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Manfred J.M. Neumann\*

# Reforming the European Monetary System

*The extreme widening of the exchange rate margins last summer has transformed the EMS from a multilateral fixed rate system into a system of unilateral exchange rate pegging. Professor Neumann characterises the current state of the EMS, outlines the major defects of the system and makes some proposals for reform.*

Europe appears to be ruled by Euroscepticism. Integration successes are valued low, such as the elimination of capital controls, the putting into effect of large parts of the Single Market programme, and the extension of economic integration to four EFTA countries by means of the European Economic Area (EEA). The failure of European governments to initiate a stable peace in former Yugoslavia, the exhausting process of ratifying the Maastricht treaty, the move into deep recession and, last not least, the breakdown of the European Exchange Rate Mechanism (ERM) have dampened the high spirit of the early nineties and, possibly, the political will to move on towards reaching European Monetary Union (EMU) as early as possible. It is telling that at present the dates set by the treaty, i.e. 1997 or 1999 at the latest, are played down in political quarters.

To be sure, sentiments regarding the future of European integration are likely to change with the business cycle. Prospects are that most European economies will be back to normal growth by 1995. Yet, normal growth will not be sufficient to permit a majority of countries' meeting the convergence criteria required by the Maastricht treaty for starting the final stage of European Union (EU). Structural fiscal positions have deteriorated almost everywhere over recent years. According to the recent IMF World Economic Outlook, of the EU's larger countries only Germany might be able to meet the budget-balance mark of 3 per cent of GDP by 1995. Therefore, from an economic point of view, the early EMU date of 1997 is not a realistic option. This might explain why in some countries, notably Spain, politicians are playing with the idea of weakening the convergence criteria. However, any weakening of the

criteria needs German consent, and hence the consent of the Federal Parliament.<sup>1</sup>

## Lack of a Clear Concept

In assessing the prospects of moving towards EMU during the nineties, we also need to take account of the fact that European integration policy lacks a clear concept with respect to the fundamental issue of widening versus deepening. Those who are led by the paradigm of a federal union will prefer a policy of deepening first because in this way standards can be set with respect to macro policies and transfers which new entrants have to accept. Given the obstacles to deepening over the foreseeable future, it seems natural not to postpone the process of widening the EU. But the acceptance of new entrants is likely to alter the balance of forces within the EU.<sup>2</sup> For example, the relatively wealthy EFTA countries are likely to oppose further increases in transfers, at the expense of countries like Greece, Ireland, Spain or Portugal. This will make negotiations with respect to deepening more difficult. Also, these countries are likely to oppose a weakening of the convergence criteria – this might be the rationale of the recent Spanish demand for excluding the new entrants from the decision to start EMU. Finally, it is difficult to see why the small EFTA countries should be committed to creating a political union (EPU).

Summing up, current prospects are that the current EU stage II will become long-lived rather than a brief period of transition towards EMU. While European economies can prosper without being part of a union which is governed by

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<sup>1</sup> Cf. Bundesverfassungsgericht: Court Rulings 2 BvR 2134/92 and 2 BvR 2159/92, Karlsruhe 1993.

<sup>2</sup> R. Baldwin et al.: Is Bigger Better? The Economics of Enlargement, Monitoring European Integration 3, CEPR Annual Report, London 1992.

a unified concept of monetary and fiscal policies, there is the risk that we will slip backward if Europe's integration train comes to a complete stop.<sup>3</sup> We cannot easily dismiss the misgiving that member governments might respond to economic problems with protectionist trade measures or the reinstitution of capital controls that further disintegration. This would be undesirable in itself and might jeopardize the option of moving on towards EMU at some later date.

These considerations lead to the conclusion that it is not advisable to postpone the reform of the European Monetary System (EMS). In the following the current state of the EMS will first be characterised, the major defects of the system will then be outlined, and finally a picture of reform will be painted.

### Current State of the EMS

The extreme widening of the exchange rate margins from  $\pm 2.25\%$  to  $\pm 15\%$  has transformed the EMS from a multilateral fixed rate system into a system of unilateral exchange rate pegging. While the ECU parities have been kept, they have lost the function of a binding constraint for domestic monetary policy-making.

Under these conditions the Bundesbank is no longer forced to intervene in support of a currency that takes part in the exchange rate mechanism (ERM), provided currencies do not approach the new margins. Thus the Bundesbank is no longer hindered in concentrating on the aim of stabilizing the German price level. This is reflected in the recent lowering of the monetary target from former 4.5-6.5 to 4-6 per cent for M3 in 1994.

Since the currency domain of the D-Mark is the largest and its reputation still the highest, the bilateral exchange rates vis-à-vis the D-Mark remain the focal points of monetary policy for the remaining central banks. Stabilizing the bilateral exchange rate enforces automatic

adjustment of domestic monetary policy. Keeping to this rule secures the credibility necessary to hinder the re-emergence of massive speculation on devaluation. It is noteworthy that most ERM currencies which had devalued sharply early in August 1993 have meanwhile returned into the former currency band. This can be taken as evidence that the EMS partners have accepted the new rules of the game.

