depositors, a number of schemes have been implemented to come into force once a crisis has been detected. The Deposit Protection Funds for banks, cooperatives and savings banks belong to this group of schemes. Since they were first introduced, these schemes have undergone considerable modifications and their nature has changed all together.

Although most of the above reforms mainly affected deposit institutions and the implementation of monetary policy, other parts of the financial system were affected by the reforms, too.

In 1977, in fulfilment of the Moncloa Accords, a commission was created to study the problems of the Stock Market. The commission's report was sumitted to the Government in 1978 and has served as a basis for all the measures, which, especially since 1980, have been and still are being introduced to change the operational features of this particular market. These measures include greater flexibility for issuing bonds and for achieving the so-called 'qualified quotations', norms on the financial information that issuing institutions must make public, regulation of public offers, of buyers' credit, and of purchase and sale orders, etc. All these measures are but a first stage in the process of reform that will provide our Stock Exchange with operational and requirement levels similar to those prevailing in the Common Market countries.

Apart from these measures, the problem of financing the public sector has been partly met by issuing medium-term bonds which, since 1977 were being placed at market rates. Mention should also be made of the short-term issues of Treasury bills, placed through auction since 1981 which, though closely linked with public sector deficit, have an important role on the implementation of monetary policy.

Finally, and in keeping with the general scope of this chapter, one must include the subject of a number of changes -some already underway, others just starting or even still on the drawing board- namely the appearence of intermediaries in response to a need which was becoming more and more apparent as the reforms of the financial system progressed firmly. Just to mention some of such intermediaries who had a strong start in business in recent years they were mutual guarantee companies, offering guarantees on behalf of their associate institutions, money-market intermediaries companies devoted to negociating short-term assets at the money market, and mortgage credit companies. A bill of law on corporate investment institutions provides for the creation of pension funds and contemplates other important changes affecting the already existing corporate investment institutions.

In the last months of 1983 and the first part of 1984, some changes in our financial system were introduced, most of which brought about a halt in the reform process described above. The new measures include raising and reforming the reserve requirement, which now applies to institutions that had been exempted previously, and involve abolishing compulsory deposit ratios by merging them with the legal reserve requirement. The table in chapter 2 shows the main features of this reserve requirement.

At the same time the investment requirement in government securities has been increased for banks and savings banks. This investment requirement, currently at a 10%, has been included in the overall investment requirement. A further change in this requirement aimed at its simplification and gradual decrease and was implemented in 1987.

Along with the foregoing, new changes have been made in the issue of Treasury bills and delegate entities were authorized to make provisions for insolvency in foreign currency. Also the credit mechanisms for financing export transactions have been modified to include foreign banks. Finally a book entry system for the subscription of public debt has been introduced.

The 1986 and 1987 reforms have implied an impulse for the reform process of our financial system. This new impulse, together with the concern for the safety and solvency of banking institutions, is an instance of a policy geared towards disentangling and simplifying certain legal requirements that had been too heterogeneous and detached from each other until now.

The transformation that have probably had most bearing on this latest stage were the ones related to changes in the solvency ratio and investment requirement, and affect banks, savings banks and cooperative trusts. There has not only been a radical change in the approach to solvency ratio, which used to be regarded as capital and reserves over liabilities and is now determined by capital and reserves over assets and risk assets, but the reform has also brought about coherence and consistency into all regulations on large exposures, expansion, profit distribution, etc., which had been disperse before.

The investment requirement has also experimented considerable change in an attempt to simplify computable assets, to give them an uniform treatment, and progressively reducing its volume. When this process is completed, the investment requirement will be the same for all banking institutions and will reach a much lower level than now.

At the same time, the legal reserve requirement, whose basic structure had remained unmodified since 1984, has changed in its proportions for the yield-bearing and non-bearing sections, which are now 17% for the yield-bearing band and 2.5% for the rest. Also the requirement to invest in Treasury bills has been reduced to 10%, the contribution to the Deposit Protection Fund have risen to 1.2 0/00 for banks, and new provisions have been taken against country risk in addition to the ones already existing for specific risk. All these measures will be analysed in detail in the appropriate chapters below.

The way accounting statements are to be worked out and submitted has been modified. Thus, consolidated balances have become compulsory, so that they can be used for calculating solvency ratio. Also banks' and saving banks' accounting statements and yields calculus have been made uniform and cooperatives have been imposed with the obligation of providing new more detailed information. In addition banking institutions have been asked to submit new statements on their international operations.

The group generally known as 'other financial intermediaries' has also been modified in its operations. Thus the money market intermediary companies have been listed in a special register and have been imposed new accounting statements as well as solvency ratios related to their overall investments. Mortgage credit companies have been made subject to new operating regulations and imposed special reserves and solvency ratios. Finance entities have been made subject to solvency provision funds. A new operational framework has been set for corporate investment institutions and, finally, a private insurance regulation has been published for insurance companies, with the accounting information they are to provide being modified.

General modifications have also affected the operations of financial institutions subject to exchange control. Perhaps the most important changes were: the complete liberalization for bank's operations in foreign currencies, the new regulation over positions and the broadning of possibilities of forward coverage for capital transactions (forward purchase of exchange currency), which was not authorized before (see annex 1). Likewise, operations with banknotes were modified and banking institutions were authorized to make remittances to and receive banknotes from their correspondents abroad, while all existing peseta accounts were simplified. Furthermore, foreign investments in Spain were liberalized and the prohibition for Spanish residents to purchase Spanish securities denominated in foreign currency was lifted, at the same time a new and more general regulation aimed toward the liberalization of outward portfolio investment has been recently approved.

CHAPTER 2

THE FUNCTIONS OF THE BANK OF SPAIN. I

Although the Bank of San Carlos, founded in 1782, could be considered the earliest forerunner of the Bank of Spain, it is generally agreed that its inmediate predecessor was the New Spanish Bank of San Fernando, created in 1847 through the merger of the Bank of San Fernando and that of Isabel II. These institutions were both issuing banks in Madrid.

In 1856, this Bank, although privately owned, received official status and changed its name to that of Bank of Spain. At the same time the State began to appoint the Governor and two Deputy Governors (at present only one) a practice which has continued up to the present day. However, this institution suffered numerous vicissitudes, many of them due to its contradictory character as a private institution performing a public function, until, in 1962, the Bank of Spain was reorganized and nationalized within the framework of a new General Banking Law.

The functions carried out by the Bank of Spain are legally defined in the Decree-Law of 1962, and in the new Law of the Regulating Bodies of the Bank of Spain, published in 1980, which we have already mentioned. This Law dealt with some aspects which had not been covered by the Decree Law of Nationalization of 1962. Naturally this Decree Law could not have foreseen all the various paths that the Central Banks would follow in the future. This fact coupled together with the ideas prevailing in Spain at the time regarding the role of monetary policy within the framework of general economic policy, explain why the Decree-Law for Nationalization and Reorganization should focus all its attention on those functions of the Bank of Spain that have little or nothing to do with monetary policy. In this way, functions related to the implementation of monetary policy, considered as the active control of monetary aggregates, were minimized and even excluded from the field of the Bank's competence.

As mentioned at the beginning, this situation was partially modified by the new Law for the Ruling of the Bank of Spain, which seeks to endow it with greater autonomy as well as to strengthen all those aspects concerning the implementation of monetary policy. Therefore, taking these two basic laws as our starting point (although in some aspects one should refer to the Banking Law of 1946) and taking into account further legislative developments, the most outstanding functions of the Bank of Spain are as follows (1).

1. Bank note issues and coin circulation

Since 1874 the Bank of Spain is the sole issuer of bank-notes, a function which it must exercise within the limits fixed by the Government on the proposal of the Ministry of Economy and Finance. The Bank is also in charge of withdrawing notes from circulation and substituting the note series in circulation after previous notice published in the Official Gazette.

The Bank is also in charge of putting coins into circulation, although this is not done in the same way as bank-notes. In actual fact, coinage is an exclusive right of the State, and coins are minted by the National Mint. The annual Budget sets a limit to the amount which can be coined each year. Within these limits the Government decides the actual quantity to be coined. Once the coins have been minted, they are deposited at the Bank of Spain which puts them into circulation when it is necessary. The nominal value of coins put into circulation is credited to the Treasury's account.

2. The State's Banker

This heading includes a number of functions traditional to all Central Banks, which generally refer to: State's treasurer, servicing the public debt and lending to the public sector.

The Bank of Spain is the State's Treasurer. In discharging this functions bridge-financing problems arise which stem from the different seasonal patterns of budget revenues and outlays. With regard to revenue, the fact that each tax has its own payment timetable, coupled with the use of banks and savings banks for tax collection purposes, causes time lags of different lengths. On the other hand, outlays (other than wages and salaries) do not follow a regular time pattern and gluts occur in certain periods of the year. "Advances" to the Treasury are linked to the State's Treasurer function of the Bank.

Given the importance which the "advances" subject has attained it is of interest to determine precisely what these advances are, according to the Law. From a general point of view, the Law foresees two main ways of financing the Treasury, namely tax receipts and Public Debt issues, but also considers other additional sources, one of which is "advances" from the Bank of Spain.

The advances are regulated by Article 20 of the Decree-Law of 1962, and in the Budget Law on every year. Their amount cannot exceed "12% authorized annual expenditures of the Central Administration and Autonomous Organizations", and are interest free.

They are, then, very short term credit facilities which, by their very nature, should be limited to the fiscal year in which they are granted. Ways and means for their repayment should be made available within that same fiscal year because their nature would be altered it they were considered to be permanent resources and their life carried over to the following fiscal year. One can say, therefore, that, lacking a more precise definition, advances act as limits to the use by the Treasury of credit from the Bank of Spain.

Of course, apart from these advances to the Treasury, the State can have recourse to Bank of Spain financing, but must do so by means of a law. This means that the financial assistance and its means of repayment must be shown explicitly in the balance-sheet of the Bank of

Spain. The Bank of Spain is authorized to extend credit to public organizations and nationalized industries within a maximum limit fixed by the Government and with maturity dates of up to eighteen months.

In this review of the services rendered by the Bank of Spain as the State's banker mention should be made of a number of activities such as issues, repayments, coupon payments, etc., relating to the service of the debt issued by the State.

3. The Bankers' Bank

Although using an expresion already coined, the functions included under this heading -custodian of liquid reserves, last resort lender, clearing functions- relate not only to banks but also to all other deposit institutions.

As the first two functions mentioned above -that of reserves custodian and lender- will be analized in later chapters which deal with monetary policy instruments and compulsory ratios, we do not need to repeat them here (2).

Clearing functions are carried out through Clearing Houses which can be either official -such as those in Madrid, Barcelona, Zaragoza and Bilbao- or private. The latter operate on the basis of local agreements. Every one of them has its own Governing Body -Chairman, Board and Manager- elected by representatives of the member institutions -Banks, Savings Banks and Cooperatives.

The Bank of Spain participates directly in some Clearing Houses. Net balances resulting from clearing operations in one or more sessions are settled by means of transfers between the member institutions and the House through their accounts with the Bank of Spain (3).

