THE EMS AND ITS INTERACTIONS WITH ECONOMIC AND MONETARY POLICIES : LESSONS FOR FUTURE PROGRESS TOWARDS EMU

The EMS is a monetary system based on an agreement between central banks, but it has broader economic effects. It can be interpreted as an attempt to use an exchange rate constraint to bring about a more general convergence of policies and performances. The stability that the EMS is designed to achieve promotes economic integration.

The EMS is a success in terms of its objective of creating an area of internal and external monetary stability in Europe. Inflation rates have declined substantially on average and converged, although there is still need for further effort in this area. Exchange rate variability within the ERM has fallen since 1979. Realignments have become less frequent and smaller in size. Monetary cooperation has advanced. Economic policy coordination has, however, progressed little and remains informal for the most part. Some doubts persist as to the beneficial influence of the EMS on growth. ?

In order to draw lessons from the EMS experience, it is necessary to examine the reasons for the success of the EMS or lack of it. The credibility of the EMS is founded on a policy consensus, but the system serves by its very nature to reinforce that consensus and put it into effect. How has this come about and what characteristics of the EMS can be drawn upon in progress towards EMU ?

This paper has the following structure. First it looks at the effect of the EMS in various policy areas, its successes and its shortcomings. Then in order to look more closely at the way to which the EMS itself has influenced policy, the paper examines the rules and procedures of the EMS. Finally, the influence of the EMS on the form and extent of economic policy coordination is investigated.

1. The EMS and economic policy convergence

The effects of the EMS monetary constraint on policy have been substantial, but concentrated, naturally, in the monetary area. Nevertheless, important pressures have been brought to bear on other policy areas.

1.1. General policy stance

Real economic divergences as manifested in external disequilibria have come to be regarded basically as matters for domestic adjustment measures, rather than for realignments (external adjustment). This is partly because inflation rates have converged and so real gaps are not appearing as fast. It is also because ex-

adjustment of
ext. imbalances
still always a
function of real econ. policy

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change rate movements that require realignments are more visible within the EMS. Devaluation is no longer regarded as the easy option.

One indication of this attitude is the practice of devaluations being accompanied by domestic adjustment measures. Another indication is the rise in real exchange rates measured in some countries, such as Italy, whose lack of current account deficit shows that considerable internal structural adjustment has taken place. In a more general sense, exchange rates are being used to keep downward pressure on inflation, rather than accomodating inflation, e.g. realignments have tended to lag inflation differentials in France and Italy since 1979 (see graph 1).

Non-participating countries, in particular UK and Spain, have shown similar convergence until recently to that of ERM countries. It could be argued that the EMS is therefore superfluous. However, the EMS zone has itself formed a reference point for non-participating currencies without which their performance may have been less convergent. Also recent resurgence of inflation in UK and Spain may be more easily countered within the framework of the EMS.

1.2. Monetary policy

As should be expected, monetary policies have converged during the EMS period. Monetary policy has taken much of the adjustment burden. This is natural in short term because the EMS is a monetary system. However, it would be perhaps worrying in longer term if it persisted, because the policy-mix would become distorted. There is such a danger because there is less constraint on fiscal policy.

Of course, most monetary convergence has come about because of tightening in high inflation countries, but there has been some symmetry in monetary adjustment. For example, temporary monetary loosening is seen in strong currency countries in times of EMS strain (e.g. Nov./Dec. 1987). In spite of this, there are no signs of inflation being compromised. Monetary targetting has still proved possible in Germany. German inflation has in fact been lower than Swiss inflation since 1979 (see graph 2). Bundesbank monetary policy has provided an anchor for the EMS.

In small countries, which are used to a lack of monetary sovereignty, monetary policy is generally more or less geared to the exchange rate. Also, the progressive removal of capital controls has left little room for manoeuvre in France and Italy, other than to gear monetary policy to the exchange rate.

