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Paul J. J. Welfens*

The Single Market and EMS Instability

The following analysis of the 1992/93 crisis of the European Monetary System finds that the unfolding of the single market dynamics will make European Monetary Union a difficult stage to achieve. Further monetary integration is only feasible if full employment and sustained growth are achieved in the EC. The Maastricht Treaty needs some add-ons if economic and monetary union is to succeed.

After five years of exchange rate stability the year 1992 brought enormous changes and instabilities in the European Monetary System (EMS), and August 1993 finally forced EC governments to switch transitorily from a standard margin of 2.25% to wide 15% margins for all countries in the Exchange Rate Mechanism, except for the guilder-DM parity which remained in the 2.25% band. Instead of moving towards less nominal exchange rate flexibility in the course of approaching stage II of Economic and Monetary Union in the EC – beginning on January 1, 1994 with the creation of the European Monetary Institute – the EC countries are almost returning to flexible exchange rates. In practice it makes only a minor difference if one adopts a medium term exchange rate target (as was done e.g. for the dollar exchange rate in the G-7 Louvre accord) or a parity grid with very wide margins of 15%. What happened in the EC in 1992/93 and is the monetary union envisaged by the Maastricht Treaty for 1997 or 1999 still feasible?

With the Maastricht Treaty signed on February 7, 1992, the EC member countries seemed to be heading not only for the single market as of January 1, 1993, but also towards monetary union by the end of the 1990s. However, within months the EC was facing (i) a confidence crisis on the part of market participants, (ii) an economic policy crisis in the sense of diverging views on the desired policy course in major EC countries and (iii) a growing concern that too rigid fiscal policy convergence criteria of the Maastricht Treaty would restrict the room to manoeuvre at the start of the single market. The start of the single market

was characterized by slow growth and strong pressures for structural adjustment in all EC countries. The EC Commission had argued that monetary integration in the sense of reduced exchange rate flexibility and finally monetary union (irrevocably fixed exchange rates or a common currency) would reinforce the benefits of real integration, meaning a stronger regional/international overlap of goods and factor markets in the EC.¹

The Bundesbank faced problems with respect to monetary policy leadership in Europe because Germany's inflation rate reached 4% in 1992 and most of 1993. This is high by German standards and hence creates fear that the Bundesbank will pursue restrictive monetary policies which reduce German inflation a little but other EC countries' growth prospects strongly. Moreover, in 1992 only Italy, Spain, Portugal, Ireland and Greece had a consumer inflation rate higher than that in (Western) Germany. Germany's monetary leadership faced external criticism on its policies, while central banks in other EC countries, notably in France and Belgium, prepared for political independence, which no longer makes the Bundesbank's institutional position look unique in Europe. The DM anchor role for the EMS was undermined by high West German inflation rates in a cyclical downturn in 1992/93. Excessive monetary growth in the preceding years created very high liquidity and high state-administered prices reinforced the problem; public procurement in Eastern Germany is particularly little price

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¹ On this view see EC Commission: One Market, one Money, No. 44, Luxembourg 1990. For a broader analysis of the issues of the Maastricht Treaty and EC monetary union see P. J. J. Welfens (ed.): European Monetary Integration, 2nd enlarged edition, Berlin and New York 1993.

sensitive and German unification generally has intensified inflationary pressures in the new Germany.

In 1992/93 speculative capital flows increased in a maximum damage EC environment, namely in a setting characterized by newly established full capital mobility in all EC countries (except for Spain, Portugal and Greece) on the one hand, and, on the other hand, the anticipated unfolding of the single EC market which implied free trade not only in commodities, but also in financial and nonfinancial services and the free movement of labour and capital. Structural adjustment pressure and locational competition has intensified in the single market. However, economic growth in the EC was impaired by high real interest rates in continental EC member countries – except for Germany – in 1992/93, when the Bundesbank was unwilling to reduce key interest rates strongly.

From the Bundesbank's point of view the virtue of small reductions in the discount and lombard rates is consistent to the extent that this policy fuels anticipation of further future interest rate reductions and does not undermine the prospects for a decrease in the long-term inflation rate. Both effects can reduce real long-term interest rates strongly, and long-term interest rates are more important in German financial markets – and for investment – than short-term interest rates. Lower real interest rates also support the Bundesbank's goal of inducing the government to reduce government borrowing, which sharply increased in the context of German unification and is considered a potential threat for anti-inflationary monetary policy.

