

## The Crisis in the EMS

AFTER A PERIOD OF STABILITY OF MORE THAN FIVE YEARS, the European Monetary System (EMS)<sup>1</sup> was forced into a series of realignments of the participating currencies' central rates in the months after September 1992. Following renewed turmoil on the currency markets in July 1993, on 2 August 1993 the ministers and central bank governors of the Community decided 'to widen temporarily the obligatory marginal intervention thresholds of the participants in the exchange rate mechanism of the European Monetary System to  $\pm 15$  per cent around the bilateral central rates'.<sup>2</sup> Although this measure was repeatedly emphasized as being 'of limited duration', as was the determination of some ministers to reach Monetary Union, these events have been designated as the 'death' of the EMS or its 'breakdown', and the Bank of International Settlements in its latest Annual Report called it 'the most significant and far-reaching currency market crisis since the breakdown of the Bretton-Woods-system'.

But rumours about the EMS's death may be premature since it is not at all clear what went wrong. Interpretations as to what caused the crisis have differed widely, ranging from the analysis that the system had been mishandled to the assertion that it was inherently flawed.<sup>3</sup> Just as varied have been prescriptions about the political consequences of the events. The former French President, Giscard d'Estaing, for example, urges that the introduction of Monetary Union should be speeded up now, while the official position of the French and the German governments is to proceed with the timetable agreed in the

<sup>1</sup> Technically speaking, most of this article deals with the Exchange Rate Mechanism (ERM) of the EMS. For reasons of simplicity, however, I shall refer to it mostly as the EMS.

<sup>2</sup> Communiqué of the European Community, Brussels, 2 August 1993, reprinted in Deutsche Bundesbank, *Auszüge aus Presseartikeln* (henceforth quoted as PA), Nr. 53, 3 August 1993, p. 1.

<sup>3</sup> For a recent example of the first view cf. Hans Tietmeyer, 'Europäische Währungs- und Kapitalmarktfragen', printed in PA 73, 21 October 1993, of the latter view cf. 'From here to EMU', *The Economist*, 23 October 1993, pp. 29–31.

Table 1

Devaluations of Currencies and Other Events in the ERM since September 1992

Date	Lira percentage	Sterling	Peseta percentage	Escudo percentage	Punt percentage
14 Sept. 1992	- 7				
17 Sept. 1992	leaves ERM	leaves ERM	- 5		
23 Nov. 1992			- 6	- 6	
11 Feb. 1993					- 10
14 May 1993			- 8	- 6.5	
2 Aug. 1993	bandwidths in the ERM widened from $\pm 2.25$ to $\pm 15$ per cent				

Source: Deutsche Bundesbank

Maastricht Treaty (with Chancellor Kohl acknowledging in an interview that there might be a delay of one or two years), whereas the British Prime Minister, John Major, has repeatedly stated that the 'EMU timetable looks wholly unrealistic today'.<sup>4</sup>

This article will attempt to analyse the causes of the EMS crisis. It will be argued that in spite of some minor flaws in its construction, the EMS on the whole was very successful in reaching the goals it was designed to reach. But a combination of overburdening the system, an external shock and changing circumstances in world financial markets led to the events described above. After briefly looking into the reasons for and the history of European currency cooperation, these points will be elaborated upon. Some problems in the construction of the EMS will also be described. We will then focus on the special problems faced by the Bundesbank, which saw itself torn between its domestic obligations and its European responsibility. And finally there will be some speculative remarks about the future of currency cooperation in Europe.

#### EUROPEAN CURRENCY COOPERATION — A LONG HISTORY AND GOOD REASONS

Although the 1980s were the decade of the markets and liberalization, European governments preferred their currencies

<sup>4</sup> Giscard d'Estaing, 'Krise als Beschleuniger', *DIE ZEIT*, 8 October 1993; 'Mitterrand: Währungsunion nicht verzögern', *Frankfurter Allgemeine Zeitung*, 17 August 1993; No. 10 Downing Street press release, 2 August 1993, printed in *Survey of Current Affairs*, Vol. 23, No. 8, August 1993.