1.3. Budget policies

Success in monetary convergence has made differences in budgetary policy more apparent. Budget deficits diverged during the first years of the EMS, but differences have been reduced somewhat since then (see table 1). If one looks at the evolution of public debt, the story is slightly more encouraging, but far from satisfactory (see table 2).

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On the other hand, the fact that monetary growth has converged more than budget deficits shows that monetary financing of budget deficits must have declined. This is one area, concerning budgets, in which the EMS does appear to have had a significant impact. No don't follow

1.4. Balance of payments financing

Foreign currency borrowing to finance current account deficits has tended to be through the market rather than by way of Community instruments. The EMS constraint has not led to extensive use of official financing and hence borrowing subject to conditionality. The notable exception being France in 1983, where the EMS played its part. The rarity of official financing could be interpreted as an opportunity lost for bringing more disciplinary pressure to bear, however the external imbalances have tended to appear more on the surplus side in recent years.

1.5. Growth strategy

The EMS is sometimes criticized for having a low growth bias. Certainly the growth records of ERM countries have tended to be behind those of Community non-ERM countries and as well as the US and Japan. Their inflation performance has however been better, apart from Japan. One reason for this is that many ERM countries started in the EMS in a poor position requiring substantial adjustment.

Unless one believes that there is a trade-off between inflation and growth, it is difficult to argue that it is the EMS itself which has restricted growth. The EMS certainly shows up clearly the interdependence between Community economies, which exists in any case. The absence of the EMS would have been unlikely to have significantly increased the growth of domestic demand in Germany, indeed the opposite may well have occurred. On the other hand the EMS adjustment rules have not pushed Germany to test if a stronger growth would been compatible with its inflation target.

2. EMS rules and procedures

Now we turn to the question of how the EMS has helped achieve its goals. The EMS is founded on an agreement between central banks and has a set of rules and procedures. These are essential elements in its performance. They involve a compromise between the needs to be both flexible and strict. The EMS does not comprise any new institution.

The EMS is a formal and public commitment (in contrast to the G-7 framework). This serves to make exchange rates highly visible. It provides for realignments which have become big media events. Exchange rate changes are condensed into one weekend. This contrasts with floating currencies where movements tend to be gradual and little noticed. EMS fluctuation limits are visible and known. The level of commitment embodied in the agreement to keep to fixed margins strengthens the credibility of the EMS by acting as a constraint on subsequent policy choices.

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Basically, the EMS contains only two principal rules (respect of the fluctuation margins and realignments by common accord). These rules set a framework involving a minimum but effective constraint.

- **The 2.25% fluctuation margin rule** is a hard option, both as compared to target zones and in respect of the width of the margins. This has the disadvantage of perhaps causing realignment speculation when or even before the margins reached, whereas a soft margin may not. But it has the advantage of forcing adjustment measures usually well before the margin is reached. Fixed margins are more credible in the markets. The divergence indicator was meant to have elements of a soft margin (early warning, adjustment expected), but it has not had its intended effect, mainly because of the symmetry question.

  At ± 2.25%, the margins were extremely narrow and constraining in the short term while inflation differentials were substantial during the early eighties. Recent progress on convergence to low levels of inflation has widened the margins in terms of inflation differentials. The emphasis has now moved to fluctuations within the margins with fewer realignments. Until Italy, the UK and Spain join the present 2.25% band, the question of narrowing the margins is not likely to become pressing. The Italian use of 6% margins has permitted a lesser degree of convergence in both the monetary and budgetary areas, but it may be argued that a more forcefull convergence process would have been unsustainable.

- **EMS realignments take place by common accord.** They are not unilateral decisions. This contrasts with the practice in previous exchange rate systems, such as Bretton Woods and the Snake, where realignments were effectively decided by the country changing its parity with little multilateral discussion. The joint nature of EMS realignment decisions is helped by the visibility of ecu central rates which show that in fact all rates change when one currency moves vis-à-vis the others. Unanimity at realignments reinforces credibility in that all participants are committed to the new parity grid. Unanimity is also an important safeguard against competitive devaluations, therefore helping to maintain the predictability of exchange rates in the EMS. The fact that the EMS functions in the Community framework has reinforced its multilateral nature compared to previous exchange rate systems.

