

NATIONAL BANK OF BELGIUM

Foreign Department

Brussels, November 2, 1988.

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TELEFAXTO THE MEMBERS OF THE DELORS COMMITTEE

Please find herewith a paper which contains a personal assessment of the working of the EMS. This paper is conceived as a contribution to our forthcoming discussions.

J. Godeaux,

He must have
reported to his
central bank
Council!

Brussels, 2nd November 1988.

THE WORKING OF THE EMS : A PERSONAL ASSESSMENT
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J. GODEAUX

INTRODUCTION

The existence of an extensive body of background material relating to the functioning and performance of the EMS, including academic research as well as reviews conducted by official committees, makes it possible for this paper to limit itself to what I consider to be the main elements of an assessment. I have aimed at a balanced judgement ; however the views here expressed, while hopefully acceptable by many fellow Governors, are mine only.

Before dealing with the actual performance of the System, a brief overview of the EMS features and developments will be presented. Section I will therefore address five topics, covering the technical functioning of the System while at the same time pointing towards the challenges ahead in these domains. Section II will then discuss the performance of the System under a number of aspects. No attempt to draw overall conclusions was made as these would involve policy preferences and personal judgements.

A final remark is that the terms EMS and ERM (Exchange Rate Mechanism) are used intermittently in this paper as one and the same thing, unless specified otherwise.

SECTION I : ASSESSMENT OF THE TECHNICAL FUNCTIONING OF THE EMS

In the present section the basic characteristics of the EMS will be recalled, viz. an exchange rate mechanism, based on a regime of fixed, though adjustable exchange rates, supplemented by credit facilities and destined to involve the participation of all the Community member states, giving Europe a distinct place on the international monetary scene. More in particular, attention will be paid as to how these features have evolved over time since the inception of the EMS and what may be the challenges ahead.

1. Exchange rate management : the issue of realignments

When looking back on nearly 10 years of EMS experience, one cannot but conclude that the skepticism and concerns voiced initially as to the durability of the System were not founded. Expectations that it would develop into a regime of unduly frequent crawling-peg type of exchange rate adjustments have not materialised. Neither has the system generated an excessive rigidity of exchange rates yielding misalignments of real exchange rates.

In the annex to the conclusions of the Presidency of the European Council in Bremen, it was stated that in terms of exchange rate management the EMS would be at least as strict as the "Snake". With the benefit of hindsight one can discern a number of definite improvements in comparison with the "Snake" concerning the issue of realignments.

Firstly, changes in central rates have become truly multilateral decisions. Secondly, their frequency as well as their magnitude have been markedly reduced after the initial learning period, i.e. 1979 to 1983.

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Experience showed that this strategy entailed some disadvantages : the ECU did not prove very helpful for the operation of the divergence indicator and delaying intervention until it became obligatory, i.e. at the margins, at times resulted in a market perception that the authorities were no longer committed to defend the existing parity grid, fuelling speculative pressure and necessitating more intervention than initially warranted.

This led the authorities to believe that a strategy of keeping their exchange rates well within the band and limiting movements against key currencies of the EMS to a minimum would be more rewarding both in terms of influencing market sentiment and in terms of domestic monetary stability. This new strategy did entail an increased recourse to intramarginal interventions relative to marginal ones as well as a more timely use of interest rate policy, especially for weaker currency countries.

With the progressive integration of financial markets and with the objective of the abolition of the remaining capital restrictions, in line with the goal of completing the internal market in 1992, the exchange rate mechanism of the EMS might have to face the prospect of increased or new strains calling for some reinforcement of the System. The result was the so-called Basle/Nyborg agreement providing for a more active and flexible use of all the instruments available to central banks for meeting short-term exchange rate pressures and for better coordination of such action among the ERM participants.

Thus, a more flexible use of the EMS band width was called for, without returning to the original situation of letting currencies drift to the limits. This in turn justified the provision of very short-term financing of intramarginal interventions under certain conditions. It also made more cooperation on monetary policy measures imperative. To promote a more effective use of the instruments available, a strengthened monitoring procedure was put in place.

