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**Article — Digitized Version**

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Intereconomics

*Suggested Citation:* Schröder, Wolfgang (1989) : Will continuing liberalisation in the EC lead to instability in the EMS?, Intereconomics, ISSN 0020-5346, Verlag Weltarchiv, Hamburg, Vol. 24, Iss. 4, pp. 161-166,  
<https://doi.org/10.1007/BF02928628>

This Version is available at:

<https://hdl.handle.net/10419/140192>

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Wolfgang Schröder\*

## Will Continuing Liberalisation in the EC lead to Instability in the EMS?

*The liberalisation of capital movements and the creation of a market without internal frontiers within the European Community have far-reaching consequences for the European Monetary System. Dr. Wolfgang Schröder analyses the opportunities and risks associated with these developments.*

According to the intentions of its founders, the European Monetary System should help foster greater exchange rate stability, lasting growth, a return to full employment and European integration. There is a cost attached, however, since the EMS restricts the scope for national economic policy. Free trade, freedom of movement of foreign exchange and capital, fixed exchange rates and autonomy in monetary policy cannot be achieved simultaneously. However, this disadvantage should be outweighed by the benefits of integration.

Having signed the Single European Act creating the single internal market at the beginning of 1986, the European Council decided in June 1988 to remove all remaining restrictions on foreign exchange and capital transactions by the middle of 1990, with only Spain, Portugal, Greece and Ireland having longer transitional periods. In this way the EC countries want not only to remove restrictions on capital movements among themselves but also to make an equal commitment to liberalisation vis-à-vis other countries.

The main innovation in the latest move towards liberalisation is the inclusion of short-term monetary and capital movements, a particularly sensitive area for exchange rate policy. In recent years the EC countries except Ireland and those in Southern Europe have already liberalised most long-term capital transactions among themselves.

The planned liberalisation measures will further reduce disparities between EC countries as regards cross-border capital movements. Freedom of movement of capital is already permitted by Germany, the United Kingdom and the Netherlands as well as by Belgium and Luxembourg, although the last two countries continue to operate a two-tier foreign exchange market. Denmark, France, Italy and Spain have taken liberalisation measures that already go beyond their strict obligations under the relevant directive and acts of accession,<sup>1</sup> although they have not yet reached the level of the first group of countries.

### Introduction of Safeguard Clauses

Progress towards open money and capital markets has been diluted, however, by the introduction of safeguard clauses. If short-term capital movements seriously harm the monetary and exchange rate policy of a member country, that country may impose restrictions for a maximum of six months. The same also applies in relation to non-member countries. It is questionable, however, whether the safeguard clauses can be applied by EC countries individually, since restrictions on capital movements by one member country against third countries can easily be circumvented by passing via a more liberal member of the Community.

These safeguard clauses can have a decisive effect on the financial markets. At worst, they allow matters to be left unchanged, but that is not all; they also contain a

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\* Landeszentralbank, Berlin, Germany. The views expressed in this article reflect the personal opinion of the author. Abridged version of a paper presented at a symposium on the role of monetary policy in the economic development of the Federal Republic of Germany. The full version will appear shortly in the proceedings of the symposium, edited by Hajo Riese and Heinz-Peter Spahn and published by Transfer-Verlag.

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<sup>1</sup> Commission of the European Communities: Annual Economic Report 1987-88, November 1987, p. 63 (German edition).

self-defeating element, since in the eyes of investors it makes a great difference whether liberalisation measures can be regarded as permanent or reversible at any time. Only if liberalisation has solid economic foundations and the government of the liberalising country takes credible steps to allow permanent freedom of movement of foreign exchange and capital can portfolio decisions be taken with peace of mind. If there is a danger that exchange controls will be reimposed, however, liberalisation can trigger turbulence in the financial markets. The resulting pressure on the exchange rate and on monetary management entails the risk that the safeguard clauses will soon be invoked and thus jeopardises the strengthening of confidence in the currency. The dilemma raised by the introduction of safeguard clauses with respect to the liberalisation of financial transactions is obvious: the very existence of such clauses creates a situation in which they have to be invoked.

Differences in taxation among the various countries create a special problem for liberalisation. France and Denmark in particular are insisting on measures to guard against tax evasion and tax fraud. In order to take account of their reservations the EC Commission is to propose measures against tax evasion and related offences by the middle of 1989.