In spite of these rules, the EMS remains flexible in the face of the ever-changing monetary environment. Examples of the flexibility of EMS rules are the growth of intramarginal interventions and the disuse of the divergence indicator. Moreover, EMS procedures can also be changed, e.g. VSTF financing, use of the dollar for intervention instead of participating currencies, the introduction of monitoring and surveillance, the 1985 and 1987 reinforcement packages. The EMS has retained flexibility not by the creation of an institution, but by keeping strict rules to an absolute minimum.

The EMS does not include any rule or procedure requiring coordination of exchange rate policies vis-à-vis third currencies. This may be considered a shortcoming given the tensions that can be caused by dollar movements. Had the ecu been placed truly at the centre of the System, an external dimension to the EMS may have been easier to accomplish. Nevertheless, lack of coordination over policies vis-à-vis the dollar generally reflect divergencies concerning the stance of monetary policy within the EMS. If a rule imposing a common exchange rate policy vis-à-vis third currencies were imposed, it would lead to a contradiction unless it was consistent with the objective of internal monetary stability.

The EMS does not follow usual Community legal framework. It is an agreement between central banks. Realignments are not Council decisions, there is no Commission right of proposal. Also the EMS is the major example of a two-speed Europe. To what extent these two factors are linked is not clear, though the sensitivity of monetary affairs seems to be behind both.

3. The EMS and economic policy coordination

3.1. The EMS strategy

The EMS is essentially a monetary agreement. But is has general economic consequences. The monetary constraint, which is put daily to the test, has required more general accompanying economic measures. In this sense, monetary convergence has advanced, pulling economic convergence along behind it.

The 1992 internal market strategy would have been more difficult to realize without stable exchange rates. In the absence of the EMS, the obstacles to trade would come much more from the monetary side (fluctuations and misalignments) than from physical, technical or fiscal barriers.

The EMS has been dominated up to now by the DM, although this is perhaps a little less so since the Basle/Nyborg agreement. The anchor role played by the Bundesbank is natural given the German inflation performance. It has enabled other countries to use the credibility of the Bundesbank as a weapon in their own fight against inflation. The success of the EMS depends very much on the underlying policy consensus. There are continual tensions over where the real decision-making power should lie (the symmetry question).

The EMS has brought home to participants the loss of sovereignty at the national level implied by monetary and economic integration. In order to compensate, there is pressure to refind influence at the Community level. Hence the arguments on symmetry and on institutional change. But the EMS lacks the institutional framework to make up for the loss of national sovereignty by replacing it with Community sovereignty. The Committee of Governors has grown in importance, for example concerning relationships with third currencies, but does not have any legal decision-making role.

The EMS framework has served as an excuse to drop the Community's formal coordination procedures (e.g. the 1974 Convergence Decision). The assertion made in 1978 that the EMS should be seen as a fundamental component of a more comprehensive growth strategy has not borne results capable of overcoming doubts. Coordination in the EMS is informal, focussing mainly on convergence of policies and performances. It relies largely on discussion rather than the formulation of a common position, let alone a joint decision. Coordination in the form of short-term monitoring and longer term surveillance takes place in the two relevant Committees, but, up to now, without convincing endorsement at ministerial level. Realignment meetings can also be interpreted as playing a coordinating role, since accompagnying policies are discussed and a common decision is needed. Sometimes coordination takes place outside the Community framework (e.g. Franco-German Economic Council).

3.2. The learning process

Economic policy cooperation has developed gradually, as have the attitudes of those involved :

- Governments. Over time, governments have increasingly committed themselves to a hard currency option within the EMS. Also they have shown more readiness to discuss monetary policy options. The EMS safety net in terms of balance of payments financing, although rarely used, may have been very useful and necessary in the initial years of the EMS in order to add to the credibility of the system and to correct potential policy errors. The need for temporary safeguards for capital liberalization can be seen in a similar context.

