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The First Stage of European Economic and Monetary Union

After two false starts, the first stage of European Economic and Monetary Union began on 1st July 1990. The following two articles discuss the consequences that the inauguration of EMU will have for economic policy co-ordination in the European Community.

Heinrich Matthes*

Need for Better Co-ordination of Monetary Policy

It is widely agreed that the EMS has worked asymmetrically in the past. In the "centre", the unified currency area with the greatest economic weight – Germany – pursued monetary targets oriented strictly to price stability. The other countries either fell in with the stability course of the "centre" or – with the help of capital controls and regular depreciations against the central currency – tried to maintain some room for manoeuvre for an independent monetary policy. But perhaps paradoxically capital controls and regular parity changes were prerequisites not only for independent monetary policies to be pursued in certain of the "peripheral" countries but also in Germany. In the absence of these frictions, Germany would have had much less influence on its own effective exchange rate.

Hence, the Federal Republic's monetary policy predominance was not unequivocal; German monetary policy played an undisputed leading role in the EMS essentially only as long as it had a clear lead in stability over the other member countries showing up on the part of the other currencies in a risk premium. This, in turn, compelled those countries to follow Germany's official

bank rate changes. With the abolition of capital controls and the growing reluctance to change parities – which reduce the ability of the Bundesbank to steer monetary policy solely towards domestic targets – and greater convergence in inflation rates – which reduces Germany's relative superiority in terms of stability – the present EMS arrangement will have to be replaced by an institutional solution: because there is no natural hegemony in Europe, the present arrangements, which clearly require an obvious leader, could become unstable.

During the early 1980s the EMS bound the "centre" and the "periphery"¹ together through a kind of "basic interest pact":² in the "periphery" a process of real revaluation facilitated stabilization; in the Federal Republic of Germany the underlying real depreciation of the mark:

□ increased net exports, and hence reduced the directly deflationary side-effects of the necessary process of budgetary consolidation;

¹ The use of the term "periphery" both here and subsequently has a definitely ironic annotation: it refers to the (n-1) other member countries of the EMS.

² See in this context also Heinrich Matthes: Die Entwicklung des EWS mit Blick auf 1992 – Thesen zum gegenwärtigen Stand der Debatte um das EWS, in: Dieter Duwendag, (ed.): Europa-Banking, Baden-Baden 1988, pp. 85-109.

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□ strengthened the German mark against the dollar and hence limited the effect of the American policy of “benign neglect”.

However, this “basic interest pact” no longer seems valid: almost all the European countries, including Germany, have recently been facing problems of actual or prospective overheating. In view of these changed circumstances, combined with greater capital mobility and greater fixity of nominal exchange rates, the key currency model solution is becoming less and less convincing as the solution to the European monetary policy problem.

The more or less complete liberalization of European capital markets which took place on July 1st,³ creates per se a new constellation by bringing about an effective real interest rate arbitrage.

In these circumstances each country will pay for the perceived degree of its lack of monetary policy “soundness” by a corresponding interest rate premium. With policy directed towards ever-greater fixity of nominal exchange rates, any inconsistency or conflict between market expectations and official policy will make these interest rate premiums painful, both for industrial borrowers and for public debt service. As a result, attempts to run independent national monetary policies will become prohibitively costly.

Paradoxical Situation

It is therefore necessary to transfer the principal characteristics of the existing monetary system to a European model, without doing away with its capacity to promote stability and thus rendering it ineffective. This implies co-ordination of monetary policy instead of central bank competition. This was clearly recognized by the Delors Report and subsequently by the Christophersen Report, which envisage the final transition to a single European currency within the framework of a three stage scheme. The “institutional” stage would begin at the end of Stage One with the establishment of a European System of Central Banks (Eurofed). Of course, the start of this stage would only be possible if the Treaty were amended; a conference for this purpose will start work in December 1990. This second stage – envisaged as the “transitional” stage to the final stage of Economic and Monetary Union – will be a period during which practical experience of

collective behaviour is gained. During this stage monetary policy “guidelines” would be elaborated on the basis of majority decisions in the European System of Central Banks but they would not yet be binding. Realignments as a means of adjustment would still be possible in this stage, but would be increasingly infrequent and limited. It would be part of the task of the ESCB in this stage to move increasingly from independent national monetary policies to a common policy. General global monetary policy guidelines would therefore have to be developed; currency reserves might also be jointly managed. The European System of Central Banks could also have to take over regulatory functions in the field of monetary policy and banking policy.

Free capital movements impose an efficient allocation of capital, the scarce factor of production. In addition, the liberalization of capital movements guarantees the freer exchange of goods and in particular of services. For example, if there was previously a very strong link between current account imbalances and exchange rate expectations, which reduced the attractiveness to investors of nominal interest rate differentials, this link has today been loosened substantially. As a result, countries experiencing strains on resources, high external deficits and high interest rates such as Italy, Spain and Portugal, have been faced with an if anything overvalued currency while the German mark, despite a very large and growing current account surplus, devalued in real terms over long periods.

