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Article — Digitized Version

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Intereconomics

Suggested Citation: Matthes, Heinrich (1994) : “Damocles shadowing”: An innovation in the second phase of EMU, Intereconomics, ISSN 0020-5346, Nomos Verlagsgesellschaft, Baden-Baden, Vol. 29, Iss. 2, pp. 75-77,
<http://dx.doi.org/10.1007/BF02928146>

This Version is available at:

<http://hdl.handle.net/10419/140442>

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Heinrich Matthes*

“Damocles Shadowing”

An Innovation in the Second Phase of EMU

Since the widening of the fluctuation bands in the European Monetary System in 1993 the previous core countries have pursued a “D-Mark shadowing”. The characteristic feature of this shadowing is the participating countries’ willingness to voluntarily return to, and maintain, the old exchange rate parities. Our author analyses this process and its consequences for the planned monetary union.

On 1 August 1993 the fluctuation bands within the European Monetary System were widened from 4.5% to 30%, representing an almost sevenfold increase in the exchange risk. For speculators, this was tantamount to placing a sword of Damocles above their heads. It also put an end, for the time being, to the one-way bets that, in the final stage of the narrow-band EMS, had enabled speculators to make an absolute fortune completely risk-free.

But why, it has to be asked, did this extreme measure have to be taken in the first place? Had not the EMS – at least since the fundamental policy shift in France in March 1983 – experienced a fairly positive period of currency stability that in the end resembled the conditions associated with a single market?

Huge Speculative Flows

The decisive date for the current difficulties was the extensive liberalization of European capital movements from 1 July 1990 onwards. Coupled with the 1992 deadline for completion of the Community-wide single market, this liberalization of capital markets signified that the EMS, in the view of the markets, had already entered as it were a preliminary stage of monetary union. As a result, exchange-rate expectations steadied enormously and the very much greater potential for speculative capital movements was initially defused. The extraordinary

increase in the elasticity of short-term international capital movements was attributable to the following factors:

- technological progress implied an increasingly marked and virtually instantaneous diffusion of information;
- innovative financial techniques (so-called financial derivatives) have recently made it possible, for a small amount of capital (but with the risk of losses being measurable from the outset), to benefit from enormous leverage effects as regards interest and thereby to exploit (if necessary, via computerized trading) relatively small exchange-rate fluctuations;
- the increasing concentration of private portfolio management in the hands of highly professional managers and the growing importance of investment funds and insurance companies are creating a potential for massive short-term capital movements that can be triggered (for whatever reason) by the slightest expectation of exchange-rate adjustments.

It is in this light that the short-term international capital movements between the various currencies amounting to the unbelievable sum of some 1,000 billion US dollars per trading day have to be seen. As a basic determinant of exchange rates, short-term capital movements thus assumed fundamental importance: they today easily dwarf the balances in goods and services.

In spite of this tremendous increase in the disruptive potential of short-term capital movements, the EMS, at least until the summer of 1992, of course, acquired stability as a system of fixed but adjustable exchange rates by

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virtue of the fact that, in the opinion of the markets, it had already embarked on a "preliminary stage of monetary union". As mentioned earlier, exchange-rate expectations steadied enormously since the markets had assumed prior to the summer of 1992 that the Community would simply move on to monetary union with the existing exchange rates.

Following the Danish referendum in June 1992, which suddenly cast doubt on the attainment of monetary union, and the ensuing steady erosion of the consensus in France in the run-up to the (superfluous) referendum in September of that year, it became increasingly evident that the preliminary stage of EMU, which had served to stabilize exchange-rate expectations, had suddenly come to an end in mid-1992, especially since the German monetary authorities, with the increase in the discount rate in July 1992, had clearly indicated that, in line with their statutory duty, the policy stance would remain geared primarily to domestic circumstances. There was then every incentive for speculators to force one currency after another out of the system. In the ensuing twelve months, which were characterized by huge speculative flows entailing intervention on a massive scale and by a whole series of realignments, the EMS as a system of fixed but adjustable exchange rates was laid to rest. The final blow came with the widening of fluctuation bands to 15% in either direction that took place on 1 August 1993.