- Economic agents. The longer the EMS has lasted and the more successful it has become, the more credibility the EMS has gained within industry. Exchange rate predictability is seen as essential for economic integration, with business organizations in non-participating countries mostly in favour.

  Markets. The EMS has also gained credibility in the markets, although interest rate differentials remain above inflation differentials (see graph 3). Capital liberalization has taken place without any signs of capital flight. Expectations of large realignments appear to have receeded.

4. Conclusion

The EMS is a monetary system with principally monetary, but also broader economic consequences. It has been a success in promoting closer monetary cooperation. Internal adjustment has come to take precedence over external adjustment when economies diverge. But the lesser success on convergence in budget policies has led to tensions in the policy-mix.

The EMS, by stabilizing exchange rates, has contributed to general economic integration. Business does not have to worry so much about exchange rate misalignments. Exchange rates have become more predictable, allowing more trade and production on an international basis rather than on a national basis. The EMS has therefore been a cornerstone for the development of the large internal market.

The rules and procedures of the EMS have been important in its success. They have been strict enough to prevent short-term pressures from diverting attention from the medium-term goal of an area of monetary

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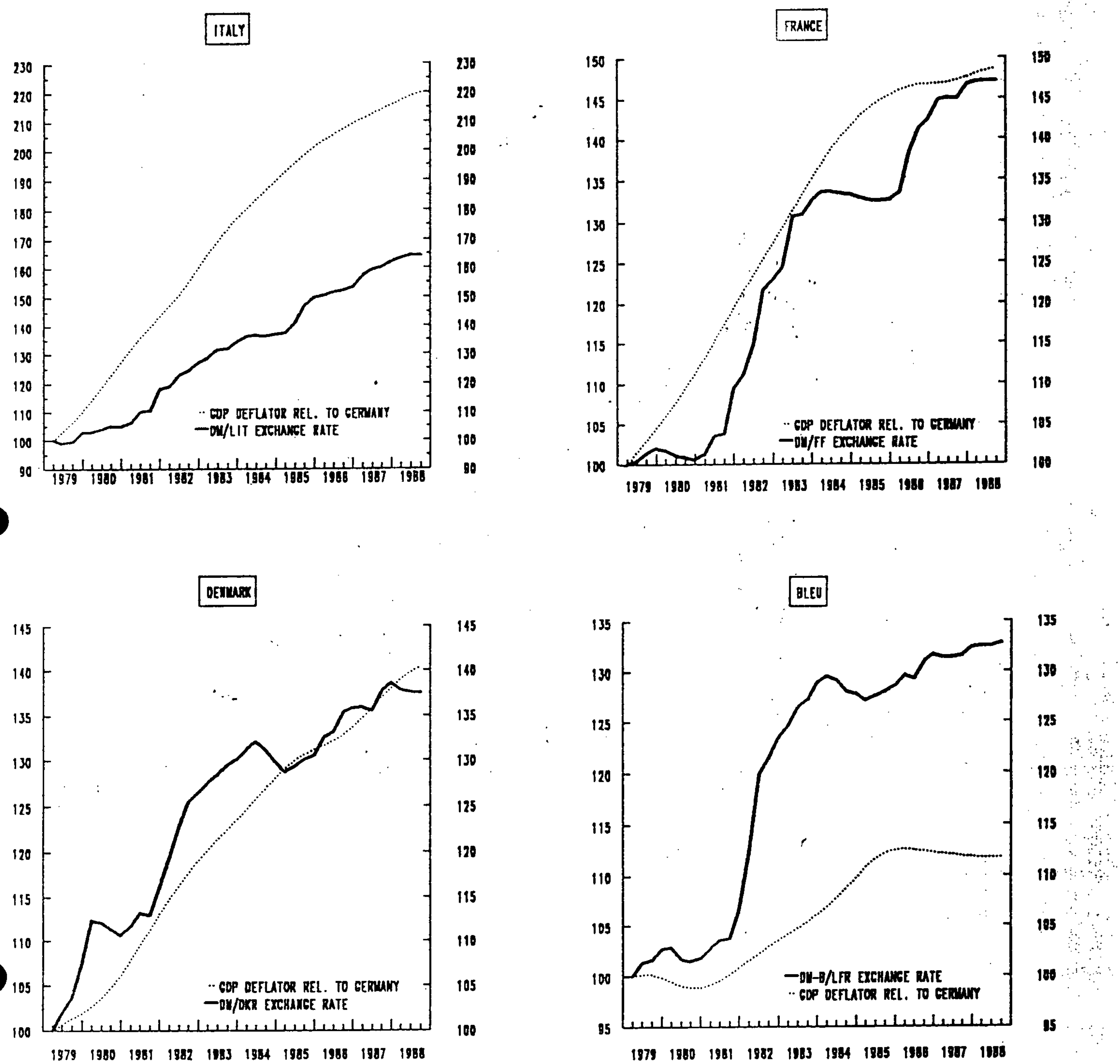
stability. Yet they have been flexible enough to allow changes in emphasis and strategy in the face of a varying monetary environment. The EMS however appears to be arriving at the limits of policy coordination based on informal procedures, as shown by the continual tensions over symmetry and calls for a more formal coordination framework.

