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## A robust system

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issuing those currencies that are "dragging the system upwards" should contribute to the maintenance of the parity grid. They could do so – without obligation, but also without prejudice – in those markets that are highly sensitive to signals and announcement effects by buying their partners' currencies and holding them in their reserves where necessary.

### Extending the System

Finally, the extension of the exchange rate mechanism to the Community as a whole is desirable. The prospective transformation of the European Community by December 31st, 1992 into an "area without internal frontiers, in which the free movement of goods, people, services and capital (will be) assured" makes this objective more than ever essential. The persistence of substantial exchange-rate risks between the Community's currencies would in fact create an obstacle to the formation of a unified economic area, by distorting companies' strategies in terms of both their marketing policies and their investment plans.

If certain Community currencies were to remain outside the exchange rate mechanism, this would handicap growth in trade within the single market, not only because of spontaneous exchange rate movements, but also by the possibility that the authorities of the variable currency countries might substitute a "monetary protectionism" for the tariff and non-tariff protectionism that will be proscribed in the newly created area.

Created against a background of scepticism and generalized floating exchange rates, today the EMS is widely regarded as a model of stability in a world in search of a new international monetary order.

This "succès d'estime" – which has to some extent been confirmed by the "grafting" of the private Ecu onto the system – must not blind us to the fact that much remains to be done. It is plainly too late to revive the original ambition of "consolidating" the EMS two years after its inception, in order to turn it into a definitive system organized around a "European Monetary Fund", and "full and complete use of the Ecu as a reserve currency and as a settlement instrument" (Resolution of the European Council of December 5th, 1978). But it is essential to recall two deadlines now looming in the immediate future of the European Community, namely the complete removal of barriers to the movement of capital, due to take place on July 1st, 1990 in accordance with the directive approved in June 1988, and, of course, the opening of the great market without internal frontiers on December 31st, 1992.

The proximity of these deadlines clearly requires that fresh progress be made towards monetary integration. In view of the impending far-reaching transformation of intra-European economic and financial relations, such progress should go beyond the improvements to be made in the working of the present EMS to embrace a decisive institutional change. But that would need to be dealt with in a separate study.

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Hans-Eckart Scharrer\*

## A Robust System

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The developments in the European Monetary System since it was set up ten years ago are surprising on several counts. The first surprise is that the system still exists at all. Given the external shocks and the internal stresses and strains to which it was subject from the outset, by all theoretical yardsticks it should have broken apart in the same way as the Bretton Woods System and the European currency snake.

At first the strains were due to the high rates of inflation in member countries and the wide inflation

differentials; in 1979 the average for countries participating in the exchange rate mechanism was 8.8% and national inflation rates were spread over a range of 10.7 percentage points, extending from 4.1% for Germany to 14.8% for Italy. In 1980 and 1981 the average rose further to 12.0% and the dispersion range widened to 15.7 and 14.1 percentage points respectively. The monetary policy of some countries fuelled the rapid increase in prices by keeping the money supply plentiful.

Soon after it was set up the system was hit by the second oil shock, when oil prices rose to \$ 32 a barrel, followed in the mid-eighties by a fall to \$ 12 a barrel. In

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the USA the Reagan-Volcker mix of expansionary fiscal policy and restrictive monetary policy – a new variant of benign neglect – first drove nominal and real interest rates to record heights and the dollar exchange rate from DM 1.71 (at the beginning of 1980) to DM 3.47 (on 26th February 1985), but barely three years later, around New Year 1987/88, the dollar was at its lowest level since the second world war. Fundamental differences of opinion between France and Germany as well as other partner countries brought the system to the brink of collapse in the spring of 1983; against the background of a doubling of the unemployment rate in the Community from 5.6% in 1979 to 11.0% in 1987 and a long period of weak economic growth, differences of economic policy stance and conflicts between priorities proved a constant source of friction between member countries. Despite this, the EMS has survived, a fact that forces one to re-examine a number of preconceptions.

### **The EMS: not an Engine of Inflation**

A second surprise: Germany's fear that the EMS would restrict the Bundesbank's scope for stabilisation measures has proved groundless. To the extent that the German monetary authorities have been or are being forced to dance to another country's tune, that tune is American monetary and fiscal policy. It is this, and not the economic policy of EMS partner countries, that has repeatedly forced the Bundesbank to change or adjust its monetary stance against its will since 1981.

Indeed, Germany's inflation rate has come down steadily from 6.3% in 1981 to -0.2% in 1986, and the behaviour of prices in the other EMS countries has shown a similar improvement. The average inflation rate for countries participating in the exchange rate mechanism of the EMS was only 2.6% in September 1988, with a range of variation of 3.9 percentage points (from 0.9% in the Netherlands to 4.8% in Italy), a respectable achievement, both in absolute terms and in relation to the situation in the early years. The question whether particular countries might have brought inflation down more quickly if they had not joined the EMS is of rather "academic" interest as far as both Germany and other countries are concerned and the empirical studies that attempt to prove this supposition appear methodologically questionable.<sup>1</sup> Contrary to the expectations of many, the EMS has therefore not been an engine of inflation.

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<sup>1</sup> The control group of "free floaters" includes the USA, Switzerland and Austria; in contrast to all other currencies, the US dollar appreciated between 1980 and 1985 ("imported stability"), while Switzerland and Austria should be considered part of the EMS group in view of the exchange rate policies they pursue.