4. Credit Information Exchange System and Balance-Sheet Centre

According to the 1962 Decree-Law, the Credit Information Exchange System was created to produce, on the basis of information provided by banking institutions, general statistics of credit developments in Spain as well as to inform credit institutions about exceptional risky borrowers.

The functioning and organization of the Credit Information Exchange System was established by Ministerial Order of February 13th, 1967. All Banks, Savings Banks and Credit Cooperatives must report to the System all loans exceeding a certain amount (four million pesetas at the moment); regardless of amounts all loans owed by borrowers under receivership, bankrupt, moratorium or insolvent must also be reported.

Loans granted to joint groups of borrowers must be reported stating the proportion of the actual liability of each individual borrower (4). Likewise, cases which, given the large indebtedness of a single borrower, show "exceptional risk concentration" (5) must be reported.

In 1983 a Balance-Sheet Centre relative to non-financial companies was organized in the Bank of Spain. Its purpose is to improve information about the sector, not only to the Government but also to entrepreneurs themselves, who are provided with reports and analyses by the Balance Sheet Centre. The last questionnaire issued by the Centre to obtain information relative to 1984 and 1985, brought from 4,900 firms (6).

The Bank of Spain has open a new Claim Service to assure a clear application of the interest rates and fees by the banks.

5. Exchange Control and Exchange Rate

a) Exchange Control

The general principles underlying the present exchange control system have been established by the Act of Parliament Nº 40 of 1979. These guidelines allow for a broad scale of discretion in the Government's ruling on the degree of freedom of transactions between Spanish residents and non-residents.

Following these guidelines, various kinds of measures have contributed to the shaping of our present exchange control system at various points in time. As a result of the system's evolution (7), the Spanish exchange control functions are now divided between the Bank of Spain and the General Directorate for Foreign Transactions. Broadly speaking, the Bank of Spain is in charge of (8) international reserve centralization, foreign payments and receipts, and all matters related to foreign financial loans awarded to Spain (9).

These functions implement the application of the general principle, which has remained unchanged, whereby Spanish residents are obliged to sell all foreign currency in their possession to the Bank of Spain within a given period of time (actually they are not even allowed to purchase it before it is just due to be used in a transaction), and the Bank of Spain is in charge of holding and managing these currencies centrally.

A good deal of the Bank of Spain's commitments have been delegated to financial institutions, namely: a) operating on the spot market in foreign currency (buying and selling foreign currency, keeping foreign currency positions, etc.); b) operating convertible peseta accounts; c) accepting foreign currency deposits and investing them with both residents and non-residents, and d) operating on the forward foreign exchange market. All these operations, which are subject to regulations laid down by the Bank of Spain, will be studied in annex nº 1.

The whole exchange control system obviously conditions the balance of payment transactions and, thus, the workings of the demand and supply of foreign currency. However, the legal guidelines, which have been outlines briefly (and will be treated more extensively further below) remain as our given of reference while the rest of this section is devoted to the study of the exchange market and to the ways in which the rate of exchange for the peseta on this market is established.

b) Rate of Exchange

There is a set of circumstances and a number of factors underlying the demand and supply of foreign currency which determine the exchange rate, but we shall mention them here only briefly and as a general framework of the institutional formation of the exchange rate in Spain.

As a rule, the trends of the components of the basic balance of payments partially determine the demand and supply of foreign currency and, therefore, the exchange rate. The different items in the balance of payments are subject to quite different economic variables, ranging from the most obvious ones -such as import or export of goods- to policies on capital and foreign investment. Even short-term capital transactions bring about fluctuations affecting trends in the exchange rate.

All this being true, it is equally certain that no direct relationship can be found, on a short-term basis, between the state of a balance of payments and the exchange rate of a given currency. This is due to several interconnected reasons, namely, that purely financial or speculative operations outweigh the commercial ones, and that the former play a fundamental role in creating business expectations often against forecasts based on a balance of payments. In addition to these, one must consider the far less decisive role of central banks.

A recent study by the Group of Thirty (10) reports that the volume of currency markets has been growing and shows the relative effect of some kinds of transactions on this growth. The overall currency exchange trade, whose operations amounted to 150 billion dollars daily in 1984, grew twofold between 1979 and 1984, whereas world exports only grew by 8.5% during a similar period of time (1979-1983). The predominant role of interbank trade on this market and the lively negotiations in new financial instruments are at the source of this growth.

In view of the characteristic features for these markets, it is clear that neither the recent developments nor the trend of the basic balance provide adequate explanation for the movements on the exchange market. To a great extent, daily foreign exchange flows are the result of short-term financial decisions and speculation, which, as such, are mainly influenced by expectations in future exchange rates and relative interest rate levels at the various markets.

Exchange market operators' expectations may at times cancel each other out at a given moment, thus striking an even balance at the previously registered rate. However this is no the usual turn of events. The normal situation is that imbalances one way or another occur every day, causing an upward or a downward pressure on the exchange rate. The scope of these movements will range in each case, depending on the importance of the factors which produce them and on the part of the market affected by them. Actually, these movements may last for a short period of time, affecting only the professional speculators but they may also influence other operators, who, although not devoted to day-to-day trade, may, at times, attempt at some ways of hedging against fluctuation.

This is because fluctuation in the rate of exchange can give rise to commercial operators' activity and reactions contributing to further fluctuations. An expected depreciation in the domestic currency will encourage importers to advance their operations or payments and to put off collecting, which will favour or even accelerate the expected depreciation. The opposite will happen if a rise in the rate is expected.

All this must be supplemented by the action of central banks establishing the exchange rate, and this action will be conditioned, in the first place, to the requirements of the exchange rate system in force. Until 1973, Spain adhered to a fixed -although adjustable- exchange rate system (Bretton Woods) and, consequently, the Bank of Spain was obliged to intervene in the exchange market to keep the exchange rate fluctuations within a margin of 0.75% around parity. Since 1974, Spain has been following a floating system controlled through intervention.

Central banks' intervention takes place in two ways. In the first place, a central bank may act, in a manner of speaking, before foreign exchange supply and demand actually arise -that is, by introducing exchange control regulations which will have a bearing on supply and demand conditions. The relevant regulations in the case of Spain would be those referring to convertible peseta accounts, operations governed by Ordinance 5/1987, etc., which will be studied further below. In the second place, a central bank may intervene directly in the exchange market with a view to achiving specific exchange rate goals.

There is a wide variety of reasons why a central bank or the appropriate monetary authority in a country should want to intervene. These reasons may range from attempting to 'conduct' the developments in the rate of exchange -thus preventing them from, otherwise, creating states of uncertainty that could seriously affect the flow of trade if fluctuations became too sudden- all the way to pursuing more concrete aims. Such aims may, in turn, include attempts to avoid too high appreciations in the exchange value of domestic currency -lest an increase should affect export operations- or any depreciations capable of bringing about inflationary effects into the home market, etc. Monetary authorities have mainly concentrated on stabilizing the effective rate of exchange of their currencies with regard to the actual quotations for the currencies used in the countries with whom they trade, even though each country's authority pursues this aim in a different way.

Beside the more or less voluntary interventions -like the ones shown in the above paragraph- interventions may occur, at times, in compliance with an agreement on an exchange-rate fluctuation scheme. The European Monetary System is a case in point.

The System is made up of the following elements: the ECU, as a set of mutual support devices under the European Monetary Cooperation Fund's (EMCF) administration, and a device limiting exchange rate fluctuations.

The structure of this device is based on a parity grid determining fluctuation limits to rates of exchange between currencies. Its operational effectiveness relies on an alarm mechanism, which is set off whenever a currency traspasses the limits it has been allowed and strays away from the other currencies, as well as on daily, weekly and monthly contacts between the member central banks, who are obliged to intervene in their exchange markets to keep the fluctuation of their currencies within the limits of $\pm$2.25% with regard to the central rate of exchange (a 6% limit band has been allowed for Italy) (11).

A central bank's action has a far more complex effect on the exchange market than a mere exchange operator's, not so much because of a greater or smaller volume of funds involved, as because of its influence on the shaping of expectations on the whole.

All these interventions imply only a direct action on the part of a central bank in the exchange market. There is, however, another way of acting, an indirect way, which is very important too. Its purpose is to influence the rate of exchange by impressing certain conditions on the domestic monetary stance and, thus, giving rise to fluctuations in the relative interest rate, which will generate capital movements. Similarly, a general economic policy, placing varying degrees of stress on securing external resources will have a bearing on the exchange market.

The institutional framework, within which central banks act is, in most cases, the result of historical and institutional factors gradually building up. In a number of countries (West Germany, France, Italy, Netherlands, Belgium, Japan, etc.), the monetary authority and the banks authorized to deal in foreign exchange set a daily fixing rate in a joint session, which balances their spot supply and demand and serves as the basis for banks' dealings with their customers. Apart from this, banks can trade with each other and with banks in countries with no fixing system (the US and the UK, for instance).

Spain belongs to the first group of countries, not without its own departures from the group's general pattern. In the first place, the fixing rate, which is established in Spain along the procedures described further below, actually sets the highest and the lowest limit between which rates can be negociated freely. Only the bank within this span is allowed for operations between a bank and a customer in our country, and, even so, the transactions between banks are exempted. In the second place, the Bank of Spain exercises its intervention, however passive, at the exchange market throughout the day.

Having made the two points above, we can now go on to analyse the daily process of fixing exchange rates.

There are two distinct stages at which spot operations in foreign currency are carried out. To begin with, delegate entities (the institutions authorized by the Bank of Spain to deal in foreign currency exchange) trade with their customers who demand or offer foreign currency at the market; this could be called the 'primary' market (12). As a result of these purchase and sale operations, the authorized institutions keep foreign exchange balances -their foreign currency position- which should be, in principle, settled with the Bank of Spain but which, following the latter's authorization, remain in their possession.

As can be seen from annex 1, in addition to the rules established in 1987, the banks can now carry out any type of transactions in foreign currency. The risks in which they incur as a consequence of such transactions are regulated by the general norms which shall be analized further on.

However, a specific regulation envisages the establishment of certain limits, in respect of own resources, regarding the open positions (long and short) for each one of the foreign currencies as well as the total balance of all of them, in foreign exchange and in pesetas (13). On the other hand, the covered positions are not subject to any limits.

This new situation, and specially the formerly non-existent possibility of maintaining open positions (negative or short)(*) in some foreign currencies, extends substancially the fields of business of the banking institutions and at the same time results in our exchange market being interrelated more closely with the international markets.

The foreign currency balances held by a delegate entity are usually not large enough to meet all net sales to its customers, and the entity is forced to deal with other institutions on the exchange market where these transactions are made and where the rate of exchange is fixed for the day. This trade between banks is called the 'secondary' market as opposed to the 'primary' one between the banks and their customers.

At the beginning of the morning session, the Bank of Spain announces its spot buying and selling intervention rates. These are the peseta/dollar exchange rates at which the Bank of Spain is prepared to buy or sell US dollars at that particular moment (the US dollar being the only intervention currency).