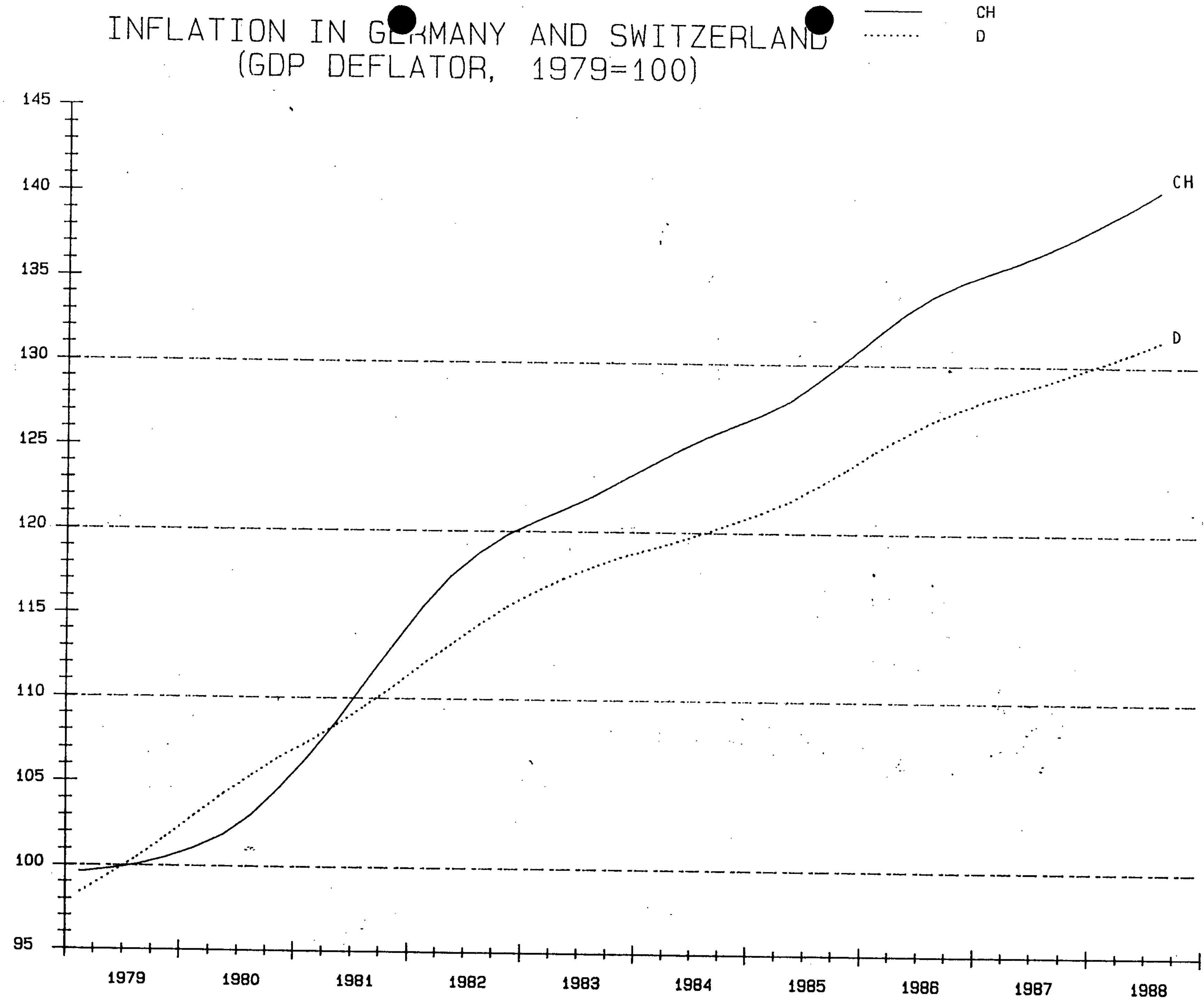
Behaviour has evolved by all those involved in the EMS : governments, economic agents and markets. There has been a learning process of adaptation to the EMS, a process which is still continuing. This is likely to occur with any new integration initiative and points to the need for a certain safety net, at least for an initial period, both to add to credibility and to provide for unexpected problems.

