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The European Monetary System as a Factor of Integration

by Wolfgang Filc, Jörg Kuhlmann, Trier*

Critics of the EMS claim that it has failed to realise the hopes aroused at the time of its inception; a convergence of economic policies, they maintain, has not been induced by fixed exchange rates. What is the true position with regard to the convergence of economic policies?

In June 1982 central exchange rates within the European Monetary System were adjusted for the sixth time since the start of the system and for the second time this year. This further realignment, which like all those before entailed the revaluation of the Deutsche Mark, drew contrasting comments from official quarters and the public.

The central bank governors and the finance ministers of the EMS countries regard the latest realignment as proof that member countries can face the problems stemming from the international economic and monetary situation in a spirit of solidarity and co-operation.¹ In particular, the revaluation of the Dutch guilder and the Mark are seen as an act of solidarity with France, for it enabled the French to devalue the franc by less and still achieve the desired devaluation effect, especially in relation to the Federal Republic of Germany, France's most important trading partner.

The situation is often viewed differently by the general public² and in academic circles.³ Doubts about the stability of the exchange rate system mount as the period between successive realignments shortens. Moreover, critics claim there is no evidence that fixed exchange rates have had an inescapable disciplinary effect on economic policy and thus led to a strengthening of convergence. On the contrary, they say, the generous credit mechanism within the EMS permits the governments of individual countries to pursue an inflationary policy for some time without paying heed to the exchange rate. Rather than the EMS imposing reasonable economic policies on member

countries, weak currency countries are repeatedly forcing Germany to revalue and are thus delaying recovery here.⁴ What then is the position with regard to convergence of the economic policies of EMS countries?

Expectations and Apprehensions

The founding fathers of the European Monetary System viewed their creation as a fresh start in the direction of greater monetary stability and hence increased price stability in the countries of the EC. The Resolution of the European Council of 5 December 1978 states that "the most important concern should be to enhance the convergence of economic policies towards greater stability".⁵ The hope was that the symmetrical obligations to intervene in the foreign exchange markets would compel countries with high inflation rates and, more often than not, expansionary

¹ Cf. Communiqué of the European Communities on the realignment of central rates within the European Monetary System, Brussels, 12 June 1982.

² Cf. Bert Hagelstein: Kettenreaktion – Neue Kurse im EWS (Chain reaction – new exchange rates in the EMS), in: Handelsblatt, 14 June 1982, p. 2.

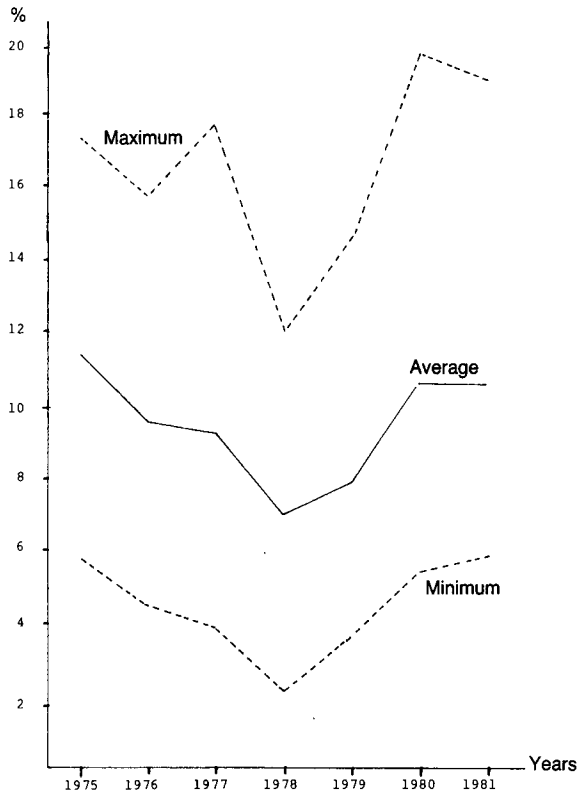
³ Cf. Hans-Eckart Scharrer: EWS: Abschied von einer Illusion (EMS: Goodbye to an Illusion), in: WIRTSCHAFTSDIENST, Vol. 62 (1982), No. 5, p. 206 f.

