THE EMS -IN THEORY AND IN PRACTICE

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INTRODUCTION

This essay analyses the rationale behind the adoption of a fixed exchange rate regime and the pertinency of such a rationale to the EMS. I will start by delimiting the costs and benefits of EMS. membership, in the context of its objectives, firstly from a monetarist and then from a "non-monetarist" perspective, particularly as they apply (although not exclusively) to the weaker, peripheral countries of the EMS (for the purposes of this essay I will define these countries as being those other than Germany, France, and the Benelux countries). Finally I will attempt to assess whether or not the EMS. has achieved its goals, particularly as viewed in light of the recent turmoil on the European currency markets.

THE THEORY OF FIXED AND FLOATING EXCHANGE RATES

The most widely discussed arguments both for and against a greater degree of monetary integration in Europe have been based largely on a monetarist model. The discussion of monetary policy and alternative exchange rate arrangements is typically biased towards the relationship between money and inflation, often either ignoring the real impact of monetary policy on output employment and growth or treating it as a transitory phenomenon.The standard arguments can be termed monetarist because they focus on the objective of reducing inflation and rely upon the causal mechanisms implicit in the quantity theory of money as a means to this. Put briefly, the argument is that control over the rate of growth of the money supply is necessary in order to control the rate of inflation.

The traditional monetarist position as embodied by Walters (1986), Laidler (1990) and Friedman (1953) is that a flexible exchange rate regime is necessary in order to facilitate individual countries' control over their own inflation rates.These writers would favour national monetary autarchy essentially in order to leave national monetary authorities free to implement "tight money" or tough anti-inflation policies in their own country. The monetarist case for joining a fixed exchange rate regime is just the reverse of this argument. Under a fixed exchange rate regime, defence of the existing exchange rate implies that the individual nation must accept the average inflation rate of the system as a whole, which is determined by the "monocentre" of the system (Hicks,1982) i.e. Germany in the case of the ERM. As Germany has a reputation for "sound-money", many monetarists are

prepared to allow the Bundesbank to set the system wide rate of inflation. However, this case has been weakened substantially in the light of the inflationary pressures generated by German reunification and the consequent punitive interest rates set by the Bundesbank.

Of the two monetarist arguments, it is clearly the position of the flexible exchange rate advocates which is the more intellectually coherent. If low inflation is the over riding objective there is no reason why domestic political and economic institutions cannot deliver it. This argument of course would not be applicable to a small open economy (such as Ireland) where the nature of the exchange rate regime is essentially irrelevant. Although a change in the exchange rate regime may change the mechanism by which the small country adjusts to policy changes emanating form the monocentre, it will do nothing to remove the final necessity of adjustment. (Smithin 1991)

However, medium sized financial powers will still have important decisions to make about their relationship to the financial superpower. These intermediate nations may not be powerful enough to affect the fortunes of others but they may have sufficient "credit" to exercise a degree of interest rate autarchy if they choose. In such cases the nature of the exchange rate regime becomes crucially important. The retention of the possibility of exchange rate changes will allow for the emergence of forward premia and risk premia (or discounts), and hence at least some scope for a different interest rate policy than that of the monocentre. (Hicks, 1982)

However, the economic basis of the case for flexible exchange rates is not as strong as it was once believed to be. (Laidler, 1990). The old Philips curve analysis which postulated a trade-off between inflation and unemployment, and hence provided a rationale for expansionary domestic policies and thus a flexible exchange regime, has been largely discredited. The curve exists as an apparently stable relationship only as long as economic agents' expectations of inflation remain stable over time. This is clearly not the case. Consequently the postulate of a long run inflation-unemployment trade-off has turned out to be illusory. However Friedman (1953) believed that there was a strong political element to the case. A flexible exchange rate confers on the domestic authorities a certain degree of short run room to manoeuvre in the conduct of stabilisation policy. But that is not the main point: a flexible rate also permits them to pick the path of domestic inflation even in the long-run. Consequently, it is argued that flexible exchange rates are the natural institutional arrangements in a world in which political power is still largely exercised at the level of the nation state, and in which electorates expect their governments to make effective decisions about the inflation rate.