to be members of a managed exchange rate system. There are good reasons for this. First of all there is a very high level of economic openness and integration between the EC countries. Although the EC as a whole shows a degree of economic openness<sup>5</sup> similar to that of the United States or Japan (12.3 per cent, 10.1 per cent and 11.4 per cent, respectively), economic integration *between* the European countries is many times greater: imports account for more than three-quarters of GDP for example in Belgium, 60 per cent in Ireland and the Netherlands, and between 25 and 30 per cent in the Federal Republic, France and the United Kingdom. While EC countries exported on average, between 1974 and 1986, 37.6 per cent of their GDP, the figure for the rest of the OECD countries is only 18.4 per cent, approximately half of the EC countries' ratio. These figures may show that limiting exchange rate fluctuations between European currencies must have a high priority for European governments, since these can seriously impair welfare in their countries by exposing them to economic shocks beyond their influence. Another main reason for pursuing exchange rate stability is the existence of the Common Agricultural Policy (CAP) within the EC. On the integrated agricultural market, prices are set in a common unit of account. Exchange rate fluctuations complicate the operation of this market considerably, resulting in the introduction of 'Monetary Compensatory Amounts', which again cause unwanted side-effects in agricultural production (namely further encouraging overproduction).

The factors outlined above have resulted historically in several attempts at limiting exchange rate volatility within Europe, ranging from the European Currency Agreement (1958) to the 'Snake' (1973).

#### THE EUROPEAN MONETARY SYSTEM

The EMS, introduced in March 1979, is only the latest in that series.<sup>6</sup> It was set up to serve two purposes, one economic, one

<sup>5</sup> Here measured as imports as a share of GDP. Figures relate, unless otherwise noted, to 1987 and are from Francesco Giavazzi and Alberto Giovannini, *Limiting Exchange Rate Flexibility: The European Monetary System*, Cambridge, MA, MIT Press 1989, p. 3 and author's calculations from OECD statistics.

<sup>6</sup> The creation of the EMS is described in detail in Peter Ludlow, *The Making of the European Monetary System*, London, Butterworth Scientific, 1982.

political: the economic purpose was to limit the volatility of exchange rates and create a zone of monetary stability in Europe; the political purpose was to exert a disciplinary effect on economic policy in the participating countries by making the devaluation of a currency (the logical consequence of high rates of inflation) a cumbersome issue which governments would strive to avoid, thereby encouraging macro-economic convergence towards low inflation.

There is little disagreement in the literature that the EMS was very successful in promoting convergence of main economic indicators in the participating countries.<sup>7</sup> This occurred with respect to the stabilization of intra-EMS exchange rates and interest rate differentials (the volatility of which have gone down both in nominal and in real terms), but most clearly with respect to inflation which has been reduced both in level and variability in the EMS countries since 1979.

But this disinflation did not come about magically. Rather it was caused by a 'conversion to macro-economic discipline' (Sandholtz) in the member countries, for which the EMS provided both a framework and a mechanism. These shifts in policy preferences (making disinflation the priority) in the EMS countries (with the exception of Germany, which, in a way, was already virtuous) were partly caused by changes in macro-economic concepts. The notion that there exists a significant and politically exploitable trade-off between unemployment and inflation (which had evidently failed during the 1970s) was given up in favour of a conception which, quite the opposite, saw low inflation as a precondition for growth and competitiveness, thereby also improving the medium-term prospects of

<sup>7</sup> Cf. e.g. Michael J. Artis and Mark P. Taylor, *Exchange Rates and the EMS: Assessing the Track Record*, CEPR Discussion Paper No. 250, April 1988, London, CEPR 1988; Susan M. Collins, 'Inflation and the European Monetary System', in Francesco Giavazzi, Stefano Micossi and Marcus Miller (eds), *The European Monetary System*, Cambridge, Cambridge University Press, 1988, pp. 112–36; Michael W. Klein, 'The European Monetary System and European Integration: An Evaluation', in Paul J. J. Welfens (ed.), *European Monetary Integration. From German Dominance to an EC Central Bank?*, Berlin, Heidelberg etc., Springer 1991, pp. 53–73; Axel A. Weber, 'Reputation and Credibility in the European Monetary System', *Economic Policy*, 12 April 1991, pp. 58–102; Michael Emerson et al., *One Market, One Money. An Evaluation of the Potential Benefits and Costs of Forming an Economic and Monetary Union*, Oxford, Oxford University Press, 1992, p. 71, Table 3.5 and the literature survey in 'The exchange rate mechanism of the European monetary system: a review of the literature', *Bank of England Quarterly Bulletin*, February 1991, pp. 73–82.