⁴ Cf. Das EMS als Störfaktor der Notenbank-Stabilitätspolitik, Fehlende Konvergenz zerstört Geschäftsgrundlage (The EMS as an impediment to the central bank's stabilisation policy; lack of convergence undermines operational rationale), in: Neue Zürcher Zeitung, 7 May 1982, p. 21.

⁵ Resolution of the European Council on the establishment of the European Monetary System (EMS) and related matters, Brussels, 5 December 1978, in: European Communities, Monetary Committee, Compendium of Community Monetary Texts, Brussels-Luxembourg 1979, p. 40 ff.

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Figure 1
Rates of Increase in the Cost of Living in the EMS Countries



Unweighted average of rates of increase in the cost of living in the last month of each quarter over the same month of the previous year; excluding Ireland.

Sources: IMF: International Financial Statistics; OECD: Main Economic Indicators; the authors' own calculations.

monetary policies to toe the monetary policy line of countries with more stable prices, with the pressure to do so resulting from sales of foreign currency. Opponents of the system suspected that countries with lower rates of price increase would have to abandon the line of sound monetary sense and adapt to the higher inflation rates of their partners.⁶ These opposing positions both foresee the convergence of inflation rates, in the one case at a high level and in the other at a low one.

An examination of views on the working of the EMS more than three years after its inception gives a mixed impression. Most agree that the exchange rate mechanism has worked satisfactorily on the whole.⁷ On

the other hand, the EMS is not considered to have lived up to its claim that it would create a zone of greater monetary stability, i. e. greater price stability, in Europe. In this respect the EMS is judged a failure.⁸ The development of inflation rates in the EMS countries is often quoted in support of this criticism. Indeed, since 1979, that is to say since the implementation of the EMS, the rate of price increase has accelerated in member countries (see Figure 1).^{9,10}

Between 1975 and 1978 the rates of price increase were slowing down in the EMS countries. Since 1979 the pace of inflation has quickened again. Moreover, the spread between the two extremes has widened rather than narrowed. Inflation rates are not converging, either towards the mean or towards the level of the country with the highest inflation or yet towards the level of the country with the lowest, which is the objective.

Far-reaching Conclusions

This price development is frequently used as evidence of the failure of the attempt to induce a convergence of economic policies by means of fixed exchange rates in order thereby to achieve the objective of greater price stability. Among the causes of the failure, and hence of the accelerating pace of price increases and the widening inflation differentials among the EMS countries, is often said to be the laxity of monetary policy.¹¹ The EMS has brought no improvement in this respect and, according to this view, the guaranteed foreign currency credits under the currency support arrangements have weakened the compulsion to pursue a monetary policy consistent with stability. A further consequence of this interpretation of price developments is that the transition of the system to its final stage, which was originally supposed to occur

⁹ Ireland has been excluded in view of its very small size. In 1979 Ireland accounted for only 1.3 % of the foreign trade of EC countries and produced just under 0.8 % of the gross domestic product of the Community (both figures measured in terms of purchasing power and computed at purchasing power parities). A further indication of Ireland's small contribution to the economic power of the EC can be seen in the fact that the Irish pound provides only 1.1 % of the ECU basket, little more than one third of the weight of the Danish krone, the currency of the second smallest EC country participating in the EMS. Ireland's small significance may also explain why the Irish pound has not been devalued once since the start of the EMS, in spite of the fact that for years Ireland has recorded current account deficits, extremely high rates of inflation (21.0 % in May 1982) and large budget deficits.

¹⁰ This and the subsequent similar figures were constructed by calculating the rates of change in the cost-of-living index for the final month in each quarter over the previous year for the EMS member countries excluding Ireland. An unweighted average of these figures was then calculated, giving the middle curve in Figure 1 ("Average"). The "Maximum" and "Minimum" curves show the averages of the extreme values for the relevant four months of each year.

¹¹ Cf. Harald Kühnen: Das EWS bedarf voll konvertibler Währungen (The EMS needs fully convertible currencies), in: Zeitschrift für das gesamte Kreditwesen, Vol. 35, 1982, No. 10, p. 418.

⁶ Cf. Rolf Caesar, Dietrich Dickertmann: Einige kritische Anmerkungen zum Europäischen Währungssystem (Critique of the European Monetary System), in: Kredit und Kapital, Vol. 12, 1979, No. 3, p. 296.

⁷ Cf. Manfred Lahnstein: Perspektiven des EWS (The outlook for the EMS), in: Zeitschrift für das gesamte Kreditwesen, Vol. 35, 1982, No. 10, p. 420.

