DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

0450

SM/92/129
Supplement 2

CONTAINS CONFIDENTIAL
INFORMATION

December 1, 1992

To: Members of the Executive Board

From: The Secretary

Subject: Economic and Monetary Union in Europe - Policy Issues and Implications for Fund Surveillance

The attached paper provides supplementary updated material for the seminar discussion of policy issues and implications for Fund surveillance of the economic and monetary union in Europe (SM/92/129, 6/26/92 and Sup. 1, 6/29/92), which is scheduled for Monday, December 14, 1992.

Mr. Masson (ext. 37483) or Mr. Vittas (ext. 38790) is available to answer technical or factual questions relating to this paper.

Att: (1)

Other Distribution:
Department Heads

CONTAINS CONFIDENTIAL
INFORMATION

INTERNATIONAL MONETARY FUND

Economic and Monetary Union in Europe: Policy Issues and Implications for Fund Surveillance

Additional Material

Prepared by the European I Department

(In collaboration with the Policy Development and Review Department, Research Department, and the Office in Europe)

Approved by Jacques R. Artus

December 1, 1992

This note supplements the material that was circulated previously to provide a basis for a Board seminar on policy issues related to the European economic and monetary integration process. 1/ The first section of the note reviews briefly recent developments in the EMS and assesses the extent to which they have modified the magnitude of the adjustment task that EC countries would be required to undertake to meet the convergence criteria spelled out in the Maastricht Treaty. This is followed, in Section II, by a discussion of some lessons that may be drawn from recent events for the management of the EMS, and the formulation and conduct of economic policies in EMS countries, during the transition to EMU. The final section of the paper expands somewhat on the discussion of Fund surveillance of EC countries that was included in the main paper. A few questions on which Directors may wish to focus their comments, in addition to the issues for discussion raised in the main paper, are noted in Sections II and III.

I. Recent Developments in the EMS

The long period of stability that the EMS had enjoyed since the realignment of January 1987 came to an end in September 1992. Tensions in the system had been building up steadily since the unexpected rejection of the Maastricht Treaty in the Danish referendum last June. During September these tensions intensified dramatically, leading in quick succession to two realignments of EMS central rates and the withdrawal of the Italian lira

1/ See SM/92/129, "Economic and Monetary Union in Europe: Policy Issues and Implications for Fund Surveillance," June 26, 1992, and SM/92/129, Supplement 1, June 29, 1992.

and the pound sterling from the exchange rate mechanism of the EMS. 1/ Subsequently, the French franc also came under a strong speculative attack but this was fended off successfully by means of concerted actions by the French and German authorities that entailed a joint statement of their resolve to defend the existing parity, a steep increase in short-term interest rates in France, a small decline in money market rates in Germany, and heavy intramarginal intervention in support of the franc by both the Banque de France and the Bundesbank. Other EC and non-EC currencies experienced bouts of heavy selling pressure during the month but a combination of large increases in domestic interest rates, official exchange market intervention and, in a few instances, selective recourse to exchange control measures allowed the authorities of the countries concerned to cope with this pressure without further immediate adjustments in their exchange rate policy. In the course of October EMS tensions eased considerably but they strengthened again around mid-November, leading to a new realignment that entailed a 6 percent devaluation of the peseta and the escudo. 2/

A detailed analysis of the factors accounting for the turbulence in international foreign exchange markets will be included in the documentation that is being prepared for the forthcoming Board discussion of the World Economic Outlook. Here, it may be sufficient to note that while the emergence of uncertainties about the ratification process of the Maastricht Treaty contributed importantly to the intensification of strains in the EMS, the fundamental causes of the crisis go much deeper. They relate to the persistence of significant divergences in economic policies among member countries, large differences in relative cyclical positions and growing evidence of competitiveness problems in some countries. In a climate of considerable uncertainty about the outcome of the ratification process, these factors combined to fuel doubts as to the ability of some ERM countries to maintain their commitment to existing rates. At the same time, the wide disparity in monetary conditions between Europe and the United States tended to exacerbate intra-EMS strains to the extent that it has fostered shifts of funds primarily into assets denominated in the stronger EMS currencies, while also aggravating the apparent loss of competitiveness of some EC countries.

1/ The realignments involved a 7 percent devaluation of the lira vis-à-vis the other ERM currencies, effective on September 14, 1992 and a 5 percent devaluation of the peseta as of September 17, 1992. The withdrawal of the Italian lira and the pound sterling from the ERM also took place on September 17, 1992. A few days prior to the EMS realignments, namely on September 8, 1992, the Finnish authorities decided to delink the markka from the ECU and allow it to float freely. The immediate response was a 13 percent depreciation of the markka in ECU terms.

2/ This realignment became effective on November 23, 1992. It was preceded by the floating of the Swedish krona on November 19 and followed on November 23 by a 6 percent devaluation of the Icelandic króna.

The currency turmoil brought about significant changes in exchange rate relationships and monetary conditions in European countries. Two summary measures of the exchange rate changes are shown in Table 1, and Charts 1 and 2. Between September 7, 1992 (i.e., the eve of the floating of the Finnish markka) and November 23, 1992 the pound sterling, the lira, the peseta and the escudo depreciated markedly in both ECU and nominal effective terms. However, the net change in the effective exchange rate indices of the other ERM currencies over this period was very small as their modest appreciation vis-à-vis the ECU was broadly offset by the recovery of the U.S. dollar.

As for monetary conditions, the most notable features of recent developments were:

a. the significant decline in market interest rates in Germany, which was mirrored in the evolution of interest rates in the Benelux countries, Switzerland and Austria;

b. the initial steep widening of interest rate differentials between the countries mentioned above and all other EMS and EFTA countries. In several countries, it was particularly pronounced at the very short end of the maturity spectrum as efforts were made to deter speculation by means of instruments (including exchange controls) that minimized, if only temporarily, adverse effects on the domestic financial system. Subsequently, the increase in differentials tended to be reversed (Chart 3). However, the reversal has been faster and more complete in countries where underlying policy imbalances were small or where prompt action was taken to strengthen financial policies. In Italy the differential began to narrow only when it became evident that policy weaknesses were beginning to be addressed and, in several countries, the long-term differential remains larger than before the currency turmoil.