Although it is still somewhat early to assess the working of the Basle/Nyborg agreement, experience gained up till now is encouraging. This doesn't exclude, however, that further measures be considered, essentially in order to gradually replace the system of ex-post concertation by one of ex-ante coordination of monetary policies.

3. Financing and settlement of interventions

Contrary to early fears by creditor countries that the EMS would open the door for more inflationary financing, in view of the increase in volume of available credit facilities and the creation of the ECU as a means of settlement, the evidence turns out to be much more balanced. No permanent net ECU positions have developed, VSTF arrangements have never been abused and the STMS facility has even remained unused. Instead, member states have preferred market related balance of payments financing and the use of foreign currency reserves to settle interventions.

The shift in intervention strategy pointed at earlier has contributed to the Deutsche Mark becoming the prominent intervention currency to the detriment of the US dollar. This evolution carried with it both advantages and disadvantages. The former consisting of opening up the possibility of intramarginal interventions against the traditionally strongest currency without influencing the German monetary base (so-called asymmetrically sterilised interventions). The latter pertaining to the fact that only one EMS currency, viz. the strongest one, was being sought after to this end by the weaker currency central banks.

The role of the ECU has thus remained limited, far from attaining a position at the centre of the System as originally envisaged. Notwithstanding its remarkable development as a financial instrument, the effective impact of the private ECU use on the operation of the EMS is still marginal.

4. Coordination of exchange rate policies vis-à-vis third currencies

It is undeniable that the greater degree of convergence in monetary performance and policies of the EMS countries since 1983 under the leadership of the Bundesbank (see also Section II) has reduced the EMS exposure to outside shocks in general, US dollar instability in particular. As long as convergence remains incomplete though, preventing EMS currencies from becoming close substitutes, the international environment will remain a potential source of instability for the exchange rate mechanism.

With the D-Mark as the nominal anchor in the EMS, the policy choice of the ERM participants to accept whatever exchange rate target (or absence of target) the German monetary authorities had chosen for the D-Mark was understandable. As such the D-Mark came to serve equally as the linchpin between the EMS and the international monetary system.

The EMS has failed to become a representative homogeneous monetary entity on the international level. This was demonstrated for instance by the fact that the Plaza and Louvre agreements have incorporated more than one EMS member on an individual basis, while for their implementation a coordinated intervention approach by all EMS members was solicited. It has to be said though, that the EMS has come to receive greater recognition over the years as a specific part of the international monetary system.

5. Non- or incomplete participation in the exchange rate mechanism

The fact that the EMS in its wider sense encompasses all EEC currencies whereas only 7 out of 12 fully participate in the exchange rate mechanism has so far caused no major difficulties for the working

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of the system, perhaps even saved it from encountering more frequent tensions. However, ERM participation of sterling might have facilitated exchange rate management for specific countries such as Ireland. Besides, apart from generating greater instability for the ECU, the prolonged non-participation of the UK has sustained doubts about the merits and the potential development of the System, especially in those circles where natural scepticism was already prevailing.

SECTION II : ASSESSMENT OF THE EMS PERFORMANCE

To be able to assess the performance of the EMS, it is necessary to bear in mind its objectives. For this it suffices to recall the following passage in the conclusions of the Presidency of the European Council in Brussels in December 1978 : "The purpose of the EMS is to establish a greater measure of monetary stability in the Community. It should be seen as a fundamental component of a more comprehensive strategy aimed at lasting growth with stability, a progressive return to full employment, the harmonisation of living standards and the lessening of regional disparities in the Community. The System will facilitate the convergence of economic development and give fresh impetus to the process of European Union".

In the following subsections the attainment of the above-mentioned goals will be assessed under three headings : the EMS as a zone of monetary stability, as a determining factor of economic performance and convergence, and as an instrument of increased (monetary) cooperation.

1. The EMS as a zone of monetary stability

Monetary stability comprises an internal as well as an external aspect : low inflation and exchange rate stability. Although no priority between these two was established at the outset, it gradually became accepted that monetary policies should be geared to make national inflation rates converge on price stability and that this in turn would lay the ground for lasting exchange rate stability.

