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Reinforcing Stage Two in the EMU Process

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REINFORCING STAGE TWO IN THE EMU PROCESS

Niels Thygesen *

Paper presented at conference organized by the European
Investment Bank, "30 Years of European Monetary
Integration - From the Werner Plan to EMU",
Luxembourg, 18-20 November 1993.¹

Revised January 1994.

Abstract

The paper initially discusses monetary policies in the context of the wide margins introduced on 1 August 1993. The new President of the European Monetary Institute (EMI) has suggested that a number of stringent non-monetary conditions must be met before there can be a return to narrow margins. While this list may be too comprehensive, the paper argues that there are also some monetary prerequisites which will be difficult to meet: at a minimum some mixture of less conditionality in interventions on behalf of creditor central banks and strong incentives for debtor central banks to raise interest rates to defend their currencies. The paper finds a continuation of wide margins for most of the transition realistic. Such a scenario might have certain advantages in relation to the transition to monetary union, provided participants continue to value exchange rate stability highly.

In the second part the specific role of the EMI is reviewed. To the extent that the EMI President, the Director-General and other senior members of the staff succeed in taking charge of the work in the Council, The Alternates' Committee and the various writing groups monetary coordination and the preparations for full monetary union should be enhanced. The latter would also be helped if the EMI were to be given some operational functions beyond the passive holding and managing of international reserves specifically mentioned in the Treaty. An operational role also in domestic money market operations and in clearing in the ecu market appears desirable.

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¹ To appear in Steinherr, A. (ed.), From the Werner Plan to EMU. EIB, 1994.

I. Introduction.

When the subject of the present paper was agreed with the organisers of the conference early in 1993 the choice seemed reasonable and not excessively demanding. Following the expected ratification of the Maastricht Treaty in the course of the summer and autumn of 1993 by the three laggards - Denmark, the United Kingdom and Germany - stage two would, by November 1993, be imminent with its intentions of reinforced budgetary convergence through the rules of the Treaty and of tighter monetary coordination assisted by the start of the European Monetary Institute (EMI). A paper under the proposed title would have focused not least on how the EMI might reinforce application of the extensive rule book of the European Monetary System (EMS) as it then existed.

Maastricht was duly ratified by Denmark in May and by the two final EC Member States in the course of recent months as challenges to the legality of ratification were defeated by the respective national courts in the United Kingdom and Germany. Nevertheless, the whole process left little of the momentum which initially inspired the project of Economic and Monetary Union (EMU) and the accompanying effort to deepen political integration. As far as the EMU process is concerned, the final destination was always much more clearly perceived than the transition. The partial suspension of the EMS on 1 August 1993 sharpens this distinction further, since the transition can not any longer be perceived to proceed almost linearly from stage one through the transitional stage two to the final locking of exchange rates and the introduction of the single currency. The rule

book has to be partly rewritten and new interpretations must be given to formulations in the Treaty which had earlier seemed straightforward.

The decisions taken by the European Council in Brussels at the end of October 1993 to locate the EMI in Frankfurt and to designate Professor Alexandre Lamfalussy as its first President, important as they are, do not help much to see where the EMU process is heading. The current trend, particularly among German policy-makers, is one of demanding maximalist prerequisites for entering full EMU, notably through a rigorous interpretation of the budgetary convergence criteria, combined with a minimalist interpretation of the functions of the new EMI. This is a potentially inconsistent mixture, unlikely to lead to EMU within any time frame. It is particularly urgent to discuss the pros and cons of a return to the narrow margins EMS and the reinforcement required to make a revived EMS more robust.

The present paper focuses next on the role(s) of the EMI. The author does retain a certain nostalgia for the early preparatory work on EMU when it was still possible to entertain bold ideas on some genuine pooling of monetary authority during the transition. But one now has to approach the latter subject by asking in a fairly pedestrian way what the EMI could realistically do within the Articles of the Maastricht Treaty and the associated Protocol on the Statute of the EMI, while keeping in mind the inauspicious starting point of the wider fluctuation margins in a somewhat discredited EMS.

The discussion in the rest of the paper is organized in two main sections. A crucial question for stage two is whether and how a return to a narrow margins EMS can be managed within a reasonable time frame, say for the end of 1994. This is the subject of section II, which starts from a cautious recent statement by the new EMI President. The section ends with a brief discussion of the reorientation of the EMI's tasks in case the wide margins are preserved which may currently appear to be the more likely prospect. Section III turns to the working methods of the new institution and to the more specific items on the EMI agenda as outlined in the Maastricht Treaty and the associated Protocol on the EMI Statute. A few tentative conclusions are offered in the final section IV.

II. Monetary coordination in stage two: a return to the narrow margins ?

When the widening of the margins of fluctuations was decided in the ECOFIN Council on 1 August, several governments made statements to the effect that the arrangement was temporary and that a return to the traditional narrow margins should be envisaged by the end of 1993 or in the course of 1994. Some governments showed disappointment that their currency had not been in a position to adopt a "Dutch solution", i.e. sticking to the $\pm 2 \frac{1}{4}\%$ margins against the DM. Subsequently little has been heard about any early return to narrow margins and the current mood, exemplified in the new EMI President's first public statement, appears to be to pour cold water on the notion:²

"Firstly, I am not sure that simply a return to the pre-1992 ERM can be regarded as a realistic objective. Secondly, I am sure that it would not be advisable to set any precise timetable for re-establishing a more constraining exchange rate mechanism. Such a move should be dependent on a number of desirable developments: a better business cycle situation; renewed progress towards broadly-based convergence; the restoration of the credibility of the policies of the Member States, and, last but not least, fiscal policies which give support to, rather than hinder, stability-oriented monetary policies."

² Lamfalussy (1993), reply to question 5 from the European Parliament Committee on Economic and Monetary Affairs. The question was: "In which way can the EMI contribute to the recovery of monetary stability, and, in that context, can the EMS be restored without adaptations ?"