Updated estimates of the convergence indicators embodied in the Maastricht Treaty are given in Table 2. For comparison, the initial estimates that had been presented in SM/92/129 are also reported in the table. The size of the revisions to the convergence indicators for 1992, which can only partly be attributed to recent events, is generally small; however, almost invariably, the revisions tend to suggest that the starting position of the least convergent countries is less favorable than assessed last June. In particular, the deviations in the rate of inflation and the long-term rate of interest in Italy, Greece, Portugal and Spain from the standards set by the best performing countries have widened. 1/ Moreover, the currency adjustments that have taken place recently would tend to widen, rather than narrow, inflation differentials in the near term.

1/ The budgetary imbalances of the U.K., Spain and Sweden are also noticeably larger than previously expected, but this mainly reflects weaker economic conditions and is not related to the currency turmoil.

The above observations are relevant for judging whether the short-term macroeconomic costs of achieving the convergence targets by 1996 would be more or less onerous than suggested in the scenarios, based on MULTIMOD simulations, presented in SM/92/129. Two scenarios were reported there for achieving the Maastricht convergence criteria; one where interest differentials with Germany narrowed steadily, the other where interest differentials remained at their mid-1992 levels because of concerns about the feasibility of a smooth transition to EMU (or concerns about the possibility of a final EMS realignment). In evaluating the relevance of these scenarios today it is useful to consider two questions: whether the size of the adjustment effort needed is significantly larger than before, and whether the events since mid-1992 have altered the credibility of the exchange rate commitments.

Though the starting positions of the least convergent countries is worse than before, the size of the fiscal adjustment for most countries is not significantly greater; at the EC level, the fiscal position is only 0.1 percent of GDP higher. Therefore, the earlier scenarios are still relevant. As for which of the two scenarios is most likely, there are conflicting effects. On the one hand, the EMS turmoil has to some extent reduced the credibility of some countries' commitment to fixed rates. If credibility is not restored, this could make the transition to EMU more difficult for these countries. On the other hand, the exchange rate adjustments that emerged in the wake of the currency turmoil may be viewed as having brought about a significant correction of exchange rate misalignments (Charts 4 and 5), and this should lower the likelihood of further realignments, or at least their magnitude. This could enhance the probability that future progress toward fiscal and inflation convergence will be accompanied by a narrowing of interest rate differentials (provided of course that the risk of a devaluation/inflation spiral is avoided).

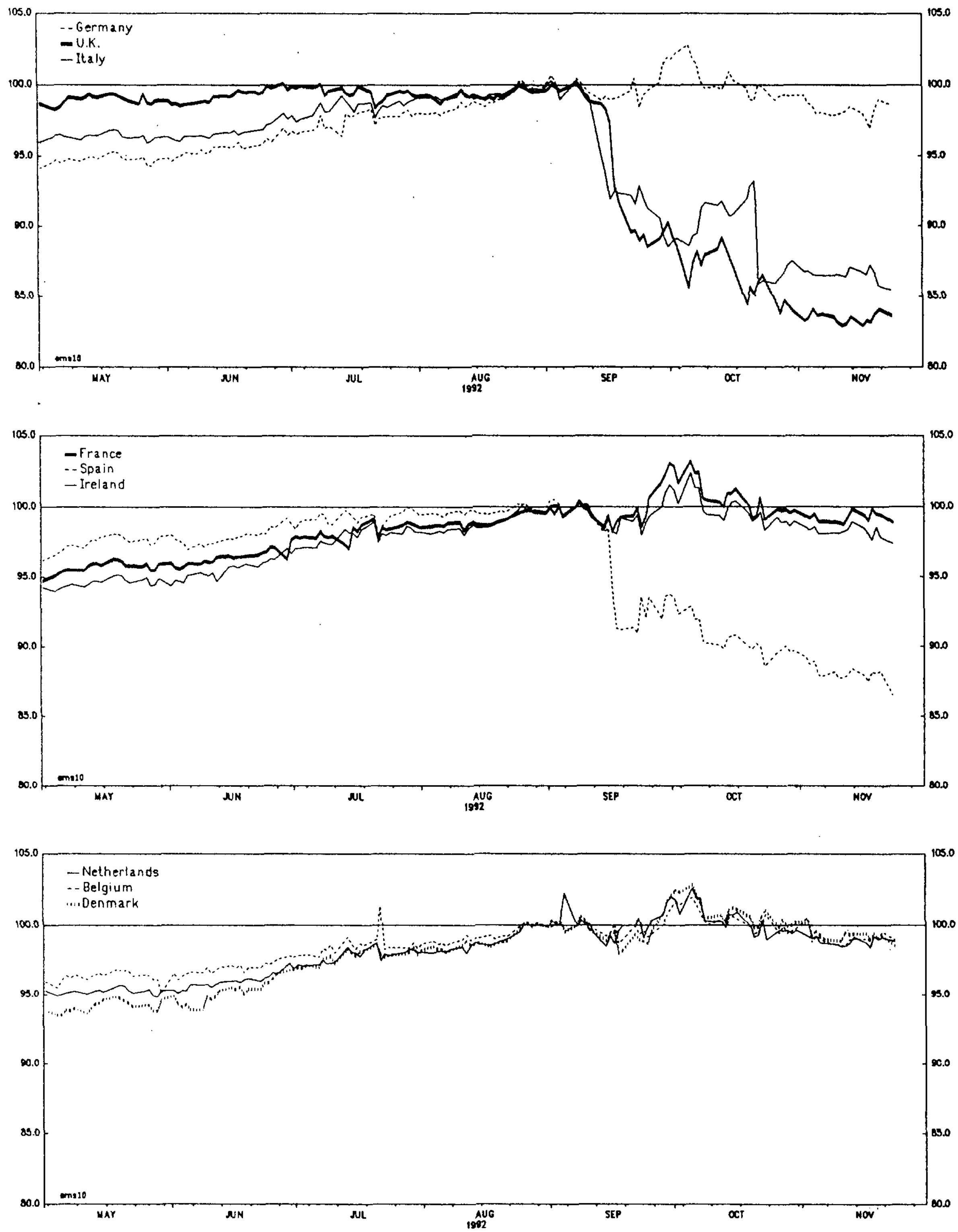
The realignments have also affected the baseline scenario--the starting point against which the scenarios with fiscal adjustment are compared. The improvement of the competitive positions of Italy, the United Kingdom, and Spain resulting from the nominal exchange rate changes should provide some stimulus to economic activity over the next few years; other things being equal, this should make less difficult the needed fiscal adjustment.

