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Christa Randzio-Plath\*

## A New Exchange Rate Mechanism for the Euro Age

*Only a limited number of countries will participate in the single currency area at its formation on January 1st, 1999. A new link between the currencies participating in the Euro zone and those unable or unwilling to do so must therefore be created. A new EMS, with the Euro as its anchor currency, must be installed to ease the path into EMU for those countries that wish to join at a later date.*

The exchange-rate stability enjoyed since spring 1995 reflects the progress in convergence achieved by all the Member States of the European Union. This success of the convergence efforts prepares the road for the new ERM proposed some years ago by the European Parliament in order to bind together the Euro area with the currencies not already joining the Euro area on January 1st, 1999. Finally all European institutions agree: a new exchange-rate mechanism is needed in Stage III of EMU in order to link the "ins" and "pre-ins" in the third stage of EMU as a framework to support the final steps to convergence among the "pre-ins" ahead of their participation in the Euro area. The Euro must become a catalyst and the cornerstone for further integration in order to include the other European currencies in the integration process. This will also rightly apply to new members from southern and eastern Europe. ERM II thus is a further link toward facilitating their membership of the European Union.

Experience has shown that exchange-rate stability depends upon sound macroeconomic management but also upon political stability within the European Union. A new ERM will demonstrate the willingness and ability of all 15 member countries to continue together in the framework of the internal market with reinforced cooperation and convergence on the one hand but also solidarity on the other hand.

### The Situation in the Current EMS

On 14th October 1996 Finland joined the current European Monetary System (EMS) as well as its exchange-rate mechanism. This is a step which

considerably increases the likelihood that Finland can be among the first members of the Euro area since the country's convergence outlook compares relatively well. Finland's participation should make it easier for Sweden to join as well because a major reason for Sweden's abstinence so far has been worry about Finnish competition via the exchange rate. Moreover, the Finnish case also shows that entry into the ERM at an appropriately chosen central rate does not incur the risk of speculative attacks, especially at the current fairly wide fluctuation margins which have considerably contributed to the dampening of exchange-rate volatility since August 1993. The success of the 15 percentage point margins underpins the insight that an exchange-rate system must be economically as well as politically credible.

Besides Sweden there are two other countries which are currently not members of the ERM – now the Italy has rejoined – namely Greece and the United Kingdom. Yet in contrast to Sweden they do already participate in the EMS. The UK has so far been reluctant to join the ERM, mainly for domestic political reasons. On the other hand the UK government wants to keep all options open with regard to membership in the Euro area. This necessarily implies that the UK must join the ERM as soon as possible. For the convergence criteria stipulate that a country must observe the normal fluctuation margins provided for by the exchange-rate mechanism of the EMS for at least two years without devaluing against the currency of any other Member State before it can enter the Euro area (EC Treaty, Article 109j). And we have only two years to go until the evaluation by the European Heads of State in 1998 on who will be in at the start of the adoption of the single European currency. Any

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country joining the ERM would strengthen its general political and economic credibility as well as its competitive situation in the Union by showing more commitment. After all, it was not the ERM which led to monetary problems in the EU and in the UK but a wrong political decision on the central sterling rate. To put it more generally: there is no economic reason why any country of the Union should not participate in the ERM under the current conditions. The wide margins, in particular, provide a useful basis for increasing convergence and credibility.

### **The Exchange-rate System and Monetary Stability**

As the experiences of past exchange-rate turmoils have clearly shown, there is no exchange-rate stability without sound macroeconomic policies and economic convergence between the countries concerned. Both a lack of soundness and a lack of convergence will even increase exchange-rate instability within an institutionalised exchange-rate system and finally lead to its breakdown because such a system cannot be credible. It cannot be credible in the first case because the markets know that the stable country will not indefinitely intervene to support the country with unsound policies. In the second case it is also clear that fundamental (real) exchange-rate movements caused by exogenous shocks or divergent developments of productivity etc. cannot be withstood by permanent intervention because this would imply a loss of control over the monetary aggregates and therefore a danger for price stability. It would even be damaging to hamper exchange-rate adjustments in these cases, not only for the strong country but also for the weaker one, because the exchange-rate adjustments help them to keep up with international competition and prevent the weaker countries from pricing themselves out of the markets.