By contrast, British financial markets are characterized by a dominance of short-term borrowing, and long-term interest rates are often adjustable so that short-term

interest rates are truly dominating. The UK and Italy (as well as some other EC countries) face a much higher vulnerability to short-term interest rate shocks than Germany, the Netherlands, Belgium or France. Theory suggests that low inflation rates will increase the average maturity of bonds and generally will encourage more long-term financing. The diverging historical inflation records of EC countries thus influence the term structure of financial markets and this in turn creates vulnerability to short-term interest rate shocks for some countries whereas others are more robust in this respect. Countries in which dominant short-term interest rates coincide with a high debt/GNP ratio (as in Italy and Greece) are most exposed to interest rate shocks arising from Germany's monetary policy reactions. Moreover, such countries then obviously cannot afford to defend overvalued currencies by a high interest rate policy over the long term.

Interest Rate Differentials

High capital mobility and considerable intra-EC interest rate differentials played a significant role in the ERM crisis of 1992. In the UK, interest rates were 6 percentage points higher than German rates between 1987 and 1990, and the differential came down quickly after the pound's entry into the ERM in late 1990. In Italy, the interest differential peaked at 8 points in mid-1987 and declined to some 2 percentage points by mid-1991, while in Spain the differential against German rates came down from 7 percentage points in the period 1987-90 to about 300 basis points in late 1991.²

“A distinguishing feature of the ... crisis in Europe, compared with earlier realignments and speculative

² IMF: World Economic Outlook, Washington DC 1993.

Table 1
Real DM-Exchange Rate Index P/eP*:(1972) = 100; on the basis of consumer prices vis-à-vis EMS Countries¹

	Pound Sterl.	Ital. Lira	Irish Punt	Dan. Crown	Belg. Franc	Fr. Franc	Guilder	Port. Escu.	Peseta	US \$
1973.IV	121.3	123.4	118.2	103.3	109.2	107.9	102.6	104.1	104.8	125
1979.IV	102.8	126.9	107.2	93.3	94.2	102.7	93.9	111.0	84.0	142
1981.IV	80.9	114.1	86.7	91.1	95.1	95.8	91.7	90.8	81.8	102
1982.IV	81.8	110.2	84.8	94.7	105.9	103.0	91.4	100.7	84.6	92
1985.IV	83.3	103.2	80.0	89.8	100.1	96.3	93.0	97.1	86.3	85
1987.IV	96.1	101.3	87.3	87.9	100.9	101.0	93.6	103.5	82.8	122
1988.IV	86.2	99.2	86.2	85.6	101.3	100.9	94.5	97.0	78.0	114
1990.IV	84.2	94.0	85.1	84.3	98.2	98.5	96.3	86.0	69.9	128
1992.II	83.8	92.1	86.0	87.2	100.4	100.3	96.5	74.8	67.9	121
% change										
92/87 ^a	-12.8	-9.1	-1.5	-0.8	-0.5	-0.7	+ 3.1	-27.7	-18.0	-0.2
92/72	-16.2	-7.9	-14.0	-13.8	+ 0.4	+ 0.3	-3.5	-25.2	-32.1	+ 21.3

¹ Except for Greece.

^a Percent change of 2nd quarter 1992 vis-à-vis 4th quarter 1987.

Source: Own computation, based on Bundesbank statistics.

attacks, is the magnitude of capital flows precipitated by fears of realignment... Also, in the 'convergence play' strategy, institutional investors had sought to exploit the existing interest differentials within Europe, given the perception that the macroeconomic performance of ERM member countries would gradually converge. They pursued this strategy, for example, by borrowing funds in the countries with relatively low interest rates such as Germany, and by investing in high-yield countries such as Italy and Spain. An investor who believed that interest rates would gradually converge toward the levels observed in the low-interest rate countries without exchange rate realignment on the way, would invest in long-term, high-yielding securities in anticipation of earning significant capital gains as interest rates fell."

After the negative Danish referendum on Maastricht in June and in anticipation of a narrow result at the French referendum in September 1992, the Maastricht plan for a future EC currency became less credible and by the same token the idea of a dominating DM more likely. In a period of high DM interest rates the movement out of ECU assets, out of dollar assets and out of weak EMS currencies but into DM assets became appealing. Italy was the first country to fall victim to its accumulated currency overvaluation and the rising DM attractiveness which had been reinforced by Germany's high interest rate policy adopted in 1992 as a means of reducing inflationary pressures (with inflation running at 4%) and to signal to the Bonn government that fiscal restraint was necessary. The role of the DM as an international reserve asset had strongly increased since 1973 and its share in world currency reserves—reaching over 15% by the late 1980s—could be expected to increase at the expense of the ECU or even the dollar if Maastricht failed.