A more fundamental issue is how to capture, in the baseline, the effects of not converging and instead continuing to run unsustainable fiscal deficits. Gauging the effects of unsustainable policies, which ultimately may involve loss of confidence, financial collapse, and abrupt policy reversals, is extremely speculative. For this reason, the scenarios in SM/92/129 did not attempt to make allowance for such effects. However, in light of the recent turmoil in the exchange markets and increases in interest rate differentials for nonconverging countries, it is fair to recognize that for the least convergent countries this approach may well have imparted an optimistic bias to the baseline scenario and may thus have overstated the transitional costs of convergence.

CHART 1
Selected EC Countries

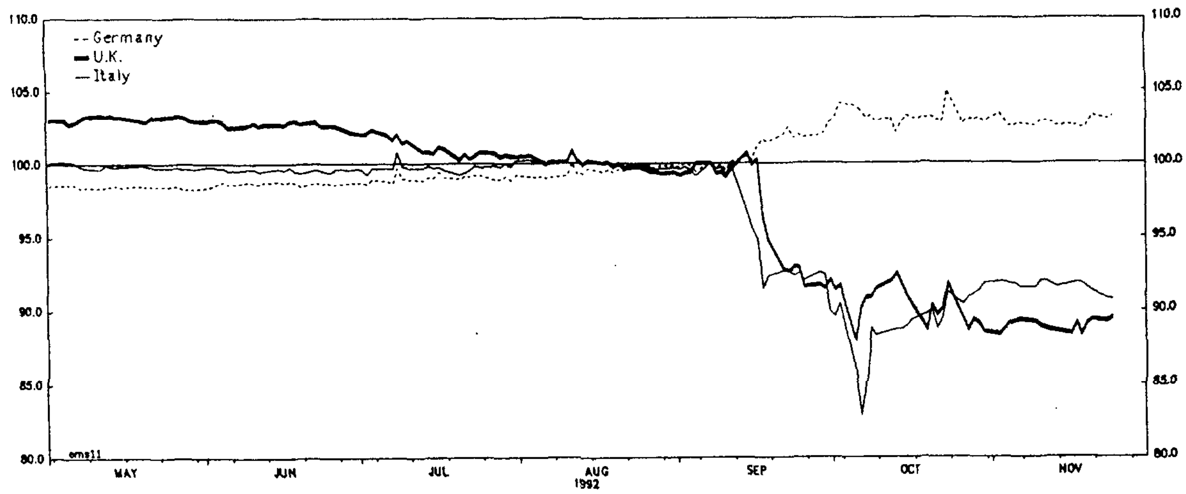
MERM Effective Exchange Rates 1/

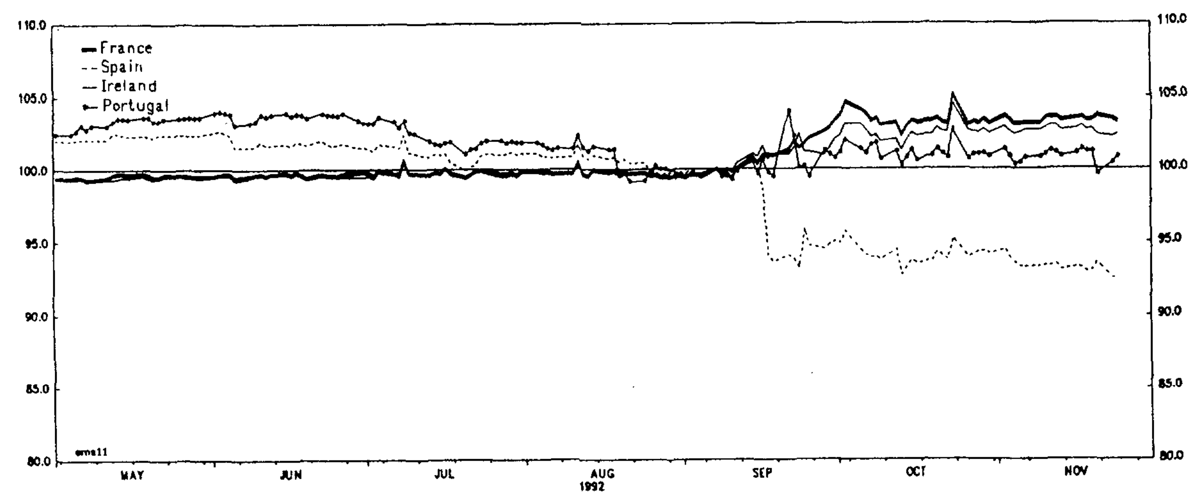
(Sept 7, 1992=100)

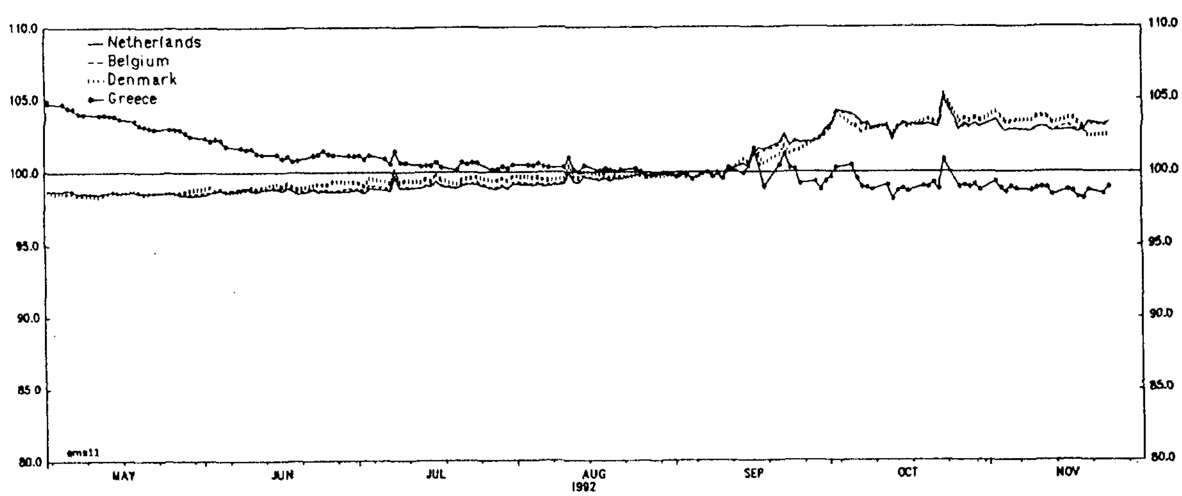


Source: IMF, Treasurer's Department.
1/ May 1, 1992 to November 23, 1992.