However, the virtuous behaviour of a few months must not be taken as proof that the new arrangement makes a viable system. It must be considered that the current situation lacks systemic stability because the rules of conduct are not supported by binding agreements. The current situation can easily degenerate into the non-regime of dirty floating. In the absence of declared rules of conduct, no country is hindered from switching to a beggar-thy-neighbour policy by enforcing a transitory real devaluation through rapid cuts in interest rates. Should one country, in the event of a slow recovery, resort to exchange rate dumping, others might follow and thus set the stage for a new wave of EMS-wide inflation.

### Defects of the System

Any system of fixed exchange rates is sustainable only if the members' monetary policies are kept in step and if large disruptive real shocks originating in one member country are dampened by realignment. In principle, both prescriptions can be achieved by an established procedure of binding, i.e. enforceable, policy coordination which assigns policy-making sovereignty to a supranational policy body. In the absence of rigid supranational coordination, an exchange rate system can only survive if it provides sufficiently strong incentives and constraints for

<sup>3</sup> Cf. R. Jochimsen: Whither Europe? – Maastricht and EMU. A View from the Bundesbank, Paper presented at the 4th meeting of the Germany-United States Economic Policy Group, Washington D.C. 1993.

Peter-Christian Müller-Graff (ed.)

### East Central European States and the European Communities: Legal Adaptation to the Market Economy

The legal adaptation in East Central European states to the market economy of the European Communities is treated in four parts:

- Law as the basis of the market economy of the European Communities
- features and problems to the legal adaptation to market economy in Czechoslovakia, Hungary and Poland
- Common Market Law aspects for privatization and public enterprises, deregulation and the protection of public goods and interests, competition and industrial policy
- the cooperation between the European Communities and East Central European states.

The author analyses these different aspects and gives a well-based overview of these problems of adaptation.

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policy adjustment towards an accepted common target which serves to anchor national policy.

From the beginning the EMS suffered from the lack of an anchor. There was no linkage between the declared aim of price and exchange rate stability and national monetary policies. The praised concept of symmetry only required that a currency did not deviate too much from the others. A currency which tended to become too weak or too strong relative to group performance was supposed to adopt internal adjustment measures or to accept realignment. The lack of an anchor promoted differential inflation during the early years of the EMS. From 1979 through 1983 EMS-wide inflation averaged 10.3 percent and German inflation 5.3 percent, the difference was made up for by repeated realignments.

Since the Bundesbank did not accept the symmetry concept but took the lead in fighting inflation, the EMS gradually transformed into an asymmetric system where a leader sets the monetary path and the followers put more emphasis on keeping the exchange rate vis-à-vis the leading currency within the agreed exchange rate band. In line with this unofficial concept the Bundesbank restructured its portfolio in favour of short-term open market operations under repurchase agreements, in order to prepare for the need for neutralizing large-scale intervention in support of EMS-currencies. At the same time, other central banks started stocking up D-Mark assets and relied on intramarginal intervention. During the second half of the 1980s it became commonplace to call the D-Mark the anchor of the EMS and to believe that the EMS permitted members to "borrow" the Bundesbank's credibility which acted as a check on national inflationary expectations.<sup>4</sup>

## Half-hearted Acceptance

However, it is to be noted that a currency can fulfil the anchor role only if the assignment as key currency is supported by consistent conduct. The issuer of the key currency must abstain from a policy of leaning against the wind. The Bundesbank instead responded to the revaluation tendency with monetary expansion.<sup>5</sup> The follower countries must safeguard the exchange rate parities by fully adjusting domestic policies or, if they are hindered by exceptional circumstances from doing so, must be ready for early realignment. The belief that credibility can be borrowed without living up to it is misleading.

As a matter of fact, the anchor role of the D-Mark was only half-heartedly accepted. Insufficient adjustment of domestic monetary policy was apparently believed to be sustainable, given the partial protection of national capital

controls (until 1991) and the available scope for intervention, thanks to the extension of the financing facility to intramarginal intervention (Basle-Nyborg agreement) and, last not least, the symmetric obligation of intervention at the margin. Although EMS-wide inflation remained twice as high as in Germany until 1991, realignments were tabooed after 1987. The short-sighted refusal of a revaluation of the D-Mark in 1991 set the stage for the final breakdown of the ERM. In the absence of a dampening realignment the German unification shock enforced a real revaluation on Germany, mirrored by a real devaluation for the rest-EMS. Consequently, the German rate of inflation was pushed up by 0.6 per cent, while the weighted rate of inflation of the EMS partners fell by 0.8 per cent in 1992.<sup>6</sup>

With hindsight it is difficult to understand that the EMS partners apparently did not anticipate that the Bundesbank would have no choice but to tighten its policy course. Also, it is a puzzle why foreign exchange markets remained patient for a long time, accepting and thus reinforcing the illusion that no realignment was necessary before the start of EMU.

## Measures for Reform

Any reform of the EMS should be guided by the following aims:

- ☐ the sovereignty over monetary policy remains in the national realm,
- ☐ national monetary policy is credibly subjected to the common aim of safeguarding price stability; and
- ☐ policy divergence is discouraged by enforcement of early realignment.