### **Credit Facilities not Used**

A third surprise: The expansion of the central banks' foreign currency credit lines under the arrangements for short-term monetary support and medium-term financial assistance and the lengthening of the credit periods (including that for the very short-term financing facility) have not led to unbridled use of these credit lines by weak currency countries. On the contrary, no use has yet been made of the short and medium-term facility.<sup>2</sup>

This has been partly the result of member countries' preparedness to gear their interest rate policies towards exchange rate stability, to adjust central exchange rates periodically in small steps and hence to avoid creating an incentive for large-scale, persistent "speculative" capital movements in the first place. A further contributory factor has been the practice of Germany's partner countries to buy Deutsche Mark in the market and to hold them as reserves during periods of DM weakness, especially in the months following realignments, a practice that runs counter to the letter of the EMS Agreement, if one interprets it in a narrow sense. In this way it has been possible to finance exchange market intervention largely out of countries' own reserves. As a result it has not been necessary to invoke the support mechanisms.

### **Monetarist Approach Vindicated**

The fourth surprise: The (Euro-) "monetarist" strategy of monetary integration is functioning better than expected. This strategy, which has very few adherents in "economics"-oriented Germany, aims to induce a harmonisation of economic policy by modifying the monetary parameters, which in concrete terms means setting fixed exchange rates.

In reality, national economic policies have not been explicitly co-ordinated with a view to achieving convergence in conditions of price stability within the EMS. Instead, Germany's partners have directed their monetary policy towards defending the exchange rate of their currency against the Mark, while the Bundesbank for its part has pursued a monetary policy oriented towards stability. In this way the Bundesbank has grown into the role of the anchor of the system, but without the other member states being forced into a passive role; it was and remains their own decision to hitch themselves to this anchor by maintaining a stable exchange rate.

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<sup>2</sup> Medium-term financial assistance and European Community loans (invoked by France in 1983 and by Greece in 1985) were combined in June 1988.

This form of symmetry is admittedly different from the one the EMS Agreement appeared to lay down – namely symmetrical economic policy adjustment by weak and strong countries towards an “average” inflation rate – and this explains the recurring conflicts between Germany and certain other member countries. The approximation of other countries’ inflation rates to Germany’s is certainly not perfect. Eight realignments of central rates against the lira and six against the French franc, in the course of which the central rate of the lira against the Mark was reduced from DM 2.19 to 1.39 and that of the French franc from DM 43.30 to 29.82, point to continuing differences in economic priorities, although exchange rate adjustments have been much smaller and less frequent in recent years. This illustrates both the limitations of the (Euro-)“monetarist” approach and the risks inherent in fixing exchange rates prematurely as part of the possible European Monetary Union.

Conclusion: In the EMS based on a key currency the (Euro-)“monetarist” approach has proved fundamentally valid so far. However, the main reason for this has not been any mechanical compulsion but the willingness of all member countries to give high priority to monetary stability.

### **The ECU not at the Centre of the System**

It is not surprising, but worth mentioning nonetheless, that the ECU has not become the “central element” of the European Monetary System as the architects of the system intended. The official ECU leads a distinctly Cinderella existence without the operation of the EMS being in the least impaired. That anyone still speaks of the ECU today is due to the “private ECU”, a spontaneous market innovation that the founders of the EMS had not planned. Like its official counterpart, it has not developed beyond a rudimentary role, being used primarily as a unit for denominating medium and long-term loans. Today it is the Deutsche Mark that is at the hub of the EMS. It has grown into this role step by step, as a result of both the credible monetary and fiscal policies of the Bundesbank and the German Federal Government and the conscious decisions taken in Germany’s partner countries.

It is also worth noting that the membership of the exchange rate mechanism has not increased since the EMS was established. Above all, the United Kingdom has not yet made up its mind to become a formal member, despite occasionally pegging sterling to the Mark in practice. The working of the system has been as little harmed by this absence as by the maintenance of the “temporary” wider band of fluctuation for the Italian lira.

### **Courageous Founding Fathers**

In retrospect, one feature that stands out is the courage of the political originators of the EMS – particularly Helmut Schmidt and Valéry Giscard d’Estaing – in pushing the system through against all political opposition and experts’ reservations. They have been vindicated by the system’s success. However, the fact that the EMS has endured for a decade is due less to the written agreements than to the unwritten evolved rules and practices that have been applied by the participating monetary authorities.

These rules include the assumption of the role of anchor by the Bundesbank, the willingness of the other member countries to accept the Mark as a lead currency and the Bundesbank as the leading central bank (including acceptance of the associated “asymmetrical” burden of adjustment), the periodic adjustment of central rates in small steps when necessary and silent central bank co-operation on interest rates and exchange market intervention. At the same time, Germany’s persistently high and growing trade and current account surpluses vis-à-vis its EMS partners and the public criticism of German monetary and economic policy voiced by some member countries point to functional shortcomings of the system.

If the EMS is to develop further it will be essential to intensify monetary policy co-operation among the EMS central banks in order to enhance the credibility of member countries’ monetary policy from the point of view of stability; real interest rates between 1 and 1 ½% above German rates indicate that such credibility has not yet been achieved everywhere. Giving the central banks independent status could help considerably in this regard. At the same time, Germany will have to play a more prominent role as an engine of growth in Europe, although this is not a task that can be performed using monetary policy instruments. This dual strategy of stability and growth should ease the conflicts that have repeatedly beset the EMS. Exchange rate realignments will continue to be necessary, not least because of the realisation of the internal market and the economic structural change that will entail; the central banks ought to be given a more prominent role in this context.

The time does not yet appear ripe to set permanently fixed exchange rates and to go over to a single currency, but experience with the (Euro-)“monetarist” strategy within the EMS indicates that one will not have to wait until Doomsday. The institutional preparations for the establishment of a European Central Bank could therefore be put in hand early.

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