Italy's foreign exchange reserves had already been melting away in the first half of 1992 and therefore the lira devaluation was inevitable. On September 14 the lira was devalued by 7%, and three days later the peseta followed with a 5% devaluation (later followed by a second and third devaluation), while the pound sterling and the lira left the exchange rate mechanism. The Bank for International Settlements noted in its 1993 Annual Report (p. 188):

"The Bank of England later published an estimate of the volume of official intervention which had taken place over the four months to end-September: the figure was over \$ 160 billion, most of which had been accounted for by sales of Deutsche Mark. For the period June-December the Bank of Italy estimated that total intervention in defence of exchange rates had been about \$ 200 billion, of which half had taken place in September alone... Nevertheless, exchange rate pressures persisted into October and, particularly, November. Many currencies

were involved, including sterling, as UK interest rates were lowered. In mid-November the Swedish government failed to obtain the necessary all-party support for its new fiscal austerity package. The market's response was instantaneous... The authorities decided to let the krona float. It was later announced that over six days the currency outflow had been the equivalent of \$ 26 billion, or 11% of Sweden's GNP. The comparable intervention figure during the three weeks of the September crisis had been ... over half this amount."

As Table 1 shows the pound indeed was overvalued and rumours would hardly have affected its position if this had not been the case. Compare 1987.IV (the last realignment prior to 1992 was in early 1987) and the index for 1992.II showing a strong overvaluation of the lira and the pound sterling. For the lira the overvaluation was about 9%, for the pound about 13%, much in contrast to the Irish punt, the Danish crown, the Belgian franc and the French franc, whose real exchange rates had changed only slightly in the period 1987 to mid-1992. Postponed adjustment requirements and fundamental changes, including considerations of relative political instability, led to sharp devaluations of the lira and the pound once it was decided to let the two currencies float. *Vis-à-vis* the DM the lira and the pound sterling lost about 25% within three months. Joint German-French measures to defend the franc in the run-up to the French parliamentary elections in early 1993 were justified to a large extent by underlying fundamentals. However, while French nominal and real interest rates came down after the French election, real long-term interest rates remained about one percentage point above the German real interest rate; compared to 1989 the Franco-German real interest rate differential was nearly halved. This could undermine the DM's anchor role in the EMS: German interest rates were the lowest in the EC, and the DM is an international reserve currency.

The chances of saving the pound parity by orchestrated intervention were minimal because once the currency had reached its lower margin in the parity grid even massive interventions would have been insufficient in view of the huge market volume. Only if the British economy had been able to get along easily with very high real interest rates as a means of defending the pound would there have been a slight chance of defending the overvalued British currency. In the UK capital mobility had increased in the 1980s. In the UK, pensions funds' shares of investments abroad increased from 6% to 20% in the period 1980-92.

With a rising number of EC countries in the ERM, the uncovered interest rate parity $i = i^* + a + R$ was increasingly bound to lead to low expected devaluation rates (a) and hence to $i = i^{DM} + R$; the interest rate i was

determined by adding a risk premium R (depending on the respective country and the width of the parity band) to the DM interest rate i^{DM} – which set the floor for long-term interest rates in the EC – such that real interest rates r_i in each of Germany's EC partner countries would exceed German rates strongly if inflation was below that in Germany; but a high r reduces prospects for output growth and this could weaken the currency. Facing already a 10% unemployment rate in 1992 the UK, Italy and France became subject to speculative attacks. The UK and Italy left the ERM in late 1992, while the speculative attacks against the FF as well as other EC currencies brought the EMS "reform" of August 1, 1993.

Anticipated Policy Switching

What happened in autumn 1992 and summer 1993 was not very different from the crisis of the French franc in 1983 when France devalued on Monday, March 21 – after the FF had reached annualized interest rates of 350% during the week before. The 1983 devaluation of 3.75% vis-à-vis the DM took place over a two-day weekend and implied an annualized yield of 675% for those happy speculators who borrowed francs on Friday in order to convert them into DM over the weekend, repaying the FF loan with depreciated currency. Market signals had strongly suggested an impending devaluation. Dealers in foreign exchange who

assumed over a given weekend a 0.5 probability of a 3.75% devaluation would be willing to hold a short-term FF position – rather than a DM position – only if markets offered two-day interest rates of some 300% at an annual rate. Anticipated policy switching is an important theoretical and practical issue.

The real DM appreciation in the second half of 1992 was strong both vis-à-vis EC partners and vis-à-vis the US dollar; in 1992/93 the DM-\$ exchange rate variability was clearly higher than the DM exchange rate vis-à-vis EC partners. The first three quarters of 1993 brought further appreciations vis-à-vis EC partner currencies, namely by about 8% but, however, the fourth quarter showed only an appreciation rate of 3.7%. Exchange rate adjustment still works in the EC, as is suggested by rapidly rising exports from the UK, Spain and Italy, whose swing in the trade balance vis-à-vis Germany was most impressive: after the lira devaluation the former trade balance deficit switched to a surplus position. Paradoxically, the lira devaluation of 1993 will partly reverse itself, namely because economic adjustment mechanisms are working if policies let them work.