Nevertheless, even in the absence of convergence on price stability, the EMS has already made a definite contribution to the realisation of the objective of exchange rate stability. Indeed, as numerous studies using different methodologies have shown, the variability of exchange rates of ERM participants - whether in nominal or in real terms - decreased markedly not only in comparison with the "Snake" period but also over time, when comparing the first half of the nine years of EMS experience with the second half. Moreover, the EMS results compare favourably with those of non-ERM participants inside and outside Europe.

More important still is that this outcome did not result from capital controls or interest rates acting as shock absorbers. In effect, capital controls have gradually been diminishing while the observation of interest rate variability before and after the EMS does not show a clear tendency towards rising instability.

Concerning internal monetary stability, the same three types of comparison as presented above can be made. Compared with the "Snake" the EMS did not lay the ground for looser monetary policies but rather provided a framework in which anti-inflationary policies could be pursued more effectively. Of course, one cannot brush aside the favourable external monetary environment in assessing the relative merits of the EMS. Only it is extremely difficult to quantify this effect in isolation.

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As to the question whether the EMS provided a better framework than other national experiences, where one has also witnessed a remarkable deceleration of inflation, the debate has so far been inconclusive. What should be borne in mind in this respect is that these other countries in bringing down their inflation rates frequently resorted to an increase in the short-term variability of exchange rates or even accepted the occurrence of misalignments, elements which are incompatible with the overall monetary stability objective of the EMS.

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Last but not least, the more recent evidence and projections on monetary and credit policies and performances is indicating a clear trend towards convergence of money growth and inflation performance among the ERM participants at low levels as compared with the other Community members. This seems to imply that the EMS is finally paying off in terms of credibility with regard to its anti-inflationary stance.

One should warn, however, against too relaxed an attitude in these matters. Internal monetary convergence on price stability is not fully achieved yet, with the measure of dispersion in inflation still having to reach the low level attained in the sixties on average. Monetary and exchange rate policies should therefore proceed along the lines followed in the past to preserve the acquired stability firmly.

Thus, exchange rate realignments will remain unavoidable for the time being, which raises the difficult issues of their timing and their being accompanied by the necessary adjustment measures so as not to rekindle the vicious circle which nearly made the System collapse in 1981-83.

2. The EMS as a determining factor of economic performance and convergence

Three issues will be addressed in this subsection : firstly, a sketchy description of the degree of convergence in economic performances and policies in the EMS ; secondly, the question whether the causes for the less satisfactory results can be attributed to the System proper ; and, thirdly, what will be their consequences for the working of the EMS. It is obvious that these are complex and even controversial matters which the present paper can only describe in a general way.

2.1. Economic performances and convergence

It can be said that the prime goal of the EMS is the creation of a sound basis for internal and external stability as a precondition for the achievement of the broader economic objectives set out by the European Council in December 1978. To attain this goal, a fair degree of convergence in economic performances must be achieved especially of course in the field of costs and prices.

If differences in economic variables such as real GDP growth, current account and fiscal balances must no longer endanger exchange rate stability, a reasonable degree of convergence needs to be achieved in these areas too. One cannot deny that results obtained so far have fallen short of what was desirable or necessary.

Real GDP growth may have been converging slightly, but at a low level instead of at the higher figure arrived at elsewhere in Europe. Recent developments of growth performances show more encouraging signs. It remains to be seen though, if this does announce a reversal of the long-term trend of sluggish growth in the EMS. Current account imbalances have not disappeared, with shrinking deficits for some member states only being replaced by increasing surpluses for others. Fiscal disequilibria have remained large with public debt levels consequently still on the rise in a number of countries.

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2.2. Is the EMS to blame ?

The question has to be asked whether the situation as described above was caused by the EMS. Or, phrased otherwise, would the situation have evolved more favourably without the existence of the System ? Complete answers are not available. Statistical analysis cannot provide decisive evidence on all counts if only because several standards of reference may be put forward to assess the performance of the EMS.