A Non-Monetarist Critique of the EMS

The debate as to the relative merits and demerits of the EMS has also encompassed the theory of optimal currency areas. An O.C.A. is defined as a group of economic entities (individuals, regions, or countries) among which welfare is maximised through fixed internal exchange rates or a common currency and a flexible exchange rate towards the rest of the world. (Mielsen et al 1991) It is argued that co-operation amongst such economic entities leads to microeconomic efficiency gains through a dampening of exchange rate uncertainty, facilitating trade and, in the case of a full monetary union, eliminating foreign exchange transactions costs.

However, viewed from the outside it is something of a mystery as to why the conventional wisdom in Europe holds that a common currency, or, at minimum, a set of fixed exchange rates is necessary to prevent the introduction of trade restrictions within the EC. Indeed Eichengreen (1990, p12) remarks that "The belief that fixed exchange rates are needed to obtain the benefits of a customs union is a recent and peculiarly European view". It can be argued that there is really no reason why in principle the existence of different currencies, subject to exchange rate changes, should in itself provide any serious barrier to trade. It is not at all clear that the costs to society of "insurance" through the provision of hedging instruments is any greater than the cost of maintaining a rigidly fixed exchange rate regime. This point is particularly salient when viewed in the light of the recent large scale speculations against the weaker currencies in the EMS.

Typically it is argued that any system of fixed or semi fixed exchange rates ought to put the lowest inflation country in charge (for example The Economist 6 Jan 1990). Whereas high inflation countries are under constant threat of having to devalue their currencies, low inflation countries are under a corresponding pressure to let theirs appreciate. However, most governments find devaluing their currency much more embarrassing than revaluing it. It is argued therefore that fixed exchange rate systems should have a natural bias against inflation. However, there is a danger that this anti-inflationary bias could become an excessively deflationary bias. Departing from the monetarist approach, I have outlined earlier in this paper, it may be suggested that monetary policy is indeed important for real economic outcomes: the decision to enter a fixed exchange rate system and to submit to the hegemony of the monocentre may not simply be a matter of accepting a different inflation rate than the one that would be "chosen" domestically but of accepting a different growth rate or unemployment rate as well. In particular the medium sized financial power forgoes a potential "escape route" from a deflationary pressure emanating from the centre, which might otherwise have been available (Smith 1991,de Grauwes 1990).

Most expositions of the concept of the OCA have essentially made the point that the area should comprise units which have both a similar economic infrastructure and a high degree of factor mobility (particularly labour mobility) between

them. If economic conditions are dissimilar across regions, unpredictable shifts in demand may well lead to situations in which the principle industries in one area are depressed whilst those in the other are booming. A common monetary policy which would be focussed on reducing inflationary pressures in the latter region would simply exacerbate the depression in the former. These regions are not OCAs and would benefit from exchange rate flexibility between them. Such an analysis could be applied to the core and periphery countries of the EMS. Eichengreen(1990) discusses in some detail the case of Puerto Rica which is very pertinent to the case of the EC, in that even though the island is a full member of the American "customs and currency union" there are obvious cultural and linguistic barriers to full factor mobility and these do seem to have had an impact.

Proponents of a fixed exchange rate must argue that the inevitable discrepancies in regional economic performance can be ironed out by mobility of the factors of production rather than by separate monetary policies and exchange rates. In the case of a full currency union (EMU), where depreciation is completely ruled out the restoration of competitiveness would require that there must be a downward pressure on regional money wages and costs. This will surely be resisted both for traditional reasons and because the linkages implicit in the currency union will encourage the use of bloc wide comparisons of relativities and norms in wage bargaining (Mielsen et al 1991). Both the resulting unemployment and the pressure for reductions in real incomes can then only be relieved by the migration of labour to the more prosperous regions.