Intervention exchange rates serve as guidelines for arbitrage dealings between delegate entities. The rates can be changed by the Bank of Spain during the course of the day, and they usually fluctuate

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(*) Now in a temporary suspension.

throughout the day as a result of the prevailing trends in the exchange trade at the time (the pressure of supply and demand from delegate entities) and of the effect quoted currencies may have had on the effective exchange rate of the Spanish peseta against various groups of foreign currencies. Within the framework of the general monetary policy both at home and abroad, the Bank of Spain aims at impressing a given trend in the effective exchange rate. In doing so, the Bank of Spain looks for both this exchange rate's nominal figures and the difference between the rate of inflation at home and in the countries who trade with us (14) (in other words, the actual term-of-trade exchange value).

In fact, the intervention is designed to stabilize the real rate of exchange with industrialized countries. Special attention is paid to the effective exchange rate in real terms with the EEC, as well as to the behaviour of the US dollar. All these criteria can only be applied in long-term and medium-term measures, as a short-term action may be affected by quite a different set of criteria.

All this can be summarized by stating that the process of fixing an intervention exchange rate every day cannot be a rutine process, as the pursuit of the objectives set by the monetary policy must follow the continuous changes of events at the market.

Every day at 12:30 p.m., delegate entities and the Bank of Spain meet at an exchange market session chaired by the Bank and held on its premises. The Bank of Spain intervenes with the view to directing quotations. At the end of the session, the Bank of Spain works out the (average) fixing of the dollar/peseta rate on the basis of the amounts and prices transacted, as well as the 'basic rates' of the other quoted currencies (price average weighed against the transacted amounts). Then the basic rates for the various currencies against the dollar are 'cross calculated' to obtain their equivalent in pesetas. The so-called 'official buying and selling rates' for each currency are determined by adding or subtracting a certain percentage in each case. These 'official rates' are published in the Boletín Oficial del Estado establishing the span of the band for free negociation allowed to all authorized institutions in settling dealings with their customers (see detailed information on the table below). In addition to the above currency exchange rates, the Bank of Spain quotes exchange rates for buying and selling foreign bank-notes every week. Although these rates are not mandatory, they are usually applied by authorized institutions in their dealing with customers.

All the foregoing portion of this section has been devoted to the ways exchange rates are determined for spot transactions. A considerable number of exchange market operations, however, differ from the usual, two-day term, spot transactions in their various forms, even though spot operations, whereby purchases or sales are settled two days later, are known to be the most frequent ones at the exchange market.

In actual fact, the operations are much more complex as the result of the concurring parties' varying aims (arbitrage, speculation or mere coverage operations). Residents needing foreign currency to meet their future payments have their bank buy the required currency for them against pesetas. The servicing bank gains a 'long' forward position in pesetas and runs 'short' of its position for the given currency. It will then try to restore its supply balance and buy this currency from other customers or delegate entities willing to sell, or else, draw on its spot position up to the extent allowed by the Bank of Spain. This latter coverage procedure implies, generally speaking, that the bank running 'short' of foreign currency will buy it on the spot market and keep it placed until the forward operation matures. Upon settlement, the bank will deliver the foreign currency against Spanish pesetas calculated at the agreed rate of exchange. The difference between this quotation and the spot market price at the time of transaction must be equal to the difference between the interest rate quoted on the Spanish market and on the market of the currency used in the forward operation.

E X C H A N G E   M A R K E T

Balance of Payment Transactions | Demand and Supply of Foreign Currencies | In principle, all currencies must be placed at the disposal of the Market within 15 days.

The Bank of Spain authorizes delegate entities to hold a POSITION.

PRIMARY MARKET: Delegate entities' dealings with their private customers. A delegate entity cannot meet all the demand by drawing on its POSITION, usually.

SECONDARY MARKET: Between delegate entities and the Bank of Spain. This market functions as follows:

9:30 a.m. The Bank of Spain fixes intervention exchange rates and informs the delegate entities.

9:30 a.m. - 12:15 p.m. Delegate entities negociate supply and demand at free exchange rate between each other and at the current intervention rate with the Bank of Spain.

12:30 p.m. Exchange rate fixing session. Representatives from delegate entities meet at the Bank of Spain under this bank's chairmanship. The Bank of Spain fixes the buying and selling intervention rates for the day. The delegate entities buy from and sell to each other at the exchange rate they wish but, obviously, within the limits set by the Bank of Spain as its intervention rates. The deals are done currency by currency, beginning with the US$. After the negociations in the US$ are over, the Bank of Spain's representative fixes the peseta/US$ rate at which the market has arrived. The Bank of Spain only quotes the US$/peseta intervention rate. For the remaining currencies, the bank limits itself to controlling that the quotations remain within the market rates.

End of session - 5 p.m. Delegate entities continue making deals with each other at their negociated exchange rates or with the Bank of Spain at the intervention rates at that moment.

5 p.m. The Bank of Spain closes its premises and stops its intervention for the day. From 5 p.m. onwards, private banks can still operate on the London market, which is open for one more hour, and then go on to operating on the American market and Far East markets.

<u>INTERVENTION EXCHANGE RATES</u>

. Rates fixed daily by the Bank of Spain.

. Rates at which the Bank of Spain is prepared to buy and sell US$.

. Resulting from developments on the market and from the competitiveness of our currency: the effective position index.

. Changing throughout the day.

<u>The fixing or the mean, peseta/US$ exchange rate.</u>

This is the weighed average of operations at their respective prices. By subtracting or adding certain percentages (1.25 0/00) from or to the basic exchange rate, the buying and selling quotations are calculated for peseta/US$. Only transactions exceeding US$ 1 million are taken into the average. These exchange rates are set a maximum and a minimum limit allowed, and delegate entities are free to negociate rates within the span of this band until the limits are altered the next day.

<u>Fixing or basic exchange rates for other currencies.</u>

These are always calculated against the US$. The minimum amounts vary from one currency to another. Once these exchange rates for given currency/US$ are obtained and having worked out the peseta/US$ rate, the respective peseta/currency rates are further worked out. These are the Official Exchange Rates for each currency.

Not all importers are sufficiently familiar with foreign short-term asset markets or adequately equipped to operate in this kind of transactions. One way to overcome such shortcomings is to operate in forward deals in which the value date extends beyong two days. Businessmen seeking dollars on the exchange market one month ahead can have them delivered on the required date and settle the deal at the exchange rate they had negociated one month earlier.

The rate of exchange for forward operations -which varies for each period and depends on expectations in the development of our currency's trends as well as on the difference between interest rates, etc.- indicates that this currency will be at a premium if the exchange rate for forward operations one month ahead is more favourable than for spot transactions, or at a discount if the situation is the opposite.

In operating on the exchange market, banks do not usually deal in such simple forward operations as the one described above. Instead, they combine these with counter transactions. In other words, a bank selling dollars to an importer in a forward operation to be settled in pesetas a month later might want to cover himself by, at the same time, purchasing foreign currency from another businessman operating on the market (for instance, from someone expecting a payment in foreign currency). On the other hand, should the bank not be able to secure a counterpart operation, it can still resort to its own position, or buy dollars on the spot market, or make a swap with another bank, which is the same as to buy and sell same amounts of foreign currency at the same time but at different quoting rates. In the case we are concerned with, the bank will sell dollars on the spot market to another bank and will buy them again on term conditions to be able to meet its settlement with its customer.

In theory, term conditions can be negociated for all lengths of time, but in actual practice, the market caters for a limited number of standard cross deals. The above described spot purchase or sale against a forward sale or purchase is one of such frequent standard deals.

The exchange rate for these forward operations is quoted, in practice, side by side with the spot rates and the forward quotation for each currency depends on the difference between the interest rates for any two currencies involved.

An elementary application of the interest parity theory, which has been seen in a different context in paragraphs above, shows that it is the same for a Spanish resident preparing a payment of a given amount of dollars, say within a month, to secure his exchange a month in advance and pay the discount at the rate quoted for this forward operation, as to buy his dollars for pesetas spot and keep them invested elsewhere until his payment is due. The fact that these two options cost the same shows that the discount a businessman must pay in the first case is equal to the difference between the interest he can gain on an investment in dollars and the interest he could have gained on an investment in pesetas. Thus, a forward exchange rate is the quotation at a given time for a currency to be delivered or received at an appointed future date and, as forward operations link two kinds of money market, this quotation is directly affected by the difference between the interest rates on these markets.

The forward exchange rate for each currency is obtained by adding or subtracting a percentage (known in the professional jargon as the 'swap rate') to or from the spot rate. The difference between the interest rates for the forward quotation of each currency affects the calculation of this percentage, whose formula is roughly as follows:

$$\text{percentage} = \text{difference between interest rates} \times \text{spot rate} \times \frac{\text{forward period}}{365}$$

This is only a simplified formula and it must be remembered that the interest rate used in this calculation will have to include the real cost of procuring and supplying funds -that is to say, including the tax on these operations.

A currency whose interest rate is higher than another's is at a discount and its forward rate for a given period is obtained by adding the swap percentage described above to its spot rate. If the currency's interest rate is lower, this currency is at a premium and its forward rate is calculated by subtracting the swap percentage from its spot rate.

A straight forward simplified example might illustrate the above.

Given: DM/$ spot rate 2.3550
Euro-$ 6-month interest 15%
Euro-DM 6-month interest 9%

$$\text{Swap percentage} = 2.3550 \times 0.06 \times \frac{180}{365} = 0.0706$$

Thus, the DM quoted for the 6-month forward period will be at a premium, since its interest rate is lower and so its forward rate for a 6-month period will be:

$$2.3550 - 0.0706 = 2.2844 \text{ DM/\$}$$

The usual way the spot and forward quotations are published shows the buying spot rate first, followed by the selling spot rate, and then the swap percentage for each forward period, as in the following example for the DM/$:

Spot 2.8302 - 2.8312
1 month 100/95

If the interest rates for one month are available, one will also know whether the DM is at a premium or at a discount and will be able to subtract or add the relevant swap percentage. If the interest rate is not known, the rule of the thumb is to look for the swap percentage; when its buying side is larger (100 -in the above example) than the selling side (95 -in the above example), then the currency in question -the DM- is at a premium and, therefore, the forward rate will be obtained by subtracting the swap percentage from the spot rate.

And so, the above quotations will be:

Spot 2.8302 - 2.8312
1 month 2.8202 - 2.8217

If, on the other hand, the buying quotation were lower than the selling one (according to the swap percentage), the currency would be at a discount and its forward rate could be obtained by adding swap percentage to the spot rate. (This procedure applies to all currencies except the sterling pound and a few others that are quoted in a similar way. These latter currencies are at a premium when the buying figure is lower than the selling one).

6. Monetary Policy

Following guidelines established by the Government, the Bank of Spain is responsible for everything that is related to implementing monetary policy.

This section is concerned with examining the basic plan on which this policy is established. In including this plan, inevitable simplifications have been necessary, and fuller explanations in greater depth are easily available elsewhere (15).

The ultimate aim of monetary policy is to maintain a given level of monetary or nominal expenditure in a country's economy over a given period of time. The slow information on the attainments of this ultimate aim make it necessary to set an intermediate target bearing an adequately stable degree of relationship with the ultimate aim.