The EMS crisis of 1993 is a problem for monetary integration in the EC; however, the two decades of EC monetary integration after 1973 show reasonable long-term adjustment tendencies. The DM exchange rate has

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Europäische und Internationale Wirtschaftsordnung aus der Sicht der Bundesrepublik Deutschland

About half of the essays in this collected volume are assigned to European integration, the other half dealing with the international economic order. Part I, now especially relevant since the coming into force of the Maastricht Treaty on 1st November 1993, begins with an analysis of the ambivalence of the rather lack-lustre economic policy debates in the European Parliament; it continues with a treatment of the two directives on biotechnology law; the label "Fortress Europe" is also considered – in the case of capital markets law somewhat hard to sustain. Part I concludes with an analysis of the, if one may put it, Colbertian nature and the regulatory and potentially disfunctional consequences of EC industrial policy. Though generally in favour of the strengthening of European integration as well as taking cognizance of the heightened factual interdependency between member states, this first part of the volume voices doubts as well as hopes about the manner in which Europe moves towards further integration. Part II, which is devoted to the international economic order, deals with the suggestion that the GATT structure should be strengthened. The book is published in German and contains French and English articles.

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appreciated vis-à-vis Germany's 18 main trading partners in nominal terms by 79% in the period 1973.II to mid-1993, while the weighted cumulated foreign price increase was 88% in this period.³ This amounted to a real depreciation of 5% in the period 1973-93 which has stimulated Germany's net exports; real depreciation vis-à-vis 15 main European trading partners was 4% over the two decades, but for some countries transitorily strong deviations from purchasing power parity were observed: based on quarterly data the maximum deviation was 15.1% vis-à-vis the Italian lira (18.9% vis-à-vis the Swedish crown). Nominal exchange rate fluctuations were on average 1.8% vis-à-vis the EMS countries; this is slightly less than vis-à-vis non-EMS countries. Prior to the formation of the EMS average DM exchange rate fluctuations reached 2.8% in the period 1973-78, but only 1% in the period 1979 to 1993. From this perspective the EMS has stimulated trade creation and investment creation in the EC – mainly by limiting exchange rate flexibility and by particularly promoting export growth of countries with low inflation rates (Germany and the Netherlands).

Limited Exchange Rate Flexibility

With anticipated fundamental shifts in international competitiveness in an enlarged EC there are powerful reasons not to limit nominal exchange rate flexibility strongly; the alternative way of adjusting real exchange rates would be greater downward flexibility of prices and the price level respectively; and this is hardly feasible. Since the single market brings about tighter oligopolies and a move towards greater R&D intensities and hence a relatively rising importance of sunk costs there is little reason to assume generally higher price flexibility. Wage flexibility might increase transitorily because fragmented trade unions face highly mobile real capital, but it remains doubtful that increasing wage dispersion – required to reduce unemployment – can be achieved in the EC. With the accession of former EFTA countries and a potential Eastern enlargement of the EC there will be adjustment requirements in the EC for quite some time, and limited exchange rate flexibility could be useful in this. A system of fixed parities in itself will remain a useful tool to achieve greater policy convergence and minimum policy cooperation in the EC. EC enlargement will render cooperation more difficult since consensus will need to be achieved among more and more heterogeneous member states. An enlarged EC internal market will have limited economic benefits if increased competition and greater exploitation of economies of scale coincides with a more unstable economic development which reflects the

Table 2
Real Exchange Rate Changes of the DM vis-à-vis EC Partner Countries and the USA

(based on wholesale price indices)

	Annual changes in % vis-à-vis EC	Annual changes in % vis-à-vis USA
1992.I	0.9	-4.2
1992.II	0.8	8.2
1992.III	3.0	20.0
1992.IV	7.2	5.6
1993.I	8.7	-0.1
1993.II	8.4	0.4
1993.III	7.6	-12.6
1993.IV	3.7	-7.8

Source: Deutsche Bundesbank; own calculations.

interplay of intensified intrinsic market dynamics and weakening policy coordination plus rising inconsistencies in the national policy mix. Clear monetary leadership by the Deutsche Bundesbank and improved monetary targeting by greater monetary cooperation are particularly important (the sharp unanticipated M3 increase in Germany in January 1993 signals problems in this respect). Equally important will be the political willingness not to defend unsustainable exchange rates in an environment of highly mobile financial capital flows. Competitive pressure in the single market will further raise capital mobility as firms are forced to reduce capital costs and since financial market liberalization and deregulation generally raise international capital mobility.

