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Article

A French view

Intereconomics

Suggested Citation: Granet, Robert (1989) : A French view, Intereconomics, ISSN 0020-5346, Verlag Weltarchiv, Hamburg, Vol. 24, Iss. 2, pp. 57-60, http://dx.doi.org/10.1007/BF02928551

problem can only be found in an adequately large number of Community countries achieving a high degree of stability. The larger this nucleus is, the greater its effect will be on the system. The development in the EC during the past few years may definitely be regarded as exemplary. France, and some other member states, have likewise contributed to this in the past few years through their success in achieving stability.

Germany has every interest in an efficient EMS and in its development in order to strengthen the cohesion in the system, in the sense of developing a Community in which exchange rate stability is based on the internal currency stability of all members. This cohesion is not only important for the completion of the internal market by the end of 1992, but to a much greater extent for the further development of the EMS into a monetary union. It is only as an economically stable Community that the member states will be able to realise a common monetary area. For this purpose there must be a reliable basic consensus among them on the orientation of their economic and monetary policies as well as the willingness to establish the prerequisites for these economic and monetary policies.

Priority of Monetary Stability

Regarding the means of achieving this objective the question immediately arises as to how monetary policy at the national level and cooperation between national bodies must be structured in order to ensure the highest possible degree of exchange rate stability during the increasing liberalisation of money and capital transactions. There can be no doubt about it that member states can no longer pursue autonomous monetary policies once capital movements are completely liberalised and exchange rates ultimately fixed. However, one cannot speak of a loss of autonomy in monetary policy until exchange rates are fixed once and for all. As long as exchange rate fluctuations are still possible, national monetary policies retain a certain amount of latitude in principle. This will be limited to the extent to which one is prepared to take supra-national objectives into account in one's own monetary policy, i.e. to maintain fixed exchange rates. This may certainly lead to conflicts of interest. It is therefore all the more important that the monetary policies still pursued at the national level are well coordinated.

In a fully integrated Community in which money and capital can circulate freely and exchange rates are established definitively, the responsibility for monetary policy must be transferred to a common monetary institution. Such a step demands a high degree of political harmony and – since economic and social interdependence is also developing – solidarity. Furthermore, it is particularly important that the Community institution responsible for monetary policy is obliged to give priority to safeguarding monetary stability as a necessary prerequisite for achieving other economic policy objectives.

The preconditions under which the Community might make this third attempt at economic and monetary union have not become any easier in view of the sometimes large differences in the economic structures of the twelve member states. It can only be hoped that the political will necessary for developing the EMS further in this direction will not flag again in view of the far-reaching implications.

Robert Granet*

A French View

Instituted by a Resolution of the European Council of December 5th, 1978 and launched on March 13th, 1979 in the form of an agreement between central banks, the European Monetary System (EMS) is ten years old. This is obviously an occasion for taking stock of what has been achieved to date.

Outside observers' assessments of the way the system is working have been positive for the most part, especially when comparing its results with those of the earlier European currency agreement, the 1972 "snake". Whereas the number of currencies participating in the latter varied between 10 and only 4 within the space of seven years, all the States initially signatory to the EMS agreement have consistently abided by its rules, with the same margins as at its inception (2.25% for six of them, and 6% for the seventh, the Italian lira).

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Considered more specifically from the standpoint of one of its members, France, the EMS experience is not entirely immune from criticism. After noting that the EMS unquestionably has brought benefits, this article will seek to identify its current shortcomings in order to ascertain what might be done to make it work better.

Stabilization of Exchange Rates

The EMS has brought undeniable benefits. Among these is the stabilization of exchange rates. Exchange rate variability has ebbed since the inception of the system. That is true for real and for nominal rates alike. The trend to stability has gathered strength in recent years, moreover. Over the short term, since the system's inception, European currencies have varied four times less than the major floating currencies. This relative stability creates a more propitious forecasting climate for firms engaged in intra-European trade.

This diminished variability has not been accompanied by the misalignments experienced by the major floating currencies. Stabilization has not, after all, prevented the system from preserving a measure of flexibility and exchange rates from adjusting to shifts in economic fundamentals. There have been eleven realignments since implementation of the EMS. The Deutsche Mark has appreciated by more than 30 % to the French franc in ten years.

These results were achieved without undue intervention in the foreign exchange markets, and recourse to the system's support mechanisms has been limited. Restrictions on capital movements were also unnecessary; quite the contrary, the recent period of exchange rate stability has also witnessed a progressive lifting of exchange controls, notably in France.