At present a high degree of confidence prevails in the stability of exchange rates in the EMS. Confidence is possibly too great – at least if one looks at the traditional fundamental factors which determine exchange rates. This results in the paradoxical situation that restrictive monetary policy becomes less feasible. With expectations of steady exchange rates, capital inflows ultimately frustrate attempts to keep interest rates as high as required by domestic factors. It is therefore no longer possible to speak of the “restrictive bias” of the EMS. To the contrary, the stabilization policy of the weak currency countries is undermined by constraints on monetary policy. This “mechanism”, which is a consequence of the progressive liberalization of capital movements in conditions of increasing exchange rate fixity, slows down the process of arriving at price stability. And in the new conditions, the “centre” finds itself much more compelled to accommodate insufficiently restrictive policies in the other members of the fixed exchange rate system. Without more coordination of economic policy the credibility of the EMS would thus be damaged.

³ With the exception of some remaining restrictions on short-term flows in Spain and Portugal and on both short-term and long-term flows in Greece.

Besides capital liberalization, German unification is another important element at least temporarily affecting the anchor function of the D-Mark. The asymmetric constitution of the EMS in the past implied that Germany's domestic needs dictated the European monetary policy stance. However, in the first half of 1990 following the announcement of the German Economic and Monetary Union interest rate differentials between Germany and most of its EMS partners have narrowed considerably, and in part through a general relaxation of European interest rate policy, evidencing an increased degree of independence of European monetary policy from Bundesbank actions. Although it remains to be seen whether this is a permanent phenomenon, this reinforces the shift towards a more symmetric system in Europe and also calls for more policy co-ordination within the EMS.

The key currency function performed until now by the German mark has been based not least on the dynamic effects of a sustained advantage, in terms of price stability, of the Federal Republic over its EMS partners. With increasing convergence and growing symmetry the German mark's key currency role is, however, increasingly losing effectiveness. The member countries of the EMS are submitting to the exchange rate constraint more and more willingly and the capital markets are rewarding this political commitment with a reduction in the risk premium. Investment decisions in capital markets are increasingly being guided by nominal interest rate differentials. In these circumstances the stability advantage for the German mark, and with it the key currency function, is diminishing. The leader and those who until now were being led are now each leading one another, especially since the stability advantage can no longer be consolidated by periodic revaluations of the key currency. This leads to an ever more pressing need for a greater co-ordination of monetary policies, a co-ordination that is now to take place on an improved basis in Stage One of monetary integration.

Stability the Overriding Goal

To begin with, this would essentially mean the continued existence of the national structures (national currencies, national central banks, which would have to be made as independent as possible) and the development of a co-ordinating European superstructure. This is the role planned for the Basle Committee of Governors: the intention is that in Stage Two – after the intergovernmental conference – it will be expanded into the European System of Central Banks, i. e. into the nucleus of the European central bank.

Stage Three should then see the transition to a single currency and a European central bank. The vision of such an institution is described in detail in the so-called Delors Report, and subsequently in the Christophersen Report. This could only be a decentralized, federal institution, conceived in strict accordance with the subsidiarity principle, which could leave considerable power in the area of monetary policy at national level. However, it must on no account play a role in financing national budgets. Naturally, external monetary policy would also have to be transferred to such an institution; this means the pooling of national currency reserves. It is self-evident that this type of institution should be based on principles similar to those underlying the Bundesbank's status and operations. Accordingly, the institution would have to be similarly independent and would focus on price stability as its overriding goal.

Probationary Period

The present monetary policy debate is about the necessarily increasing co-ordination of monetary policy. This has to replace the previous key-currency standard, because under the new conditions of a more symmetric system that standard is no longer providing satisfactory results. German unification – at least for the time being – makes this result even clearer, as it is making the system even more symmetrical. If stable exchange rates are to be maintained, the increasing symmetry of the EMS has to be accompanied by substantial efforts of co-ordination by the monetary authorities. They will have to set monetary targets coherently and monitor individual countries' monetary policy continuously, in order to ensure money supply paths that are consistent with fixed exchange rates. Thus, deliberate monetary co-ordination seems to be more urgent than ever. The recent round of cuts in official rates in Europe implies that – at least for the time being – Germany's domestic needs are no longer dictating the monetary policy stance in other countries. Compensatory leadership on the part of other bigger EMS countries (e. g. France) is required. This is to ensure that the degree of freedom given by the decreasing interest rate differential with Germany is not used at the expense of price stability.

The present shift in the working of the EMS, however, need not be a permanent one. European monetary policy is going through a probationary period involving more deliberate co-ordination. If co-ordination fails in the present circumstances, it cannot be excluded that – after a period of adjustment – much of the previous asymmetry of the system will be re-established. From a European standpoint and in view of the increased capital mobility this would be a suboptimal solution.