Defending an overvalued parity by means of high nominal and real exchange rates has high politico-economic costs because economic growth is impaired and the cost of government borrowing strongly increased thereby. While the (non-interest) primary deficit is increasing because of a cyclical downswing, the rise of interest rates raises the burden of government interest payments such that borrowing needs are indirectly increased. The latter in turn might increase devaluation pressures further as foreign bondholders could interpret higher borrowing needs as a pressure on more inflationary future policies and thus greater future devaluation rates. In highly indebted countries continued capital inflows under such conditions can only be assured if the nominal interest rates are increased in order to provide a corresponding risk premium for uncertain future devaluations. Here lies a major problem of the wide parity margins chosen because highly indebted countries such as Belgium, Ireland or Spain could face increasing effective real interest rates for government debt. The greater the share of public debt held by foreigners the more will the country become subject to speculative pressures once monetary policy is no longer in line with the requirements of stable nominal exchange rates. Figures on international securities transactions are scarce but Table 3 clearly shows that financial

³ Deutsche Bundesbank: Monatsberichte, November 1993.

internationalization in the sense of cross-border transactions in bonds and stocks has accelerated in the 1980s. In Germany central government debt held by foreigners was reported to have increased from 5% at the end of 1974 to 34% at the end of 1988. EC financial market liberalization in the context of the single market and privatization of banks and insurance companies in EC countries should reinforce similar tendencies in other EC countries, too. The USA reported that foreign and international entities held 7% of the federal government's outstanding securities at the end of the 1970s, whereas that share was 17% at the end of 1988.⁴

Under such conditions it will be impossible to make progress on the way to achieving the Maastricht convergence criteria in the area of fiscal policy: the 3% GNP/deficit ratio and the 60% debt/GNP ratio. The 60% debt/GNP ratio itself is quite doubtful as an indicator of the stability-orientation of economic policy because this stock-flow ratio mainly reflects past debt policies. Less arbitrary and more future-oriented would be the rating of a country's debt. Candidates for monetary union – stage III of the EC Economic and Monetary Union – could be required to achieve at least an AA rating with two leading rating agencies, to fulfil the criteria of low inflation and low expected inflation/low nominal interest rates: low inflation (interest rate) is defined in relative terms in the Maastricht Treaty, namely that the inflation rate should not exceed the inflation rate of the three countries with the lowest inflation rates by more than 1.5 points (2 points). However, one should introduce the full-employment criterion as an additional requirement in order to avoid a future EMU's being faced with a conflict-prone inflation-unemployment trade-off in the critical initial phase of monetary union. The EC single market programme in combination with major national adjustments in goods and labour markets should first be geared towards re-establishing full employment in the EC: with an unemployment rate of about 12% the EC is

far from full employment. The benefits from monetary union calculated by the EC Commission – about 1% of EC GDP – are small and uncertain relative to cutting the EC unemployment rate by half. Major improvements in EC labour markets are, however, not feasible if wage flexibility is not increased and the deregulation of labour markets not accelerated. Given the legacy of high unemployment in all EC countries (except for Greece and Portugal), one should consider the reform of national unemployment schemes and encouraging the creation of new firms as a means of restoring full employment. Convincing unions and workers to accept greater wage flexibility and wider wage differentials could be difficult in a period in which the relatively more mobile factor, namely capital, benefits from lower taxes on profit income and from new investment opportunities in the EC. However, governments could provide massive conditional tax incentives for workers who are willing to accept steps towards a "share economy" in which workers increasingly hold part of equity stock. Worker participation in investment funds could be encouraged by new tax regulations but also by the privatization of major state companies in EC countries.

Risk of the Brussels Reform

If exchange rate margins are very wide, as is the case after the Brussels reform of the EMS ($\pm 15\%$), the EC countries are almost back to a system of fully flexible exchange rates. Exchange rate flexibility has certain advantages for all countries, namely that balance of payments problems will not occur and that a low level of official international reserves is feasible. Moreover, there is limited exposure to the international business cycle, which will affect the country mainly via nominal and real exchange rate changes and associated impacts upon the price level, the trade balance and income or wealth. However, fixed exchange rates also have clear advantages:

Due to limited or no exchange rate risk international trade and investment are stimulated; portfolio investments played an increasing role as a source of equity capital in Europe in the 1980s, and since portfolio capital flows are affected by anticipated devaluations high exchange rate flexibility could distort capital flows in such

Table 3
Increasing Financial Internationalization:
Cross-border Transactions in Bonds and Stocks
(Gross purchases and sales of securities between residents and non-residents in % of GNP)

	1970	1975	1980	1985	1990
USA	2.8	4.2	9.3	36.4	92.5
Japan	n.a.	1.5	7.0	60.5	118.6
FRG	3.3	5.1	7.5	33.9	54.5
France	n.a.	n.a.	8.4 ^a	21.4	53.3
Italy	n.a.	0.9	1.1	4.0	26.7
UK	n.a.	n.a.	n.a.	367.5	690.1
Canada	5.7	3.3	9.6	26.7	63.8

^a 1982.