Inconsistency Triad

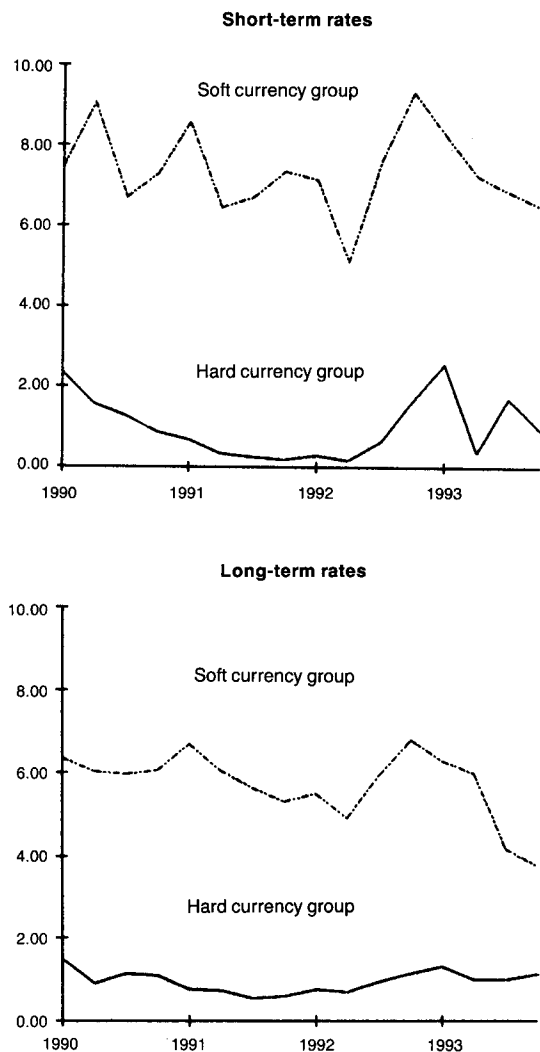
The real reason for our current difficulties on exchange markets is to be found, however, in the so-called inconsistency triad of economic policy. In an exchange-rate system such as the EMS there is an irreconcilable conflict between the freedom of capital movements, autonomous monetary policy and fixed exchange rates. One of these objectives must be jettisoned. For as long as there was hope of soon reaching the "safe harbour" of Maastricht, there was no need to consider the unyielding implication of this triad.

At the same time, it became quite clear that, in order to safeguard the "four basic freedoms" (freedom of movement for goods, individuals, services and capital) within the Community-wide single market, a *de facto* monetary union was essential. "One market, one money" was how the Commission itself put it. Accordingly, the alternative to Maastricht would not be an internal market that functioned in an entirely satisfactory manner *without* a single currency, but the renationalization of economic policies and hence the dismantling of what had already been achieved. Free exchange rates nurture uncertainty and are detrimental to investment and integration.

This brings us straight to the following conclusion: only two monetary orders can survive in the Europe of the future: either a full monetary union or floating. Flexible exchange rates would, of course, deprive us of the main advantage of the large single market: reliable planning horizons.

It then has to be asked whether the development of the EMS since 1 August 1993 as an arrangement for shadowing the German mark is not the most telling argument for rebutting the above view. Have not exchange rates (after some initial depreciation) moved back fully within their previous fluctuation bands within this "new

Interest Rate Differentials vis-à-vis Germany



The hard currency group consists of France, Belgium, the Netherlands and Denmark; the soft currency group consists of Italy, Portugal and Spain.

Source: Commission Services (Quarterly data).

EMS"? Is this not the best possible proof that a system of floating can most certainly be managed in a manner compatible with the single market?

A New EMS?