### Cross-border Capital Flows

In the five years from 1983 to 1987 EC member countries accounted for a good 50 % of Germany's total short and long-term capital flows, more or less in line with their share of Germany's foreign trade. The capital flows within the EC are relatively large in relation to current account balances, since Germany's current account surplus with its Community partners accounted for only 20 % or so of its total surplus between 1983 and 1987, although in recent years this percentage has increased sharply.

The balance-of-payments statistics do not show where the financial resources from Germany are ultimately used and from what source they come. To evaluate the macro-economic importance of cross-border capital flows it is useful to differentiate between financial intermediation and other capital movements. To the extent that EC countries act as international financial centres, as in the case of the United Kingdom, Luxembourg and to some extent the Netherlands, capital flows between Germany and these countries do not necessarily reflect a corresponding interdependence between the saving or investment processes. Part of the financial flows consists of "through traffic" that is neither generated by saving in,

say, the United Kingdom nor used there for investment in real capital.

Such "transitory" credits became especially conspicuous in 1986. Germany's current account surplus with EC partners soared from DM 2.1 billion in 1985 to DM 24.7 billion in 1986 and at the same time inflows of long-term capital from EC countries rose from DM 5.4 to 27.3 billion. The surplus in Germany's basic balance with the rest of the Community therefore increased from DM 7.56 to 52.0 billion. To finance their current account deficits and long-term investments in Germany, EC countries used short-term credits and deposits from Germany with a net value of DM 100 billion; this sum was far in excess of their bilateral financing requirement and thus formed the basis for net onlending to third countries.

Between 1983 and 1987 Germany had a net outflow of long-term capital to third countries amounting to DM 50 billion. Long-term capital transactions with EC countries, by contrast, produced a net inflow of DM 20 billion. This highlights the exceptional increase in securities transactions. As a result of the globalisation of the financial markets, German investors' transactions in foreign securities more than doubled between 1983 and 1987 to DM 420 billion. The growth in transactions in the opposite direction was even more remarkable: transactions in German securities by non-residents increased ninefold over the same period, rising from just under DM 80 billion to around DM 700 billion. A process of "Europeanisation" is particularly evident in German investments in foreign currency bonds; bonds of EC issuers accounted for more than 40 % of transaction turnover in 1987 (around 25 % in the case of dividend-bearing securities), against only 16 % in 1982.<sup>2</sup> At the same time the share of US fixed-interest securities fell to 25 %.<sup>3</sup> The EC share of the substantial foreign demand for German securities is even higher; in 1987 EC investors accounted for 69 % of the turnover in German fixed-interest securities and 52 % of that in German dividend-bearing paper.<sup>4</sup>

### Portfolio Effects

How the liberalisation of capital movements will affect the distribution of capital flows and portfolio choices in the EC cannot be predicted a priori, since it triggers stimuli that work in opposite directions.

In this connection it is helpful to distinguish between

<sup>2</sup> Deutsche Bank Bulletin, June 1988, p. 12.

<sup>3</sup> Ibid.

<sup>4</sup> Ibid, p. 13.

one-off portfolio effects and effects that are of a more enduring nature. The adjustment of portfolios from the composition prevailing under a regime of capital controls to an optimum configuration as a result of the reaction of international investors from the liberalising countries can be regarded as a one-off effect that will be completed within a relatively short period of time. Since it is non-recurrent, exchange rate policy should react to prevent speculative bubbles, but the measures should be easy to amend.

The steps already taken to liberalise long-term capital flows and the complementary measures on short-term investments and credit have not led to intolerable strains in the exchange rate mechanism. For example, the Governor of the Bank of Italy has reported positively on the effects of the removal of restrictions on capital movements in Italy since 1987.<sup>5</sup> These positive experiences give cause to hope that monetary policy will be able to cope with further portfolio adjustments among ERM currencies. However, only time can tell what effects the complete liberalisation of short-term capital flows will have. Even in the past, when exchange controls were in place, flows of short-term capital have exacerbated tensions within the exchange rate mechanism and made monetary management more difficult.

### **Influence on Exchange Rate Stability**

The liberalisation of capital transactions will undoubtedly increase the volatility of capital flows. It is impossible to say a priori whether exchange rates will become more unstable as well, since they are also subject to forces working in the opposite direction. On the one hand, the legalisation of cross-border monetary and capital flows reduces transaction costs and hence lowers the threshold for profitable international capital transactions. Other conditions remaining unchanged, the volume and volatility of capital transactions will increase.