This is a rather forbidding list of conditions for reestablishing anything like the old EMS. It is also noteworthy that the list contains exclusively non-monetary conditions and, in particular, no hint of what would be required in terms of revisions of the EMS rules themselves to make a return to narrow margins feasible. Essentially, the EMI President appears to imply that no conceivable revision of the rules could substitute for any of the non-monetary prerequisites listed. While his statement is no doubt a loyal reflection of current attitudes in the EMS central banks to warn the political authorities against the idea that "monetary gimmicks" can paper over significant policy differences between countries, the list appears too critical of current performance and incomplete by its omission of any references to the EMS itself.

The EMI President is too critical in giving no credit to the high degree of convergence with respect to several of the Maastricht criteria which is already observable, or likely to become so, notably with respect to inflation and long-term interest rates.³ Convergence in these nominal respects will be difficult to improve under any conceivable circumstances, once the German inflation rate edges down into the 2-3 % interval (for consumer prices) which it should reach in the course of 1994. Budget deficits are currently on average more than twice the reference value of 3 % to be aimed for according to the Maastricht Treaty, but the dispersion around this average has become smaller, as some of the countries which had some room for manoeuvre left have allowed some cyclical increase in the deficit, while taking also modest discretionary actions to stimulate their

³ See figure 1 in Daniel Gros' comment, this volume.

economies (France, Denmark). Since all countries are faced with the same unfavourable recessionary trends and most of them have broadly similar budget deficits due to a common cyclical component, it is not clear why monetary policies have to be so different as to rule out a tight exchange rate arrangement between them. The competitive positions inside the European Community are generally seen by both officials and independent analysts as being near equilibrium levels and external imbalances are generally modest. The confirmation of past central rates on 1 August was another indication that these rates are broadly in line with economic fundamentals.

Even if one grants that the above list of reasoning softens the stringent non-monetary requirements of Mr. Lamfalussy for recreating the previous EMS or something close to it, the question remains whether the EMS rules themselves need to be rewritten or simply adhered to more rigidly. The central banks and the EMI will have to address this question and in a more precise way than was done in the two official reports prepared in April 1993 to draw the lessons of the currency turmoil of 1992-93.⁴ Putting the responsibility for restoring the previous EMS - of which all participants were proclaimed supporters prior to the August relaxation - solely on factors beyond their own control will not suffice. In order to begin such a discussion, an autopsy first has to be performed on the narrow margins EMS.

The rule book of the defunct EMS was the so-called Basle-Nyborg

⁴ Committee of Governors (1993) and Monetary Committee (1993).

Agreement of 1987.⁵ This agreement was negotiated as a response to the speculative attacks which had triggered a realignment in January 1987 at a time when economic fundamentals did not suggest a need for a realignment. The Basle-Nyborg Agreement made explicit an emerging consensus among the central bankers which survived virtually intact for more than five years. The EMS was to be defended, in a world of increasing capital mobility, by a mixture of three mechanisms. Although the precise application of them was not spelt out in the agreement itself, subsequent practice justifies the following summary description: first, currencies should be allowed to move inside the margins in response to market pressures. Second, if this first buffer had proved inadequate, interventions could be used to stem undesirably strong fluctuations; for that purpose the use of the Very Short-Term Financing Facility was made more easily accessible to debtors wishing to intervene intramarginally. The credit period was also extended (from 2½ to 3½ months) in order to ease the problems for debtors of creating a reflow into their currency sufficient to settle the intervention debt incurred vis-à-vis the issuers of a strong currency. Third, if tension persisted with interventions reaching large figures, short-term interest rate differentials should be adjusted to make future interventions unnecessary - or at least small.⁶

⁵ Press Communiqué of the Committee of Governors of 18 September 1987, reprinted in Gros and Thygesen (1992), p. 99.

⁶ This interpretation of the sequencing of the defensive mechanisms may not be shared by all officials. The Bundesbank, followed by some smaller Northern central banks, has tended to emphasize a rapid escalation all the way to interest rate adjustments, possibly skipping interventions altogether, or using them primarily to bolster changes in interest rates.

If these three defensive mechanisms did not abate the tensions, a realignment would be resorted to, though this final point is not mentioned in the official text from 1987 which is in itself significant in view of the emphasis on realignments in the 1993 official reports. In 1987 the central bankers were anxious to be seen to regard realignments as a last resort and certainly not as a pre-emptive weapon. Since the general consensus was that the latest realignment of January 1987 had been superfluous, it seemed desirable to stress that the central rates should only move in truly exceptional circumstances.

Several policy-makers commented on the Basle-Nyborg Agreement by explaining that, if a realignment had become inevitable, it should be sufficiently small to permit continuity of market exchange rates. This implied that realignments should at a maximum be within twice the width of the margins then in existence - or 4-4½% for most of the participants - assuming that weak and strong currencies switched places inside the margins at the time of realignment. Such a switch could be encouraged by an appropriate management of short-term interest rates; in other words the central bank of a devalued currency should not rush into a lowering of interest rates. Avoiding jumps in market exchange rates was seen as strategically important in deterring future speculative attacks, since no immediate gains would then be made by market participants from taking open positions. Indeed, speculators would lose since they would be incurring abnormally high borrowing costs in the currencies in which they had gone short.

For a long time the provisions of Basle-Nyborg worked remarkably well. They were put to a severe test already in early November 1987 when, after the crash in the New York Stock Exchange, the US dollar fell and created asymmetric movements of EMS currencies. Following significant intramarginal interventions Germany and France moved interest rates temporarily in opposite directions which effectively checked speculation in a realignment.⁷ The Basle-Nyborg Agreement also survived without major conflicts the removal of residual capital controls in eight EC countries in the 1988-90 period, the entry of two major additional currencies (peseta and sterling), the narrowing of the margins for the lira in January 1990 and the entry of the escudo in April 1992. In retrospect, it is impressive that a simple rule book could suffice to keep the EMS together for more than five years. A careful analysis of how tensions were contained in several episodes would be instructive to undertake in order to modify the present excessively critical evaluation in official circles and in the public debate of the EMS based on its final year of existence.