So market participants who know about these issues will try to protect their investments by selling assets denominated in the currency which they expect will inevitably depreciate (and finally devalue). By doing so they will only increase the speed of adjustment to the new exchange-rate equilibrium. The power of such dynamic processes can be impressive, as was seen during the European exchange-rate crises of 1992 and 1993. In these cases political commitment to the existing central rates was clearly untenable with regard to the economic and policy uncertainties, and much turmoil could have been prevented if the political evaluation of the situation had been more realistic.

Past experiences, especially those of 1992 and 1993, are precious when it comes to modifying the European Monetary System to the needs and conditions of Stage III of Economic and Monetary Union, for they help to prevent crises in a transition phase which is critical for further European integration. Therefore the sensitive political and economic transition period which will last until all Member States are also members of the Euro area must by no means be burdened by unnecessary strains from monetary cooperation between "ins" and "pre-ins". This implies that the design of EMS II and ERM II is of strategic importance for the future of the Union.

Whereas sound policies and economic convergence are necessary for exchange-rate stability they are not sufficient to reach that goal. In a world with a daily turnover of foreign exchange to the order of US\$ 1300 billion, and considering the fact that markets may well misjudge developments and overshoot in their reactions, it can be useful to give them some guidance. This guidance can be provided for by properly chosen central rates and intervention points with margins reflecting the state of economic convergence. Such an intervention system is by definition credible and will thus assure the market participants that exchange-rate movements will indeed be limited by the intervention bands because market participants who figure with rates beyond will incur losses.

The European Union has achieved substantial progress in recent years, especially in the field of price stability, where rates have been converging at a low level. Indeed the average inflation rate of the EU has fallen to an historical low of under 3% recently. From this side we can thus expect a major contribution to exchange-rate stability. On the other hand substantial risks stem from the fiscal side, where debt and deficit ratios remain at high levels. The debt incurred binds substantial parts of the budgets by interest payments and limits the flexibility of reactions to possible cyclical and other economic problems. Moreover, high indebtedness of the public sector can always threaten price and exchange-rate stability. Another reason for exchange-rate turmoil in this context lies in the fact that highly indebted governments are economically and politically more vulnerable in the case of adverse economic developments. The related risks trigger negative evaluations from the financial markets and volatile exchange rates. One of the most important tasks, especially of the "pre-ins", is therefore to stick to their impressive adjustment efforts even when we have entered Stage III of EMU. From the institutional side the incentives for sound fiscal policies will be

enforced by the forthcoming stability pact which will consequently also contribute to exchange-rate stability.

### **A New ERM for the Euro Age**

The Treaty of Maastricht makes participation in the Monetary Union dependent on the fulfilment of stability criteria which are not easy to meet in the current economic climate. In the case of Denmark and the United Kingdom, the Treaty lays down that they are not obliged to take part in the Monetary Union. Other countries will initially remain outside because they cannot yet meet the convergence criteria or because they will ask for postponement. Accordingly, on 1st January 1999, it is probable that only a limited number of stable currency countries will form the Monetary Union. However, it is equally clear that the single currency is an essential element of the single market and that it must be a definite objective of the Union to ensure that, ultimately, all Member States of the Union also become members of the Monetary Union.

Two years ago the European Parliament therefore rightly called for a new link between the currencies participating in the Euro zone and those unable or unwilling to participate. A new system of solidarity and stability should link the currencies in the mutual interest of both sides because the Euro zone fears the threat of competitive devaluation, while the other countries fear that they will be confronted with speculative attacks and that there will be problems with becoming members of EMU later. So now there is agreement in the EU that a new EMS has to be installed. The Verona ECOFIN Council made this clear, as did the Florence Summit in 1996; and the Dublin Council in 1996 will decide on the general formal framework to be introduced. This new exchange-rate policy cooperation in Stage III will enter into force at the very beginning of Monetary Union on 1st January 1999.

The impact of currency fluctuations on both intra-Community and extra-Community trade is not marginal. Currency fluctuations, especially intra-European currency movements, are of importance for economy, trade, investment and employment. During the past couple of years, Europe has been exposed to the shock of intra-European devaluations. This shock has been difficult to absorb for some firms located in strong currency countries since it was parallel to another dramatic exchange-rate shock, the competitive devaluation of the US dollar. The implications of intra-European (nominal as well real) exchange-rate volatility and exchange-rate movements have to be

evaluated in the light of the transition to EMU and the single currency. The functioning and possible disruption of the Single Market, as well as the future cohesion of Europe – depending on whether centripetal or centrifugal forces prevail – is at stake. The currency devaluations which have taken place in the nineties have put some European economies in trouble. The problems have occurred because the devaluations had a real impact on trade and growth in the European Union. That means that some countries have taken advantage of dramatic exchange-rate movements when other countries have had to bear the negative effects of the devaluations. Clearly, there have been winners and losers. The real winner among the four countries involved following the exchange-rate movements during the 1992-1995 period was Italy. At the other extreme, the main loser was Germany. In the second quarter of 1992, Italian unit labour costs were 5 per cent above those in Germany. In the second quarter of 1995, Italian unit labour costs were 37 per cent below German ones.