EXCHANGE RATE AND PRICE LEVEL RELATIVE TO GERMANY
(BY COUNTRY - BASE 79I = 100)



GRAPH 2

INFLATION IN GERMANY AND SWITZERLAND
(GDP DEFLATOR, 1979=100)



INTEREST RATE AND INFLATION DIFFERENTIAL WITH GERMANY
(BY COUNTRY)

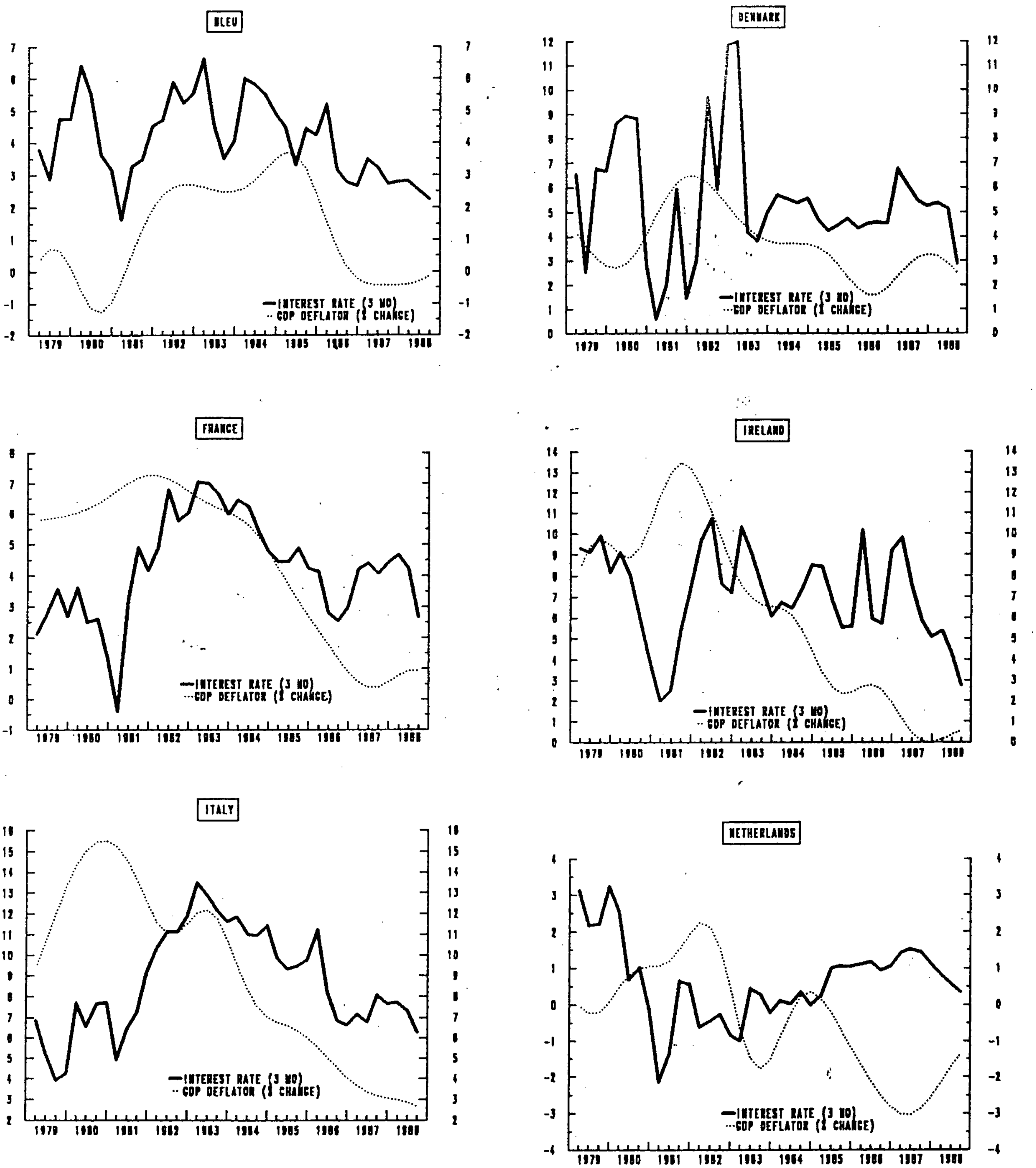


TABLE 1

GENERAL GOVERNMENT NET LENDING (% GDP)

	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988*
B	-7.1	-9.0	-12.7	-10.9	-11.2	-9.3	-8.3	-8.9	-7.2	-7.1
DK	-1.7	-3.3	-6.9	-9.1	-7.2	-4.1	-2.0	3.1	2.1	0.9
D	-2.6	-2.9	-3.7	-3.3	-2.5	-1.9	-1.1	-1.3	-1.8	-2.3
F	-0.8	0.0	1.9	-2.8	-3.2	-2.8	-2.8	-2.9	-2.5	-1.9
IRL	-11.4	-12.7	-13.4	-13.7	-11.6	-9.6	-11.1	-11.0	-9.1	-6.5
I	-8.3	-8.5	-11.3	-11.3	-10.6	-11.5	-12.5	-11.4	-10.5	-10.0