By the late summer of 1992 the Basle-Nyborg Agreement with its carefully graduated responses to tensions did become inoperative, as its basis premises were violated one by one. Fluctuations inside the margins did not provide the intended useful initial buffer mechanism, since markets began to interpret movements of some currencies towards or to the bottom of the margins as a sign of impending realignment rather than as an event increasing the likelihood of future appreciation back towards the centre of the margins. Rather than

It was disappointing that no similar effort was made in somewhat analogous circumstances in 1993.

obviating the need for intervention, movements in the band tended to increase their size. Interventions came to be relied on too heavily, particularly since both strong and weak currency countries were anxious to protect their domestic financial markets against the impact of external flows. In short, both groups of countries largely sterilized their interventions. As is well known, the more complete is the degree of sterilization, the more the need for interventions is perpetuated, and the more countries will try to shift the burden of intervening to the partner country at the opposite side of the margins. Given the need to repurchase a "weak" currency from the central bank of the "strong" currency within a short span of months, even when the latter was extended to 3¹/₂ months by the Basle-Nyborg Agreement, the spirit of the agreement was violated by the build-up of such massive requirements for subsequent settlements that the necessary reversal of private capital flows began to look improbable. Anyway, by September 1992 the interventions by the Bundesbank to support the lira had become so large that the Bundesbank invoked its 1978 understanding with the German government - not unknown to the EMS partners, though largely forgotten after nearly 14 years of desuetude - that the presumed mandatory interventions at the margins could be suspended if they began to threaten domestic monetary stability.

In September 1992 an important reason why the escalation from interventions to adjustment of short-term interest-rate differentials did not work was that the two countries with currencies under attack -

Italy and the United Kingdom - found it technically difficult⁸ and potentially counterproductive to raise the rates in order to defend the currency. The rapid spill-over of defensive hikes in short-term interest rates to long-term rates on government bonds (Italy) and mortgage rates (the United Kingdom) weakened the resolve of these two countries to follow the Basle-Nyborg guidelines. In Italy, determined action along these lines would have aggravated the budget deficit which was the major source of lack of confidence in the currency. In the United Kingdom higher mortgage rates would have sapped the political will to continue in the EMS and, in the view of some UK observers, might have made ratification of the Maastricht Treaty - however tenuous the link between the two issues - impossible.

To make the picture of the violations of the EMS procedures complete, the first realignment tried in practice - the 7% devaluation of the lira against all other EMS currencies - was much larger than twice the width of the margins and still considered inadequate by the market participants who had identified a more substantial overvaluation of the lira. The sizeable gains made by speculators, and the prospect of more to come in the shape of further jumps in the lira or other currencies, created an explosive mixture, prompting a few days later the exit of sterling and the lira. These events in turn triggered a series of sizeable realignments inside the EMS, lasting until May 1993, because the competitive positions of the remaining participants had weakened and because speculators had "tasted blood".

⁸ The UK authorities point to problems inherent in their techniques of monetary management which dampen the liquidity effects of foreign exchange interventions; the UK money supply showed few traces of the major outflow of reserves.

It can be argued that the EMS had by 1992 become indefensible by means of the combination of instruments available. According to this view distortions in relative prices had built up over the five years since the previous realignment while inflation rates had not yet converged enough to justify rigid nominal exchange rates. The EMS authorities were in 1992 committing the classical error in managing the exchange rate system, viz. to try to defend basically misaligned rates, an error which market participants can spot and force to be corrected.

It is more puzzling why speculative attacks continued for another ten months after the more obvious misalignments had been corrected. As far as the ultimate crisis in the EMS which led to the major relaxation of the margins on August 1 is concerned, it would appear that the error was the opposite of that of September 1992, viz. to fail to defend a constellation of exchange rates which was not in any obvious way out of line with fundamentals. In such a context it is necessary to ask what would have had to be changed in the EMS rule book in order for the system to have survived. The answer to this question is basically the same as that to the question of what would need to be changed or reinforced in the EMS in order to make a return to narrow margins viable.

The autopsy performed on the EMS suggests that two modifications would have been required, cet.par., for the survival of the system or for the reintroduction of narrow margins: a declared readiness to take on unlimited interventions by creditors and early escalation to changes in short-term interest rate differentials to ensure that interventions

would not, in fact, have to be enormous. Neither one of these modifications appears fully adequate in itself, although making the intervention obligations of the creditors more explicitly unlimited would in itself have helped to reduce their actual size; some combination may have to be aimed for. Put in other words: some form of monitored unsterilized intervention has to be practiced by both weak and strong countries. Is it possible to be more specific as to the provision required ?

A restatement of the obligation to intervene without limits could be seen as a major favour to the weaker participants, since they can by themselves only undertake to defend their currency by means of the international reserves they own or can mobilise at the short notice required. While these resources can be substantial, the experience of 1992-93 has been that even a well-endowed central bank (Italy, Spain, France, and - outside the EMS - Sweden), could lose an unacceptably large part of their owned and borrowed reserves during a speculative attack. While the EMS rules of intervention are in form symmetrical, in practice the reserve constraint assures that it works asymmetrically. This situation is somewhat eased by the shortness of the credit period of the Very Short-Term Financing Facility which was designed to reverse early on the liquidity impact of the interventions by the creditor central bank(s) by offering a firm commitment from the debtors to repurchase their own currency accumulated by the creditor within a fairly short period of time. This arrangement was not sufficiently robust in view of the recent size of private capital flows which sapped both the Bundesbank's willingness to undertake in principle unlimited commitments for even the short period required

and the capacity of the debtors to withstand.

