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From the Old to the New EMS

At first glance, effectively suspending the EMS by widening the band for exchange rate fluctuations from 4.5 to 30 per cent looks like a severe setback for the European Community. The pressure of the market has destroyed the system which had governed monetary and economic relations amongst the EC member states for the last 14 years. A major institutional pillar for the transition to European economic and monetary union has also tumbled: according to the Maastricht strategy the path to monetary union is via fixed exchange rates kept within narrow margins.

The reversion to floating exchange rates at a time when monetary convergence with low inflation rates had nearly been accomplished and the achievement of monetary union seemed to be within reach, is an irony of EC history. In fact, the EMS has been put to the test and succeeded a number of times since its inception in the spring of 1979: almost straight away the second oil price hike with inflation rates of between 6 per cent (Germany) and 20 per cent (Italy); then the Reagan shock with German money market rates well above 10 per cent (1981) and a dollar ascending to DM 3.47 (February 1985); then a powerful recovery of the D-mark to DM 2.50/\$ (at the end of 1985) and less; and finally the shock of German unification, which within two years (1989-1991) reversed the balance on current account and the capital flows to the tune of DM 140 billion – 5 per cent of German GDP.

An assortment of explanations has been proffered for the collapse of the EMS, some placing responsibility at Germany's door, and especially at that of the Bundesbank. Viewed superficially, the Bundesbank's lowering of interest rates on July 29th, which was not considered adequate by the markets, dealt the system the fatal blow. The interest rate decision was, however, in line with the policy of taking small steps which the Bundesbank had been following for a year, and could by no means be regarded as its final move. Nor can it be the job of an autonomous central bank to let itself be guided by the expectations of the Buba-watchers.

A weightier argument is that the Bundesbank was compelled by ill-advised fiscal-policy and wage-policy decisions to adopt a more restrictive stance than would have been, or is, appropriate in view of the recession in Germany and Europe. With their policy of business as usual for the old "Länder", and in particular their failure to curb subsidies, the federal and regional governments contributed to the explosion of budget deficits following reunification. At the same time, wage agreements reached by employers and trade unions exacerbated trends which were undesirable from a stability policy point of view. The Bundesbank could be rebuked for having, amidst the reunification euphoria, responded too late to these adverse trends and clung too long to its high interest rates policy, but at the same time it is worth recalling that even at their peak of 9.8% in August 1992 German money market rates were still well below the levels observed at the time of prior stabilization drives in 1973 and 1981. The causes of the crisis in the EMS that nevertheless occurred at the end of July 1993, when interest rates had already fallen to about 7%, must also be sought outside Germany.

A theoretical argument often cited in this context is that fixed exchange rates are incompatible with the free movement of capital and sovereign economic policy. It is true that the

rolling back of restrictions on capital flows in the EC has increased the scope for financial disruptions. The allegation that the member states have pursued an autonomous economic policy regardless of the financial markets is, however, untenable. The Bundesbank had long adopted the role of the key central bank in monetary policy, whose decisions were followed by all the other EMS central banks. A hallmark of the policy of these central banks has in fact been the alignment of their currencies to the D-mark; it has *not* been autonomous. In this way, the EMS countries have not simply "borrowed" stability from Germany – as is sometimes wrongly claimed – but they have in fact exerted an active stabilizing influence on the behaviour of their economic actors and social groupings. Fiscal policy was, and still is, being charted autonomously, but adverse market reactions e.g. to the Belgian budget deficit of 7% of GDP and public debt of 120% of GDP were not to be observed in the past.

So the problem is not so much that the member states would have to forfeit their (monetary policy) independence in the "magic triangle" – they have done this already – but rather that the markets are unable to set any reliable guidelines. The central banks have always tested the market anew and carefully sounded out their leeway for interest rate policy. In addition, some countries have managed to better Germany's stability record. The markets have not honoured this good behaviour. In the EMS system of fixed exchange rates recently neither convergence in stabilization policy nor the ongoing adjustment of policy to market conditions afforded security against surprise pressure on the exchange rate: as late on as mid-June, the French franc was being traded near the central rate; by the end of July there was no holding it any more, and all this despite the fact that there had been no discernible change in fundamentals.

The decision to change over to flexible exchange rates was thus inevitable and correct. Retaining the formal EMS grid was a political decision, which may facilitate the return to narrower margins at a later stage. Any other option would have been worse. Introducing restrictions on capital movements (or a tax on foreign exchange transactions), as advocated by some, would have been in serious breach of the goal of the single market, and would also have entailed the deployment of extensive administrative resources without being able to guarantee the desired stability in exchange rates. The defence of the narrow band margins at all costs was never a viable option: the requisite interest rate policy decisions in Germany and the countries threatened by devaluation, possibly flanked by further massive interventions on the foreign exchange markets, could not have been sustained for any length of time and would have been detrimental to the credibility of monetary policy. It would not have repaired the structural weakness of the EMS, and fresh currency crises would have been pre-programmed. For the same reason, there is no prospect of an early return to narrower margins.

Now, the opportunities offered by the new system – freed from the invitation to speculate with "one-way bets" – must be grasped. The opportunities meant here are not, for example, neglecting long-term stability in favour of short-term employment and pursuing a beggar-thy-neighbour policy via exchange rates. This will not pay in the medium and long term, as the experience gained in the 70s demonstrates. Rather, the new parameters will make it possible to aim for convergence on the stability front without the formal discipline of fixed exchange rates and hence make national central bank policy even more credible. Creating a domestic reference system for monetary policy, in the form of money supply targets for example, will enable central banks and social groups to glean experience of direct relevance for a future European central bank: the monetary policy of this bank is not to be linked to an external anchor, the exchange rate, but to be geared to internal stability. In their new roles, the anchor function of the D-mark and the Bundesbank will also change – the new rules of the game still need defining. German monetary policy will be afforded greater room for manoeuvre; the D-mark will be freed from its exchange rate trap.

The "new" EMS, then, does not yet mean the end of economic and monetary union. On the contrary, it could help strengthen the economic foundation for union. It is now up to the central banks and to governments to make proper use of their new-found freedom.

Hans-Eckart Scharrer