Traditionally, whenever the monetary authorities of a country are faced with the problem of selecting a variable that will enable them to take action within the sphere of monetary expenditure, they are obliged to choose between controlling interest rates or the amount of liquidity -that is to say, between controlling amounts and controlling prices. The Spanish monetary authorities have preferred to control the supply of liquidity in the economy as their target, because control of money supply is effectively a more viable target than others (such as interest rate, credit, or exchange rate, etc.) and because its relationship with the ultimate aim is more reliable. However, in the short-term, the Bank of Spain concentrates its attention on interest rates which thus becomes the prime variable-target just under this specific circumstance.

Before early seventies, an active and stable monetary policy to control amounts did not exist in Spain, and the Bank of Spain could only act, without further iniciative on its part, to attend to situations arising from the application of the general economic policy. When a situation became critical, sudden monetary restrictions would be introduced.

A new approach to monetary policy was introduced in our country in 1973; the "Liquid Disponibilities" or the "M_3" was selected as the most appropriate variable. M_3 holds a stable relationship with the level of nominal expenditure and can be also influenced by the monetary authorities' action. Furthermore, its development can be watched without having to wait too long for statistical information.

During the ten years following the introduction of this approach, our financial system has gone through a sequence of gradual changes which, with regard to implementing monetary policy alone, first, proved that to consider the originally selected variable on its own was becoming less and less reliable, then, this valiable had to be supplemented with another one, and, in the end, it became necessary to substitute it all together.

The process of our economical development on the whole and, to be more specific, the inflationary tendency of the process in our country during the last few years accounts for important changes in the attitudes of both the financial intermediaries -whereby either the existing operators' practices changed or new intermediaries appeared- and of the ultimate savers, who have become much more concerned with profit and liquidity.

In addition to these changes, the growing public sector financing needs, which are partly a product of the economic recession, have made it necessary to continue seeking new financial instruments and this has also affected the financial reform process.

Also, mention should be made of another fundamental factor appearing in every innovation process, as it did in our country, too -namely, the financial institutions' action seeking to develop new procedures apart from the legal regulations on ratios and interest rates, and to evade taxes whenever a difference in the treatment of various instruments made it possible. The clearest and the most recent example to this respect has been the effect that the new law on fiscal treatment of certain financial assets is having on the implementation of monetary policy (16).

Furthermore, the increasing integration of Spanish markets with foreign markets (in the sense of both Spain's entering foreign markets and foreign institutions' entering Spain) has strengthened this process.

All the foregoing led, especially in the early eighties, to the appearance of new intermediaries and new financial instruments or to the modification of the ones already in existence. All these instruments: bonds, Treasury bills, certificates, bills of exchange, mortgage securities, banks' promissory notes -new in some cases and modified in others- have been keenly accepted in portfolios by savers, who had become increasingly sensitive to the stimulus of profit. At the same time, these instruments were strengthened by the banks as an alternative to obtaining funds by means of deposits. The combination of the public's and the banks' attitudes has triggered off a process that has made the target M_3 lose importance as the sole source of information on the monetary expenditure flow.

This process reached the peak of its development in 1983, which, from this point of view, can be considered as a transition year. In fact, the foregoing showed that the relationship between M_3 and the level of monetary expenditure was becoming less consistent, at the same time as a new and more comprehensive variable than the previous one -the 'Liquid assets held by the public' or the ALP (17)- recorded a more stable and significant relationship with the level of monetary expenditure.

Although an ALP target was not explicitly defined in 1983, the development of this variable was kept under indirect surveillance, as continuous adjustments in the evolution of M_3 were being made in accordance with the estimate for the larger variable consisting of liquid assets held by the public.

No target in terms of the ALP could be formulated explicitly in 1983, because the incoming information on the evolution of this variable was slow and because the currently available instruments only allowed this evolution to be controlled with frequent distortions.

LIQUID ASSETS IN THE HANDS OF THE PUBLIC (1)

Assets \ Issuers	THE CREDIT SYSTEM					S.M.M.D.	TREASURY
	BANK OF SPAIN	PRIVATE BANKS	SAVING BANKS	COOPERATIVE CREDIT BANKS	GOVERNMENT CREDIT		
Coins and banknotes (2)	*						
Sight, saving and time deposits	*	**	**	**			
Liabilities on insurance operations			**				
Bonds		**	**				
Mortgage debentures		**	**	**	*		
Endorsed drafts		**	**	**			
Guaranteed promissory notes		**	**	**			
Sale and repurchase agreements of private assets		**	**	**		**	
Sale and repurchase agreements of public assets	*	*	*	*		*	
Monetary regulation certificates	*						
Treasury bills							*

M3

ALP

(*) This item is included in the monetary and liquidity aggregates.

(**) Items included in determining the monetary and liquidity aggregates currently computed in the cash ratio.

(1) "General Public" means resident, private persons or corporate bodies who are not part of Public Administration or Credit System or Intermediaries Companies.

(2) The circulation of metal coins issued by the State is treated by the statistics as if it were carried out by the Bank of Spain.

Since the beginning of 1984, after the problem of delays in statistical information had been basically solved and the control instruments had been modified, especially in the case of the reserve requirement, the ALP variable became explicitly considered by the monetary authorities as an intermediate target along with the M_3. By using both, more accurate time adjustments could be made. The M_3 has become more relevant to the short time horizon, whereas the ALP is now more important at medium and long term because its relationship with expenditure levels is more stable.

This state of affairs continued until 1985. It was then, as we have pointed out above, that deliberations and the subsequent ruling on the fiscal treatment of certain financial assets introduced shifts in the demand of funds, and the M_3 became less relevant.

A full survey of this subject would be too complex in this context. It is, however, necessary to remember that two important events have taken place and affected the implementation process of monetary policy. First, Treasury bills became almost the only instruments still keeping their 'fiscal haven' character, whereas other competitive financial assets were burdened with tax substancially. As could be expected, this caused a shift from deposits and other bank liabilities towards Treasury bills -hence the lesser effect from the variable M_3- wherefore the monetary authorities concentrated mainly on the ALP variable. However, even the ALP became affected, as interest rates on Treasury bills began to decrease as a result of the working of the above mentioned law, and the compound effect of all this was a new shift towards real assets.

The implementation of the new monetary policy is even more complex due to the difficulties in establishing the accurate volume of the above mentioned shift and in predicting its future development in view or the unstable figures in the multiplier, which is where the monetary control is applied. Given the scope of this work, aiming at an analysis of the basic monetary policy implementation, a more detailed explanation will not be provided (18).

Once the target variable has been selected, the Government establishes the variable's annual growth rate in consistency with the expected monetary expenditure trend. The target for the given year is determined and published along with a $\pm 1.5\%$ band span around the centre line. It is customary that the monetary target be published, as this enables finance businessmen to follow the monetary policy during the period. It is also a common practice to establish the fluctuation band, which enables the monetary authorities to take action within a certain degree of flexibility and to reach the ultimate aim, avoiding sharp, short-term fluctuations.

Given the foreseen objectives for production and prices, and bearing in mind (yearly budget) the expected financial needs of the public sector and its claim on the different markets, and also estimating the likely trend in the Capital Balance, the monetary policy's role in determining the ALP growth rate is to facilitate a trasfer of real flows between the sectors by creating adequate liquidity. The greater the growth allowed by the authorities, the more flow will add on to the capital resources for financing the different sectors' investment. But, at the same time, a greater pressure on the resources will generate price increases.

The simplest and the clearest way of analyzing the fundamentals of money control system is by using a consolidated balance of the credit system with some simplifications incorporated into it.

Central Banks' Balance		Private Banks' Balance	
ASSETS	LIABILITIES	ASSETS	LIABILITIES
AEN (BC)	EMP	AEN (Bp)	Deposits
CSP (BC)	ACSB	CSP (Bp)	Other liabilities
CSB		CSp	CSB
		ACSB	

in which,

AEN = net external assets held by the Central Bank (BC) or by private banks (Bp),
CSP = credit awarded to the public sector,
CSp = credit awarded to the private sector,
CSB = credit awarded by the Central Bank to private banks,
EMP = cash in the hands of the public,
ACSB= required and free reserves.

A consolidation of these two balances leads to:

Credit System Balance

ASSETS	LIABILITIES
AEN (BC)	EMP
AEN (Bp)	Deposits
CSP (BC)	Other liabilities
CSP (Bp)	
CSp	

which is the same as: $AEN + CSP + CSp \equiv ALP_1$

The application of this accounting identity shows that, once a Δ aim of the ALP has been determined, variations within either member on the first side of this identity must be offset by varying another member in the opposit direction.

It is worth remembering that most of the ALP is made up of the banking system's liabilities, which are the counterpart of credit to the different economic sectors. Therefore, if Treasury bills are subtracted from ALP, we shall be left with an ALP_1, which is the part made up of liabilities of the banking system. The above consolidated balance provides the growth of the private sector's credit, which is consistent with the set aim of ALP.

ASSETS	LIABILITIES
Net assets against foreign countries (estimate)	ALP_1 (target)
Net credit to the public sector (estimate)	Other liabilities
Net credit to the private sector (target consistent with ALP)	

Thus, after having determined the ALP growth target subject to all the above mentioned conditions, the next step is, then, to determine a variable that, even though allowing for the Bank of Spain's control within a reasonable degree of reliability, should maintain a steady relationship with the ALP. This variable is the 'Cash Assets of the Banking System (ACSB) and its relationship with the ALP is given by the new reserve requirement acting as a multiplier.

Both the funds secured by means of deposits and the ones secured by other means are, in fact, banks' liabilities, and banks must keep an adequate degree of liquidity in their assets to meet their customers' withdrawals of funds with ease and to comply with the reserve requirements.

Therefore, banks' holdings in eligible liquid assets and the degree of liquidity they choose to maintain will limit their capacity to generate new liabilities. The fact that there is a stable relationship between the ACSB and banks' liabilities allows the Bank of Spain to reinterpret the growth target of the ALP in terms of an ACSB growth target, which is conditioned by the forecast of this relationship, as well as by the cash demand from the public and by an estimate of Treasury bills in the hands of the public.

In fact, if we allow for a lesser degree of accuracy, in order to explain the fundamental concept more clearly, the above reasoning could be expressed as follows:

Reserves ratio (c - legal: e - voluntary)

$$c + e = \frac{\text{ACSB}}{\text{Liabilities}}; \qquad P = \frac{\text{ACSB}}{(c+e)}$$

If we add EMP (coins and bank notes) and Treasury bills held by the public (PT) to both sides of the equation,

$$\text{PT} + \text{EMP} + \text{P} = \frac{1}{c+e}\,\text{ACBS} + \text{EMP} + \text{PT}$$

$$\text{ALP} = \frac{1}{c+e}\,\text{ACBS} + \text{EMP} + \text{PT}$$

If the EMP, PT and the voluntarily kept ratio <u>e</u> are estimated, and the required ratio is determined, an ALP target is reinterpreted in terms of an ACBS target. As it has been pointed out already, the estimate of mortgage debentures issued by official credit entities has been waived, as this component has but little effect on the ALP.

Once the ALP and the ACBS trends of growth have been established, the next step would be to reinterpret them as short-term targets.