unemployment. This change of view was not unrelated to the liberalization of financial markets, occurring increasingly since the mid-1970s, which (by increasing capital mobility) imposed an important external constraint on national economic policy-making because relatively higher inflation in one country would lead to outward flows of capital and downward pressure on the currency.<sup>8</sup> Faced with this situation, the EMS provided an attractive mechanism for national policy-makers as it reduced political and economic costs for them. In economic terms it did this by providing facilities to finance interventions for the stabilization of the exchange rate, which meant that there was less need for adjustment of domestic interest rates than there would have been without the ERM. Politically the EMS was attractive, as it allowed policy-makers to shift the blame for necessary adjustments to an international regime, thereby evading electoral punishment.<sup>9</sup> As John Woolley has put it: '... it is politically useful to have a policy one prefers "imposed" from somewhere else when it involves short-run costs'.<sup>10</sup>

This worked, as is generally acknowledged, by 'borrowing' an anti-inflationary reputation and credibility from the independent German central bank, the Bundesbank, whose currency, the D-Mark, became the nominal anchor currency of the EMS. It did not become the anchor by decree, but through its low inflation record, thereby determining the absolute level of prices.<sup>11</sup>

To conclude this section we can say that the EMS was very successful in bringing about disinflationary convergence in its member economies. This worked, because the EMS, based on

<sup>8</sup> A brief country-by-country account of these shifts in policy is given in Wayne Sandholtz, 'Choosing union: monetary politics and Maastricht', *International Organization*, 47, Winter 1993, pp. 1–39.

<sup>9</sup> This point is also stressed by David M. Andrews, 'From *ad hoc* to institutionalized coordination and beyond: twenty years of European monetary integration', Paper presented at the Inaugural Pan-European Conference of the ECPR, Heidelberg, September 1992, who speaks of the EMS as providing opportunities for 'political blame management': 'High interest rates could be blamed on the Bundesbank, and coordination within the EMS could be justified in terms of its association with the cause of European integration more generally.' (p. 19f.)

<sup>10</sup> John Woolley, 'Policy Credibility and European Monetary Institutions', in Alberta M. Sbragia (ed.), *Euro-Politics. Institutions and Policymaking in the 'New' European Community*, Washington D.C., Brookings, 1992, pp. 157–90, p. 171.

<sup>11</sup> Every exchange rate system must have such a nominal anchor, since exchange rates, by themselves, define only *relative* prices. This is known in the economic literature as the 'N-1' problem.

**Table 2**  
The State of Economic Convergence 1987–92 as Measured by Average Yearly Rates

	Inflation (CPI) (percentage)	Current account as percentage of GDP	Gross national debt as percentage of GDP
Germany	2.4	2.3	43.6
Netherlands	1.9	3.3	78.4
Luxembourg	2.4	29.5	8.3
Belgium	2.5	1.5	130.2
France	3.1	-0.4	47.8
Ireland	3.1	2.9	108.1
Denmark	3.4	-0.2	68.6
Italy	5.7	-1.2	97.5
Spain	5.9	-2.5	45.2
United Kingdom	6.0	-3.4	45.9
Portugal	10.8	-2.2	70.6

Source: Deutsche Bundesbank, Annual Report 1992

Note: Greece is not mentioned as it did not participate in the ERM. Spain joined in 1989, the UK in 1990 and Portugal in 1992.

policy decision of its member countries, was credibly committed to a low inflation policy.

### THREE CAUSES OF THE CRISIS IN THE EMS

Why then, we ask, in spite of all these successes, did the crises in the EMS occur after the summer of 1992? They were the cumulative effect of three separate causes: the 'stiffening' of the EMS for political reasons, the economic shock caused by German unification, and great changes in world financial markets.

*Developments in the EMS.* Although the EMS was conceived as a system of fixed, but adjustable exchange rates, there were no realignments of currency parities for more than five years after January 1987. Economic convergence, as noted above, did occur, but it was far from complete. There were still significant differences in the economic developments among the European countries which would have made realignments necessary.