If a narrow margins EMS is to be restored - without there being any assurance that central rates can not change - a different package of commitments and obligations would seem necessary for the restoration of credibility. Just before the turmoil of the past summer, a study group set up by the European Parliament outlined a possible package of such commitments and obligations designed to improve the robustness of the EMS.⁹ On the one hand it was proposed to remove the obligation for debtors to repurchase their own currencies, or at least to extend the credit period substantially, possibly to the start of final EMU. Leaving the reform at that might well have eased the concerns of the debtors and of market participants, but the creditor central banks would have been justified in regarding the proposal as a recipe for full loss of monetary autonomy not only in the short, but also in the longer run. The reform would certainly imply that it would become impossible for a creditor central bank to insulate through sterilization its domestic financial market from the impact of the interventions.

It was therefore suggested to balance the first proposal with a second one to assume that the debtors do not abuse the greater freedom which a confirmation of the intervention obligations and the lengthening of the credit period would imply. This could be done through a provision that a country which had lost a large amount of international reserves by its own and partner interventions - for

⁹ Collignon et al. (1993). The two proposals referred to in the text are due to Peter Bofinger and Graham Bishop respectively.

example corresponding to some percentage of its broad money supply, say 10 or 15% - would also lose its monetary autonomy. If a country passes the chosen threshold, the creditors would take over, raise interest rates in the debtor country or take other measures to restore confidence in the weak currency. Such a prospect would give the debtor a strong incentive to take action early of the type that might be forced upon him later. This second proposal will be regarded as appealing by those monetary authorities who see themselves inherently in the role of creditors, but it might still be insufficient to lay at rest their apprehensions about the first proposal. Anyway, the prospect of assuming responsibility for another country's monetary policy is not inviting and would be burdensome and conflictual as long as political integration is not more fully developed.

Both proposals were intended to oblige the participants in a narrow margins arrangement to make their domestic financial markets reflect external pressures on their currencies. The first makes sterilization more difficult for the creditors, the second pushes the debtors into a more rapid escalation of the defensive mechanisms of Basle-Nyborg towards the use of what was always regarded as the main weapon, higher short-term interest rates. As a package it had a certain logic making it a possible candidate for EMS reforms prior to August 1993. Given the present climate of reluctance to intervene which was the main inspiration behind the relaxation of the margins, and the evidently jealous efforts to retain monetary sovereignty during stage two, the prospect for implementing anything like the two proposals now appear dim for quite some time.

The EMS could be regarded as a skillful compromise between rules and discretion. The rules defined the central rates, the intervention obligations, settlement procedures and the normal conduct in crisis in the form of the Basle-Nyborg Agreement; the latter left some room for discretion, notably about who was to adjust to whom. On 1 August much of the rule book disappeared or became inoperative; what remains is a largely discretionary system. A return to narrow margins reinforced along the lines suggested would bring back an enlarged rule book, and reestablish the old balance between rules and discretion. Something like that would probably be required as a monetary prerequisite for reentering the narrow margins.

At the same time the countries reentering narrow margins should at a minimum refrain from any statement that realignments were still considered an instrument and, even more so from repeating the notion in the April 1993 official reports that realignments should be used more flexibly and ahead of market expectations of such actions. By emphasizing flexibility in the EMS in the form of realignments, the officials stacked the cards against their own efforts to maintain the narrow margins EMS. If there is to be a return of a significant number of currencies to the narrow margins - at a minimum of the seven which were in the narrow margins before August, preferably also of the two Iberian currencies and of some of the currencies of the applicants for EC membership when their entry into the European Union occurs in 1995 - it should be made clear that the revived system is only open to those countries that have no intention of undertaking realignments during the rest of the transition to EMU.

The argument of this part of the paper is, in short, that there are also monetary prerequisites for returning to narrow margins EMS. Fewer reservations by creditors as to interventions combined with stronger mechanisms to restrain debtors in their use of the automatic facilities would be an economically sound approach to a revival of a system, provided pretensions to retain flexibility in the core of the system, the central rates, were suppressed.

The present paper shares the first point of the EMI President's statement reported at the start of this section. It could not be regarded as a realistic objective simply to return to the pre-1992 EMS; some reinforcements are needed even if the non-monetary conditions are broadly right. The EMI Council and its President face an important task in clarifying how such reinforcements would be designed in detail. If the reinforcements are impressive, they might possibly substitute for some of the very stringent non-monetary prerequisites for reviving the EMS listed by Professor Lamfalussy. The EMI would itself have an essential role in monitoring any remaining rules in the EMS and as an arbiter in the discussion of how discretion is to be used inside the rules at any time. If a revised system were to go as far as envisaging more direct interventions into the monetary policy of a debtor country, the EMI, or more precisely the qualified majority of 9 out of 13 members of its Council, would be a more natural executor of the appropriate recommendations and actions than one or more creditor central banks.

It is impossible at the present time to assess whether a narrow margins EMS could be restored - reinforced or not - within a reasonably close

time span, say by the end of 1994 or so. The option deserves careful study, both by the EMI and by the national monetary authorities. Its potential use can not simply be made to depend on developments in other areas. It is also important to examine the option in the perspective of EMU; the absence of references to the final stage of EMU in official statements since mid-1992 has been remarkable, but with Maastricht ratified, and the EMI about to start this can no longer be postponed.

Whether the EC Member States do return to the narrow margins will also be highly relevant to that part of the EMI's agenda which deals with issues other than the preparation for the joint policy in stage three.¹⁰ This is the subject of the following section. But before turning to that it is appropriate to reflect in general on the nature of a wide margins EMI and its implications for the EMU process.