Source: Bank for International Settlements: 62nd Annual Report, Basle 1992.

⁴ Cf. M. Goldstein, D. J. Mathieson and T. Lane: Determinants and Systemic Consequences of International Capital Flows, in: IMF (ed.): Determinants and Systemic Consequences of International Capital Flows, p. 5.

⁵ On the increasing role of portfolio capital flows as a source of equity capital cf. Bank for International Settlements: Annual Report, Basle 1992; on related issues of foreign direct investment flows in Europe cf. M. Klein, P. J. J. Wellens (eds.): Multinationals in the New Europe and Global Trade, Berlin and New York 1992; and G. N. Yannopoulos: Multinational Corporations and the Single European Market, University of Reading Discussion Paper No. 45, Reading 1992.

a way that capital does not go into those countries and investments which yield the highest marginal product.⁵

□ Countries which peg their currency to a stability oriented international reserve currency will face disciplinary forces on domestic monetary policy because inflation rates exceeding those of the key currency imply losses in price competitiveness in international markets (within the area of the fixed exchange rate regime). Conversely, switching to exchange rate flexibility means that countries will feel a lack of stabilization pressure, so that monetary policy could quickly become very inflationary again.

□ Furthermore, by joining a fixed exchange rate regime countries can gain policy credibility, which is particularly important for the costs of disinflation: with tying monetary policy to the stability-oriented monetary policy of a key currency, disinflation policies would be credible only if sharp and sustained reductions in the monetary growth rate occurred, and various political obstacles might prevent monetary policy's being sustainable; under such circumstances inflation could be reduced mainly by reduced long-term monetary growth and via transitorily high increases in unemployment. Under fixed exchange rates the costs of disinflation – in the form of unemployment – could be reduced by improved policy credibility, which will translate into quickly changing low-inflation expectations and finally into low actual inflation rates. Giavazzi and Pagano have emphasized the credibility argument for fixed exchange rates:⁶ namely that countries which otherwise have a pro-inflationary policy bias could enjoy an enhanced policy credibility – and hence a smaller rise of unemployment during disinflation – if the currency is pegged to a country with a stable monetary policy and a good inflation record: entering the ERM also reduced nominal and real interest rates in the UK in 1990. This argument applies some basic ideas of Kydland and Prescott, and others, to the question of exchange rate arrangements in Western Europe.⁷

□ Finally, fixed nominal exchange rates create in effect bigger integrated financial markets, which are no longer separated by high exchange rate volatility and exchange rate risk; this could reduce nominal and real interest rates so that growth is stimulated: there is indeed evidence that

fully fixed exchange rates raise the risk of excessive public borrowing.⁸ However, this could also mean that the market discipline enforced upon governments is reduced because in periods of tranquility there is a low probability of exchange rate devaluation, which would in effect raise debt burden to the extent that bonds are held by foreigners; foreigners experiencing a devaluation abroad will require a more than proportionate risk premium for future engagements in titles denominated in the foreign currency.

Fixed exchange rates have the advantage that overshooting, which is a typical problem of flexible exchange rates, is avoided; overshooting means that – due to slowly reacting prices and quickly reacting interest rates – the initial devaluation (revaluation) can be much stronger than is warranted by long-term forces in line with purchasing power parity. At the same time there is the risk that a cumulated positive/negative inflation differential vis-à-vis the key currency will lead to misalignment, namely to a real exchange rate that is moving away from the initial real equilibrium exchange rate. However, if monetary policy follows stability-oriented monetary policies in the key currency country, the inflation rate in the whole fixed exchange rate area will on average be lower than otherwise. Fixed exchange rates have benefits for the partner countries of the key currency country as long as internal price flexibility in each country is sufficient to absorb technological shifts and cyclical impulses on the one hand, and, on the other hand, as long as the key currency country's monetary policy itself is geared toward low inflation rates and sustainable economic growth. High and rising interest rates in the key currency country will have parallel effects in other countries, too, and if economic growth is falling at the same time (as in Germany in 1992/93) this will spell economic trouble for partner countries in the fixed exchange rate area. The pros

Figure 1
Pros and Cons of Fixed Exchange Rates

Advantages	Disadvantages
Low exchange rate risk stimulates trade/international investment	Lack of exchange rate flexibility requires resilient markets/ effective stabilization policy
Requirement of high official reserves	Increased exposure to international business cycle
Gain in credibility of disinflation policies	Loss of autonomy of monetary policy
Lower nominal (i) and real (r) interest rate stimulates growth	Risk that public deficit is increased
Lower inflation (if low inflation in key country)	Risk of misalignment and postponed "mega-devaluations"
Overshooting problem (typical of flexible rates) avoided	Exposure to speculative attacks

⁶ F. Giavazzi, M. Pagano: The Advantage of Tying One's Hands: EMS Discipline and Central Bank Credibility, in: European Economic Review, Vol. 32, 1988, pp. 1055-1082; cf. also R. Barro, D. Gordon: Rules, Discretion and Reputation in a Model of Monetary Policy, in: Journal of Monetary Economics, July 1983, pp. 101-121.