On the other, a currency is regarded more highly by internationally orientated investors after liberalisation,

for its quality has improved in an important respect: conversion into other currencies at any time is guaranteed, financial investments in the country in question can be acquired or resold and the proceeds converted into other currencies, and inward and outward transfers of this and other currencies are no longer subject to any restriction. Hence there is no longer any reason for residents to invest abroad or for foreign investors to avoid this country and its currency.

Confidence in the liberalised currency will take some time to strengthen, however; this will not happen simply as a result of the announcement of the relevant laws and regulations. It can therefore be expected that the initial period after liberalisation will be characterised by increased capital outflows, and hence stronger pressure on the currency and heightened monetary policy activity to counter that pressure.

Since the globalisation of the financial markets was accompanied by much greater volatility of international capital flows and exchange rates,<sup>6</sup> the question arises whether volatility will also increase within the EMS. Nevertheless, there is a decisive difference between global capital flows and those within the EMS; in the global markets several competing currencies<sup>7</sup> are used internationally as close substitutes one for another, whereas within the exchange rate mechanism the Deutsche Mark is the only currency used internationally. For this and other reasons, the EMS exchange rate mechanism has not witnessed long waves with substantial real revaluations and devaluations of currencies. Hence globalisation and Europeanisation are to be assessed differently, despite having many features in common.

### **Substitutability of EMS Currencies**

The mutual substitutability of EMS currencies will certainly be increased by liberalisation and it will rise further if economic fundamentals converge. In order to encourage monetary integration, monetary, financial and incomes policies must be oriented towards maintaining parallelism between developments in purchasing power and real yields in EMS member countries. If instead growing disparities were to emerge, heightened capital mobility and currency substitutability would rapidly generate large flows of short-term capital, which pose risks for the management of monetary aggregates and exchange rates.

As long as the economic conditions that are relevant for exchange rate determination continue to differ from one member country to another, interest rate differentials must remain. The rationale for them would

<sup>5</sup> Carlo A. Ciampi: The world economy, the Italian economy, exchange rates and the European Monetary System, in: Deutsche Bundesbank: Auszüge aus Presseartikeln, No. 87, 28th November 1988, pp. 6 f.

<sup>6</sup> W. Schröder: Globalisierung der Finanzmärkte – Folgen für die Geldpolitik, in: Wirtschaftsdienst, 1988, No. 7, pp. 382 ff.

<sup>7</sup> Currency competition is analysed in theoretical terms from the point of view of its dominant influence on the world economy in Hans-Joachim Stadermann: Weltwirtschaft, Tübingen 1988, p. 81. An empirical analysis of the effect of currency competition on Germany is to be found in Heinz-Peter Spahn: Bundesbank und Wirtschaftskrise, Studien zur Monetären Ökonomie, H. Riese and H.-P. Spahn (eds.), Regensburg 1988.

only disappear in a system of permanently fixed exchange rates, in which currencies would develop into perfect substitutes. As this situation is brought ever closer by the increasing freedom of movement of international capital, interest rate differentials between European currencies will narrow and the average level of real interest rates in Europe will fall.

Controls on capital movements created obstacles and costs for cross-border capital flows and thus helped protect the currency. In some circumstances the freedom of movement of capital may make it more difficult to ward off exchange rate pressures. The weapons available in the EMS for that purpose have been adapted and reinforced in connection with liberalisation.

#### Financing of Exchange Market Intervention

For example, it has been made easier to finance exchange market interventions; as long ago as 1985 the central banks of the EMS countries agreed to simplify the use of the ECU as a payment instrument among central banks. In 1987 the ceiling for the compulsory acceptance of ECUs in the settlement of balances resulting from very short-term financing was raised de facto to 100 %. In addition, it was agreed that very short-term financing could also be used for intramarginal interventions.<sup>8</sup>

However, intervention can only stabilise the foreign exchange market over the short term and is subject to

limitations, since the weak-currency country has only limited foreign exchange reserves and borrowing ability and the strong-currency country can sterilise only a finite volume of interventions. As the speculative capital flows generated by anticipation of a realignment can be expected to increase, the limits of exchange market intervention will be reached more quickly.

Real adjustment in response to external imbalances can be spread out by borrowing and hence made economically and socially more acceptable. At the meeting of the European Council in June 1988 it was therefore decided to enlarge and improve stand-by credit arrangements among members of the EMS as an adjunct to the liberalisation of capital movements.