⁸ Cf. Hans-Eckart Scharrer, op. cit., p. 206.

two years after the entry into force of the EMS, has not been carried out. Both the EC Commission¹² and the Deutsche Bundesbank¹³ consider that what is most needed is action to increase the co-ordination of the economic policies of member countries. Only after this has been done can consideration be given to the institutional arrangements for the second stage. In Germany a relaxation of the exchange rate provisions, perhaps by doubling the margins of exchange rate fluctuation, is being discussed and recommended in many quarters.¹⁴ In the absence of monetary convergence, this course is said to be essential in order to reduce imported inflation from EMS countries and increase the Bundesbank's room for manoeuvre.

How are these far-reaching conclusions to be judged? Are they the necessary consequence of the different monetary paths followed by EMS countries since 1979?

Past Experience

Central banks use a range of variables as monetary targets. The choice of monetary target variables is determined by the theoretical concept underlying central bank policy, by the central bank's views on the process whereby monetary stimuli are transmitted to the real economy and by the institutional realities of the country in question, in particular the organisation of the

banking system. The common feature of the different target variables is the fact that they should reflect the degree of tension between supply and demand in the financial markets and thus the conditions for financing business activities.

Particular importance attaches to the money supply, the volume of credit and the level of interest rates within the spectrum of possible target variables for central bank policy. We therefore propose to examine developments in capital market interest rates (current yields on public authority bonds), rates of growth in the M_1 money supply and rates of change in the volume of credit in order to establish whether the monetary policies of countries belonging to the EMS (excluding Ireland) have indeed diverged since the system was set up, as has been claimed, or whether a process of

¹² Cf. Communiqué of the Council of Ministers of the European Communities on the realignment of central rates within the European Monetary System, 21 February 1982; Harald Hotze: Das EWS diszipliniert alle Partner (The EMS disciplines all its members), interview with the Vice-President of the EC Commission, François-Xavier Ortoli, in: Wirtschaftswoche, Vol. 36, 1982, No. 20, p. 115.

¹³ "All these factors raise the question of how the EMS is to develop further if the inner cohesion between the member states seems to be so insecure." (Annual Report of the Deutsche Bundesbank for the Year 1981, p. 79.)

¹⁴ Cf. Hans-Eckart Scharrer: Fehlentwicklungen im EWS (Wrong turns in the EMS), in: WIRTSCHAFTSDIENST, Vol. 61, 1981, No. 10, p. 471; Helmut Geiger: Für erweiterte Bandbreiten im EWS (For wider margins within the EMS), in: Der Volks- und Betriebswirt, 6/1982, p. 11.

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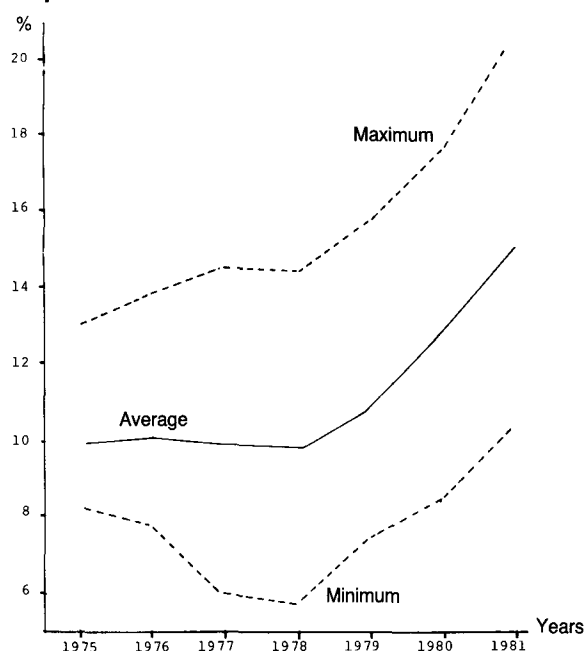
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Figure 2
Capital Market Interest Rates in the EMS Countries



Unweighted average of current yields on public authority bonds at the end of each quarter; excluding Ireland.