As can be seen from Table 2, with respect to average yearly inflation we can distinguish three groups of countries in the EC: one, consisting of the Benelux countries, which has the same level of price stability as the German 'anchor', then a group with

slightly higher rates, consisting of France, Ireland and Denmark, and finally a group of the southern countries plus the United Kingdom, whose yearly rates of inflation were then ranging from about 6 to 11 per cent. It can also be seen from this table, that all the countries outside the first group show a deficit in their current account (with Ireland being the only exception). Furthermore, some countries in comparison show very high levels of public debt, most notably Belgium, Ireland and Italy. We can conclude from the above that between 1987 and 1992 exchange rates remained stable, although the development of economic 'fundamentals' did not justify such complete stability. Realignment should have brought the external value of currencies (the exchange rates) in line with their internal value (determined by inflation).

For political reasons they did not occur. The Single European Act, coming into force in July 1987, provided for the completion of the internal market by 1992. In the run-up to that magic date, countries were eager not to be seen falling behind, as would have been the case with a devaluation of their currency. This effect was enhanced when in 1988 a single European currency was discussed at the Hanover summit and resulted in the Delors report (April 1989), the findings of which were endorsed by the EC summit in Madrid in June 1989. It laid out a timetable for Economic and Monetary Union (EMU). At the end of 1989, the EC summit at Strasbourg announced an Intergovernmental Conference on EMU for 1990. The consultations of this conference resulted in the signing of the Maastricht Treaty in December 1991, setting the starting date for EMU in 1997 or 1999 at the latest.

During this whole process, the countries participating in the EMS acted almost as if Monetary Union were already in place. But since macro-economic convergence was far from being complete, it meant that considerable pressure was building up within the EMS. The situation was paradoxical: since currency stability was seen as being of high symbolic (and political value, as intended in the construction of the EMS), countries avoided realignments. The more time passed, the more the need for a realignment grew, but at the same time the higher the costs of a realignment would have been, for the bigger it would have to be and the closer one would have come towards the end of EMU. The more economically necessary a realignment became, the less politically feasible it became without loss of face. In a way the EMS can be said to have become the victim of its own success.

(That decision procedures for realignments within the EMS facilitated this, will be discussed below.)

Economically, this was not necessarily the best way either. Keeping exchange rates constant while price developments differed resulted in a real appreciation of the currencies with higher inflation than the anchor currency, with an ensuing loss of competitiveness of their national economies. On top of this, domestic interest rates had to be higher than otherwise in this case, although the markets, apparently themselves believing in imminent Monetary Union, did not demand a full premium to cover the exchange rate risk. When the rejection of the Maastricht Treaty by the first Danish referendum in June 1992 cast serious doubt on the realization of Monetary Union, the markets 'rediscovered' this exchange rate risk. Moreover, the convergence criteria set out in the Treaty as a precondition for Monetary Union seemed almost impossible to meet for some countries, in particular with respect to national debt. But due to the domestic economic situation, governments were seen as unable to raise interest rates to the levels required to cover these risks. Some exchange rates were therefore judged to be untenable, and the currencies came under attack by the markets.

*The economic consequences of German unification.* An additional cause for the turbulence within the EMS were the consequences of (in economic terms) an exceptional external shock, German unification. Integrating the economically obsolete former German Democratic Republic into the Federal Republic required (and still requires) enormous sums of money. This was further exacerbated by introducing the D-Mark at a rate of 1:1, resulting in a *de facto* revaluation of more than 300 per cent for the East and an almost complete collapse of production there. As a consequence, massive transfers from the West to the East were needed. They amounted to 113 billion D-Mark in 1991 and 145 billion D-Mark in 1992, or approximately 5 per cent of the German GNP.<sup>12</sup> Because the West German chancellor had promised (be it for political reasons or by seriously underestimating the size of the problem) that unification would not require tax rises, these transfers had to be paid for by increased government borrowing. Together with the boom resulting from additional demand from the East, serious overheating of the (West-German) economy and inflationary

<sup>12</sup> Cf. Horst Siebert, *Das Wagnis der Einheit. Eine wirtschaftspolitische Therapie*, Stuttgart, DVA, 1992, p. 139ff.

pressure which threatened price stability were the consequence. But since 'price stability is the first commandment in German monetary policy (and perhaps the second and third commandment as well)',<sup>13</sup> the Bundesbank had to resort to a tight policy, raising interest rates considerably. The discount rate, which had been at 6 per cent in November 1990, was raised to 8.75 per cent in July 1992 before being lowered again gradually from September 1992 onwards. The Lombard rate had even peaked at 9.75 per cent. While being successful insofar as it induced a sharp recession in Germany and hence lowered inflationary pressure, this policy also affected the other European countries since it forced them to raise interest rates as well, at least if they wished to maintain their exchange rate vis-à-vis Germany.