The ECOFIN Council on 1 August wisely decided to retain the central rates and not simply to suspend the EMS. The main implications of the wide margins is to take away for a lengthy period the obsession in financial markets with the perceived need for changing the central rates in order to accommodate temporarily a more differentiated interest rate policies among the participants. Moderate interest rate cuts in those countries where there is a need to ease borrowing costs in the late stages of the recession no longer

¹⁰ This paper does not consider intermediate options between the present system and a return to something like the previous $\pm 2 \frac{1}{4} \%$ (though those margins were arbitrary), since conceivable intermediate options would only confer benefits if countries embarked on a more divergent course than seems likely today.

endangers the credibility of the central rates. One may put the point differently: while market participants may well have accepted even before August that central rates were appropriate from the viewpoint of longer-term fundamentals (which anyway are of less interest to investors with a fairly short time horizon) this was overshadowed by a lack of credibility for the short-term interest rate policies required to sustain the parity grid with narrow margins and this in turn made the central rates look unsustainable. In the present more relaxed atmosphere the underlying credibility of the central rates is reappearing; interest rate cuts still tend to weaken currencies though only marginally, but anticipations of a reversal towards the centre of the margins sustain capital flows into the weakened currency and limit depreciation. Indeed, after the weakening in the early weeks of the new system currencies have stabilized at levels not substantially different from the levels observed before August.¹¹ If one assumes that the positive scenario outlined above prevails, exchange rates would not necessarily move much more during 1994. This is, of course, conditional on the persistence of fear by the monetary authorities of testing markets aggressively and on their perception that such behaviour might jeopardize any prospect of a return to narrow margins - an option they like to retain, even if they in the end do not exercise it.

In this positive scenario Member States will retain the option of reviving the narrow margins, but they may begin to feel so

¹¹ By late December 1993 the Belgian and French francs had returned to their pre-August EMS margins, while the Danish krone was only marginally below it.

comfortable with the wide margins that they feel little incentive to go back to narrow margins. Discussions at the national level will come to focus increasingly on how to facilitate the preservation of low and stable inflation rates through domestic policy, notably targets for monetary aggregates and/or nominal income. Discussions in the EMI will focus on the compatibility of these national objectives, the convergence of long-term interest rates and the implications for exchange-rate stability, while the monitoring of interventions, sterilization and linkages between short-term interest rates will fade more into the background. There will be much to do for the EMI and no need to stop regarding the nine participants in the EMS as a group of countries with cohesion (as seems to be the current trend in some recent reports by private financial institutions or international organizations such as the IMF).

The wide margins may also bring the two currencies which left the EMS in September 1992 closer to those which still have a central rate. Policy discussion in the United Kingdom in particular, but also in Italy, runs more parallel to that in the EMS countries after 1 August than during the 10-11 months preceding that when most of the EMS countries focused narrowly on their links to German short-term interest rates. The costs to the two floaters of joining the wide margins must now seem negligible, but of course the benefits in terms of credibility effects of joining the present system must also be seen as modest. But at least the present system offers a better prospect for dispassionate discussion of an eventual reentry of sterling and of the lira with central rates that did the narrow margins EMS. For both, of course, reentry requires a careful evaluation with their partners of the

central rate to be chosen.

Some observers obviously believe that a resumption of the EMU process obliges the EMS participants to return to narrow margins. The Maastricht Treaty sets (Art. 109 j) as one of the entry requirements to the final stage of EMU that a Member State, in order to qualify, should meet the criterion that it has observed

"... the *normal* fluctuations 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" (italics added).¹²

This may appear at a superficial reading to require those countries which want to qualify for full EMU when the first effort has to be made to examine whether a majority of EC Member States is ready (before the end of 1996) to reenter the 2VA % margins before the end of 1994.

This, fortunately, appears to be a misinterpretation. The decision of the ECOFIN Council to widen margins to $\pm 15\%$ could be seen to have made the latter the "normal" margins.¹³ According to this

¹² Similar wording is used in the separate Protocol on the convergence criteria (Art. 3); this Article adds the proviso that management of the currency should have been "without tensions".

¹³ The fact that the DM and the guilder have preserved their previous narrow margins by a separate bilateral arrangement does not modify this conclusion. This example may, however, offer a hint of what may be attempted by some other EMS countries in the course of 1994-95.

interpretation the 1 August decision has opened the option that Member States, when a majority of them have maintained their central rates in the wide margins without tensions for two years - which should be much easier than performing this act in the narrow margins - may proceed directly from the wide margins to the permanent locking of exchange rates at the beginning of the third and final stage. Such a qualitative jump would no doubt require that the prospective participants in full EMU - of which there would have to be at least six¹⁴ - had in fact seen their currencies stabilize to such an extent that only a minor part of the scope for fluctuations available in the wide margins had been used.

The notion that EMS participants could move straight to monetary union from a system which is presently regarded as dangerously loose may seem farfetched. The point made here is simply that there is no formal obligation to return to narrow margins for the EMU process to resume. Substance, i.e. de facto convergence and exchange rate stability is, in this case, more important and impressive than form.

It is important to pay attention to this second road to EMU. Some countries may be positively interested in it, while others may accept it as a second best. This approach would make the road to EMU easier because it appears to get around two potentially destabilizing features of the Maastricht Treaty. Had the narrow margins still been in existence, 1994 would have been the last date for sneaking in a

¹⁴ In view of the UK and Danish opt-outs from the final stage, these countries would not participate in the vote, hence the majority drops to six.

devaluation while retaining the credentials to qualify for the final stage by late 1996. The narrow margins would also have left a residual risk of a jump in exchange rates at the very end of stage two at the time of choosing the conversion rates to be used for the locking of exchange rates. Though such last minute realignments never looked probable, they were, unfortunately, not explicitly ruled out in the Treaty. If wide margins continue in existence right through stage two, the transition to the final stage could appear less risky from this perspective. Some currencies may at that time have stabilized inside the margins at a rate which does not coincide closely with the central rate. If so, markets will anticipate that a recent average of market rates will be chosen for the conversion, enabling the start of the final stage to take place without disruptive discontinuities in market exchange rates.¹⁵

In short, continuing with the wide margins throughout stage two can not be met with the objection that they are thereby blocking any advance towards EMU. Nor could it be maintained that this approach is entirely without advantages. Going back to narrow margins remains the main approach to EMU, but it is not the only one.