Sources: IMF: International Financial Statistics; the authors' own calculations.

monetary convergence has occurred. Let us be clear what we mean: monetary convergence is present if the target variables for central bank policy in the member countries draw closer to one another over time, in other words if there is regression towards the mean. In a situation where *monetary factors are tending to produce additional price rises*, convergence occurs if the averages of the rates of growth in monetary aggregates

rise and/or the average level of interest rates falls, in conjunction with a reduction in differences. Vice versa, when central bank policy has a *restrictive, price-curbng stance*, there is convergence if the average rates of growth in monetary aggregates fall and/or interest rates rise over time, again in conjunction with a narrowing of the spread.

Let us take interest rates first (see Figure 2). Between 1975 and 1978 there was little variation in the average of capital market rates in countries that were later to join the EMS. However, the widening difference between the extreme values (maxima and minima in Figure 2) might be viewed as an indication of increasing monetary divergence. Since then, in other words from the time of implementation of the EMS until 1981, interest rates on the capital markets have risen sharply and continuously; this is true of the extreme values as well as the mean. The range of interest rates in EMS countries has widened further (see also the figures for standard deviations in the table). Monetary convergence, defined as a reduction in interest rate differentials, is not discernible here.

Taken alone, however, capital market interest rates are a bad indicator of the degree of monetary policy integration. First, the central banks cannot influence capital market rates directly, but only in the main via the money market. Secondly, the different rates of inflation in the various countries should be taken into account.

In general, the higher the rate of price increase, the higher the interest rate on the capital market. If the difference between capital market interest rates and the rate of increase in the cost of living is computed and

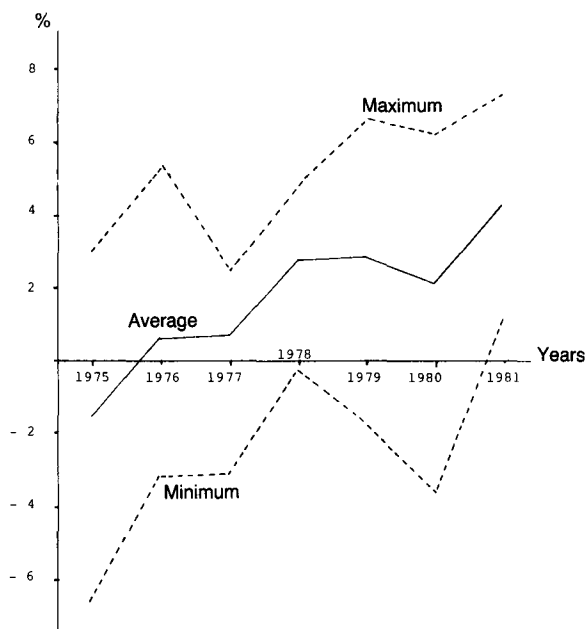
Averages and Standard Deviations of Rates of Increase in the Cost of Living and of Monetary Aggregates in the EMS Countries¹

	1975	1976	1977	1978	1979	1980	1981
Rate of price increase ²	11.54 (4.16)	9.56 (3.78)	9.33 (4.62)	7.04 (3.81)	7.96 (4.31)	10.75 (5.24)	10.74 (4.74)
Capital market interest rate ³	9.9 (1.87)	10.13 (2.30)	9.98 (3.17)	9.86 (3.28)	10.84 (3.14)	12.92 (3.28)	15.13 (3.92)
Real capital market interest rate ⁴	-1.64 (3.86)	0.57 (3.03)	0.65 (2.12)	2.82 (2.00)	2.88 (3.13)	2.17 (3.52)	4.4 (2.26)
Rate of growth of the money supply ⁵	13.47 (6.22)	13.69 (7.04)	11.08 (5.41)	12.55 (6.77)	10.29 (7.43)	5.97 (5.43)	7.46 ⁷ (5.45)
Rate of growth in the volume of credit ⁶	15.96 (5.36)	18.97 (5.12)	13.23 (6.06)	14.28 (5.63)	13.4 (3.32)	13.0 (2.27)	12.72 ⁷ (3.06)

The figures in brackets are the standard deviations. ¹ Excluding Ireland. ² Cost-of-living index; unweighted average of changes for the last month of each quarter over the same month of the previous year. ³ Unweighted average of current yields on public authority bonds at the end of each quarter in per cent. ⁴ Difference between the "capital market interest rate" and the "rate of price increase" in per cent. ⁵ Unweighted average of rates of change in the money stock narrowly defined (primarily cash in the hands of non-banks and the sight deposits of non-banks) at the end of each quarter compared to the same quarter of the previous year, in per cent. ⁶ Unweighted average of rates of change in the volume of credit outstanding at the end of each quarter over the same quarter of the previous year, in per cent. ⁷ On the basis of the first three quarters.