### **The Euro and the Non-participants**

The lessons of the years 1994 and 1995 have been learnt. Therefore a new structure of the relationship between the currencies of the Euro zone and those that do not participate (the "pre-ins") has to be installed: a new ERM, an ERM II adjusted to the Stage III of EMU. The main objective should not be just to minimise any threat to the cohesion of the European Union and in particular to the working of the Internal Market, but to ease the path into EMU for those countries that wish to join. The EMU process must not be politically or economically divisive. This is especially the case with further political integration and the enlargement of the Union in view. The aim is to bring all 15 Member States into EMU.

In order to counter the risks of competitive devaluations as well as the possibility of those not participating in EMU being exposed to speculation, the relationship between the "ins" and the "pre-ins" should be clear.

Exchange rate policy cooperation in Stage III should therefore be guided by the following principles:

1. All Member States should be involved in determining the framework for economic and exchange-rate policy in Phase Three. The arrangements should be based on those of the Treaty and not go beyond it. The Treaty requires that both the "ins" and the "pre-ins" treat their exchange-rate policy as a matter of common interest (Article 109m). This article excludes competitive devaluations. Logically one

special institutional link between the "ins" and "pre-ins" is foreseen by the Treaty: Member States not participating in the Euro area will have a seat in the General Council of the European Central Bank (ECB). This will contribute to keeping the exchange rates in the European Union as stable as possible and guiding the "pre-ins" to the Euro area. The Euro should become the anchor currency in the new EMS. Given the different economic and political circumstances, exchange-rate arrangements will need to vary according to countries. Participation in any formal arrangements of exchange-rate targeting would be voluntary. But it should be recalled that for accession to EMU the Maastricht Treaty requires adherence to the normal fluctuation margins provided for by the exchange-rate mechanism of the EMS for at least two years without devaluation against the currency of any other Member State.

2. The institutional framework of the new EMS/ERM should retain the two-pillar structure of the present system. The EMS/ERM should be based on a European Council Resolution with operating procedures being determined by agreement between the ECB and the national central banks of the participating "pre-ins" as in the current system, where this fundament has worked well.

3. Bilateral central rates with the Euro should be established in a procedure involving all the parties concerned. The Euro should be the anchor currency since it will be the major European currency, and for the "pre-ins" who want to join the Euro zone the Euro obviously is supposed to be the fixed point. Bilateral fluctuation bands should be wide and could be of various widths depending on the situation of the currency concerned (say +/-15%, +/-5%). In the new ERM realignments should be made in a timely manner and by common procedures.

4. Tensions in the new ERM would need to be counteracted by a range of measures designed to encourage convergence:

On the principle that a necessary condition for exchange-rate stability is a convergent policy, the general economic policy stance would need to be reviewed to see whether adjustments are required.

Whilst maintaining the principal objective of price stability, monetary policy (interest rates) could be adjusted.

Limited intervention obligations at the margins. It is clear that the availability within the ERM of unconditional, unlimited intervention possibilities from the strong currency central bank provides the market with the opportunity of a one-way bet without guaran-

teeing the maintenance of the parity. In the context of the new ERM, the potential monetary disruption to the Euro of unconditional, unlimited intervention could prejudice the goal of price stability. Therefore it might be preferable either to make unlimited intervention conditional on the defence of a reasonable exchange rate or to provide for the provision of substantial, but nevertheless limited intervention facilities.

The realignment mechanism has been a problem in the ERM and had become too political. Realignments could work better without losing their disciplinary effect if the initiative for realignments, instead of coming from the Member State most directly concerned, could also come from the ECB (whereby its initiatives should be based on an assessment of the underlying economic situation and would be confidential) or if realignments were based on mutual agreement.