In a broader time perspective one must not overlook the fact that at the start of the eighties the current account and/or fiscal balances of most of the ERM participants were not very satisfactory, being quite often worse off than in other non-EMS countries in Europe. The adjustments imposed on some EMS members led them to policy measures conducive to dampening domestic demand, leading in turn to slower growth in the EMS compared with growth performances outside.

The necessary adjustments could surely not have been delayed in the absence of the EMS. On the contrary, the existence of the EMS provided the weaker currency members with a credible commitment to strengthen their public finances in a non-inflationary way. Their willingness to resist inflationary pressures arising out of the devaluations of their currencies in order to improve their current account situations, however, gave rise to realignments that most of the time did not totally wipe out differences in their real exchange rate movements vis-à-vis the D-Mark in particular. As mentioned above this limit placed on realignments has the merit of maintaining some "foreign exchange constraint" in the weaker economies.

But one may ask whether the tendency to a relative undervaluation of the D-Mark might not have enhanced German competitiveness and added external stimulus to Germany's growth rate. This would have alleviated the need for Germany to give further stimulus to domestic demand.

It appears extremely difficult, if not impossible, to identify the relative importance of the various factors that account for the persistent divergences in the area of fiscal policy and current account developments. With regard to the latter which are increasingly mentioned as a possible threat to EMS stability, the analytical work done so far does not offer a satisfactory explanation of the persistent divergences by referring to the relative cyclical positions and cost/price developments only. It seems that other more structural factors need to be taken into consideration equally.

2.3. Consequences for the EMS

Irrespective of the causes of disappointing growth performances, current account disequilibria and fiscal policy divergences, the persistence of these phenomena will clearly have an unfavourable impact on the functioning of the System.

As yet two major consequences can be perceived. The first one is a credibility problem insofar as references to a possible deflationary bias of the System and to the risk of a buildup of fundamental balance of payments disequilibria do cast some doubt on the intrinsic stability of the System and on its potential development. Secondly, it is undeniable that fiscal policy and current account divergences imply the persistence of interest rate differentials which themselves could delay or complicate the progression of convergence.

The System has to defend itself against the objection that it is a low growth area. It has also to defend itself against the objection that it is an "asymmetrical" system. To avoid misunderstanding, the whole question of asymmetry deserves deeper analysis and research.

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3. The EMS as an instrument of increased monetary cooperation

The EMS monetary cooperation has now reached a content that largely outweighs the degree of cooperation achieved in most other areas of Community policy. A lot of the credit for this achievement is due to the flexibility of the System. Pragmatic arrangements were often preferred to strict or explicit rules. This pragmatism has permitted the evolutionary change as evidenced in the ECU package of July 1985 and most visibly in the Basle/Nyborg agreement of September 1987.

It may be recalled that the "flexible cooperation approach" was at the outset conceived as a transitory arrangement only. According to the Brussels Resolution, an institutional phase had to be reached not later than two years after the inception of the System. However, in December 1980, the European Council decided to postpone such a step "sine die". Frankly speaking, there is not much hope that this institutional step will be taken nor much insistence that it should be.

One can therefore say that in the perennial debate on "rules versus discretion" the participants to the System have laid great weight on discretion.

I am quite sure that this pragmatic approach is still capable of bringing further progress. Yet one cannot avoid the fact that, in order to cope with the challenges ahead, viz. preserving monetary and exchange rate stability in an environment of free capital movement while contributing to the completion of the internal market, one should expect a continuous move towards collective decision-making on even the

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most vital parts of national monetary policy. Although the present strategy of voluntary policy coordination undoubtedly still leaves room for ample improvement, the question arises how long such a stance can continue meeting the increasing requirements of joint monetary policy-making and can remain a satisfactory answer to the expectations of market operators, of public opinion and of the political sphere.

We therefore have to ask ourselves whether a new Basle/Nyborg package can be put together and made public or what institutional step can be taken despite our obvious preference for the pragmatic approach. To paraphrase the English expression about justice "not only must progress be made, it must be seen to be made".

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