CHART 2
Selected EC Countries
ECU Exchange Rates 1/
(September 7, 1992=100)





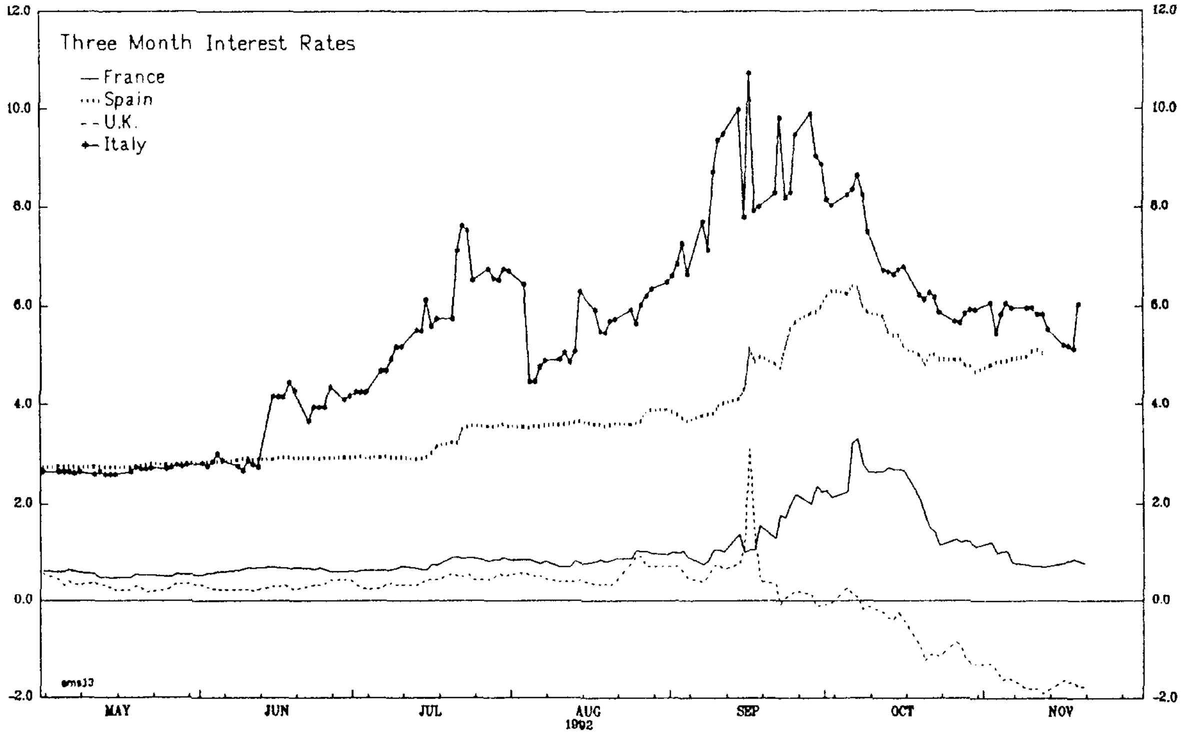


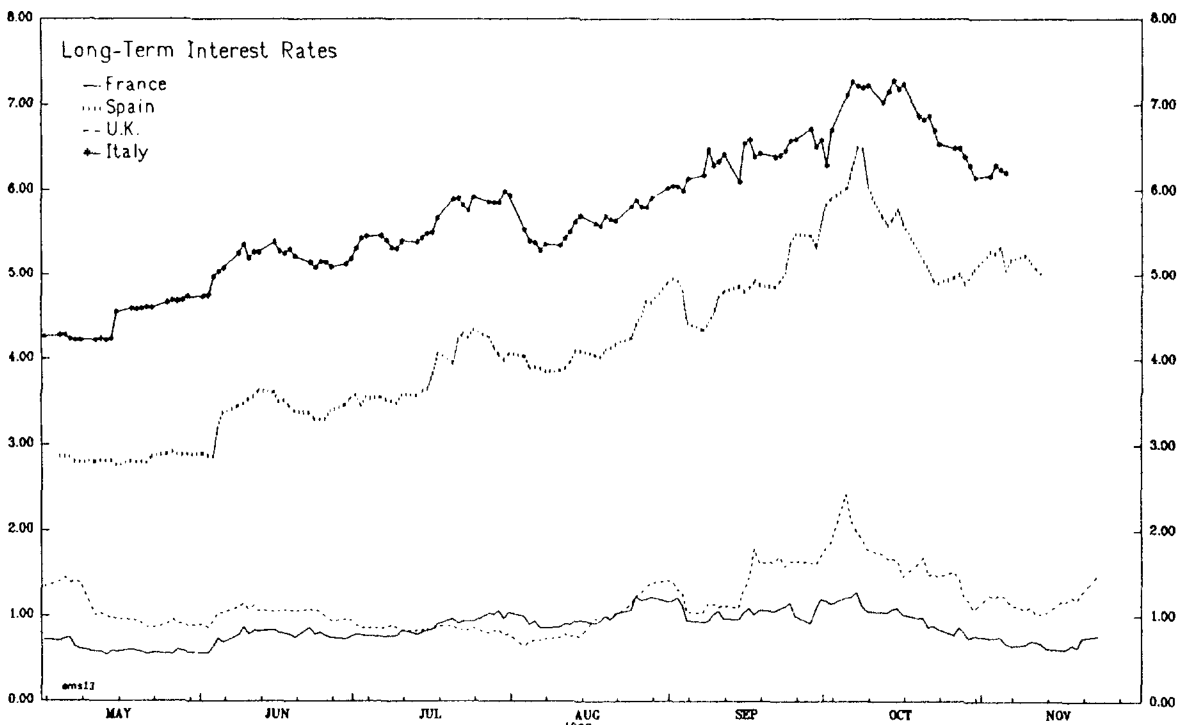
Source: IMF, Treasurer's Department.
1/ May 1, 1992 to November 23, 1992.