Sources: IMF: International Financial Statistics; OECD: Main Economic Indicators; the authors' own calculations.

Figure 3
Real Capital Market Interest Rates
in the EMS Countries



Difference between unweighted averages of current yields on public authority bonds at the end of each quarter and unweighted averages of the rise in the cost of living over the previous year; excluding Ireland.

Sources: IMF: International Financial Statistics; OECD: Main Economic Indicators; the authors' own calculations.

used as an estimate of real capital market rates, there emerges a different picture of the state of monetary integration within the EMS (see Figure 3). The mean real capital market rate, which is a better barometer of the monetary policy stance than the nominal rate, has shown a trend increase since 1975. After falling slightly in 1980, the mean real rate rose abruptly in 1981. At the same time the difference between the extreme values narrowed substantially, as did the standard deviation used as a measure of the average deviation from the mean (see the table). In 1981 no EMS country had capital market interest rates below the rate of price increase, in contrast to the situation that frequently prevailed in previous years.

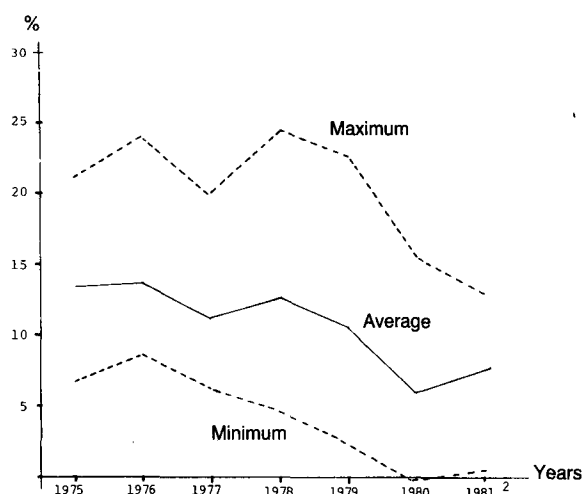
In 1981 in particular the central banks of all EMS countries tightened their monetary restrictions, insofar as this is reflected in real capital market rates. It is also remarkable that no central bank pursued a policy that ran counter to the general line. Finally, it should be remembered that the escalation of interest rates in Europe in 1981 was triggered by the restrictive stance of the Deutsche Bundesbank. The central banks of other EMS countries followed suit, in some cases less out of conviction as to the appropriateness of this monetary

policy than as a result of the pressure exerted by the system of fixed exchange rates.

The rates of growth in monetary aggregates have shown similar developments to those in capital market interest rates since the implementation of the EMS. The average rates of growth in the money supply in the EMS countries changed little between 1975 and 1978 and the spread between the mean maximum and minimum rates widened from about 14 percentage points in 1975 to 20 in 1978 (see Figure 4). Since 1979 the pace of monetary expansion has slowed down considerably and the distance between the extreme values has diminished, to stand at just under 13 percentage points in 1981. The lower standard deviation figures also indicate a convergence of monetary policies rather than a divergence (see the table).

Finally, the rates of change in the volume of credit in EMS countries also provide evidence that, far from drifting apart, the monetary policies of those countries have shown an impressive convergence since 1979 (see Figure 5). The rate of growth of credit volumes has slowed down less dramatically than that of the money supply, but the poor synchronisation of the two aggregates should not be adduced as evidence that the central banks lacked the determination to curb monetary expansion. On the contrary, in times of monetary restriction – and especially when the general economic trend is poor – it can often be observed that

Figure 4
Rates of Change in the Money Supply
in the EMS Countries



¹ Unweighted average of rates of change in the money stock narrowly defined (primarily cash in the hands of non-banks and the sight deposits of non-banks) at the end of each quarter compared to the same quarter of the previous year; excluding Ireland.

² On the basis of the first three quarters.

Sources: IMF: International Financial Statistics; the authors' own calculations.

credit continues to expand at a rapid pace for a fairly long time, as payment delays force firms to take up additional credit. Quite spectacular, however, is the reduction in the spread between the extreme rates of growth of outstanding credit from about 18 percentage points in 1978 to around 8 in 1981 (see Figure 5) as well as the almost halving of the standard deviation between these two years (see the table). This is evidence of an extraordinary convergence of credit policies within the EMS.