⁷ Cf. F. Kydland, E. Prescott: Rules Rather than Discretion: The Inconsistency of Optimal Plans, in: Journal of Political Economy, 1977.

⁸ Cf. on this T. Lane: Market Discipline, IMF Working Paper, WP/92/42, Washington DC 1993, forthcoming in IMF Staff Papers.

and cons for fixed and flexible exchange rates are summarized for the non-reserve countries in Figure 1. From this perspective the Brussels EMS reform of introducing wide $\pm 15\%$ margins implies high risks for some EC countries, namely new inflationary pressures and – with some delays – high risk premia for foreigners holding assets denominated in the respective currency. Countries whose public debt is held to a large extent by foreigners could therefore have a strong interest in shadowing the guilder-DM margin of $\pm 2.25\%$: Belgium, Ireland and Denmark are obvious candidates in this respect. A formal as well as an informal commitment to reduce exchange rate flexibility within the EMS will become subject to the test of speculators at some point. If speculative attacks are to be survived it is important that international monetary cooperation is effective and that measures to defend the parity (normally higher interest rates) are feasible and credible, the latter requiring that unemployment rates as well as public deficits are not very high. Before returning to narrower margins most EC countries therefore face at first the task of reducing unemployment rates and reducing public deficits, and both problems require the stepping up of measures for structural adjustment and economic growth.

Too strong a reduction of inflation rates – below what nationally would be an optimal inflation rate under fiscal revenue aspects (given tax structures, marginal tax collection costs and options for seigniorage gains) – could create accentuated social conflicts concerning the income distribution between labour and capital as well as acceptable tax burdens, and such conflicts in turn could weaken growth.

As much as the UK interest rates fell when the UK joined the ERM/EMS in 1990 the British interest rates came down when the UK left the ERM in late 1992 such that floating obviously also has its benefits in terms of lower interest rates and hence higher investment plus output growth. However, it is clear that the British devaluation game cannot be repeated by all EC countries. It was the core lesson of the 1930s that competitive devaluations finally yield no economic benefits but propagate protectionism.

German and EC Perspectives

In Germany the Maastricht Treaty has created a vivid discussion among academics, the banking community and the general public about EC monetary union. Economists from academia were not really involved in the pre-Maastricht decision-making of the German government and hence it is not surprising that after Maastricht the government faces a majority of critical economists. The banking community has always

supported EMU, possibly because they expect profitable opportunities to expand in a common currency area, the functioning of which would follow the well-known lines of Bundesbank policies. An initially very supportive business community has become more sceptical in Germany in 1992/93 because a stability-oriented ESCB seems to be more difficult to establish than anticipated in 1990 and because German exporters' and importers' advantage of invoicing in the home currency (DM) is no longer a source of comparative advantage if all EC countries are members of an ECU/ESCB club.

There are three forces which could destroy the EMS: the Bundesbank – which never liked the EMS system – with a high interest rate policy (indirectly motivated by German unification) which induces devaluation pressures on other EC currencies; the mighty speculators whose power is increased by the EC's switch to full capital mobility, the single market and privatization projects in major EC countries; and inadequate macroeconomics policies in EC countries.

The Brussels ad hoc reform of the EMS showed that not only EC monetary union is a delicate issue. The transition stage in a period of higher capital mobility and increased internal and external adjustment pressure is a strategic topic for EMU. With a parity margin of 15% the EMS is almost floating, and the advantages of a fixed exchange rate, downward inflationary convergence and increased policy credibility were given up in a critical situation. More exchange rate flexibility is indeed useful in a situation of asymmetric shocks (German unification, CMEA disintegration and EC single market dynamics) and high unemployment rates in all major EC countries. However, after a transition period of much greater flexibility reduced parity bands should be introduced (maybe with margins of $\pm 4\%$). The Brussels meeting of Sunday, August 1, 1993 proved that the EC partners have the political will to save the EMS; however, their crisis management was no swift reaction. According to the Financial Times of August 3, 1993 the monetary committee's meeting (the previous Saturday) brought only an agreement to preserve the ERM and its central parity grid. When the ECOFIN met on Sunday, Germany's proposal for solving the crisis was to widen the margins in the EMS. France absolutely refused to devalue the franc, and Germany insisted that the Bundesbank could not be expected to provide unlimited intervention. A Franco-German proposal that the DM should leave the ERM (for a certain period) turned out not to be feasible. The Netherlands, which has traditionally maintained a currency parity with the DM, signalled that it intended to follow the Germans out of the ERM. Reacting to the Dutch move Belgium, Luxembourg and Denmark indicated that they, too, wanted to leave the ERM. France