These targets become specific when monthly documents on monetary targets are produced, whereby an ALP trend and its compatible bank reserves trend are established for monthly, ten-daily and daily periods. This interpretation in terms of shorter time periods, allowing in its estimates for events occuring at home and on international markets, and for the market's reactions to these events, enables the Bank of Spain to implement the monetary policy day by day.

Thus:

ACSB -----------------> (target)	
EMP ANE SP Other	(autonomous factors)
Transactions with the banking system	Bank of Spain's action: Monetary Policy

In daily transactions, the Bank of Spain conducts the offer of the ACSBs so that their trend should keep in consistency with the trend desired for the ALP. To achieve this, the Bank of Spain has to use all its available instruments in a constant attempt to offset the development of the so- called 'autonomous factors' by generating liquidity in the desired direction. These factors are the result of the development of the public sector's and external sector's cash balances and of the public's demand for ready cash.

Even though the Bank of Spain may have some long-term influence on these factors, by carrying out its exchange rate policy or by supporting reform measures in the public sector, etc., the fact is that these factors can be regarded as 'given' in the short term and even medium term. This is why in order to achieve the desired effect, the Bank must act by using the part of its balance it can manage direct -that is to say, its operations with the banking system.

The various ways the Bank of Spain can affect the banking system in applying the monetary policy have been evolving along with the developments and improvements in the system itself. Several instruments that used to have a significant importance -such as the common and the special discount- have lost all their relevance today, whereas some of the more recently introduced measures -such as the 'specific' credits, intended for times of crisis- cannot be regarded as actual monetary instruments.

Hence, leaving aside the above instruments, which are but channels linking the Bank of Spain with the banking system, what deserves to be analyzed are the reserve requirement and money market operations.

The reserve requirement cannot be used as an instrument in money control, as it cannot be subjected to continuous fluctuations lest they should invalidate it. It is, in fact, used with quite another purpose within the monetary control outline, and the day-by-day control relies on the auction of Treasury bills (to drain off liquidity), assets sales with repurchase agreement and loans (usually overnight ones), whenever a boosting action is necessary.

When the new monetary control system was introduced, the banks used to hold debts with the Bank of Spain and so the first efforts were concentrated on creating an instrument that would secure liquidity. This role was performed by the 'Money Regulation Loans'.

When these loans were granted inicially, the amounts used to be allotted in proportion to each bank's resources and below the interest rate prevailing on the market. Then, gradually, the method of awarding these loans changes to granting them at an auction on a day-by-day basis, while a special window attend, only in very special occasions, unforeseen requirements of ready cash at penalty rates. The normal way of providing liquidity is through this auction's loans. Although Bank of Spain has a quantitative target -ALP- it follows the evolution of interest rate. The marginal interest rate of these auctions is the rate which is used by the Bank of Spain in order to move the short term markets interest rates in one way or another. This is the key rate and is called 'Bank of Spain's daily intervention rate'.

The existence of a sole instrument was sustaining a basic outbalance, which began to cause concern as the situation changed. The only way to excercise restrictions on liquidity was to let the awarded loans mature and not renew them. In view of this situation and of the subsequent control problems, it was necessary to create instruments specially intended for drainage of liquidity. The actual form of these instruments varied, in time, from Treasury bonds, through Bank of Spain's certificates of monetary regulation and Treasury bills, to assets sales with repurchase agreement, etc., and they were all meant for draining liquidity when the market conditions called for it.

Besides these instruments, the reserve requirement has also been mentioned: this cannot be used frequently but should be described in some detail because it has been modified recently. This instrument has been available since 1970 and has had different characteristics in regard to the amount and manner of computation for different financial institutions. During the ten years since the new monetary policy plans were established, the reserve requirement has undergone important changes and the most important one coming into force in January 1984. Since then, over the following years up to date, only minor changes were implemented albeit keeping the same basic structure of the reserve requirement which has prevailed almost as it was designed during the 1984 reforms.

Mention has been made of the problems in planning monetary policy raised by the use of new instruments for obtaining liabilities, as well as by the appearance of intermediaries who are not affected by the regulations traditionally applied to institutions whose activity is based on taking deposits from individual customers.

The changes in the reserve requirement involved abolishing the compulsory interest-bearing deposit ratio that had existed until then. The aim behind these changes was threefold: to give the same treatment to all the means of securing funds, and so to prevent artificial profits from shifting from one means to another, to place all the institutions competing in the same business under the same regulation, and to further the effective control over the available liquidity, which justified substituting M_3 for ALP. The other important factor in the modification of reserve requirement (related to its level) is the public deficit.

Now the same figures apply to all institutions securing liabilities, regardless of the way they do so; the interest-bearing ratio is 17.0% for all institutions plus additional, non-interest-bearing 2.5% for banks and saving banks. The chart below shows the most outstanding features of the new ratio for banks and saving banks.

Up to this point, we have been saying that the monetary policy establishes targets in terms of amounts -growth rate of ALP and M_3- as the centre of the money control plan. However, even though keeping to this plan, the monetary authorities are not unaware of the effect of the trend of interest rates and exchange rates on the means of controlling them. The expanding integration of international markets and the reforms carried out in the home market -with the resulting speed with which effects are transmitted from one market to another- require increasing attention to be paid to interest rates.

Keener competition on the domestic market has made financial intermediaries act more flexibly and pay greater attention to the management of their surplus cash assets, considering timing costs, at the same time as their policy for the management of liabilities, adapted to the new circumstances, has had to become more flexible, too. Of course, this has caused greater fluctuations in the cost of resources and, thus, in the interest rate. It is also interesting to mention in this connection that, thanks to the new instruments, intermediaries subject to the monetary control plan have been able to develop a new line of liquidity -with both public and private securities- free from cash reserve requirements, which

Eligible Assets:

- Cash and deposits, interest-bearing or not, in the Bank of Spain.

Computable liabilities:

- Resident private sector deposits.
- Certificates of deposit, promissory notes or other commercial paper issued for the bank's own financing.
- Bonds, debentures and other securities in pesetas (including mortgage debentures).
- Bills of exchange, promissory notes not issued by the Treasury or other endorsed or assigned commercial paper.
- Guaranteed promissory notes or similar commercial paper issued by companies.

The Bank of Spain may include other instruments to substitute the functions of the above mentioned ones.

Percentage:

- The cash ratio has been established at 19.5%, although it may reach 20%. The Bank of Spain is responsible for establishing the figure and the manner of calculating it (*).

Calculation:

- A ten-day average.

Tranches:

- Up to 2.5%, non-interest bearing.
- Over 2.5% and up to the limit, bearing interest fixed by the Bank of Spain following the evolution of the money markets.

Institutional covering

Banks, saving banks, cooperative institutions, money market intermediary companies, financing companies.

(*) See annex nº 1 for more details about convertible pesetas and foreign currency's reserve requirements.

enables them to react with greater refinement to monetary policy authorities' measures by attributing an increasingly more important role to changes and interest rates.

The fact that Spain's integration with foreign markets is becoming closer and that it relies on them for adjustments has become a new link between interest rates at home and abroad (19).

After all this potential has been met by the financial intermediaries' action, their operations affect other markets by broadening the fluctuation of interest rates throughout the whole economy.

Also, from a point of view more akin to monetary control, interest rates provide an excellent indication of the degree of pressure on a market. Whenever it is necessary to modify quantitative targets while the success of some of the proposed adjustments is uncertain, the interest rates provide very valuable guidelines to go by in directing these measures.

It is in view of all this that the Bank of Spain does not establish an interest rate target but watches closely the development of this rate on the home and international markets in case a change in the quantitative targets becomes advisable.

FOOTNOTES TO CHAPTER 2

(1) Inspection and supervision over credit and saving institutions are not mentioned here, as their main purpose and features will be analyzed in the second part of this chapter.

(2) By this we mean the voluntary deposits kept by banks with the Bank of Spain for liquidity and working purposes, as well as the obligatory deposits, which include the ones designed to cover the required percentage for financing export operations.

With regard to the Bank of Spain's function as a lender, discount operations, lombard credit, personal loans, special loans and monetary control loans will be explained in due course.

(3) In the case of a debit balance, the clearer, who is the institution's representative, gives the house manager a money order for the balance amount, which he draws against the institution's account with the Bank of Spain. In the event of a credit balance an inverse operation is performed.

(4) The way to do this is as follows:

(a) In the case of a joint loan, when each borrower is liable for a specific share of the loan, each share is to be reported as if it were an individual loan.

(b) Several liability credits must be reported in full as one individual loan to each one of the borrowers, whenever the overall amount of the loan divided by the number of borrowers is equal to 2 million pesetas or more.

(5) The Bank of Spain determines the amount above which there is an 'exceptional risk concentration'. This figure is 150 million pesetas at the moment.

(6) Further information on the Balance Centre can be found in Banco de España, 'Memoria de actividades del Banco de España', Informe Anual 1983, 1984, 1985, 1986.

(7) The Spanish Foreign Exchange Institute (IEME) was created in 1939 in replacement for the Foreign Exchange Committee. The Decree-Law by which the Bank of Spain was nationalized and reorganized empowered the Government to transfer the centralization of international reserves and the implementing of foreign transactions to the Bank of Spain. In 1969, IEME's operating functions were transferred to the Bank of Spain. Finally, the IEME was extinguised in 1973 and its functions were divided between the Central Board for External Transactions -a department of the Ministry of Economy and Finance- and the Bank of Spain.

(8) Specifically, the functions transferred to the Bank of Spain were the following:

(a) Acting as the sole and official buyer of foreign currency in Spain;
(b) Buying and selling gold and silver coins and bullion, as well as Spanish and foreign securities quoted internationally;
(c) Accepting and depositing in custody the above holdings;
(d) Opening accounts in foreign currencies;
(e) Borrowing and lending foreign currency;
(f) Holding and borrowing amounts of Spanish currency to meet its commitments;
(g) Carrying out all operations required for the fulfilment of all the above mentioned functions;
(h) Publishing official exchange rates daily; and
(i) Authorizing financial credits secured in foreign currency.

(9) The Bank of Spain's competence in this field is centered round its authorizing businessmen to secure credits, above certain limits, from abroad as well as dealing with matters concerning the actual application of the funds, credit conditions and any changes in these conditions, leap payments, etc. It should be pointed out, however, that public and private sector's lombard loans are subject to authorization from the Interministerial Committee for Foreign Financial Loans Received (CIFEX), who establishes the outline for borrowings from abroad within the general objectives of the country's economical policy.

(10) 'The Foreign Exchange Market in 1980s (the view of Market's participants)', edited by the Group of Thirty (New York, 1985).

(11) A broader analysis can be found in Gonzalo Gil, Aspectos monetarios y financieros de la integración española en la Comunidad Económica Europea, Estudios Económicos, 37 (Madrid, 1985).

(12) All private persons are obliged to surrender all amounts of foreign exchange to banks within a stated period of time since these amounts come into their possession. At present, this period of time is 15 days. Foreign exchange may only be obtained for special purposes and must be authorized by the General Directorate for External Transactions. This currency may only be used for its authorized purpose, otherwise it must be returned to the bank that sold it.

(13) Definition of the position. See annex 1.