Overall Conclusion

Whichever is chosen from the range of monetary targets (capital market interest rates, the money supply or the volume of credit), the same picture emerges: no divergence of monetary and credit policies since the implementation of the EMS can be detected but, on the contrary, a considerable degree of integration. Hence the European Monetary System has not only stabilised exchange rates in the foreign exchange markets but has also helped to strengthen the central banks' economic stabilisation efforts and to harmonise monetary measures. Two points may be inferred from this and a summary conclusion drawn.

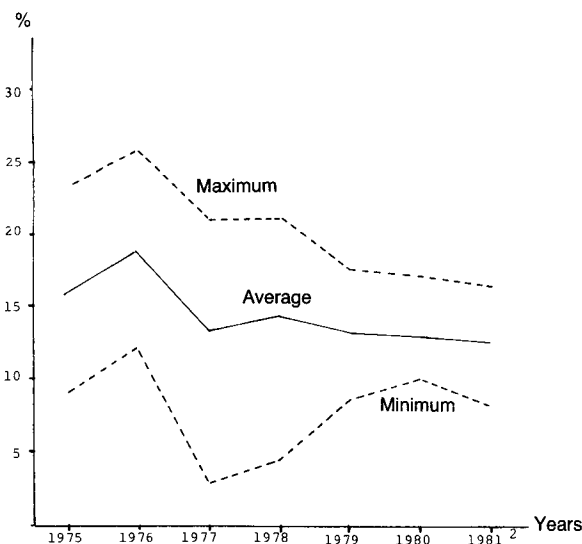
- The Deutsche Bundesbank plays the lead role in determining the monetary course of the EMS countries. The fear of the German Board of Experts for

Assessment of Overall Economic Trends that the operational capability of the EMS might be harmed by the lack of a key currency¹⁵ has not therefore been realised. It has been seen repeatedly that steps taken by the Bundesbank have been followed swiftly by measures in the same vein by the central banks of other member countries, as on the occasions when the Bundesbank tightened its monetary stance or when it relaxed its restrictions at the beginning of 1982. The Deutsche Bundesbank therefore bears special responsibility for economic developments not only in Germany but also in other European countries.

- Although the power of the EMS to bring about integration is unmistakable as far as the monetary policies of member countries are concerned, the trend of prices shows that the degree of monetary convergence achieved so far and convergence in the field of monetary policy alone are not sufficient to bring progress towards the declared aim of the European Monetary System, namely the creation of a zone of greater price stability.

- As mentioned earlier, the Commission of the European Communities and the Deutsche Bundesbank conclude on the basis of the price trend in the EMS countries that what is most urgently needed is action to promote the convergence of the economic policies of member countries. Only then can further-reaching arrangements be made to strengthen institutional integration as well and the transition to the final phase of the EMS take place. In view of the monetary developments in EMS countries since 1979, this seems to be the wrong tack. It is extremely unlikely that the observable convergence of monetary and credit policies would have occurred had it not been for the implementation of the EMS. The system's intervention rules – in other words the institutional arrangements – exerted real pressure on the central banks of the other countries to fall in line with the Bundesbank's monetary policy. Monetary convergence was the consequence of institutional rules and the EMS was therefore a force binding the monetary policies of member countries together. Accordingly, further convergence of economic policies cannot be achieved until progress is made in the institutional arrangements. Actual compulsion is a more powerful agent for restarting the faltering process of integration than the hope of economic enlightenment.

Figure 5
Rates of Change in the Volume of Credit in the EMS Countries¹



¹ Unweighted average of rates of change in the volume of credit outstanding at the end of each quarter compared to the same quarter of the previous year; excluding Ireland.

² On the basis of the first three quarters.

Sources: IMF: International Financial Statistics; the authors' own calculations.

¹⁵ "In the absence of a key currency it remains unclear which countries must shape their monetary policy primarily so that they can uphold the parity of their currencies and which country should direct its monetary policy towards stabilising the value of money, a condition that is essential to the functional capability of the entire system." (Board of Experts for Assessment of Overall Economic Trends: Annual Assessment for the year 1978/79, Wachstum und Währung, Stuttgart and Mainz, 1978, section 347.)