The relative success of the new EMS since 1 August 1993 is in no way an argument for floating as an arrangement conducive to integration. Instead, the countries that previously formed the narrow-band group have, since 1 August 1993, renounced any monetary policy with a national focus even *without* the constraint of a narrow band. The upshot is that their monetary policy, even reinforced, is now geared solely to the objective of exchange-rate stability. In this new system, in which there is no longer any requirement on the anchor-currency country to intervene, the penalty mechanisms are, therefore, even more stringent. As a result, the risk premiums of the previous core countries have, to a large degree, evened out (see graphs).

This is particularly true for long-term capital movements, which have naturally been stabilized by the continuing prospect opened up by Maastricht to a greater extent than short-term movements. Here too, however, the risk premiums have shrunk to a comparatively insignificant level as a result of the policy of shadowing the German mark. This new level (compared with the level in June 1992, when the old system had, for the last time, reduced risk premiums to a comparatively low level) represents, as it were, the costs of the new system of "Damocles shadowing". In point of fact, it is quite clear to speculators that under this system, as if it were "a fleet in being", the sword of Damocles of severe exchange-rate penalties is hanging over them all the time where speculative inflows or outflows are concerned. It should once again be stressed that, in line with the "inconsistency triad" argument, the new system dispenses altogether with any national focus of monetary policy.

The "Damocles shadowing" is, as it were, the innovative feature of stage two of monetary union. It keeps speculative disruptions to a minimum, eliminates any intervention on the part of the anchor-currency country and reinforces quite significantly the penalty-based constraints as compared with the previous "one-way bet" system. Fairly large speculative upheavals in exchange rates can no longer occur, and this accordingly eases exchange-rate expectations and hence the pressure on interest rates (namely by negating the relevant risk premium). The system is, therefore, a target-zone system with a pronounced integrationist effect. Against the background of the strong convergence process that is still strikingly underscored by the Maastricht-based policy, the "Damocles shadowing" seems to qualify as the system for

the transitional phase. This new system differs from free floating in two respects:

- it operates only in the context of far-reaching convergence policies as formulated in line with the criteria laid down at Maastricht;
- it results in comparatively minimal risk premiums only at the cost of a more pronounced convergence policy. Of course, this price is paid only because of the prospect of much wider-ranging integration, including not least the eventual nullification of all risk premiums.

European Burden-sharing

At the same time, in the wake of German unification, the "Damocles shadowing" affords the existing anchor currency ideal protection during the transitional phase to the single currency. It prevents oligopolistic conflicts surrounding the anchor function which would be damaging to integration and in which, given its accumulated credibility potential, the Bundesbank would, in any case, remain unchallenged as things stand. At the same time, it leads to intra-European burden-sharing as regards the real costs of unification. After all, the temporary withdrawal – accepted by the others – of the credibility umbrella which the Bundesbank had unfurled over the EMS entails a temporary strengthening of the German mark and, to that extent, further reinforces the asymmetry of the new EMS. This is, of course, a *voluntary* move on the part of the countries constituting the former stable core; it serves the interests of a rapid restoration of stability in the anchor-currency country. This also obliges the Federal Government to do its utmost to reformulate in a more symmetrical fashion its policy mix, which has suffered as a result of unification. Moreover, the Bundesbank must continue to exploit whatever scope there is for reducing its short-term rates. Without this *quid pro quo*, the "Damocles shadowing" is also destined to fail.

It is now clear that the events which occurred after 1 August 1993 and were celebrated by many as the definitive collapse of the hated Maastricht plan have in fact resulted in an extraordinarily positive turnaround in the policy on integration. For the first time, a feeling of genuine European solidarity is developing between the anchor-currency country and the other countries making up the stable core group. In view of this solidarity, two predictions can be made:

- the "Damocles shadowing" could turn out to be a durable feature of the current stage;
- the start of the final stage will, and this is perfectly in line with the Maastricht rules, take place earlier rather than later, provided the necessary political resolve exists.