(14) The effective exchange rate index is but and index of the average value of the peseta, weighted by bilateral trade vis-à-vis three groups of countries: developed countries, EEC countries and the total of the world. The effective value of the peseta vis-à-vis each group is obtained by applying weighted geometrical averages of peseta exchange indices against the currencies of the countries belonging to each group. (A general analysis of this subject can be found in Miguel Angel Arnedo, Formulación de un índice de posición efectiva de la peseta mediante medias geométricas, Estudios Económicos, 16 (Madrid). When exchange rates have

been obtained in this way, they are used as guidelines for the desired trend of spot exchange rate intervention. A survey of the concept and methodology of effective term of trade exchange rate of the peseta can be found in Pillar L'Hotellerie, Efectos de una modificación en las ponderaciones utilizadas en el cálculo del tipo de cambio efectivo nominal de la peseta, EC/1987/10, Research Department, and Diego González, Propuesta de cambio a base 1985 de los índices base 1980 de posición efectiva nominal de la peseta, ES/1987/2, Research Department, Banco de España.

(15) In fact, a description and analysis of the monetary policy can be found, among others, in the following works: José Pérez and Angel Rojo, La política monetaria española: objetivos e instrumentos, Estudios Económicos, 10 (Madrid, 1977); Raimundo Ortega y José Pérez, La posición monetaria como instrumento de estabilización, ICE, 1582 (Madrid, 1977); Pedro Martínez Méndez, El control monetario a través de la base monetaria: la experiencia española, Estudios Económicos, 20 (Madrid, 1981); Raimundo Ortega, Problemas en la instrumentación de la política monetaria durante el período 1977-1980: un examen retrospectivo, ICE, (Madrid, May 1981). A closer survey of the changes in the instrumentation during 1983 -and especially as of January 1984- and of the reasons behind these changes can be found in Javier Arízteguі and José Pérez, Cambios de la instrumentación de la política monetaria, Boletín Económico, (January 1984) as well as in Javier Aríztegui, Variables monetarias básicas: instrumentos de control, Papeles de Economía, 18 (1984). More information has been provided by Banco de España, Informe Anual 1983, (May 1984), pp. 117-139, 217-227 and Informe Anual 1984, (May 1985), pp. 114-138, 153-164. More recent sources of information are José Pérez, Instrumentación de la política monetaria en 1985, edited by Instituto Español de Analistas de Inversiones, (Madrid, 1986) and Pedro Martínez Méndez, Changes in Money Market Instruments and Procedures: Objectives and Implications, in Autumn Meeting of Central Bank Economists, edited by the Bank for International Settlements (Basle, November 1985).

(16) The Law on Tax System establishes that some kinds of remunerations both in money and in species, in exchange for attracting external resources that had been exempted from tax until the law came into force, are to be regarded as capital gains and, hence, as subject to tax. It applies most particularly to issue premiums and to the difference between the purchase price and the writing off price of securities issued at a discount. The new tax, then, encompasses, as we have already seen, many components of the ALP that have been exempted before.

The new law points out that Treasury notes and securities issued by the Bank of Spain will be exempted from this tax in consideration of their function as instruments of the monetary policy. This affects all the transactions that have been dealt with in this text but there are other kinds of transactions besides these that have also been exempted. Some of the latter are: interest on the Treasury's endowments to the Official Credit, yields on accounts held by non-residents, etc.

20% is witheld from all interest and on each transfer of securities at a discount. Assets issued at a discount under certain conditions -such as, for certain periods, by certain category of issuers and within certain limits of volume, etc.- are subject to a special ruling, and there is a single withholding on these issues, which amounts to 45% of the discount.

The same law also provides for the important aspects of an obligation to various intermediaries to submit tributary information, but this will not be dealt with here.

(17) The ALP variable is made up of the M_3, plus Treasury bills and notes, financial paper and Treasurer's promissory notes, the CRM from outside the banking system, and mortgage debentures. The chart on page 37 shows an outline of all the monetary variables in current use. The Bank of Spain's Annual Report 1982 (Madrid, May 1983) analyzes all the process of implementing the monetary policy and the effect of financial innovations on this process. A broader survey of financial innovations, not devoted to Spain, can be found in Luis A. Lerena, Los cambios en el proceso de intermediación financiera, Situación, Banco de Bilbao, 4 (1982).

Banco de España, Boletín Económico, issues from February 1983 onwards, and Banco de España, Boletín Estadístico, issues from February 1983 onwards contain descriptions of the development of the M_3 and ALP.

(18) An analysis of the problem envolved in implementing monetary policy from a general point of view and specifically from the point of view of the effect of the Law on Tax Liability of certain financial assets can be found in José Pérez, Instrumentación de la política monetaria en 1986 (paper delivered at the XII Seminar on Financial Perspectives and Exchange Rate), edited by Instituto Español de Analistas de Inversiones, (Madrid, January 1986).

(19) A practical instance of the importance of this phenomenon is evidenced in the Spanish banking institutions' growing concern for interrelating their management of Spanish Treasury assets (which has been a tight compartment until very recently) with their trade in foreign currency. As would be expected -and the experience of other systems proves it should- the higher the degree of liberalization, the more favoured this interrelation is, and the greater the efficiency of the institutions in the management of their resources, which, ultimately, benefits the system as a whole.

This process of liberalization not only modifies the behaviour of private institutions but also forces the central bank to introduce greater refinement and intrinsicacy in its control mechanisms to enable it to face this interrelation.

The great choice of financial instruments on the international markets, the quick changes and innovations on these markets, their developing sophistication, etc. are beginning to call for a kind of financial institution that is unlikely to arise unaided out to the process onto which our financial system has just embarked.

CHAPTER 3

THE FUNCTIONS OF THE BANK OF SPAIN. II

Supervising the Banking System

In some European countries the Central Bank deals generally with all matters referring to planning and implementing monetary policy, while the task of supervising and inspecting banking institutions is vested in organizations that are, to a greater or lesser degree, independent from the Central Bank. This is not the case in Spain, where the Bank of Spain carries out both functions in respect of the private banks as well as the savings banks, cooperatives and Money Market intermediaries.

1. Commercial and Investment Banks

a) Original legal regulations:

The supervisory powers vested on the Bank of Spain have their legal foundation in the 1962 Decree Law for Nationalization and Reorganization, whereas the faculty of imposing sanctions is still governed by the Banking Law of 1946, as its provisions regarding this matter were not repealed by the 1962 Law.

The Decree Law of 1962 empowers the Bank of Spain to undertake regular as well as special visits to examine banking institutions whenever it deems them necessary. During these examinations the Bank may require the institution concerned to produce all documents and information necessary for a complete analysis of the conduct of the bank's business. As a result of this examinations, the Bank of Spain can censure the Board of Directors for adopting policies which, although not unlawful, the Bank of Spain considers do not reflect an adequate conduct of business.

Where any breach of regulations is observed, the Bank of Spain can propose to the Ministry of Economy and Finance that sanctions should be imposed. Sanctions can vary from a mere warning, which can be either private or public, fines of varying amounts, suspension of the advantages derived from operating with the Bank of Spain, to the suspension of Board members (in the case of recurrent serious offences), and even the exclusion of the institutions from the Register of Banks and Bankers and its liquidation (1).

The foregoing constitutes what we can refer to as the original legal foundation. However, during the evolution of any financial system, and ours is no exception, the institutions and the kinds of operations undertaken become increasingly more complex, and carry more inherent risks, which the primitive legal regulations were unable to foresee. Consequently, in common with the experience of the EEC countries in the past years, Spanish monetary authorities have endeavoured to supplement the legal instruments already in existence (solvency ratios, legal risk limits, etc.) by taking action along two lines.

Firstly, the supervisory powers of the Bank of Spain have been enlarged and its inspection means have been strengthened, in an attempt to deal with matters that original regulations had not foreseen. Secondly, new regulations have been introduced regarding assets provisions. However, no coefficient, however ideal, no instrument, however perfect, can completely prevent the appearance of dire crises. Consequently, the monetary authorities took action along another line, namely providing means to deal directly with the problem once it had arisen.

We shall now analyze the specific measures that have been implemented to deal with the problems mentioned above. The attached diagram presents an overall view of this norms.

b) Objetive solvency norms

Included under this heading are the instruments that can be called "preventive" -such as solvency ratios, legal limits for banking exposures and regulations on assets provisions.

SUMMARY OF INSTRUMENTS USED BY BANK OF SPAIN TO SUPERVISE THE BANKING SYSTEM

SOLVENCY COEFFICIENTS	PROVISIONS	DEPOSIT GUARANTEE FUNDS
Definition Own resources Disboursed capital, open reserves, general provisions, revaluation reserves, subordinated debts, 35% of current years profits, saving and cooperative banks' social funds. Assets All assets (net of provision and depreciation charges). Level - Own capital always equal or higher than the sum of accounting balances of assets and off-balance-sheet items multiplied by mandatory ratios. - A minimum equal to 4% of entities' total assets. Calculation Semi-annually. Other Special norms for large exposures limitation, profit distribution, etc. Applies to Banks, Saving Banks and Cooperative Credit Banks.	Individual Risk Definition Provisions for losses should reach certain levels, regulated legally, for assets more or less prone to risk (doubtful, bad and very doubtful). As a general norm, funds thus categorized cannot fall below 1.5% of loans and off-balance-sheet items. Applies to Banks, Saving Banks and Cooperative Credit Banks. Country Risk Definition - Provisions to cover country specific risks due to other than the usual commercial risks. - Based on a general division in 6 groups, set up by the Bank of Spain, each individual bank classifies each country in a group following the guidelines of the regulation. Applies to Banks, Saving Banks and Cooperative Credit Banks.	a) Fund Resources 1.2 0/00, banks, and 1 0/00, saving banks, of the deposits of the entities at the end of each year, plus an equivalent amount furnished by Bank of Spain. b) Administration of the Fund A committee or representatives of Bank of Spain and the affected institutions. c) Additional Resources Bank of Spain can concede advance payments with or without interest. When advance payments of the same are more than four times the annual joint provision, the Government can declare the extension up to 2/1,000 quota. d) Maximum Deposit Amount Insured Up to 1,500,000 pesetas per depositor. e) Funds Functions Has the capacity to bring forth legal action in order to resolve management difficulties which might arise in any institution prior to its liquidation. f) Existing Funds One for each group of institutions: Banks, Saving Banks and Cooperative Credit Banks. The three have similar characteristics.

Rules on own resources

In fulfilling its commitment, every authority who is in charge of supervising financial systems is concerned with the solvency of financial institutions and with preventing troublesome problems as far as possible (2). This also happens in Spain and recent rulings on deposit entities' own resources are eloquent instances of this concern.

There are two general differences between the new rules and the previous ones: the central idea underlying the rules themselves has changed, and the concepts and principles, once disperse, have become interconnected into one consisten body.

In fact, solvency, which used to be measured by the relationship between an entity's own resources and its deposits, is now measured by the relationship obtained between its own resources and its assets.

Secondly, all entities attracting deposits (banks, savings banks and cooperatives) come under one general rule and the subjects dealing with the opening of branches, profit distribution and large exposures, which had been disperse hitherto, are now integrated into the general rule.