CHART 3
Selected EC Countries

Interest Rate Differentials vs. Germany 1/

(In percent)



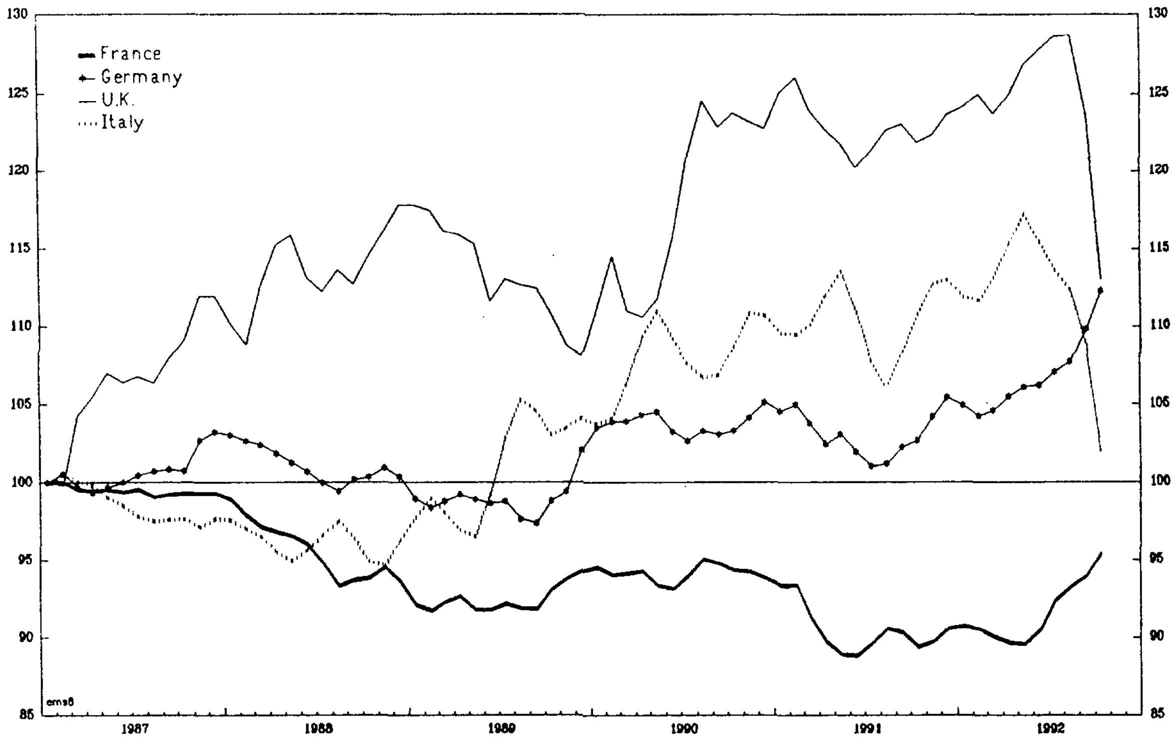


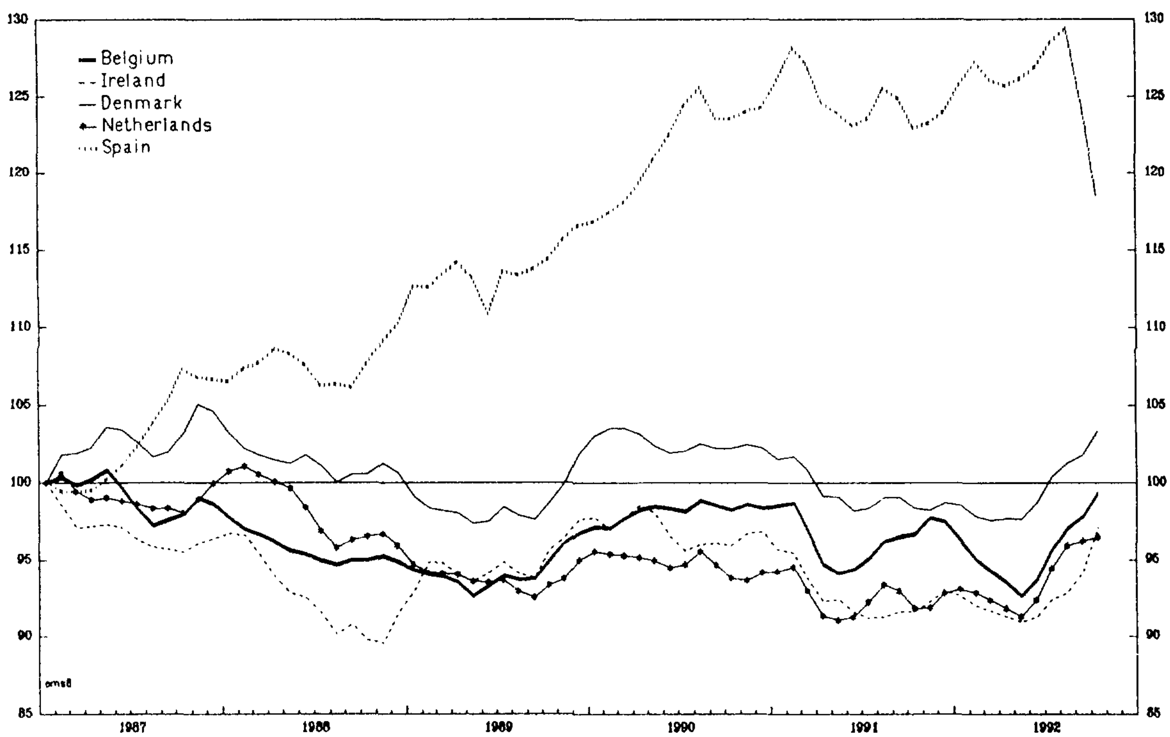
Source: IMF, Treasurer's Department.
1/ May 1, 1992 to November 23, 1992

CHART 4
Selected EC Countries

Real Effective Exchange Rates 1/

(Jan 1987=100)