III. The agenda of the EMI.

The present section will look briefly at the tasks confronting the EMI and at the ways in which the new institution with its Council and

¹⁵ In this situation it might be useful if the ECOFIN Council were to announce some time, say six months, in advance of the starting date of the final stage what rates would be used for conversion to smoothen the transition further. I owe this point to Peter Kenen.

President will operate differently from the procedures of the Committee of Governors which has been in charge of monetary coordination and the planning of EMU during stage one, lasting from mid-1990 to the end of 1993.

The section begins with an evaluation of the significance for the EMI's work of its institutional separateness, the autonomy of its Council and the greater centralization of initiative and monitoring in the new body. It then turns to the implications of the provisions in the EMI Statute that the new body may hold and manage foreign exchange reserves for the individual central banks, asking whether other operational tasks might be transferred to it. The section further discusses whether the EMI's role in facilitating the use of the ecu might take on increasing significance. Finally, the EMI's forward-looking tasks to prepare for the joint monetary policy in stage three needs to be evaluated also in the perspective of its feed-back on current monetary coordination.

First, does the creation of the EMI on 1 January 1994 generate any realistic expectations that its working methods and efficiency will become visibly different from those of its predecessor(s), the Committee of Governors (and the Board of the European Monetary Cooperation Fund, EMCF) ?

Ever since the Intergovernmental Conference decided, shortly before the signing of the Maastricht Treaty, that the new institution should not be vested with any major new authority and that the name EMI should be given to it in order not to confuse it with the powerful

successor institution in stage three, the European Central Bank (ECB), the tendency of most national officials has been to emphasize the extent to which the EMI should be seen as simply a continuation of the Committee of Governors.

There can be no doubt that there was a major scaling-down of the new institutional framework for the transition from the time of the Delors Report of 1989 until the signing of Maastricht. The Delors Report envisaged the new central banking structure as evolving in a gradualist way from the start of stage two with the set up of the ECB as the most important feature of the stage. The Delors Report recognized the difficulties of organizing a gradual transfer of decision-making power from national authorities to a Community institution at a time when "the *ultimate* responsibility for monetary policy decisions would remain with the national authorities" (italics added).¹⁶ This formulation seemed natural in view of two facts: (1) realignments had not been ruled out in stage two, and (2) Member States were not obliged to give independence to their national central banks before the end of stage two. This did not prevent the Delors Report from proposing a number of important innovations, including the pooling of part of foreign exchange reserves in the new institution and firm ex ante guidelines for national monetary policies. The language in recent pronouncements by officials is substantially more guarded; the new EMI President also spoke in his statement quoted above of the need to avoid " infringing on national monetary policy autonomy". The slippage in the whole concept is evident. Yet it could be a mistake to

¹⁶ Committee for the Study of Economic and Monetary Union (1989), Art. 57.

regard the EMI as simply a consultative body continuing the informal coordinating efforts of its predecessor, the Committee of Governors.

In particular, the initiative will shift. The nomination of a President of the EMI who is not one of the Governors and therefore unlikely to feel bound to aim for the lowest common denominator of current views among his colleagues will mark a change. The three Presidents of the Committee of Governors during stage one, Messrs Pohl, Hoffmeyer and Duisenberg, have all come from the more cautious of the EMS participants which should make the change more visible. It would be appropriate, if not only the EMI Council, but also the bodies preparing its work - the Committee of Alternates (typically the Deputy Governors), and the numerous sub-committees and working groups - were to be presided over by officials of the EMI rather than by national representatives. This step, feasible only when the EMI staff has been nominated over the next few months, would assure a tighter work plan, a more coordinated effort and less defensiveness in the surveillance of national monetary policies. One wonders whether other international organizations would long survive a working method where the discussion of individual country situations and policies is based primarily on oral presentations by the individual countries or by their contributions to written documents. The EMI must, as do other organizations, make use of the services of its own staff for setting the agenda and not simply for providing a forum for meetings. The presence in the EMI as it moves to its new site in Frankfurt in the course of 1994 of a growing professional staff with the task of looking systematically at the common interest with the appeasement of national views only a subsidiary consideration, will

make a qualitative difference. Unfortunately, but not surprisingly, there appears to be resistance from some participants to this type of evolution.

The Council of the EMI will have more scope for coordinating policies efficiently than the Committee of Governors, also because several Member States have not stuck to the cautious line they took in the Maastricht negotiations on one important issue. They have proceeded to give autonomy to their respective national central banks earlier than they envisaged two years ago, as exemplified by the legislation recently enacted to give autonomy to Banque de France and the changes introduced in 1992-93 in Italy and Spain. In its exercise of collective responsibilities the EMI Council is already endowed with more independence of the political authorities than its predecessor. The Maastricht Treaty and the EMI Statute state explicitly: ¹⁷

".. .the Council of the EMI may not seek or take any instructions from Community institutions or bodies or governments or Member States. The Community institutions or bodies as well as the governments of the Member States undertake to respect this principle and not to seek to influence the Council of the EMI in the performance of its tasks."

This is a foretaste of the independent authority to be vested in the Governing Council of the ECB from the start of stage three. These provisions take on special significance in the perspective of the text of Art. 109 f, 4. of the Maastricht Treaty which confers upon the

¹⁷ Protocol on the EMI Statute, Art. 8.

EMI Council the right to formulate by a qualified majority, i.e. presently nine of its 13 members, opinions and recommendations not only on the overall orientation of monetary policy and the functioning of the EMS, but also on the conduct of policy in a Member State. It is hard to believe that such opinions and recommendations coming from a significant majority of increasingly independent central banks and prepared by the professional analysis of the EMI will fail to have an impact on the policies of those to whom they are addressed. Whether monetary policy is during stage two to be only "ultimately", or more or less fully, in national hands, these provisions introduce an element of collective responsibility which is new. This conclusion holds whether the EMI will be acting in the framework of the present wide fluctuation margins or after a return to narrow margins. In the wide margins the EMI Council would no doubt find use for the provisions of Article 103, 4 of the Maastricht Treaty in reinforcing tight multilateral surveillance of a country which pays inadequate attention to its exchange rate.