Another factor is a lack of coordination of German fiscal and monetary policy. As noted above, fiscal policy of the central government was very expansive, in part because complicated configurations in German federalism make it difficult to adjust quickly to new challenges which imply considerable distributive changes between the different levels of government. But the government also introduced measures which were in open confrontation with the restrictive monetary policy of the independent Bundesbank, namely subsidizing credits to East Germany. As credit expansion was one of the main causes of the rapid expansion of the money supply which the central bank was worried about, these subsidies cut the cost of money which the Bundesbank tried to raise. This meant that the Bundesbank had to raise interest rates even further.

But German unification had a second economic effect as well. The boom resulting from the additional demand in East Germany desynchronized the German economy with that of its neighbours (which also profited from this demand, but to a far lesser extent). While most of them were on a cyclical downward path, Germany experienced a post-unification boom, which meant that high German interest rates came at a time when most European economies needed lower interest rates to recover from recession. This further increased the pressure and the problems arising from the 'stiffening' of the EMS which have been described above.

In abstract terms, the problem consisted of the fact that the EMS anchor currency, the D-Mark, the long-time guarantor of stability, was suddenly inflation-prone. As a result, from the second quarter of 1991 onwards countries such as Denmark,

<sup>13</sup> Sandholtz, *op. cit.*, p. 5.

**Table 3**  
Volume Developments in World Trade and World Currency Markets

	1987	1991
(I) World trade volume per year	\$4000 bn.	\$7100 bn.
(II) Currency market volume per day	\$250 bn.	\$880 bn.
(III) Ratio (I/II)	1/20	1/37

Source: see text

France, Belgium, Ireland and eventually even the United Kingdom had lower rates of inflation than Germany. This situation meant that while *real* interest rates in Germany were not as high as their nominal level indicated, they were even higher outside Germany. But there was apparently little that could be done about it. The anchor role of the D-Mark resulted from the credibility acquired through its low inflation record, and the currency markets seemed to trust the Bundesbank to solve its inflationary problem. Apparently in the markets' view no other currency possessed enough credibility to replace the D-Mark.

*The revolution on the currency markets.* The third cause for the troubles in the EMS is the enormous changes which have taken place on the currency markets in recent years, completely altering the circumstances under which the EMS operates. Since 1986, the volume of activity on world currency markets has more than tripled, growing by 116 per cent between 1986 and 1989 and by 44 per cent between 1989 and 1992. This exceeds by far the developments in world trade. As the figures in Table 3 show, the volume of world trade in commodities is literally dwarfed by the volume traded in the currency markets, amounting to approximately 1/37<sup>th</sup> of it.<sup>14</sup>

This of course has important consequences, both for economic theory and policy. On the one hand it means that movements in the exchange rate are determined much more by speculative movements in the currency markets than by the trade flows. Economic fundamentals therefore have far less influence on the development of the exchange rate than they used to have, and it is by no means certain that, e.g., a trade deficit would lead to a

<sup>14</sup> Figures for 1987 are taken from Dieter Hiss, 'Geld- und währungspolitische Implikationen einer Globalisierung der Finanzmärkte', *Wirtschaftsdienst*, II, 1988, pp. 71–78; Figures for 1991 are author's calculations from *United Nations Statistical Yearbook*, 1990–91, New York 1993 and Bank for International Settlements, *Central Bank Survey of Foreign Exchange Market Activity in April 1992*, Basel, BIS 1993.

currency devaluation which would in the medium term lead back to an equilibrium. What was new about the events of 1992–93 was above all that speculative attacks, which in the past used to be directed only against countries pursuing an inflationary policy, now also take place against currencies whose economic ‘fundamentals’ are in order such as France, changing them into ‘political’ speculations and raising fears about ‘conspiracy’ on the markets. But one need not resort to such theories, since the markets’ behaviour can be explained very well as a rational reaction to a combination of little risk and huge potential profits, should the ‘one-way bet’ against the central banks succeed. From a theoretical point of view, however, these developments have been analysed as ‘market failure’, implying that individual profit-maximizing behaviour on currency markets no longer leads to an overall economic optimum. This is seen as proof that currency markets are not an efficient means for fixing exchange rates.<sup>15</sup>

