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EMS Ten Years On: Assessment and Outlook

The European Monetary System was ten years old on 13th March. The following three contributions assess the progress made so far and the outlook for the future.

Leonhard Gleske*

Monetary Integration Has Made Progress

During its ten years' existence the European Monetary System has developed into one of the most important assets in the field of European integration. In keeping with its objective it has proved itself to be a "system conducive to closer cooperation in monetary policy" and has made remarkable progress on the road "to a stable monetary area in Europe". As a result of the member states' economic and monetary policies, which have been geared to achieving internal stability, inflation rates have significantly declined and the exchange rates between the currencies participating in the exchange rate mechanism of the EMS have increasingly stabilised. Exchange rate parities within the EMS have not changed for more than two years.

The system is still incomplete in many respects, of course. Of the EC's twelve members only seven countries are so far subject to the disciplines of the EMS exchange rate mechanism, while Italy still enjoys a special position because its currency fluctuates within greater exchange rate margins. Moreover, there are still considerable restrictions on the movement of money and capital; until these are removed, the EMS will remain incomplete. Finally, inflation differentials still necessitate exchange rate adjustments from time to time despite the fact that economic and monetary policies are more resolutely geared to achieving stability than before. Similarly, large budget deficits in some countries and external trade imbalances endanger the internal and external monetary stability within the EMS.

Despite these reservations the integration of European monetary policy has developed more strongly than was originally expected, given the background of a difficult global economy. It has also had an impact on economic integration as a whole. The idea of completing the internal market by 1992 would hardly have gained the momentum which has become so characteristic of any activity within the European Community today, had it not been for the progress made in monetary policy. The internal market project has also greatly stimulated European monetary integration. The realisation of a monetary union with a common currency and an institution which is to be solely responsible for monetary policy within the EC is on the agenda of the heads of state and government of the EC member states. A committee under the chairmanship of the President of the EC Commission and consisting of the governors of all EC central banks is currently discussing these far-reaching objectives. The report of this high-ranking committee is to be submitted to the European Council at its meeting in Madrid in June.

With this report the Community is venturing on its third attempt at economic and monetary union. Under the chairmanship of Professor Hallstein as far back as 1961 the EC Commission had emphasised in its programme for the second stage of customs union and in view of the consequences of exchange rate fluctuations on agricultural policy that the Common Market would not be complete without monetary union. The second attempt was made at the beginning of the seventies with the resolutions on gradually setting up an economic and

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monetary union on the basis of the so-called Werner plan. Both initiatives failed in the end due to a lack of political will and the inability of the partners to meet the difficult convergence requirements of an economic and monetary union. This second attempt at monetary union gave rise to the European narrower margins arrangement on which the EMS was later based.

At first the Bundesbank reacted sceptically to this regional system of fixed exchange rates. In the first place the original plans for the EMS provided for elements which could have proved a danger to stability. Moreover, there were still quite considerable inflation differentials between the member countries, and these gave rise again and again to fears of tension in the system. Defending unrealistic exchange rates threatened in turn to undermine the monetary policy of countries with more stable currencies.

Divergent Aims

Contrary to the original plan, the narrower margins arrangement was not based on the ECU but on bilateral exchange rate relationships. The system was therefore geared *de facto* to the most stable currency and not to an average of all currencies, which in the end also represents the average inflation rate of the Community. In the dilemma between adjustment and financing great significance was placed on the disciplinary elements of the system from the beginning. Germany paid particular attention to adequate and timely adjustments to central rates within the EMS in times of tension. Movements of money and capital associated with such realignments, just like interventions, were kept on a scale which could still be controlled.

That the initial fears of the Bundesbank were not quite unfounded became evident during the first few years of the EMS when divergent aims in economic and monetary policies often led to tensions which resulted in no fewer than seven realignments in four years. The turn for the better came when our partners, and France in particular, increasingly geared their economic, monetary and financial policies to restoring and maintaining internal stability. In March 1983, when a comprehensive realignment of exchange rates was being undertaken, the then French government decided to remain within the EMS despite a strong political contingent that was pleading to leave the system. In making the decision, the government had come to the obvious conclusion with respect to its economic policy. The success of its stability-oriented policy stance speaks for itself; the differential in inflation *vis-à-vis* the Deutsche Mark, which was still considerable when the

EMS was established, declined to about 1 ½ percentage points.