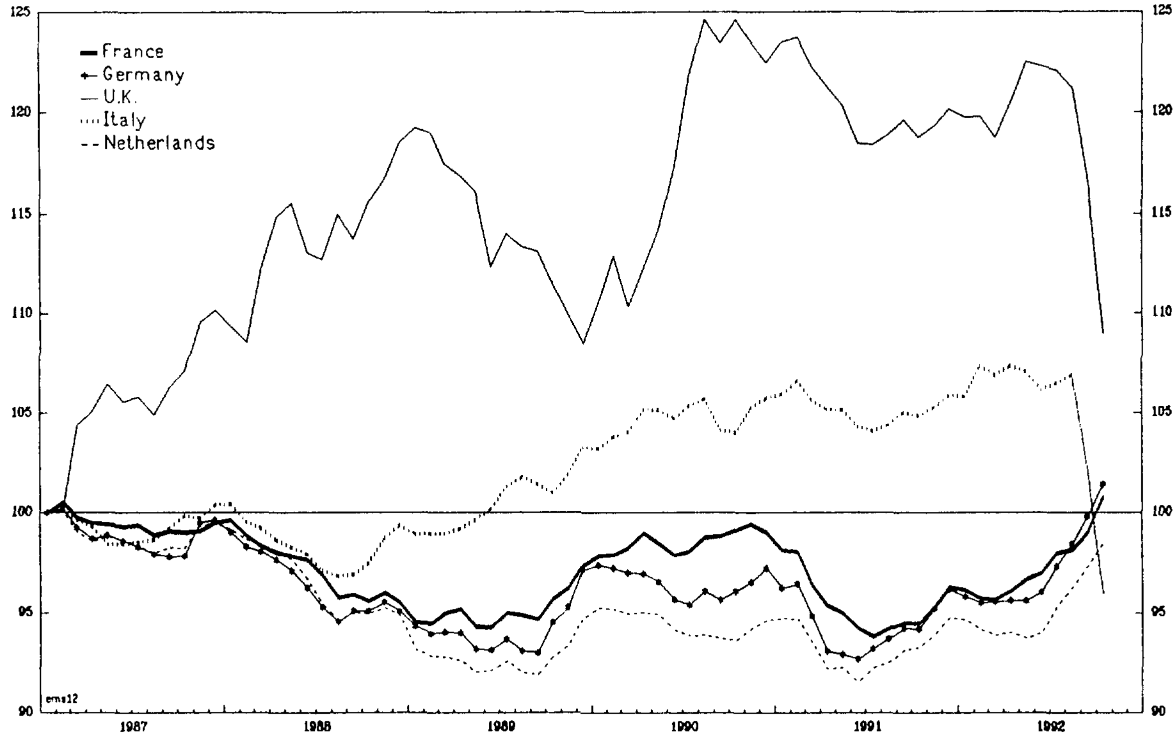
Source: IMF, PDR Department.

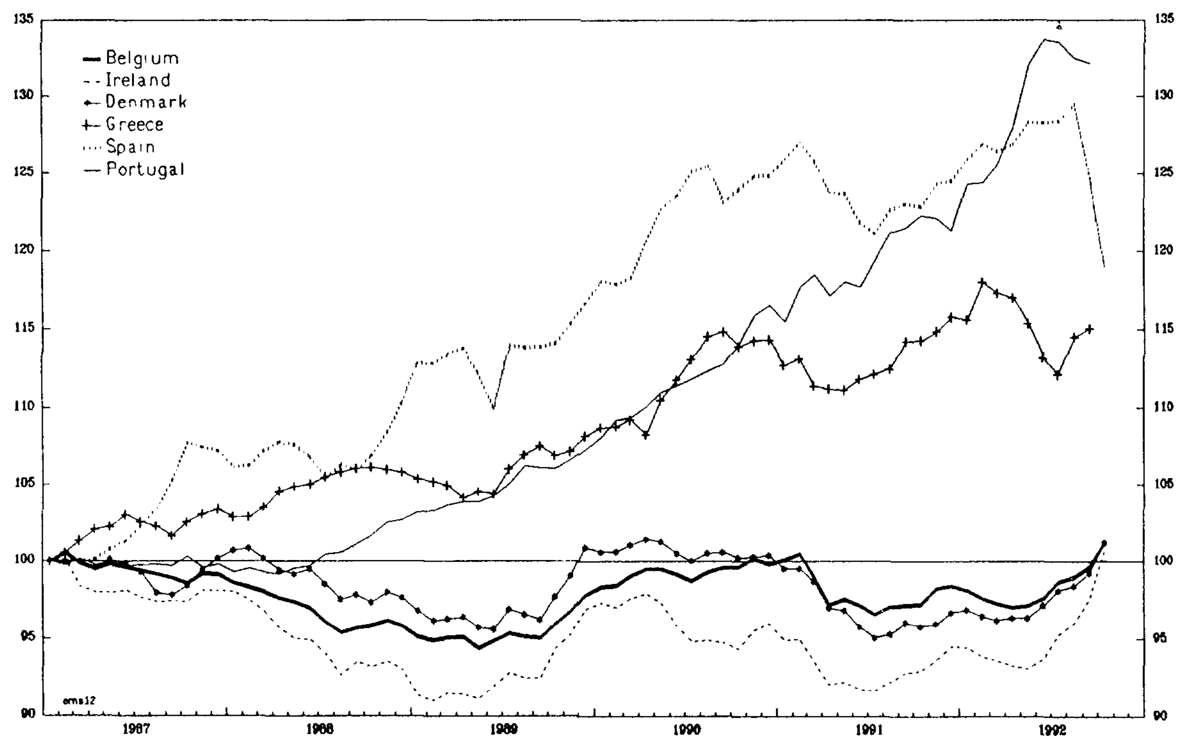
1/ Based on normalized unit labor costs in manufacturing, January 1987 to October 1992.

CHART 5
Selected EC Countries

Real Effective Exchange Rates 1/

(Jan 1987=100)





Source: IMF, PDR Department.
1/ Based on consumer price indices, January 1987 to October 1992.