The following sections are intended to show these aspects:

General definition of the ratio

The new own resources ratio (3) must be always equal to or higher than the sum of accounting balances of risk assets (net of provision and depreciation charges) multiplied by mandatory ratios (4), which are increased in proportion to the degree of risk and which can be modified by the Bank of Spain within certain limits.

Notwithstanding that, an entity's or a group's own resources may, under no circumstances, be less than 4% of its global investment (clear of provisions and depreciations).

Penalty weightings for large exposures

The coefficients applied to the assets increase when the sum of risks of any type with a customer, or a group of customers, exceed certain proportions of the consolidated balance sheet total. If the total consolidated risks with a company or group of companies represent between 1.25 and 2.5% of the balance, coefficients are doubled; between 2.5% and 5% they are multiplied by three; and over 5%, they are multiplied by four.

The coefficients applied to companies belonging to the bank's group but not consolidated are doubled in any case; multiplied by three if the total risks represent between 1.25 and 2.5% of the balance, by four between 2.5 and 5%, by six between 5 and 7.5%, and by ten if those total risks represent more than 7.5% of the balance.

Credit to board members, general directors and similar members of staff will have the above surcharges applied and these credits will have to be authorized by their company's board and, should such credits exceed four million pesetas, they must be reported to the Bank of Spain.

Distribution of profit and expansion

General rule

- Profit distribution. Companies are free to distribute their profit but, when their equity balance shows a deficit equal or bigger than 20% of the legal minimum, the companies must apportion all of their profits to reserves. If this deficit is less than 20%, the affected company must submit its proposed profit distribution to the Bank of Spain. If this is the case, Bank of Spain can authorize profit distribution till 50% maximum.

- New offices. Banks, savings banks and cooperatives may freely open offices anywhere in Spain. The Bank of Spain might demand that an authorization be secured before a company may open a branch if the parent company is short of resources or does not comply with due mandatory ratios, or has lost its expansion power. Newly created entities, foreign banks and savings banks expanding outside the autonomous region where they have their registered address will remain under the specific rules for such entities.

Regulations on assets provisions

Banking supervision cannot be based only on the observance of certain ratios which are checked from time to time by the responsible authorities. A supplementary way of trying to prevent banking crises as far as possible is to be found in an exigent accounting of the various banking operations, which value assets and liabilities on the banking balance sheet objectively and uniformly, as well as in practicing an appropriate profits distribution policy, which must provide both for sufficient reserves and doubtful assets provisions. Aiming at these two lines of action, a number of Circulars (5) have been issued in the last few years which seek to achieve these objectives.

Regulations belonging to the first set of measures are those which try to define more precisely the accounting procedures applicable to banking operations, giving special attention to the Profit and Loss Account. This account must show with rigor the profits or losses during the year and amortization and depreciation policies, and the results arising from ordinary banking operations must be expressed separately from those due to non-banking activities. In order to achieve these aims, the Circular already mentioned has introduced important changes in the prudential Balance-sheets and Profit and Loss Accounts and have increased the number of dates on which banking institutions must make a report on certain operations (6) to the Bank of Spain.

Besides, twice a year, banks, savings banks and cooperative credit banks have to submit to the Bank of Spain the balance sheet and profit and loss account on a consolidated basis.

The second group of measures mentioned above, that is, regulations designed to provide for appropriate reserve provisions and to regulate certain banking practices, deal with "cross loans" (7), provisions for doubtful assets and provisions for country risk.

Because "cross loans" are not granted on the basis of the borrower's solvency, the Bank of Spain considers that they are against sound banking practices and therefore should not be carries out.

Lastly, mention should be made of regulations which cater for the constitution of reserves aimed at guaranteeing sound profit distribution policies. These regulations are, in the final analysis, an answer to the need to observe sound lending policies, not only at the moment of actually granting loans, but also throughout the period of their existence. Present regulations on this matter belong to two groups. The first one includes the regulations that deals with individual risks. Within this group assets are classified according to their riskiness. With regard to this, "very doubtful assets" include credit facilities, fixed interest securities and other debit balances owed by a borrower who has been declared bankrupt or has suffered an irrecuperable loss of solvency. The same consideration is to be given to balances which remain unpaid for three years after having been classified as "bad" or "doubtful". All these assets are to be written-off and passed to a below-the-line account applying the provisions which might have been made for this purpose.

"Doubtful assets" are those, matured or not, which the banking institution concerned judges to have scant possibility of being repaid. "Bad" assets include: a) matured fixed-interest securities which remain unpaid for six months after maturity; and b) bills, repayment instalments, personal balances, etc., standing unpaid ninety days after maturity.

Insolvency funds should at least equal the sum of provisions prescribed:

a) in the case of "bad" assets, as a function of the length of time remaining unpaid; b) in the case of doubtful assets, on the basis of subjective criteria, within limits; and c) in the case of "contingent" liabilities, on the likelihood of payment by the banking institution (8).

In any case, insolvency funds, which are to be shown expressly on the balance-sheet, must total at least 1.5% of all unsecured loan investments and contingent liabilities.

To the second group belong all the criteria for provisioning related to country risk.

The main features of this new regulation are:

a) Definition

This is a country-specific risk arising from a given country's overall debts and due to other than the usual commercial risk. There are two kinds of such risk: Sovereign risk and transfer risk (9).

In order to make provision for this country risk, the Bank of Spain establishes a six groups general classification, and each group has a particular provision level. The Bank of Spain does not include any specific country in these groups. The private banks, following the guidelines of the regulation, include each country in the group.

b) Groups

The classification set up by the Bank of Spain is as follow:

Group 1: OECD countries
Group 2: Countries not included in other groups
Group 3: Temporary difficulties
Group 4: Doubtful
Group 5: Very doubtful
Group 6: Insolvent

For countries in Groups 3 to 5, non-fulfilments are graded as failing to comply with redemption of loan capital, with interest payments, re-negotiation of their loans, etc.

Countries that have repudiated their debts or failed to honour redemption or interest payments for four years, have been listed in Group 6.

c) Criteria for accounting and provisions

According to the group in which each country is included, the banks have to make different provisions.

The criteria for building up the provisions are as follow:

- Insolvency assets will be deemed as unrecoverable and booked in moratorium accounts.

- Very doubtful. These assets and off-balance-sheet items must be covered by a minimum 50% one year after they have been included in this group, and 75 and 90% since the beginning of 2nd and 3rd year.

- Doubtful. Minimum of 20% when the asset is included in the group, and 35% since the beginning of the second year.

- Temporary difficulties. Minimum 15%.

- Countries not included in other groups (Group 2). Reserve not less than 1.5% of total risk.

- This reserve will be calculated subtracting the risks that have been accounted for under other rules, as long as their insolvency funds are bigger than required hereby.

- In any case provisions for cover risks over countries in temporary difficulties, doubtful and "very doubtful" must total at least 25% of risks with those countries.

The provisions for cover either individual risks or country risk in foreign currency can be made with some restrictions in foreign currency (except in the case of foreign banks).

C) Strengthening the powers of inspection

As we have seen above, the weaknesses and loopholes that exist in our basic legislation mainly concern possible penalties -which are still based on the Banking Law of 1946- and the possible measures that the Bank of Spain can undertake to avoid any serious situations in the future by putting adequate precautionary provisions into practice. In order to correct this both the Government and Parliament decided that it was of the utmost urgency to provide the Bank of Spain with specific means by which it could deal rapidly and efficiently with any crises that could arise. To this end the Royal Decree-Law 5/1978 of the 6th March was issued. This Law permitted the Bank of Spain to decree temporary suspension of the governing bodies of an institution, when the known facts and the circumstances of the institution in question made such a step necessary, and to appoint temporary officials to manage the institution's business.

d) Further measures of control and protection

In moments of crisis it is extremely useful to have a series of instruments at one's disposal which, on the one hand, will protect the small saver and, on the other, help to confront the crisis by minimizing as far as possible its effects on the rest of the affected sectors.

In order to deal with both problems, the Spanish monetary authorities, following the recommendations made by the Community authorities and the measures put into practice in some Common Market countries, adopted a deposit insurance scheme.

The Deposit Insurance Fund was created in November 1977. In two successive stages, March 1980 and August 1981, the Insurance Fund suffered modifications that have completely changed its nature. In fact, from merely acting to ensure deposits, it has become an institution in its own right, with legal status and governed by a Commission (10), which is not only concerned with guaranteeing deposits -now up to a higher level of 1,500,000 pesetas- but also undertakes a series of actions which try to solve such conflictive solvency problems which may arise in any banking institution. To this end, the Fund can take over losses, offer guarantees and acquire assets in order to achieve its aims.

The central idea is that an institution in trouble should be able to reassume all its activities once its share capital desequilibrium has been restored.

This enlargement of the functions assigned to the Insurance Fund meant that it needed a larger volume of resources, and consequently, as well authorizing the Bank of Spain to grant the Fund loans with or without interest, the private banks' contribution was increased to 1.2 thousandth of their deposits at year-end. The Bank of Spain contributes annually an amount equal to that paid by all the private banks. Also the amounts contributed by the banks are no longer eligible for reserve requirement obligations.

2. Savings Banks

Since 1971 the inspection and control of the savings banks has been in the hands of the Bank of Spain and follows the same lines as that of the private banks. All the norms are similar.

The savings banks have a Deposit Insurance Fund similar to that of the private banks. All savings banks belong to it and their contribution is 1 0/00 of their year-end deposits, with the Bank of Spain contributing the same amount. Each institution's contribution has to be deposited with the Bank of Spain and is not eligible for reserve requirement obligations.

The Fund guarantees deposits up to the amount of Pts. 1,500,000 per depositor and comes into force in the event of partial or total insolvency of the institution in question. The functions and administration of the Insurance Fund, which is a legally constituted entity, are carried out by a management commission (11). It does not play a merely passive role, advising whether the insurance scheme should be activated or not, but it also has other functions. Among these it should be mentioned that the Fund can propose, in the public interest, to grant loans either interest-free or otherwise, to resolve a specific matter. The Fund can also decide whether an institution should undergo an audit, establishing the periodicity and extension of such audits.

As well as the foregoing, and following the line of action common to all the deposit institutions, the policy for assets provisions for the savings banks is similar to that of private banks. Consequently, as well as modifying accounting statements -including greater frequency in sending information to the Bank of Spain- the registration of all items has been carefully redesigned paying special attention to ensure that the Profits and Loss Account shows distribuible profits -which in the case of the savings banks are split between reserves and social undertakings- that are compatible with the solvency and sound functioning of the institution.

In order to achieve all this, apart from all the accountancy norms which we are not going to state here (12), the measures referring to the definition of assets and reserve requirements which have already been described in the paragraphs referring to private banks are also applicable to the savings institutions.

3. Cooperatives

Cooperatives come under inspection by the Bank of Spain in the same way as all the other deposit institutions. Likewise the Royal Decree-Law of November 3, 1978 established a similar penalty table.

At the same time, balance sheet and profit and loss accounting norms, as well as reserve provision norms for forseeable insolvencies and solvency coefficient apply to cooperatives in the same way as banks and savings banks. The Cooperatives' Deposit Insurance Fund carries the same characteristics as that of savings banks, which was analized in the preceding section.