was facing the strange option of being left behind with Portugal and Spain – the latter two enjoying the $\pm 6\%$ parity band. This solution would have resulted in a kind of two-tier snake arrangement, and France certainly was not eager to create the impression that the “franc fort” policy (maintaining the DM-FF parity) had failed. At the same time the French government faced a public opinion which favoured lower interest rates and employment growth over the goal of exchange rate stability. The final solution was to adopt a fluctuation band of 15% for all ERM currencies. The effective revaluation of the DM could reduce import prices and reduce inflationary pressures in Germany so that the Bundesbank in turn could adopt a policy of more quickly reducing interest rates. However, given the fact that about 50% of all prices are state-administered prices or prices strongly influenced by government procurement a rapid reduction of German inflation is unlikely; this holds especially because the excessive monetary growth of 1991/92 will translate with a lag into inflation in 1993/94. EC monetary problems can only be overcome if labour market clearing is reinforced and economic growth is increased. Growth rates could be depressed by exchange rate uncertainty and shocks (e.g. German unification).

Widening vs. Deepening

The collapse of the CMEA, the USSR and the Warsaw Treaty Organization mean that Germany and the other EC countries have lost an external catalyst for political cooperation in Western Europe, and indeed in all EC countries the political focus is strongly back on the national interest (“where is my net gain?”) and sometimes nationalistic perspectives influence politics again. Weakening EC cohesion could indeed result not only from increasing internal political conflicts in the EC12 group, but EC-widening could furthermore weaken the political cohesion as decision-making becomes more complicated, ineffective and inefficient in an enlarged Community. If political unification, or at least stable and efficient political schemes for achieving intracommunity consensus, competition and coordination, were a prerequisite for a viable currency union or unification, EC-widening – whether towards Scandinavia or central and eastern Europe – would be the wrong step. Hence, facing a trade-off situation of EC-deepening (monetary union) vs. EC-widening Germany might find that its

politico-economic gains from EC enlargement are considerable, but those from EC-deepening quite uncertain. By itself Germany is unlikely to give up the idea of EC monetary union and strongly emphasize potential opportunities in central and eastern Europe, although the ex-CMEA area offers new opportunities not only for exporting goods and acquiring firms, but also for exporting the Bundesbank model to the increasing number of countries plagued by hyperinflation and the desire to establish a stable currency. On balance a united Germany – facing enormous adjustment problems in the context of unification⁹ – cannot gain much from central and eastern Europe because in economic terms the region is poor and has limited prospects for a successful economic opening-up. However, transforming economies in the ex-CMEA could reduce EC cohesion and change German policy perspectives indirectly.¹⁰ If Germany’s main EC partner, France, faced serious agricultural and industrial adjustment problems as a consequence of the economic opening-up and transformation of former CMEA countries, this would raise pressure on Germany to step up its net contributions to the EC budget – while the contribution of France would be reduced; this could sharply intensify the German discussion about the gains from EC membership. From an economic point of view Germany’s gains from higher trade through EC membership clearly override the fiscal contributions, but in the political debate the gains from trade are underestimated because they are spread over millions of products and millions of consumers/investors, while the contributions are clearly visible. Germany’s prospects of imposing its monetary policy course on other EC countries has improved after German unification. Germany’s firms traditionally faced lower wage pressure than their EC rivals in the 1980s and if Germany can restore its lead in price stability in the even more competitive single market in the 1990s the political pressure in other EC countries to match low German inflation rates will be reinforced. The critical assumption here is that Germany can achieve modest inflation rates in 1994/95, where it is clear that recurrent intervention needs would make it impossible for the Bundesbank to reduce the inflationary pressure in Germany and Europe.

A feasible transition to monetary union will require that stage III of EMU be postponed by several years compared to the initially envisaged dates of 1997 or 1999. A stable union would require that only a small group of EC countries initially take the risk of finding out what the true benefits of full monetary integration in Europe is. The EC Commission suggested that monetary union would bring benefits of about 1% of EC GDP, but in reality this could be more or less, depending on the kind of group forming the union.

⁹ Cf. IMF: German Unification, Economic Issues, Occasional Paper No. 75, Washington DC 1990; P. J. J. Welfens (ed.): Economic Aspects of German Unification, Heidelberg and New York, 2nd edition, 1994.

¹⁰ Cf. P. J. J. Welfens: Market-oriented Systemic Transformations in Eastern Europe, Berlin, New York 1992; P. J. J. Welfens (ed.): The Single Market and the Eastern Enlargement of the EC, Berlin, New York 1994.