Second, to what extent can the EMI take on new operational tasks and what difference would it make ?

The Maastricht Treaty and the EMI Statute contain one potentially significant operational role for the EMI, which may "hold and manage foreign exchange reserves as an agent for and at the request of national central banks."¹⁸ This role will be determined by the readiness of individual central banks to set up the appropriate contractual framework and it is subject to the proviso that the

¹⁸ Protocol of the EMI Statute, Art. 6.4.

resulting transactions "shall not interfere with the monetary policy and exchange rate policy of the competent monetary authority of any Member State and shall be consistent with the objectives of the EMI and the proper functioning of the exchange rate mechanism of the EMS.¹¹¹⁹

It is reportedly uncertain at the present time how many countries would be prepared to let the EMI become its agent in foreign exchange management and what the significance of the provision could be in the environment of wide margins in the EMS. Some countries are apparently even contesting whether the wording "hold and manage" applies to foreign exchange interventions or only to more passive management functions, and whether the agent function applies to all foreign exchange holdings or should exclude EMS-currencies. If confined to non-EMS currencies and to passive management of assets, the provision would, indeed, become rather meaningless.

Some pooling of operational activity in joint-owned institution early in the EMU process was proposed by none other than the current EMI President in one of his contributions to the Delors Committee.²⁰ He proposed a common operational facility incorporating all of the foreign exchange and domestic market activities of the national central banks. This was seen to have several advantages: (1) it would make the operations of each participant fully transparent to the other

¹⁹ Ibid.

²⁰ Lamfalussy (1989).

participants; perhaps surprisingly to outsiders, this has not been the case up to now, except for interventions proper which are monitored through the telephonic concertations, or bilaterally in the case of intramarginal interventions, and recorded in the books of the EMCF (now transformed into the EMI); (2) it would permit a common appearance in the markets, since private market participants would be unable to determine the source of instructions for operations from the jointly owned institution; the proposal would thereby shift the informational advantages clearly in favour of the authorities; (3) it would provide a more efficient training ground for national foreign exchange and money market operators during secondment to the joint operational centre than ad hoc concertations of interventions provide today, hence improving the preparations for the final stage; (4) it would provide some scope for cost savings through centralization in analogy to what commercial banks achieve by organizing their foreign exchange and money market operations efficiently in one location.

Despite these strong arguments the Lamfalussy proposal never won much favour among central bankers in the Delors Committee or among the drafters of the Maastricht Treaty. Some found it too minimalist; France proposed outright pooling of foreign exchange in stage two - or even in stage one - while others wanted to assign to the new institution more definitive authority over an important domestic policy instrument (reserve requirements), hence fore-shadowing the use of a common instrument in stage three.²¹ Most central bankers and other national officials were critical of the proposal, maybe

²¹ For a more detailed discussion, see Gros and Thygesen (1992), pp. 363 ss. or Bini-Smaghi, Padoa-Schioppa and Papadia (1993).

because they were preoccupied less with the transitional stage two than with the emerging detailed blueprint for the final stage of full monetary union with an ECB combining centralized decision-making with decentralized implementation of policy. The idea of early centralization of some or all operations did not fit in very well. In the end, only the voluntary bilateral pooling of foreign exchange operations by individual central banks survived and even that more modest step is still subject to criticism and suspicion from the Bundesbank. The Germans have clearly indicated that they do not intend to make use of this provision and they are apparently trying to discourage others from entering into bilateral contracts with the EMI. In the meantime the move to wide margins has made the pooling of foreign exchange management, even if including interventions in the EMS-currencies, look out of date, since the very purpose of wide margins is to minimize reliance on interventions.

It is an important task for the EMI - which will come naturally to its President who provided the original inspiration on the subject - to reflect on the present usefulness of this approach. If several central banks show an interest and the joint operational activities are not too severely circumscribed by the exclusion of the management of assets in the EMS currencies and of interventions, some pooling of operations could still be worth pursuing for the reasons mentioned, even though the environment has changed. The purpose has now become primarily forward-looking rather than to provide an element of a common policy for stage two. If the new environment of the wide margins persists throughout stage two, the pooling of operations ought, in this author's view, to be extended, as envisaged in the

original Lamfalussy proposal, also to domestic money market operations.

Art. 109 f, 7 in the Maastricht Treaty and Art. 7.2 in the EMI Statute open the possibility that the EMI may perform tasks for the preparation of stage three in addition to those currently listed, if such tasks are conferred upon it by the Council, acting unanimously on a recommendation from the Commission and after consulting the European Parliament and the EMI. There would appear to be good arguments in favour of seeking the assignment of (a significant part of) domestic money market operations to the EMI to underpin its effort to prepare for the future joint policy with a positive feed-back on stage two itself. As argued above, with the wide margins the EMI's task of coordinating monetary policy shifts from the more mechanical rule book of the narrow margins EMS towards the monitoring of the consistency of national monetary management and of the methods by which the individual central banks exercise domestic monetary control through operations in their respective money markets. Familiarity with these operations thereby becomes a more important asset also in a current perspective. Assigning an operational role to the EMI in this area would greatly enhance the authority of the new institution.

Third, the EMI is entrusted with the tasks of facilitating the use of the ecu and overseeing its development, including the smooth functioning of the ecu clearing system.

Here again the EMI is faced with more of an uphill fight than was

foreseen in the Maastricht Treaty. The ecu remains the prospective future single currency in EMU, but the importance of this quality has, for the time being at least, in view of most observers receded further into the future while becoming more uncertain. The pressure from market participants to anticipate the use of the future single currency by making rapidly increasing use of the unit during stage two - which could have become almost the major task confronting the EMI in circumstances more favourable to rapid realization of full EMU - has accordingly weakened. In the present very flexible EMS and with two major currencies, representing one fourth of the basket, still floating, the ecu has reverted to its earlier role as a potentially useful hedge against fluctuations in individual currencies, which may still be enough to spur some further growth in its use, but not any qualitative change. In any case, the hostility of the Bundesbank to any form of encouragement of the evolution of the ecu appears to have increased; most governments, including those of the United Kingdom and France, continue to use the unit in their bond issues and clearly take a much greater interest in the smooth development and growth of the market.