Stand-by credit remains an ambivalent exchange-rate instrument, even in connection with liberalisation of the capital market. On the one hand it demonstrates that facilities are available to bridge a fairly long period of external adjustment if this proves necessary, thus providing an added deterrent to speculation against EMS currencies. Seen in this light, the credit facilities foster economic integration. On the other hand, they give a country with balance-of-payments problems a breathing space, thus easing the pressure to take action. This respite could be misused to delay necessary but unpopular adjustment measures.

<sup>8</sup> For a discussion of this and other changes in the rules, see Peter Bofinger: New Rules for the European Monetary System?, in: Geld und Währung, Vol. 4, No. 1/2, May 1988, p. 7.

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### SUBVENTIONIERUNG IM WELTSCHIFFBAU

Large octavo,  
185 pages, 1989,  
price paperbound  
DM 48,-  
ISBN 3-87895-377-1

The aim of this study, which was conducted for the Federal Ministry for Economic Affairs, is to examine the effects of the various types of subsidies on the structure and the competitive situation of the shipbuilding industry in the most important shipbuilding countries. The results of the subsidies granted are discussed from the points of view of business economics, macroeconomics and the international economy.

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### Effects on Monetary Policy

External adjustment cannot be postponed indefinitely by means of intervention; countries also need to respond in other ways. The first step could be changes in monetary policy, which would have to produce a restrictive effect in the weak-currency country and an expansionary one in the strong-currency country if they were to promote equilibrium. Here too the crucial question is whether liberalisation will induce more rapid and pronounced changes in monetary policy.

To neutralise the incentives for capital outflows from weak-currency countries that could jeopardise exchange rate stability, these countries will probably have to raise interest rates and tighten other monetary conditions more often than before liberalisation and strong-currency countries will have to make larger adjustments in monetary policy instruments to sterilise capital inflows. Larger variations in interest rates and monetary policy therefore appear to be a substitute for restrictions on the movement of foreign exchange and capital.

The Bundesbank's dominance over European exchange rate policy will therefore become even more obvious, for it will be even easier for capital flows to offset divergences from the monetary policy stance of the strong-currency country. Criticism from other member countries stems from the asymmetrical operation of the EMS, which places the burden of adjustment solely on weak-currency countries. However, such asymmetry is essential if the EMS is to become an area of stability, as its members are agreed it should. Greater symmetry would weaken the emphasis on stability and would sometimes create asymmetry to the detriment of countries with greater price stability.<sup>9</sup>

### Latent Political Instability

Since Germany's partners sometimes resent the dominant influence of the D-Mark, they want monetary and exchange rate policy to be determined jointly and to be co-ordinated in accordance with the level of market integration. This illustrates a latent political instability in the EMS, fuelled by the pattern of macro-economic data. On the one hand the EMS countries have achieved a high degree of price and exchange rate stability coupled with real economic growth, but on the other unemployment rose until 1984 and then remained at a high level. Price stability is therefore no longer the prime

objective of economic policy that it was in the early years of the EMS, so that the EMS countries are showing less interest in sharing in the Bundesbank's credibility as a bastion of stability and in using the EMS as a counter-inflationary weapon. Their interest in combating unemployment is growing, however, thus strengthening their desire to test the possibilities of promoting growth and employment by monetary means. The political tussles over this issue could therefore intensify further, partly as a paradoxical consequence of the success of the EMS and partly as a result of liberalisation of the capital markets.

In the history of the EMS to date the adjustment of central rates has increasingly become the final resort, and less and less part of routine operations. Growing economic interdependence within the EC has made realignments more difficult to arrange. First and foremost, the Common Agricultural Policy is an obstacle to the more frequent adjustment of central rates. It is now more than two years since the last realignment. The length of this period and the sometimes strenuous efforts to defend exchange rates indicate a strong common interest in maintaining stable exchange rates, an interest that is likely to increase. More frequent adjustments would keep exchange rates more in line with developments in fundamentals, and hence would prevent distortions due to exchange rates, but they would have the disadvantage of reducing the associated pressure for economic convergence. The creation of a European internal market implies closer economic co-operation, greater economic integration that demands closer co-ordination in the monetary and exchange rate fields, which in turn militates in favour of greater economic adjustment and against swifter realignments of central rates.

