Reforming the European Monetary System

The extreme widening of the exchange rate margins last summer has transformed the EMS from a multilateral fixed rate system into a system of unilateral exchange rate pegging. Professor Neumann characterises the current state of the EMS, outlines the major defects of the system and makes some proposals for reform.

Europe appears to be ruled by Euroscepticism. Integration successes are valued low, such as the elimination of capital controls, the putting into effect of large parts of the Single Market programme, and the extension of economic integration to four EFTA countries by means of the European Economic Area (EEA). The failure of European governments to initiate a stable peace in former Yugoslavia, the exhausting process of ratifying the Maastricht treaty, the move into deep recession and, last not least, the breakdown of the European Exchange Rate Mechanism (ERM) have dampened the high spirit of the early nineties and, possibly, the political will to move on towards reaching European Monetary Union (EMU) as early as possible. It is telling that at present the dates set by the treaty, i.e. 1997 or 1999 at the latest, are played down in political quarters.

To be sure, sentiments regarding the future of European integration are likely to change with the business cycle. Prospects are that most European economies will be back to normal growth by 1995. Yet, normal growth will not be sufficient to permit a majority of countries’ meeting the convergence criteria required by the Maastricht treaty for starting the final stage of European Union (EU). Structural fiscal positions have deteriorated almost everywhere over recent years. According to the recent IMF World Economic Outlook, of the EU’s larger countries only Germany might be able to meet the budget-balance mark of 3 per cent of GDP by 1995. Therefore, from an economic point of view, the early EMU date of 1997 is not a realistic option. This might explain why in some countries, notably Spain, politicians are playing with the idea of weakening the convergence criteria. However, any weakening of the criteria needs German consent, and hence the consent of the Federal Parliament.¹

Lack of a Clear Concept

In assessing the prospects of moving towards EMU during the nineties, we also need to take account of the fact that European integration policy lacks a clear concept with respect to the fundamental issue of widening versus deepening. Those who are led by the paradigm of a federal union will prefer a policy of deepening first because in this way standards can be set with respect to macro policies and transfers which new entrants have to accept. Given the obstacles to deepening over the foreseeable future, it seems natural not to postpone the process of widening the EU. But the acceptance of new entrants is likely to alter the balance of forces within the EU.² For example, the relatively wealthy EFTA countries are likely to oppose further increases in transfers, at the expense of countries like Greece, Ireland, Spain or Portugal. This will make negotiations with respect to deepening more difficult. Also, these countries are likely to oppose a weakening of the convergence criteria—this might be the rationale of the recent Spanish demand for excluding the new entrants from the decision to start EMU. Finally, it is difficult to see why the small EFTA countries should be committed to creating a political union (EPU).

Summing up, current prospects are that the current EU stage II will become long-lived rather than a brief period of transition towards EMU. While European economies can prosper without being part of a union which is governed by


a unified concept of monetary and fiscal policies, there is the risk that we will slip backward if Europe's integration train comes to a complete stop. We cannot easily dismiss the misgiving that member governments might respond to economic problems with protectionist trade measures or the reinstatement of capital controls that further disintegration. This would be undesirable in itself and might jeopardize the option of moving on towards EMU at some later date.

These considerations lead to the conclusion that it is not advisable to postpone the reform of the European Monetary System (EMS). In the following the current state of the EMS will first be characterised, the major defects of the system will then be outlined, and finally a picture of reform will be painted.

**Current State of the EMS**

The extreme widening of the exchange rate margins from $\pm 2.25\%$ to $\pm 15\%$ has transformed the EMS from a multilateral fixed rate system into a system of unilateral exchange rate pegging. While the ECU parities have been kept, they have lost the function of a binding constraint for domestic monetary policy-making. Under these conditions the Bundesbank is no longer forced to intervene in support of a currency that takes part in the exchange rate mechanism (ERM), provided currencies do not approach the new margins. Thus the Bundesbank is no longer hindered in concentrating on the aim of stabilizing the German price level. This is reflected in the recent lowering of the monetary target from former 4.5-6.5 to 4-6 per cent for M3 in 1994.

Since the currency domain of the D-Mark is the largest and its reputation still the highest, the bilateral exchange rates vis-à-vis the D-Mark remain the focal points of monetary policy for the remaining central banks. Stabilizing the bilateral exchange rate enforces automatic adjustment of domestic monetary policy. Keeping to this rule secures the credibility necessary to hinder the re-emergence of massive speculation on devaluation. It is noteworthy that most ERM currencies which had devalued sharply early in August 1993 have meanwhile returned into the former currency band. This can be taken as evidence that the EMS partners have accepted the new rules of the game.

However, the virtuous behaviour of a few months must not be taken as proof that the new arrangement makes a viable system. It must be considered that the current situation lacks systemic stability because the rules of conduct are not supported by binding agreements. The current situation can easily degenerate into the non-regime of dirty floating. In the absence of declared rules of conduct, no country is hindered from switching to a beggar-thy-neighbour policy by enforcing a transitory real devaluation through rapid cuts in interest rates. Should one country, in the event of a slow recovery, resort to exchange rate dumping, others might follow and thus set the stage for a new wave of EMS-wide inflation.

**Defects of the System**

Any system of fixed exchange rates is sustainable only if the members' monetary policies are kept in step and if large disruptive real shocks originating in one member country are dampened by realignment. In principle, both prescriptions can be achieved by an established procedure of binding, i.e. enforceable, policy coordination which assigns policy-making sovereignty to a supranational policy body. In the absence of rigid supranational coordination, an exchange rate system can only survive if it provides sufficiently strong incentives and constraints for

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