Characteristics of the System

The EMS as a whole has developed over the years into a system with the following characteristics:

- Thanks to economic and monetary policies, which are more concerned with stability than they used to be, the convergence of economic developments, measured by the rates of inflation, has remarkably improved.
- The stability of the exchange rate relationships between the parties to the system has profited from the decline in inflation rates and inflation expectations. Excessive exchange rate fluctuations, which continually recur above all in the case of important floating currencies such as the dollar and the pound sterling, have not happened within the EMS.
- Tensions in the exchange rate system are not completely unknown, however, and cannot be entirely ruled out for the foreseeable future either. The EMS currencies continue to react, for example under the influence of the dollar rate, in different ways. This varying assessment of the currencies in the markets is an indication that, despite all the progress that has been made, the convergence of economic and financial policies still leaves something to be desired. The consequence of this is that some of our partners have to live with high interest rates in order to defend their exchange rate.
- In striving for greater stability the members of the EMS have accepted that their currencies are aligned to the Deutsche Mark as the most stable EMS currency. Germany's economic and monetary policies have therefore become more or less the stabilising force of the system.

Role of the Deutsche Mark

It is true that the influential role of the Deutsche Mark seems problematic to some of our partners. They see themselves compelled by it to pursue a policy which appears too restrictive in their eyes. This explains demands to reduce the so-called asymmetry of the EMS, which imposes relatively higher adjustment burdens on countries with weaker currencies. This "dominance problem" would not be eliminated if Germany were to pursue a course which could endanger its internal price stability. Some of the proposals to ease the financing of intervention and the settlement of balances as well as to build up reserves in Community currencies would relax the discipline of the system and would therefore neither be in our interests nor in those of the Community. The solution to the

problem can only be found in an adequately large number of Community countries achieving a high degree of stability. The larger this nucleus is, the greater its effect will be on the system. The development in the EC during the past few years may definitely be regarded as exemplary. France, and some other member states, have likewise contributed to this in the past few years through their success in achieving stability.

Germany has every interest in an efficient EMS and in its development in order to strengthen the cohesion in the system, in the sense of developing a Community in which exchange rate stability is based on the internal currency stability of all members. This cohesion is not only important for the completion of the internal market by the end of 1992, but to a much greater extent for the further development of the EMS into a monetary union. It is only as an economically stable Community that the member states will be able to realise a common monetary area. For this purpose there must be a reliable basic consensus among them on the orientation of their economic and monetary policies as well as the willingness to establish the prerequisites for these economic and monetary policies.

Priority of Monetary Stability

Regarding the means of achieving this objective the question immediately arises as to how monetary policy at the national level and cooperation between national bodies must be structured in order to ensure the highest possible degree of exchange rate stability during the increasing liberalisation of money and capital transactions. There can be no doubt about it that member states can no longer pursue autonomous

monetary policies once capital movements are completely liberalised and exchange rates ultimately fixed. However, one cannot speak of a loss of autonomy in monetary policy until exchange rates are fixed once and for all. As long as exchange rate fluctuations are still possible, national monetary policies retain a certain amount of latitude in principle. This will be limited to the extent to which one is prepared to take supra-national objectives into account in one's own monetary policy, i.e. to maintain fixed exchange rates. This may certainly lead to conflicts of interest. It is therefore all the more important that the monetary policies still pursued at the national level are well coordinated.

In a fully integrated Community in which money and capital can circulate freely and exchange rates are established definitively, the responsibility for monetary policy must be transferred to a common monetary institution. Such a step demands a high degree of political harmony and – since economic and social interdependence is also developing – solidarity. Furthermore, it is particularly important that the Community institution responsible for monetary policy is obliged to give priority to safeguarding monetary stability as a necessary prerequisite for achieving other economic policy objectives.

The preconditions under which the Community might make this third attempt at economic and monetary union have not become any easier in view of the sometimes large differences in the economic structures of the twelve member states. It can only be hoped that the political will necessary for developing the EMS further in this direction will not flag again in view of the far-reaching implications.

Robert Granet*

A French View

Instituted by a Resolution of the European Council of December 5th, 1978 and launched on March 13th, 1979 in the form of an agreement between central banks, the European Monetary System (EMS) is ten years old. This is obviously an occasion for taking stock of what has been achieved to date.

Outside observers' assessments of the way the

system is working have been positive for the most part, especially when comparing its results with those of the earlier European currency agreement, the 1972 "snake". Whereas the number of currencies participating in the latter varied between 10 and only 4 within the space of seven years, all the States initially signatory to the EMS agreement have consistently abided by its rules, with the same margins as at its inception (2.25% for six of them, and 6% for the seventh, the Italian lira).

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