Economic Policy Coordination

There have also been successes in the coordination of economic policy. Monetary policies are tending with increasing coherence to be directed towards fighting inflation. This trend is illustrated notably by the gradual slowing in the rate of growth of monetary aggregates in the Community since the years 1982-1983.

Monetary policy coordination between West Germany and France is by no means confined to the institutional aspect represented by the recent setting-up of the Franco-German Economic and Financial Council. It has been particularly extensive on certain occasions, particularly at the time of the Autumn 1987 stock market crisis, within the framework of the Basle-Nyborg agreement signed shortly beforehand. Measures taken then to restore calm to the markets combined strengthening the central banks' reciprocal support mechanisms and more flexible use of the margins of fluctuation with concerted and simultaneous interest rate movements between the Bundesbank and the Banque de France.

Progress has been slower on the fiscal front, even though fiscal performance has become less divergent since 1985. However, the importance of coherent fiscal policies – particularly with respect to public-sector deficits and methods of funding them – has become increasingly evident. Today, it is one of the concerns of the experts working on Europe's monetary integration. The trend now emerging here is toward proscription of monetary financing of Treasuries via automatic access to central bank funding and compulsory purchase of government paper by the commercial banks.

Converging Economic Performance

Certain progress has also been made with respect to the convergence of economic performance. This is undeniable in the field of price movements. After the strains in 1980-1981 following the second oil shock, countries belonging to the exchange rate agreement have very significantly narrowed the gap between their respective performances on inflation. Between France and Germany, for instance, the inflation differential has come down from 6.6 % in March 1979 to 1.5 % in December 1988.

Moreover, this trend to homogeneity has not occurred around the average performances of the system's currencies; rather, it has taken the form of a faster slowdown in inflation than in the industrialized countries not belonging to the EMS, among which, furthermore, no narrowing of inflation differentials is to be observed. Thus, fears expressed at the time of the system's inception that the resulting monetary cooperation would fuel inflation have proved unfounded.

Results are less positive with regard to growth rates and balance of payments situations. Growth rate convergence has in fact taken the form of a sharper slowdown in growth rates than in countries outside the EMS. It is important, in this respect, to bear in mind the considerable disparity between unemployment rates in Europe and those in the industrialized countries on other continents: 2.5 % in Japan, 5.5 % in the United States, against more than 10 % for the EC as a whole.

Concerning balances of payments, lastly, we are bound to acknowledge that disequilibria tend to be growing rather than shrinking, especially in the case of the most important of these, namely West Germany's huge trade surplus, expected to work out to DM 125-130 billion for 1988, or even larger than the record DM 117.5 billion surplus recorded for 1987.

While the experience of the EMS must be regarded as a relative success in terms of its most visible objective, namely domestic and external monetary stability, we do need to recall that, in keeping with the terms of the conclusions adopted by the Presidency of the European Council in December 1978, the system was founded in order to ensure "sustained growth with stability". It was supposed to contain neither an inflationary nor a deflationary bias. To assess fully the results of the EMS we must keep in mind this dual objective. As *these* results have not been as impressive in promoting "sustained growth" as in fostering stability, we need to try to see how the workings of the system might be improved.

Elimination of Asymmetry

The workings of the EMS need to be improved. It does indeed appear indispensable to attach greater importance to the complete range of economic objectives involved in the construction of Europe. The root of the problem lies in the de facto asymmetry that characterizes the workings of the EMS. To be sure, the obligation to intervene in case of strains between the system's currencies affects upwardly and downwardly diverging currencies symmetrically, and carries with it financing procedures organizing solidarity between the central banks at the very moment of crisis. But because the facilities extended in these circumstances must of course be repaid, the central bank whose currency is least in demand always ends up shouldering the burden of Community discipline even if it was not its currency that triggered the strain. Its partner country, meanwhile, has merely to issue its own money while retaining the possibility of neutralizing the effects on its domestic economy of money created surplus to requirements.

While misleadingly symmetrical on the margins, the system is openly asymmetrical within those margins. The country whose currency is least in demand in fact finds that it is alone in intervening by drawing on its reserves or going into debt. By sanctioning over-permissive monetary policy, this mode of operation does have the merit of automatically channelling the system towards stability; the results indeed testify to its effectiveness in this regard. But its major drawback, on the other hand, is the absence of any automatic mechanism to correct over-restrictive monetary policy. While the present mode of operation may be well-founded in periods of strong inflationary pressure, it is no longer so when, as is currently the case, inflation is now at a low level and the most prominent trade disequilibrium is not a deficit but a surplus.