### Welfare Effects of Liberalisation

The liberalisation of capital movements is expected to have positive welfare effects, since financial and real capital can flow unimpeded to the places where yields are highest. It will promote an optimum use of capital at Community level. From the point of view of individual member countries, however, a shift in capital formation can also have adverse consequences. Seen through their eyes, in some circumstances this can mean investment shifting in other countries, and with it the opportunities for additional production and income. From the national point of view the situation after liberalisation will be beneficial only firstly if the interest income earned by the capital-exporting country is greater than the income lost as a result of forgoing a growth in output and secondly if the income growth in the capital-importing country exceeds the foreign

<sup>9</sup> Cf. Norbert Kloten: Wege zu einem Europäischen Zentralbanksystem, in: Europa-Archiv, Vol. 43, No. 11, 10th June 1988, pp. 286 f.

payments to be made on the investment. This process leads to a convergence of the marginal returns on capital in the various EC countries.

If the exchange rate applying under capital controls produced a balanced current account (and hence a balanced capital account) and if liberalisation induces net capital exports from country A (the country with a lower marginal return on capital) to country B, this results in an appreciation of B's currency, which in turn produces a current account surplus for country A. The external equilibrium shifts from a situation of suppressed capital movements and current account balances to one in which a current account deficit or surplus is offset by a surplus or deficit on capital account.

For the capital-exporting country, liberalisation leads to a current account surplus that has an expansionary effect. In other words, output and income are also stimulated in the capital-exporting country. Unlike comparative statics, this analysis cannot establish clearly whether the net increase in incomes will be greater in the capital-importing country or in the capital-exporting one. The difference between this and comparative-static analysis is that the latter considers only the redistribution of an existing capital stock but not the resultant growth stimuli.

### **Governments under Pressure to Adjust**

The liberalisation of capital movements, and especially that of short-term transactions, further reduces the scope for EC countries to diverge from the other members of the Community as regards macro-economic performance and economic strategy and also institutional arrangements. Liberalisation increases the volatility of cross-border capital flows. In the past, capital controls made it easier to maintain fixed exchange rates despite inflationary differentials, that is to say differing degrees of success with stabilisation policy. These differences cannot be attributed solely to the willingness or unwillingness of European governments and central banks to follow the stabilisation road; in part they reflect structural differences in wage and price formation and in market reactions in the various countries. Liberalisation will expose both structures and governments to adjustment pressure.

Advancing towards a single internal market without first agreeing all the details creates a dynamic imbalance that of itself adds impetus to the integration process. Liberalisation measures have a direct impact both on governments, since the processes under their direct control change, and on market structures, since

national markets grow even closer. Liberalisation of capital movements and greater freedom to provide services, including financial services, work in tandem towards greater structural uniformity. They generate competition and hence create pressure to react to the superior institutions, regulations and structures of other European countries and to adopt them where appropriate. The initiative for change springs from the market. Change is no longer dependent on genuine political initiatives and negotiated compromises, for in the absence of the necessary reaction from European governments market forces will replace inefficient arrangements by more competitive solutions.

### **Restriction of National Autonomy**

The liberalisation of foreign exchange and capital transactions will further restrict the national autonomy of EC countries. The advantages associated with liberalisation stem firstly from the larger market and secondly from the greater international weight of the EC. Individual national governments cannot exert anything like as much influence as the Community. The differences in economic and political power between the EC and its world counterparts are far smaller than those between individual member countries and their partners. For example, the Community's dependence on trade with third countries is about as low as that of the USA and lower than that of Japan, at around 10% on both the export and import sides. It is therefore not surprising that the global strategic advantages are emphasised as well as the purely intra-European ones in the debate about closer integration.<sup>10</sup>

If market forces resulting from the creation of the single European market make it impossible for countries to steer an independent course, in other words if the economy is a step ahead of the political institutions and if the ability of national governments to control the economy is further restricted but the need for such control remains undiminished, then it is time for the European institutions to be adapted to suit economic realities. The present situation offers opportunities to do so, since it creates pressure for political action – as in the lively debate about the European central bank, for example – but if policies are not sufficiently co-ordinated it also contains the risk<sup>11</sup> of creating tensions that jeopardise what has already been achieved.

<sup>10</sup> Such global strategic considerations are the subject of David P. Calleo et al.: *The Dollar and the Defense of the West*, in: *Foreign Affairs*, Vol. 66, No. 4, 1988, pp. 846 ff.

<sup>11</sup> The Padoa-Schioppa report illustrates these risks. See T. Padoa-Schioppa et al.: *Efficiency, stability and equity. A strategy for the evolution of the economic system of the European Community*, Paris 1987.