II. Lessons to be Drawn from the Recent EMS Turbulence

Several tentative conclusions seem to emerge from the recent currency turmoil. Executive Directors may wish to comment on the validity of these conclusions and on their implications for management of the EMS in the future. First, the magnitude of speculative pressures underscored the fact that uncoordinated monetary policies are incompatible with fixed exchange rates in the context of free capital movements and sophisticated financial markets. If fixed rates are to be maintained, interest rates must be adjusted promptly and, when necessary, by large amounts in order to defend parities. Official exchange market intervention is not a potent enough instrument to resist strong speculative pressures when unassisted by interest rate adjustments. A second conclusion is that a smooth transition to EMU without exchange rate adjustments requires a larger degree of convergence of underlying economic conditions than exists at present. The cumulated loss of competitiveness resulting from persistently higher inflation than in partner countries must be reversed at some point. This raises the question of whether occasional exchange rate adjustments may have a role to play in this regard, in particular whether such adjustments could help lower the unemployment and output costs of restoring competitiveness, without losing the degree of discipline that the EMS is meant to impose. Third, the recent events have confirmed that pegged exchange rates are not a substitute for a common currency because there will always subsist doubts concerning even "irrevocably fixed" parities. This may be seen as an argument for seeking to accelerate convergence and in this way permit progress to full monetary union in order to attain monetary stability. These ideas are developed further below.

1. Monetary independence

If ERM parities are to be defended in the face of strong exchange market pressure, domestic monetary policy has to be brought into play, even if doing so conflicts with domestic objectives. It may be true that there is some scope for monetary independence in normal times, especially in the larger EMS countries, and it may also be true that even in the absence of capital controls there is some short-term insulation of domestic interest rates from pressures from abroad. For instance, in France it proved possible, at least for a short period of time, to prevent increases in money market rates from leading to increases in the rates charged by the banks to their borrowers. Similarly, in Spain selective reserve requirements seem to have had a transitory effect in discouraging capital outflows thus moderating the need for increases in interest rates. However, the degree of independence is slight and temporary. Capital controls may achieve some short-run insulation, but they are both distortionary and unlikely to be effective for extended periods of time. Exchange market intervention, especially if it is coordinated with the anchor country and is part of a broader strategy, may also have some role to play in defusing uncertainty and stabilizing markets. However, recent events have confirmed once again that sterilized intervention is not a substitute for changes in interest rates. Executive Directors may wish to comment on whether they agree that early interest rate increases to counter incipient exchange market pressures are essential to demonstrate the will of the authorities to defend their exchange rate commitments and restore stability.

Political influences over central banks may be seen as constraining the flexibility of interest rate policy. This suggests that central bank independence may enhance the credibility of the exchange rate commitment. The commitment of Belgian and Dutch central banks was never called into question, and their currencies successfully followed the deutsche mark--despite the fact that on the Maastricht convergence criteria, Belgium is much farther from qualifying for Stage 3 than is France. Do Directors share the view that early achievement of formal independence for central banks, which must in any case occur by the end of Stage 2, would help smooth the transition to EMU by focusing monetary policies more clearly on exchange rate targets?

2. Convergence

Recent events have highlighted the conclusion that fiscal and inflation convergence are essential for a smooth transition to EMU. Though a peg to a hard currency can help to bring down inflation, unless convergence occurs quickly, losses of competitiveness accumulate tending to raise doubts as to whether the peg is tenable. Convergence of real variables is also important to enhance the credibility of EMS parities in the transition. Until unemployment is reduced to satisfactory levels, the political will to maintain strict financial policies may be called into question, and exchange rate depreciation may be viewed as an attractive alternative. This consideration reinforces the argument for structural policies to improve labor market flexibility and thereby reduce unemployment.

Attempts to maintain uncompetitive exchange rates may lead speculators to anticipate a realignment and force exchange rate adjustments in conditions of market turmoil. This raises the question of whether, in the transition to Stage 3 and until adequate progress toward real and financial convergence has been achieved, it might not be advisable to strengthen the monitoring of economic developments and policy as well as to provide for occasional small realignments, within existing exchange rate bands, in order to reduce overvaluation of currencies without creating the expectation of large discrete exchange rate changes. A related dilemma is whether any such realignments should be limited in scope, so as not to weaken the discipline of the system, or whether they should instead focus on fully compensating for past losses in competitiveness so as to increase the probability that the new rates will be credible and sustainable. In either case, periodic realignments would not of course preclude countries which have converged to low inflation and sustainable fiscal positions to continue, and perhaps reinforce, their commitments to existing exchange rate parities, provided those parities were generally agreed to be credible and sustainable.

The recent events suggest that a balanced policy mix in all countries is essential to avoid strains in the EMS and ensure smooth progress toward monetary union. Moreover, when parities are credible, the commitment of all countries, including the anchor country, to defend these parities can be a key factor in deterring and ultimately defeating speculation. Reaffirmation of that commitment, and of the willingness to take measures to enforce it, could therefore be helpful. Executive Directors may wish to comment on these issues and on the desirability and scope of increased coordination of monetary and fiscal policies in EMS countries.

3. Need for Monetary Union

The credibility of the EMS as a zone of monetary stability has been shaken by the recent events. The EMS had been considered until now as a close substitute for monetary union, since exchange rate fluctuations had largely disappeared. It was reasonable to imagine, as some did, that the EMS could evolve into gradually narrower exchange rate bands and that eventually exchange rate fluctuations would be eliminated entirely. Recent events have shown that such a view was not consistent with the reality of incomplete real and inflation convergence, divergent fiscal positions, and separate monetary institutions with domestic objectives. In the absence of a single monetary authority and a single currency, exchange market pressures may always develop, even if not justified by economic fundamentals, with the potential for disruption to other aspects of European integration. Therefore, it is unlikely that an intermediate stage--like a reinforced EMS--would be a fully satisfactory substitute for a single currency. In the light of the above, Executive Directors may wish to indicate whether they view recent developments as strengthening the need to begin the monetary union as early as 1997, and in this case, which additional efforts to converge should be recommended.

III. Fund Surveillance

The recent turmoil in exchange markets has strengthened the case for new initiatives to increase the effectiveness of Fund surveillance over the exchange rate policies of the industrial countries in general, including the ERM countries. In response to this development and to the underlying concerns about global economic developments and prospects, the Fund's work program for the period to the Spring 1993 meetings, which Directors have recently endorsed, has placed emphasis on systemic issues and on enhancing the Fund's surveillance role. In the context of this program, the staff is at present assessing the merits of various suggestions that have been made to strengthen surveillance activities and will submit detailed recommendations in the documentation that is being prepared for the biennial review of Fund surveillance. The forthcoming seminar on EMU will provide Executive Directors with the opportunity to guide the staff in this work. In particular, it would be useful for the staff to have the Board's guidance as to how the Fund could increase its involvement in the discussion and resolution of regional and global exchange rate policy issues, while respecting the paramount need for confidentiality. Executive Directors' reactions to the specific suggestions that the staff put forward in Section V of SM/92/129 would also be helpful.