Common Objectives

Having failed to build an exchange-rate system revolving around the Ecu from the outset, we should be looking now at possible steps to remedy the present situation, seeking in particular a common definition of economic and financial objectives for all the countries in the system. Over and beyond the present system of consultations between the Community's monetary officials in the framework of the Monetary Committee and the Committee of Central Bank Governors it would be necessary to lay down common economic policy objectives. These could, for example, take the form of target ranges to be achieved as regards growth, price variations and payments balances.

It would also be necessary to determine monetary objectives ex ante by common agreement, with reference to the overall situation in Europe instead of aligning them, in fact, with the objectives of the country whose currency is most in demand, as is currently the case. Although even then they would not be uniform, the objectives thus set for each country in Europe would have the advantage of being compatible among themselves and with the properly conceived interests of the group as a whole. One might hope, notably, that this sort of coordination might allow interest ratios to find the lowest level compatible with the imperative of disinflation – while respecting a hierarchy based on the different performances of the countries concerned.

The effective control of divergences also seems important. The EMS was admittedly supplied at its inception with an indicator of divergence. But this has never played the role assigned to it, notably because of intramarginal interventions, and a major drawback associated with it is that it applies to exchange rate divergences only. It would be far more satisfactory to use the battery of indicators referred to earlier to monitor movements of the leading economic and financial variables. Any country that diverged significantly and durably from the selected targets would, after possible discussions within the appropriate community forums, be expected to take the appropriate corrective economic and monetary policy measures.

Some sharing of the effort to achieve intramarginal exchange rate stabilization also appears to be necessary. Once the economic fundamentals are no longer at issue, it is surely natural that the central banks issuing those currencies that are "dragging the system upwards" should contribute to the maintenance of the parity grid. They could do so – without obligation, but also without prejudice – in those markets that are highly sensitive to signals and announcement effects by buying their partners' currencies and holding them in their reserves where necessary.

Extending the System

Finally, the extension of the exchange rate mechanism to the Community as a whole is desirable. The prospective transformation of the European Community by December 31st, 1992 into an "area without internal frontiers, in which the free movement of goods, people, services and capital (will be) assured" makes this objective more than ever essential. The persistence of substantial exchange-rate risks between the Community's currencies would in fact create an obstacle to the formation of a unified economic area, by distorting companies' strategies in terms of both their marketing policies and their investment plans.

If certain Community currencies were to remain outside the exchange rate mechanism, this would handicap growth in trade within the single market, not only because of spontaneous exchange rate movements, but also by the possibility that the authorities of the variable currency countries might substitute a "monetary protectionism" for the tariff and non-tariff protectionism that will be proscribed in the newly created area.

Created against a background of scepticism and generalized floating exchange rates, today the EMS is widely regarded as a model of stability in a world in search of a new international monetary order.

This "succès d'estime" – which has to some extent been confirmed by the "grafting" of the private Ecu onto the system – must not blind us to the fact that much remains to be done. It is plainly too late to revive the original ambition of "consolidating" the EMS two years after its inception, in order to turn it into a definitive system organized around a "European Monetary Fund", and "full and complete use of the Ecu as a reserve currency and as a settlement instrument" (Resolution of the European Council of December 5th, 1978). But it is essential to recall two deadlines now looming in the immediate future of the European Community, namely the complete removal of barriers to the movement of capital, due to take place on July 1st, 1990 in accordance with the directive approved in June 1988, and, of course, the opening of the great market without internal frontiers on December 31st, 1992.

The proximity of these deadlines clearly requires that fresh progress be made towards monetary integration. In view of the impending far-reaching transformation of intra-European economic and financial relations, such progress should go beyond the improvements to be made in the working of the present EMS to embrace a decisive institutional change. But that would need to be dealt with in a separate study.

Hans-Eckart Scharrer*

A Robust System

The developments in the European Monetary System since it was set up ten years ago are surprising on several counts. The first surprise is that the system still exists at all. Given the external shocks and the internal stresses and strains to which it was subject from the outset, by all theoretical yardsticks it should have broken apart in the same way as the Bretton Woods System and the European currency snake.

At first the strains were due to the high rates of inflation in member countries and the wide inflation differentials; in 1979 the average for countries participating in the exchange rate mechanism was 8.8 % and national inflation rates were spread over a range of 10.7 percentage points, extending from 4.1 % for Germany to 14.8 % for Italy. In 1980 and 1981 the average rose further to 12.0 % and the dispersion range widened to 15.7 and 14.1 percentage points respectively. The monetary policy of some countries fuelled the rapid increase in prices by keeping the money supply plentiful.

Soon after it was set up the system was hit by the second oil shock, when oil prices rose to $ 32 a barrel, followed in the mid-eighties by a fall to $ 12 a barrel. In

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