But consequences for economic policy, in particular currency policy, are just as important. It means that intervention by central banks has little chance of having any lasting effects on the markets, simply because the volume of central banks’ currency reserves is almost negligible as against the volume of overall trade. The overall volume of interventions in the six months between June and December 1992 according to the Bank for International Settlements (BIS) was an impressive \$200 billion, but that is only a quarter of one day’s turnover. On 30 July 1993 alone, the Bundesbank spent 30 billion D-Mark in interventions, but that amounts to a mere 2 per cent of that day’s turnover. True, much of that volume is in trade with the US Dollar, and intervention ratios relative to market volume between EMS currencies are therefore larger. But nevertheless central banks, which used to command nearly inexhaustible reserves, need be no longer dominant in the currency markets. They are just ordinary players among others.

To conclude this section we can say that a combination of three causes led to the turmoil on the currency markets in 1992–93: since 1987 the EMS was for political reasons robbed of its in-built flexibility and forced to act as if Monetary Union were already in place, although economic developments and fundamentals were still not ready for that. The system was overburdened, causing economic problems such as loss of competitiveness in the member

<sup>15</sup> Peter Bofinger, ‘Der Name des EWS’, *Wirtschaftsdienst*, IX, 1993, pp. 454–57.

countries' economies. These underlying problems were exacerbated in the extreme when the shock of German unification resulted in a desynchronization of business cycles in the EC and an expansionary fiscal policy in Germany forced the Bundesbank to raise interest rates to record levels. These were transmitted via the artificially 'stiffened' EMS to other European countries, prolonging recession there. All this took place against the background of an explosion of the volume traded in currency markets, which robbed central banks more or less of their ability to support exchange rates via intervention, leaving these at the mercy of the markets. Once the markets had 'smelled blood', enormous speculative attacks, induced by low risk and high potential profits for those who could force a currency into devaluation, were launched and buried the hopes of policy-makers.

#### PROBLEMS IN THE EMS

Does it follow from the crises of the EMS that the EMS itself is 'inherently flawed'? This has frequently been stressed by the UK government. But there has been no political action to draw consequences from it, e.g. at the EC special summit in Brussels in October 1993. Suspicions therefore remain that these statements were meant mainly for domestic consumption, to rationalize what has been called 'the most dramatic and momentous turning-point in macro-economic policy since Thatcher's election in 1979', sterling's forced exit from the ERM.

But this does not mean that the EMS is faultless. Two criticisms are evident from the analysis so far: operational asymmetry and the decision-making mechanism for realignments.

*Operational asymmetry.* Although the EMS was explicitly constructed to provide symmetry in the distribution of adjustment pressures between appreciating and depreciating currencies, *de facto* there exists an asymmetry. This is caused by the fact that problems for individual currencies do not occur via the 'divergence indicator', but rather via their bilateral exchange rate with the D-Mark. This has been criticized as shifting the burden of readjustment disproportionately upon the weak currency countries.<sup>16</sup> This asymmetry results mainly from the fact that the

<sup>16</sup> Cf. e.g. Giavazzi and Giovannini, *op. cit.*

strong currency country is able to 'sterilize' the expansionary effects of intervention on its money supply through measures of monetary policy and hence does not need to adjust its policy, while the weak currency country is limited in its intervention capacity by the amount of currency reserves, because money borrowed for intervention from other central banks has to be paid back within a couple of months. The weak currency country therefore has to adjust its policy or face devaluation.

But on the one hand empirical studies have shown that the influence on monetary policy in Germany and the other EMS countries runs both ways, rejecting the hypothesis of one-way influence. On the other hand, this asymmetry can be seen as a result of a combination of inherent and intentional aspects of the EMS, in that low inflation currencies rise to the top of their bands and exert discipline upon the high inflation currencies.<sup>17</sup>

*Decision-making in the realignment process.* An evident problem in the EMS is the mechanism to decide about realignments of central parities. Since the EMS is not a form of supranational integration but one of intergovernmental cooperation (since technically it is an agreement between central banks), unanimous decisions are required to achieve realignments. This in effect means that every single participating country possesses a veto. Neither do institutions exist that can require revaluations, nor is there a consensus about conditions that require revaluations. As a consequence, some countries have vetoed realignments for domestic political reasons, causing severe strains within the EMS. France, for example, rejected the suggestion of a D-Mark revaluation which had been proposed by the Bundesbank immediately after German unification; the United Kingdom declined to participate in a general realignment of EMS parities (which would have involved a sterling devaluation) in exchange for a more pronounced interest rate cut by the Bundesbank at the beginning of September 1992, only ten days before sterling was forced out of the EMS.<sup>18</sup> Both examples are clearly linked with the present problems of the EMS, and it could well be that the crisis of the system could have been avoided had a revaluation taken place on one of the two occasions.