Has the EMS Fulfilled its Goals?

Aside from its political significance, the principle economic goal of the EMS has been to provide a stable international monetary environment that would generate welfare improving macroeconomic benefits for member countries. Before the turbulence in the financial markets of recent months many authors had presented evidence that exchange rate fluctuations had been reduced (see for example OECD Economic Outlook, Dec. 1989). This held true both when the situations before and after the establishment of the EMS were compared, and when ERM countries were compared with a control group consisting of non ERM countries. Perhaps, however, the development of inflation represents the most significant example of convergence in economic indicators. In other fields such as real economic growth and unemployment levels, signs of convergence have been less clear (Mielsen et al 1991).

However, when looking at exchange rates it is important to look at real as well as at nominal movements. (The real exchange rate is the nominal exchange rate adjusted by the ratio of domestic and foreign price levels). For example a study by the CEPS Economic Policy Group (1991) found that the lira and peseta had appreciated significantly since the mid 1980s, in sharp contrast to the experiences of the two largest economies in the EMS, Germany and France and most of the

smaller northern European countries. It is argued that a major deterioration in competitiveness is observable in Italy throughout the period of EMS membership and in Spain since about 1985. They argue prophetically that, especially against the background of a deterioration of the current account and a decline in the export/GNP ratio in both countries, continued divergence in competitiveness inside the EMS can only lead to a point where the system becomes unsustainable.

However, the foregoing analysis has been overshadowed by the currency market turbulence of recent months. Of the ten currencies that were members of the ERM last September (Greece is not a member, and the Luxembourg franc is set at par with Belgium's) only five remain unscathed; sterling and the lira have left the system, and the peseta, the escudo and the punt have all been devalued. All fixed exchange rate regimes are vulnerable to external shocks - which is exactly what happened when Germany reunited. The Bundesbank has been unyielding in its response to the inflationary pressures generated by reunification. Consequently, German short term rates which set a floor for those in the rest of the EC are at historically high levels. Other countries must maintain higher real interest rates than their depressed economies need. This has generated considerable political tension, particularly as the option of devaluation has become less favourable since the late 1980s when the ERM was chosen as the appropriate vehicle for European union and the balance between flexibility and stability tipped decisively towards the latter. The spectacle of EC governments airing their criticisms of each other makes a mockery of the spirit of cooperation which the EMS ostensibly embodies.

Conclusion

Clearly in the light of recent events, the theory and reality of the EMS have diverged dramatically. The fact that true political and economic power still lies at the level of the nation state is illustrated by the unwillingness of governments to subordinate their economic policy making to the achievement of a transcendental "European" goal. Perhaps now we are experiencing the backlash of the many awkward questions pushed aside earlier.

Although the EMS rules were built on the principle of "reciprocity", the role of the German mark expresses the fact that in practice the EMS is dominated by an"asymmetry" with the burden of adjustment having been placed on the weaker economies. This is in sharp contrast to the original intentions of the EMS. Initially countries which did not wish to submit themselves to the discipline of the Bundesbank could either rely on capital controls by which the domestic money market would be partly shielded in respect of the mark, or else make use of periodic central exchange rate adjustments to maintain a certain autonomy in long run monetary development. Consequently the other nations in the E.M.S. have been obliged to acquiesce to the tight monetary policies pursued by the Bundesbank, ruling out, for example, the option of an easier monetary policy to reduce domestic unemployment.

If, as seems likely, the E.M.S.will stagger on, bloodied and bowed, the recent signs of a softening of its stance by the Bundesbank will be welcomed throughout the system. However, events of recent months do not augur well for the prospects of a European currency union within the timescale envisaged at Maastricht. Perhaps at a time when unemployment throughout the EC is approaching 20 million it is time for a radical rethink by E.M.S. member governments of the form monetary policy takes over the coming decade.

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