These aims can be achieved by a reform which makes central banks the rulers of the EMS. The most important building block is providing the central banks of all EMS members with the status of full independence from government. The Maastricht treaty requires this measure anyway, and some countries, notably France, have already enacted this step, though it remains to be seen whether actual provisions measure up to what seems to be

<sup>4</sup> Cf. F. Giavazzi, and A. Giovannini: Models of the EMS: Is Europe a Greater Deutsche Mark Area? in: R. Bryant and R. Portes (eds.): *Global Macroeconomics*, New York 1987, pp. 237-265.

<sup>5</sup> Cf. M. J. M. Neumann and J. von Hagen: Monetary Policy in Germany, in: M. Fratianni and D. Salvatore (eds.): *Monetary Policy in Developed Economies, Handbook of Comparative Economic Policies 3*, Amsterdam 1993, pp. 299-334.

<sup>6</sup> R. Vaubel: The Breakdown of the ERM and the Future of EMU: Explanations, Predictions and Simulations from a Public-choice Perspective, Paper presented at the Conference of the Money, Macro and Finance Research Group, London Business School 1993.

indispensable with respect to institutional and personal independence.<sup>7</sup> Independent central bankers have the personal interest and the means to permanently stabilize the price level. Consequently, the main reason for realignments at regular intervals will cease to play a role. The fundamental congruity of interests will permit central bankers to coordinate the permanent stance of policies. But there will be no need for negotiated coordination because each currency will become an anchor of price stability in its own right.

A second reform element is providing central banks with the undivided power to negotiate exchange rate parities. Withholding the right to decide on intervention and exchange rate matters leaves the status of central bank independence seriously incomplete. Preserving price stability presupposes consistent exchange rate parities, and this might require occasional parity adjustment. If governments keep their authority over exchange rate policy, they can hinder monetary policies' providing stability, if only by delaying realignment. The credibility of the EMS requires the subordination of exchange rate policy to monetary policy.

As a final measure it is advisable to do away with the stipulation of bilateral compulsory intervention at the margin. This provision is a relict of the original vision of a symmetric EMS and has proven to further instability. It has induced governments to try divergent policies, fostering the belief that the threat of massive intervention will discourage foreign exchange markets from speculating on parity correction, and for this very reason it has effectively prolonged periods of misalignment by delaying corrective speculation. In the absence of this stipulation, we would not have experienced the unprecedented scale of riskless speculation, with intervention jumping to one third of the German monetary base, of September 1992, or France losing its stock of foreign reserves, as in July 1993.

The three measures proposed would permit the re-installation of the EMS as a system of fixed though adjustable rates with narrow exchange rate bands. The reformed EMS would make a more flexible and at the same time more stable system. To understand this one must consider the possible sources of exchange rate tensions. A first source is differential inflation. This would be eliminated because independent central banks would tend to fall into step and signal to private agents as well as public authorities that the goal of price stability is taken seriously.

To global shocks which hit all economies alike central banks would respond in a similar fashion, and tensions within the ERM are not to be expected.

Matters are different if it comes to diverging real trends or large country-specific real shocks. In those cases realignment is advisable in order to avoid the slow and costly price adjustment in the markets of goods and services. Given their interest in domestic price stability, it is hard to see why the central banks should avoid timely realignment. However, it is to be noted that limiting public sector deficits – by an early enforcement of the Maastricht 3 per cent (of GDP) limit – would contribute to the stability of the EMS. After all, history shows that the largest country-specific shocks are produced by debt-financed fiscal expansion; examples are the Reaganomics of the early 1980s, the Reaganomics at the Rhine of the early nineties, and the Reaganomics in permanence in Italy.

Once virtue is credibly installed, there is no need to do without the former narrow bands. From a technical point of view, central banks will be able to dampen the host of smaller country-specific shocks such that the margins are not violated. But even if this happens, it will be rare and not invite notable speculation because markets will know that it is not an indication of fundamental disequilibrium.

## Concluding Remarks

Not everyone will share the view that the EMS is in need of reform.

On the one hand, there are those who believe that the narrow exchange rate bands can formally be re-established once markets have learned that EMS governments have no intention of exploiting the wide margin of the current band. This is this author's reading of the recent annual report of the German Council of Economic Experts.<sup>8</sup> The problem with this proposal is that it bypasses the fundamental issue of the lack of effective constraints on national monetary policy-making. What will hinder policy divergence from re-emerging?

On the other hand, there are the supporters of flexible exchange rates. In their view nothing needs to be done. It is up to the EMS partners to decide whether they wish to adopt the Austrian solution of pegging the D-Mark or not. Should they choose a policy course of monetary stimulation instead, the current wide band will shield Germany from importing inflation. The problem with this position is that it neglects the potential benefits of a non-rigid system of fixed exchange rates that anchors price stability: a deepening of European market integration and a greater willingness to liberalize markets rather than protect them from outside competition.

<sup>7</sup> M. J. M. Neumann: Precommitment by Central Bank Independence, in: *Open Economies Review* 2/92, pp. 95-112.

<sup>8</sup> Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung: Annual Report, Stuttgart 1993.