<sup>17</sup> Cf. Bank of England, *op. cit.*

<sup>18</sup> *The Economist*, 7 August 1993, p. 21; John Woolley, *op. cit.*, p. 188; Will Hutton, 'The Chancellor, the Banker, and Deaf Ears in Bath', *The Guardian*, 30 November 1992, p. 3.

This implies that new rules about the process of realignments within the EMS are necessary. Of course there is a tension between fixed rules and the desire for political room to manoeuvre. And calls to 'depoliticize the fixing of exchange rates'<sup>19</sup> are in evident conflict with the intended disciplinary effect of the EMS which should deter governments from using currency devaluation as a 'soft option' for monetary policy. But recent political developments might provide a way out of that dilemma: since most European countries have taken steps to grant independence to their central banks and commit them to pursuit of price stability, adjustment of parities could be left to them while there would be no need to worry about inflationary consequences.

#### THE SPECIAL PROBLEMS OF THE BUNDESBANK

The German central bank, the Bundesbank, faced some special problems in the period leading up to the crises of the EMS (i.e. since 1990–91) which will be looked into briefly. One problem was the tension between its domestic task and the *de facto* influence of its decisions on a European level, resulting from the D-Mark's anchor role. The Bundesbank is legally obliged to maintain price stability in the Federal Republic of Germany, and it is independent of government instructions.<sup>20</sup> It is therefore quite clear that for the Bundesbank German price stability must come first. Moreover it can be argued on good grounds (as the Bundesbank has in fact done) that, given the D-Mark's anchor role, a stable D-Mark is the best service it can provide for the European countries, thereby assuring markets and keeping medium- and long-term interest rates low.<sup>21</sup> Letting German inflation rise in order to silence criticisms about its monetary

<sup>19</sup> Cf. Reimut Jochimsen, 'European Economic and Monetary Union: The Do's and the Dont's', *The World Today*, June 1993, reprinted in *PA*, 44, 1993, 25 June 1993, pp. 9–14, p. 13.

<sup>20</sup> The Bundesbank's independence from government and its obligation to pursue price stability, until recently only encoded in the Bundesbank Act, have recently even been set down in the Basic Law and now have constitutional validity.

<sup>21</sup> The Austrian economist Erich Streissler has even analysed the D-Mark as being a European 'public good' provided by the Bundesbank. Cf. Erich Streissler, 'Unsere goldlose Goldwährung', in J.-M. Graf von der Schulenburg and Hans-Werner Sinn (eds), *Theorie der Wirtschaftspolitik. Festschrift zum fünfundsiebzigsten Geburtstag von Hans Möller*, Tübingen, Mohr, 1990, pp. 106–28.

policy was therefore not really an option, especially as it would have destroyed the Bundesbank's hard-won anti-inflationary credibility.

A second problem was the fact that the Bundesbank, within the EMS and given the existing economic situation, faced a veritable dilemma. Since growth of the German money supply was too high and incompatible with the announced target, arousing fears about future inflation, it could not lower interest rates. But this meant that other EMS currencies came under downward pressure, forcing the Bundesbank to intervene in their favour, buying these currencies against D-Marks. This in turn caused the German money supply to grow further, even if some of these interventions could be 'sterilized' by other measures of monetary policy. The increase in the money supply again made it impossible to lower interest rates, which in turn resulted in downward pressure on the EMS currencies . . . There was no way out of this vicious circle other than a realignment involving a revaluation of the D-Mark which the Bundesbank had repeatedly called for, but, as noted above, had been denied.