5. Early warning against possible tensions in the new Exchange Rate Mechanism should be an important element, coming through surveillance procedures to be installed and regarding markets and economic policy. Consultations on measures to relieve tensions (policy changes, interest-rate movements, coordinated interventions, etc.) could be triggered when exchange rates move close to the fluctuation limits. The sustainability of exchange-rate relations will need to be closely monitored on a permanent basis. The division of responsibilities in this area must respect the independence of the ECB and the NCBs. Intervention at the wide margin should in principle be automatic. It must be clear that the ECB cannot intervene if this entails actions that would conflict with its primary objective of maintaining price stability in the Euro area. Therefore the ECB will have the possibility of suspending intervention under defined circumstances. Appropriate policy responses have also to be given to the question of the sharing of the cost of interventions.

The relationship between the "ins" and the "pre-ins" could be divisive for the European Union if it is not handled well, while the aim is to bring all 15 Member States into EMU. The economic risks relate to the smooth functioning of the Single Market, either because of exchange-rate misalignments or other distortions, and to the effect on the ability of the "pre-ins" to qualify for the Euro area in the future. The Union has to ascertain that everything possible is done to strengthen the integration of the European Union. Otherwise economic effects could lead to more general political divisions within the EU. EMU and a new ERM II will contribute to promoting integration.

The inclusion of as many members as possible is a

main concern on the way to EMU. Given the need for a sufficient degree of convergence it is clear that not all EU Member States can participate in EMU. Some countries are unlikely to meet the 1999 deadline. Therefore the framework of the EMU has to support the efforts of the "pre-ins" to join the Euro area, especially in time before the Euro banknotes and coins are introduced. A close policy coordination between the Euro area and the other members of the EU is a matter of common interest and an integral part of the completion of the EMU process. Everything has to be done to avoid real exchange-rate misalignments between the Euro and the other EU currencies, and to avoid excessive nominal exchange-rate fluctuations because trade between Member States would be

negatively affected. The lessons have been learnt from past experience.

Given the linkage between exchange-rate stability and convergence there will be a role for reinforced convergence programmes in the management of the new ERM. A favourable performance relative to convergence objectives would be expected to strengthen the case for support for a currency outside the Euro area in the case of speculative attacks. Convergence and exchange-rate discipline among the "pre-ins" will improve and monetary solidarity within the Union will become stronger in order to protect the Single Market and make it work. The new ERM in Stage III will be decisive to provide the prospect of full participation in the Euro area and to protect the Single Market.

Alexander Jung\*

## Is There a Causal Relationship between Exchange Rate Volatility and Unemployment?

*In his article on "Germany's Stake in Exchange Rate Stability" (INTERECONOMICS, September/October 1996), Daniel Gros recently wrote that, as he sees it, the exchange rate volatility of the D-Mark against the other European currencies has a causal impact on the German unemployment rate. In the following it is examined whether Granger causality tests support this view and whether it is possible to infer from this that the establishment of a monetary union in Europe will contribute to a significant easing of unemployment problems.*

A closer look at the trends in the exchange rate volatility and in the unemployment rate (Figure 1) makes this seem doubtful. It shows that the structural increase in unemployment in Germany in the past few years is obviously not attributable to a corresponding increase in the exchange rate volatility. At most, it can be assumed that there is a correlation between the change in the unemployment rate and the exchange rate volatility. In fact, it is precisely this relationship which was tested by Daniel Gros in the above-mentioned article by means of a simple regression analysis on the basis of annual data for the period 1971-95.

However, it seems noteworthy that, if monthly data and Granger causality tests are used instead of the simple regression analysis, the existence of the impact asserted by Daniel Gros cannot be proved

even for changes in the unemployment rate. Instead, Granger causality between changes in the unemployment rate and the exchange rate volatility points in the opposite direction.

For the purpose of the analysis, the monthly standard deviation of the weighted external value of the D-Mark vis-à-vis the currencies of the other EU countries serves as a simple measure of volatility.<sup>1</sup> The standard deviations were calculated on the basis of daily data, which were only available from September 1977 onward, however. In order to eliminate potential structural breaks caused by German reunification, unemployment in Germany was examined on the basis of the west German unemployment rate expressed as a percentage of the labour force, and the causality tests were based on the change in the unemployment rate, both relative to the previous

\* Deutsche Bundesbank, Frankfurt am Main, Germany. The author would like to thank W. Friedmann and M. Scharnagl for helpful comments. All views expressed and all remaining errors are the author's own.

<sup>1</sup> Further volatility measures were used in: Deutsche Bundesbank: Financial market volatility and its implications for monetary policy, Monthly Report, April 1996, pp. 51-67.