Apart from the provision of statistics and current analysis of trends in the ecu markets, including that the unit is, at a minimum, treated on a par with foreign currencies and not discriminated against in the legislation or administration of Member States, the main issue for the EMI would appear to be whether it could - and should - take over from the BIS the settlement function in the clearing system. For a few years the BIS has been acting as agent for the Ecu Banking Association in this capacity.

To an outsider, it would seem natural for the EMI to take over this function and to begin considering whether some overnight credit element should be introduced in the functioning of the clearing system as has earlier been proposed by some central banks. The Treaty is silent on the feasibility of such a step; it does not list the task among those of the EMI, but nor does it exclude it. If there is opposition to the EMI taking on this task, recourse might be tried, as was the case for the pooling of domestic monetary operations, to Art. 109 f, 7 of the Treaty. But a first line of approach would be to argue that the clearing function belongs naturally among the tasks of the EMI without the need for any further explicit authorization.

Fourth, the EMI has the main role of preparing the framework for conducting a single monetary policy in stage three. This covers the design of a strategy for intermediate objectives, notably the role of monetary aggregates (or possibly nominal income) in achieving the primary objective of price stability, the operating procedures and the policy instruments, as well as the more pedestrian, but essential preparatory steps in the area of payments, accounting and information systems and the production and distribution of ecu banknotes. Most of these preparations are progressing steadily in the framework of the various subgroups set up by the Committee of Governors, but work may need to be accelerated in order for "the regulatory, organizational and logistical framework necessary for the ESCB to perform its tasks in the third stage"²² to be ready before the end of 1996.

²² Art. 109 f, 3 of the Maastricht Treaty.

The main test is the design of the joint policy itself. With stage three building on a "national" vision of monetary policy jointly for all participants, rather than on a further intensification of coordination of national monetary policies²³, it was always questionable to what extent studying the design of the future environment could teach something of ready relevance for stage two. The transition to wide margins has not basically changed this perspective. The aggregation of harmonized national monetary aggregates into a single measure may, however have become even more complex in view of the transition to wide margins which must be presumed once more to have modified the degree of substitutability of national monies. A good deal of solid analytical effort is required here, but no conclusive results should be expected. Improvisation and flexibility will still be required in stage three.

²³ This qualitative jump which became clarified in the Delors Report is illustratively discussed in Bini-Smaghi, Padoa-Schioppa and Papadia (1993).

IV. Conclusions.

The present paper on reinforcing stage two of the EMU process has ranged widely. Section II asked a number of questions regarding the macroeconomic and monetary environment likely to prevail in stage two, and more specifically, whether it is desirable and feasible to return to the narrow margins within a shorter time span of a year or so. Starting from a very demanding list of non-monetary prerequisites for such a step, established recently by the new EMI President, the discussion centered on the type of reinforcements of the EMS which would be useful in reviving the system. Removal of doubts as to the extent of intervention commitments, and mechanisms to assure a more rapid escalation in the use of the defensive mechanisms of the Basle-Nyborg Agreement than could be observed in the prolonged turmoil of 1992-93, given the traumatic experience of the past year, will be the main determinants of whether a narrow margins EMS could once more become a stable framework. However, unless it became clear that its future participants had convincingly renounced the use of realignments for the future such a return could still be regarded as risky.

Given the demanding non-monetary and monetary prerequisites for going back to narrow margins and the, so far, relatively smooth operations of the wide margins introduced on 1 August 1993, one has to consider the implications of continuing the present arrangements, not just for a brief transitional period, but throughout stage two. A recent, but still tentative conclusion is that - provided Member States continue to use their enlarged room for manoeuvre with caution, in

order to maintain their promising degree of nominal convergence, and hence the long-run credibility of their central rates - such a scenario may yield satisfactory results not only as far as current policies are concerned but also a route to EMU, alternative to the straight path via a reintroduction of narrow margins. One point, sometimes overlooked in the debate is that countries would not disqualify themselves from qualifying for EMU simply by maintaining their currencies in the wide margins, since the latter have now become "normal" in the sense of the Maastricht Treaty.

Section III went on to ask in which ways the set up of the European Monetary Institute (EMI) at the start of stage two marks a qualitative change and how the new institution could, within the framework of the Maastricht Treaty, reinforce monetary coordination. One useful element is the change in working habits with more of the input, initiative and responsibility for implementation in the hands of the EMI President and his full-time staff rather than of the more defensive national central banks. The Maastricht Treaty and the EMI Statute assigns a potential role to the new institution in the holding and management of foreign exchange reserves. Although such a role is less important under the wide margins EMS than it would have been under the arrangements expected to prevail when the Treaty was drafted, this limited operational role is potentially useful, particularly in a forward-looking perspective and it ought to be used and not circumscribed by restrictions of various kinds of the EMI's capabilities. The possibility of extending an operational function for the EMI as an agent for national central banks in their domestic money market operations could be explored along the lines originally

proposed in the Delors Report by Professor Lamfalussy. The EMI also would appear to have a natural role to play as the settlement agent in the ecu banking market; this function should be transferred to it from the BIS and extended in the direction of a limited lender-of-last-resort function for the ecu banking market. With much of the incentive to anticipate the future role of the ecu as the single currency sometime after the start of stage three gone because of the increased uncertainty surrounding the realization of EMU according to the Maastricht timetable, the EMI will, also in this area, have less to do than was planned for.

The task of preparing in detail for the third stage has, however, become more demanding than ever and will in any case leave the new institution with a crowded agenda.

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