The third special problem was the fact that a restrictive monetary policy of raising short-term interest rates throughout Europe for the reasons mentioned above had rather different effects in the various countries, causing different levels of problems in the respective economies. Due to big differences in national systems to finance the economy, dependence on short-term financing varies considerably among the European economies, as does the sensitivity to changes in interest rates. The higher the dependence and the sensitivity, the higher is the 'pain' inflicted by rises in short-term interest rates. Within Europe, the United Kingdom and Ireland seem to suffer most from this effect, since most mortgage and business credits as well as most outstanding business debt are issued with a variable interest rate.<sup>22</sup> In contrast, other countries rely primarily on long-term debt with either fixed interest rates or interest rates tied to long-term bond yields, and some of them have developed special credit institutions for long-term debt such as mortgages. The importance of long-term debt seems to be especially pronounced in Germany, and France and Italy fall somewhere between the British and the German position. Long-term interest rates,

<sup>22</sup> For the following cf. Bank for International Settlements, 63, *Annual Report*, Basel, 1993; *The Economist*, 14 August 1993, p. 68; John Ridding and David Buchan, 'Between a Rock and a Hard Place', *Financial Times*, 22 September 1993, p. 17.

however, only remain low if the markets are convinced that on average inflation will remain low. This requires a credible anti-inflationary monetary policy, which in turn demands high short-term interest rates. The Bundesbank's policy therefore had an asymmetric effect, felt especially strongly in those countries sensitive to movements in the short-term interest rate. But this effect, it should be added, is also an indicator of the amount of harmonization that still has to take place among the European economies, if Monetary Union is to be introduced.

It can be concluded from the above that the Bundesbank did not wilfully neglect the economic interests of other European countries, but acted according to the logic and the demands of its situation. Although impeding its main task of keeping German inflation low, the Bundesbank fully adhered to its obligations to support other currencies via intervention. Nevertheless it was widely blamed for the negative developments. But this is only proof of one of the attractive properties of the EMS as seen from a standpoint of political rationality: to provide a 'scapegoat' on which blame for necessary policy decisions can be shifted.

#### EUROPEAN MONETARY POLICY: A NEW SITUATION?

Has, as a result of the crises in the EMS, a new situation arisen for European monetary policy? Will development towards Monetary Union progress, or has it been halted? While it is obviously impossible to answer these questions here, some ideas can be offered as to what has changed and what has remained the same.

According to Wayne Sandholtz's analysis quoted above, five factors have contributed to the decision in favour of Monetary Union as laid down in the Maastricht Treaty: 1) the project to complete the internal market by 1992; 2) support for it by the business community and national opinion polls; 3) the interest of France and other countries to reduce the dominance of German monetary policy; 4) the wish of German politicians to demonstrate an ongoing commitment towards European unity in the face of German unification and 5) the wish of the governments involved to make a commitment to a non-inflationary economic policy which was caused by a change in economic policy beliefs.

While the first two factors only provided a favourable environment and were not decisive, it seems that little has

Table 4

	Before crisis	After crisis
<i>Political (or 'Downsian') rationality</i> (electoral success)	Disciplinary effect of the EMS	Economic recovery, 'free riding'
<i>Economic rationality</i> (long-term economic success)	Lacking convergence in real economy	Stable exchange rates important because of economic integration

changed in the other three factors. This would mean that Monetary Union as described in the Maastricht Treaty is still the preferred option. An indication for this could be official statements by most European governments and the fact that at the time of writing (November 1993), European governments have made no use of their new-found 'freedom' in monetary policy, i.e. by slashing interest rates substantially and accepting devaluation in an effort to promote economic recovery. While this is being frowned upon by some commentators who state that 'parrots often stay sitting in their cages long after the door has been opened', it may be a perfectly rational pursuit of their economies' long-term interests.

But in the short term there may be a collision of interests that could be described as a collision between *political rationality* (focusing on short-term electoral success) and *economic rationality*, which focuses on long-term economic interests.

If one looks at the D-Mark parities of the currencies most affected by the crises in the EMS, there have been substantial changes between August 1992 and September 1993: Sterling -12.1, Lira -21.4, Peseta -20.3 per cent. These massive devaluations, of course, have an effect on economic activity, and may therefore be attractive to a government facing an election under conditions of recession. But it is an option not all governments have at the same time. Benefits can only be reaped if single currencies devalue, not if all embark upon competitive devaluations. Whether governments can resist the temptation to try to 'free ride', will be an empirical test of the hypothesis of 'conversion to macro-economic discipline'. As Table 4 shows, this means that *political rationality*, which prevailed before the EMS crisis (and prevented realignments), would have to give way to the dominance of *economic rationality* which puts a premium on long-term economic interests.