In the meantime, and in the context of bilateral Article IV consultations with EC member countries, the staff has continued to focus attention on issues of regional importance including an assessment of the convergence plans that several of these countries have prepared (in accordance with the provisions of the Maastricht Treaty). The 1992 Article IV consultation discussions with Italy have come at an opportune time insofar as they have overlapped with the preparation of a medium-term adjustment plan for Italy that is to be supported by EC resources. The staff has been in close contact with the Italian authorities and the EC Commission throughout the preparation of this plan. Moreover, the authorities have requested staff missions to review progress under the plan and required adjustment in policies in 1993. In cooperation with national authorities, the staff will continue to explore ways to increase its contributions to the formulation and review of the adjustment policies of other member countries. At the same time, the staff will continue to pursue its analytical work on systemic issues as well as issues related more directly to the European monetary integration process.

Table 1. Exchange Rate Indicators

(Changes in percent, from September 7, 1992)

	ECU Rates 1/		Effective Exchange Rates (MERM)	
	Oct. 30	Nov. 23	Oct. 30	Nov. 23
1. ERM currencies				
Belgium	3.2	3.2	-0.2	-1.0
Denmark	3.5	2.5	0.2	-1.5
France	3.1	3.5	-0.3	-1.1
Germany	2.9	3.1	-0.7	-1.4
Ireland	2.4	2.2	-1.1	-2.6
Italy (suspended)	-8.1	-9.2	-12.5	-14.6
Netherlands	3.1	3.3	-0.4	-1.2
Portugal	0.9	0.4	...	...
Spain	-5.8	-7.5	-10.3	-13.5
U.K. (suspended)	-11.5	-10.8	-16.0	-16.4
2. Other currencies				
Greece	-1.2	-1.5	...	...
Austria	3.1	3.0	-1.7	-2.7
Finland	-10.4	-12.5	-14.9	-17.9
Norway	-0.2	-0.3	-4.1	-5.3
Sweden	-0.2	-11.3	-3.9	-15.9
Switzerland	2.8	1.9	-0.2	-2.3

Source: IMF, Treasurer's Department.

1/ Calculated on the basis of noon quotations in London.

Table 2. Convergence Indicators for 1992

(In percent)

	1991 GDP weights		Consumer price inflation		General government balance/GDP		Gross government debt/GDP 1/		Long-term interest rates	
	In EC	In world								
EC Countries										
France	19.7	5.1	2.7	(2.7)	-2.8	(-2.0)	47.7	(47.6)	8.7	(8.5)
Germany	25.5	6.5	4.0	(3.9)	-3.5	(-3.5)	42.5	(42.7)	7.8	(7.9)
Italy	17.7	4.5	5.5	(5.3)	-10.4	(-10.4)	108.5	(108.0)	13.5	(12.2)
United Kingdom 2/	16.8	4.3	3.7	(3.7)	-6.3	(-5.1)	35.9	(34.2)	9.0	(8.9)
Largest four countries 3/	79.5	20.4	3.9	(3.9)	-5.5	(-5.0)	56.9	(56.6)	9.6	(9.2)
Belgium	3.2	0.8	2.5	(3.0)	-5.9	(-5.5)	133.4	(133.4)	8.8	(8.7)
Denmark 5/	2.2	0.6	2.1	(2.5)	-2.3	(-1.8)	71.3	(65.9)	8.9	(8.7)
Greece 6/	1.1	0.3	16.6	(15.2)	-13.8	(-14.6)	114.8	(118.0)	21.5	(21.0)
Ireland	0.7	0.2	3.5	(3.7)	-2.8	(-2.7)	100.0	(96.0)	10.0	(9.1)
Luxembourg	0.1	--	2.8	(3.1)	1.0	(1.5)	5.8	(5.8)	7.8	(7.9)
Netherlands	4.6	1.2	3.3	(3.3)	-3.8	(-3.6)	80.0	(80.0)	8.0	(8.1)
Portugal	0.9	0.2	9.1	(8.5)	-5.2	(-5.2)	69.5	(62.5)	16.5	(16.0)
Spain 4/	7.7	2.0	6.3	(5.8)	-5.1	(-4.5)	48.2	(47.3)	12.6	(10.9)
Smallest eight countries 3/	20.5	5.3	5.1	(5.0)	-4.8	(-4.6)	76.4	(76.0)	10.8	(10.4)
All EC 3/	100.0	25.7	4.2	(4.1)	-5.4	(-4.9)	61.2	(60.6)	9.9	(9.5)
Maastricht convergence criteria			4.1	(4.2)	-3.0	(-3.0)	60.0	(60.0)	10.8	(10.5)
Non-EC Countries										
Austria	...	0.7	3.9	(3.8)	-1.9	(-1.9)	55.8	(55.8)	7.9	(8.0)
Finland	...	0.6	2.7	(3.5)	-8.8	(-8.6)	33.0	(25.0)	12.8	(12.4)
Norway	...	0.5	2.5	(3.8)	-4.3	(-3.7)	50.0	(48.5)	9.6	(9.0)
Sweden	...	1.0	2.2	(2.5)	-6.4	(-3.9)	50.0	(45.8)	10.3	(9.5)
Switzerland	...	1.0	3.4	(4.5)	-1.7	(-1.8)	34.3	(33.0)	6.6	(6.4)
Five non-EC Countries	...	3.8	2.9	(3.6)	-4.4	(-3.7)	43.7	(38.9)	9.1	(8.7)

Sources: National sources and staff projections as of November 1992, except for figures in brackets which refer to staff projections as of May 1992.

1/ Debt data are from national sources. They relate to the general government, but may not be consistent with the definition agreed on at Maastricht.
2/ Debt on fiscal year basis.
3/ Average weighted by 1991 GDP shares.
4/ Debt figures refer to net debt.
5/ The debt to GDP ratio would be below 60 percent if adjusted in line with definition agreed at Maastricht.
6/ Long-term interest rate is 12-month treasury bill rate.