NL	-3.7	-3.9	-5.4	-7.0	-6.3	-6.2	-4.7	-6.0	-6.3	-5.2

* Commission forecast

Source : Commission staff

TABLE 2

EVOLUTION OF GENERAL GOVERNMENT GROSS DEBT SITUATION (% GDP)

(+ improvement, - deterioration)

	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988*
B	-3.3	-5.7	-12.0	-7.6	-9.7	-5.7	-6.5	-2.9	-4.9	-2.4
DK	-5.1	-6.5	-10.2	-9.4	-9.6	-4.4	1.7	5.5	1.4	0.6
D	-0.7	-1.9	-3.7	-3.0	-1.6	-0.8	-0.8	-0.1	-1.2	-1.2
F	-1.0	-0.3	0.7	-4.0	-1.6	-2.2	-2.0	-1.3	-1.6	-0.6
IRL	-5.6	-1.6	-4.9	-5.5	-10.1	-4.7	-3.0	-11.5	-3.3	-3.5
I	0.5	2.8	-2.0	-5.8	-5.6	-5.2	-6.6	-4.2	-4.7	-4.0
NL	-1.8	-3.2	-4.4	-5.2	-6.4	-4.2	-3.5	-1.5	-3.8	-4.4

* Commission forecast

Source : Commission staff