FOOTNOTES TO CHAPTER 3

(1) With regard to sanction of penalty aspects there have also been some regulation changes. Maintaining the initial framework set up by the original regulations already mentioned, changes have aimed at widening the range of sanctions as well as at favouring their automatic imposition by the Bank of Spain whenever legal obligations regarding coefficients are not fulfilled. Some of the most important changes are: the Bank of Spain's power (Decree 56/1967) to apply penalty interest rates on its operations with any bank that does not fulfill coefficient obligations; the Bank of Spain's capacity (MO Sept. 20, 1974) to reduce branch expansion in the face of specific behaviour, and the imposition of sanctions on breaches of exchange control.

(2) This point has been developed in "Aspectos financieros de la integración de España en la CEE", Estudios Económicos nº 37.

(3) The following assets are defined as own resources:

- Disbursed capital, founding funds (for savings banks) and contributions (for cooperatives).
- General provision.
- Reserves.
- Savings banks' mandatory social and philanthropical contribution fund.
- Subordinated debt (up to the amount fixed by the Bank of Spain, but never exceeding 30% of shareholders' equity).
- 35% of current years profits.

(4) These ratios pivot around the 6% assigned to the "normal" banking business operations (non guaranteed loans and advances and others) and range from 0.25%, for cash in pesetas, deposits in the Bank of Spain and public sector assets, up to 100% for fictitious assets not deducted from equity; there are intermediate rates such as 3% for assets with mortgage guarantee, or 8% for shares and subordinated loans, etc.

(5) Regulations on Balance-sheets and Profit and Loss Accounts of banking institutions -which were spread over various Circulars- were compiled into a new Circular (Nº 19/1985) which also deals with hitherto untreated problems.

(6) Usually when dealing with supervision of deposit institutions people tend to think only of direct inspection of the institutions themselves. In facts, supervisory tasks also comprise another, sometimes previous and always supplementary, stage devoted to what we may term "external supervision".

At this stage, supervision -directed to the appraisal of compliance to legal obligations and to the analysis of the financial and economic conditions of the institutions- works on the basis of the information that the institutions must regularly submit to the Bank of Spain.

(7) Circular 172 defines "cross" loans in the following way: a "cross loan" is a lending operation by means of which a banking institution grants a credit facility to a company directly or indirectly associated with another banking institution which, in its turn, grants credit facilities to companies associated with the former banking institution. There are similar operations, which, although somewhat different in their formalization procedures, should also be considered forbidden.

(8) Circular Nº 19 of 1985 defines the amount of insolvency funds as the total of the following provisions:

a) Assets classified as doubtful will be provisioned by applying percentages which the banking institution will apportion according to the probability of default, but which will never be less than 25% nor smaller than that which would result from the schedule in (b) below.

b) Assets classified as bad will be provisioned by applying the following percentages according to the length of time they may have been so classified.

From 3 to 9 months	25%
From 9 to 15 months	50%
From 15 to 18 months	75%
More than 18 months	100%

c) Contingente liabilities which the banking institution is likely to have to make good will be provisioned in full.

(9) Risks not included are:

- Private sector risks quoted in local currency.
- Shares and investment holdings.
- Part of risk subject to foreign residents guarantee when the foreign resident has a better position within the list of countries.
- Part of risk covered by mortgage or pledge guarantees with OCDE countries.
- Risks from Spanish banks' trading with foreign bank branches operating in Spain.
- Documentary credits of less than 3 months.
- Risks in trading with private sector belonging to the currency area of a Group 1 country.

(10) Made up by four representatives from the Bank of Spain and four representatives from private banks appointed by the Ministry of Economy and Finance.

(11) The Managing Commission is made up by four representatives from savings banks and four representatives from the Bank of Spain, one of them acts as chairman. The Fund is authorized to receive advances from

the Bank of Spain and the savings banks, the Bank of Spain can suggest to the Government an increase in annual contributions. Likewise the Bank of Spain can prescribe a decrease in annual contribution if, after the repayment of the Bank of Spain's advances, the amount contributed stands at a high level.

(12) Circular Nº 19/1985. Savings banks must provide the Bank of Spain with the same monthly, quarterly and annual information as the private banks except for some specific features arising from their different nature.

ANNEX 1

FOREIGN OPERATIONS OF THE SPANISH BANKING SYSTEM

The transactions of the banking system with non residents -whether in pesetas or in foreign currency- have been traditionally subjected to different regulations which, in general, were more restrictive than those applicable to resident customers.

At present, the situation is different and the banks can carry out any type of transactions, with the exception of loans in pesetas to non residents.

The exposure of risks they take in respect of their investment transactions must be counterbalanced by their own resources, applying to the relevant computable balances the same percentages fixed in the general regulations regarding the solvency ratios (see Chapter 3).

Apart from this general rule and like in most other financial systems, the banks are subjected to specific regulations concerning the positions they can maintain in foreign currency.

In the case of Spain, the covered positions (1) are not subject to any limitation; for the open positions, whether short or long, there is a limit related to the own resources of each institution. This limit is contemplated in two ways: on the one hand, for each one of the currencies (pesetas included) the position cannot exceed a certain percentage of the own resources; and on the other, the sum of all positions, short and long, neither of which can exceed a certain percentage of such resources (2).

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(1) The position is the result of the difference between assets and liabilities. The assets include capital assets, yields and purchase commitments. The liabilities include the correspondent liability operations.

(2) The limits are fixed on a individual basis depending on the degree of activity in foreign currency of each bank.

On the basis of these general regulations, the transactions the banks can carry out are as follows:

Foreign currency accounts can be opened freely by non-residents or foreign diplomatic officials in Spain or Spanish subjects living abroad by means of sight-, saving- and term-deposits or any other form, and the funds can be used by them withdrawing the same currency or converting it into other quoted currencies or into pesetas. The institutions which operate these deposits can use the balances freely in the domestic or foreign market.

The interest rates for all transactions can ben negotiated freely, whether for investments or fundings.

Convertible peseta accounts in the name of non-residents: Since the peseta became externally convertible in 1961, apart from the specifically called convertible peseta accounts, other kinds of accounts for non-resident holders (up to 6 different types) were introduced, some of them being convertible and others not.

The variety of accounts of non-resident holders has disappeared, and at present only two kinds remain: Ordinary peseta accounts in the name of non-residents (which can only reflect a credit balance and their funds are to be used only for payments in Spain) and convertible peseta accounts in the name of non-residents, which will be described below.

Under the present regulations, any authorized institution is entitled to open foreign accounts in convertible pesetas in the name of non-resident individuals and legalle constituted entities. These accounts can be opened establishing sight-, saving- or term-deposits, and the interest rates on them are freely negotiable between both parties. Their balances are freely convertible in the Spanish foreign exchange market.

The credit and debit entries to the foreign accounts in convertible pesetas can be:

a) Credits for: the proceeds from the sale of foreign exchange which non-residents effect in the foreign exchange market, the proceeds from the sale of foreign bank-notes, the amount of remittances of Spanish banknotes received from foreign correspondent banks, payments from residents to non-residents arising from any balance of payments transaction, interest, and transfers from another foreign account in convertible pesetas.

b) Debits for: the amount of the purchase of foreign exchange and foreign bank-notes, the amount of the remittances of Spanish bank-notes, the amount of the remittances of Spanish bank-notes to foreign correspondent banks, payments to residents arising from any balance of payments transaction, withdrawals of cash in favour of the holder or another non-resident, and transfers to other foreign accounts of any kind.

The institutions authorized to operate these accounts have to report all the above mentioned debit and credit entries every ten days to the Bank of Spain. Overdrafts on these accounts, other than those originated by the payment of documentary credits, are not allowed.

Recently (as from the 10th of March), the increases recorded in these accounts, have been subjected to a cash ratio of 19.5%. Its characteristics are similar to the ratio being applied to peseta deposits(*).

(*) As from 28th of April, and on temporary basis, the interest payment on this deposits has been prohibited.

<u>Forward operations</u>: As a rule, forward foreign exchange purchases or sales against pesetas which the authorized institutions effect with residents are only allowed to provide cover for receipts and payments of any balance of payment transactions. Thus, residents can sell forward to the authorized banks the foreign exchange receipts arising from any balance of payment transaction. That is, they can sell forward the foreign exchange they are going to receive in respect of exports, remittances, loans, etc. Forward foreign exchange purchases are also allowed for any balance of paymen item. These forward contracts must always be effected against pesetas and their period until maturity is without limitation. Also roll-over forward contracts are authorized. In any case, the last maturity date of the contract cannot exceed the final payment date of the transction.

On the other hand, foreign exchange operations are to be contracted in the currency of the underlying transaction in question, and this foreign exchange can only be used to settle the transaction for which it was contracted.

The transactions with non residents against convertible pesetas or against foreign currencies and those effected between authorized institutions can be contracted freely.

In forward sales of currency against pesetas only the balances already existing with the delegate entity can be sold, and those balances must be maintained without interruption until the date this contract expires. The maturity of the contract cannot be under 1 month.

Table 1 shows the evolution during the last years of the external position of the Spanish banking system (in pesetas as well as in foreign currency), which reflects the following characteristics:

1. Throughout the last years, the growth of the international activity of the Spanish banking system has been strong. The assets increased at an annual average rate of 10%.

2. A trend towards a balanced total net position, whereas in the first years it was strongly negative.

3. Development of a positive net position against with the international banking system.

In spite of this evolution of the Spanish banking system, its relative importance within the international banking system is still quite small. In fact, as reflected in Table 2, the figures of the assets concerning the foreign business of our system, as of end of 1986, did not reach 1% of the total foreign assets of the banks reporting to the BIS.

TABLE 1

EXTERNAL BALANCE OF THE SPANISH BANKING SYSTEM *

(millions of $) (Positions at the end of period)

	1979	1980	1981	1982	1983	1984	1985	1986
ASSETS								
Credit entities	10,147	12,335	14,383	11,628	9,897	11,255	12,828	15,326
Loans	3,861	5,009	6,658	5,215	5,308	5,439	6,181	6,608
Securities	243	288	302	432	642	738	924	1,748
Others	97	106	118	88	76	93	106	132
TOTAL ASSETS	14,348	17,738	21,461	17,363	15,923	17,525	20,039	23,814
LIABILITIES								
Credit entities	11,842	14,006	15,975	11,864	10,037	10,800	9,156	11,898
Others	7,829	9,310	10,847	9,673	9,380	10,409	11,783	13,511
TOTAL LIABILITIES	19,671	23,316	26,822	21,537	19,417	21,209	20,939	25,409

(*) Residents.

TABLE 2

EXTERNAL POSITION OF THE INTERNATIONAL (1) AND SPANISH (2) BANKING SYSTEM

(m.m. $)

	ASSETS				LIABILITIES			
	1983	1984	1985	1986	1983	1984	1985	1986
Position in all currencies	2,097	2,155	2,532	2,999*	2,028	2,114	2,495	2,947*
Spanish participation								
in m.m.	15.9	17.5	20.0	23.8	19.4	21.2	20.9	25.4
in %	0.76	0.81	0.79	0.80	0.96	1.00	0.84	0.86

(1) Banks reporting to BIS.

(*) September.

Source: International Banking Developments, BIS, and Banco de España.

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