

# Towards ERM2: Managing the Relationship between the Euro and the Other Currencies of the European Union \*

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## 1. Introduction

The Treaty on European Union (hereinafter, the Treaty) envisages the possibility that some of the member states of the European Union (EU) do not participate in the final phase (third stage) of Economic and Monetary Union (EMU) either because they are entitled to avail themselves of opting out provisions (as in the case of the United Kingdom and Denmark), or because they fail to meet the convergence criteria laid down in the Treaty itself to join the single European currency, the euro. In addition, it may be possible that, when the EU admits new members, some of these may not be in a position to participate in EMU from the outset. In all these cases the questions arise whether and how to organise monetary and exchange rate policy cooperation between the euro area and the other EU countries.

Limited attention had been paid, both by monetary authorities and outside observers, to the implications of this problem at the time of the Treaty negotiations or immediately thereafter, perhaps under the tacit assumption that all EU members would indeed qualify

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to participate in the third stage. The severe crisis that has hit the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS) in 1992-93 has however sorely exposed the inadequacy of the convergence process in the EU and the persistence of domestic and external imbalances in a number of member countries, thereby making the prospect of a partial EMU a concrete possibility. As a result, attention focused on the fact that the Treaty did not provide for a comprehensive and systematic treatment of exchange rate relationships between the euro and the currencies of the other members of the EU.

Work on this issue was conducted both within the European Monetary Institute (EMI) and the Monetary Committee of the EU and the matter was submitted for consideration of the European Council (whose members are the Heads of State and Government of the EU) in Madrid in December 1995. The European Council recognised that it was indeed necessary to clarify the principles and the procedures for monetary and exchange rate policy cooperation between the euro and the non participating currencies and gave a mandate to the Council of Finance Minister (Ecofin) and to the EMI to formulate concrete proposals. The European Council at its meeting in Dublin in December 1996 has agreed on the main features of a new exchange rate mechanism (hereinafter called ERM2) that would embrace the euro and the other currencies of the EU. As was the case in 1978 with the establishment of the first ERM (or ERM1), a Council Resolution will be adopted laying down the basic principles of the new arrangement, while the legal and operational details will be spelled out in an Agreement between the European Central Bank (ECB) and the central banks of the countries not participating in EMU. The ERM2 will enter into force on January 1, 1999, simultaneously with the inception of EMU.

The paper is organised as follows: Section 2 will examine the legal and economic rationale for ERM2 as laid down in the Treaty and in the decisions of the EU policy-making bodies; Section 3 will analyse the main features of ERM2, underlining the innovations with respect to ERM1;<sup>1</sup> in Section 4 a preliminary assessment of the adequacy of the new arrangement will be made.

<sup>1</sup> The analysis will be based on the *Report* by the EMI (1996) which describes the main operational features of the new exchange rate arrangement. The *Report* has been submitted to the European Council in Dublin on December 13-14, 1996 and made public on that occasion. See also Lamfalussy 1996a and 1996b.

## 2. The legal and economic rationale for ERM2

Academic economists deserve credit for having raised publicly the question of the relationships between the so-called "ins" and "outs"<sup>2</sup> (see, among others, Kenen 1995, Gros 1996a, Spaventa 1996a, Thygesen 1996a, Wyplosz 1996, Persson and Tabellini 1996). However, too much ado has been made in the literature about alleged obstacles set by the Treaty on the road to a viable solution to this problem.

It is true that nowhere in the Treaty<sup>3</sup> is written that after the beginning of EMU a new ERM should be set up which non-participating countries might be able to join. And it is also true that the Treaty contains language to the effect that, with EMU, the EMS mechanisms for the creation of ecus "shall be unwound" and that all claims and liabilities arising from the EMS financing mechanism "shall be settled" (Article 23 of the Statute of the EMI). This has led some commentators to conclude that at the start of EMU "the EMS itself will cease to exist" (Spaventa 1996a), thus impeding the continuation of the ERM, which is the operational framework of the EMS. But since the Treaty at the same time requires "the observance of the normal fluctuation margins" of the ERM for two years by would-be participants (Article 109j(1)), pre-ins would be confronted with an unmanageable situation: to join EMU they must be members of the ERM, but after EMU the ERM would cease to exist.

In fact, an objective analysis reveals that the Treaty contains sufficiently clear language to conclude that the continuation or the

<sup>2</sup> This is the terminology currently used in the media and the literature with reference to the problem examined in this paper. It is unnecessarily harsh and somewhat misleading from an institutional point of view. In fact the "outs", although not participating in EMU, sit in the General Council of the European System of Central Banks (ESCB) and remain, of course, full members of the EU. Yet, alternative denominations are not easily found. "Upstairs-downstairs" would be more accurate institutionally as describing occupants of different quarters of the same house, but has an unpleasant "master-servant" connotation. The EU Commission in its documents had opted for "ins" and "pre-ins", which is a perfect example of "Eurospeak" but, at least, hints at an important feature of ERM2, which is to facilitate convergence and eventual participation in EMU. The formal definition of pre-ins in the Treaty is "countries with a derogation", while the EMI *Report* also refers to them as "non-euro area countries". These last three definitions will be alternatively used in the paper.

<sup>3</sup> Throughout the paper references to the Treaty are meant to include, in addition to the Treaty proper, also the Statutes of the EMI and of the ECB and the ESCB contained in Protocols annexed to the Treaty, of which they are integral parts.

adaptation of the exchange rate arrangement between ins and pre-ins: *a)* is not legally prohibited; *b)* is explicitly encouraged; *c)* is legally possible.

The first point is easily argued. The only possible legal impediment is Article 23 of the EMI Statute, quoted above, which refers to the termination of the mechanism for ecu creation and for financing of interventions. However, although these instruments play an important role in the working of the EMS, they are not in any way essential elements of the system. The ERM, with its array of parity grid, oscillation margins, intervention obligations, etc., could function without any attendant mechanism to finance interventions or to create official ecu for the settlement of intervention obligations. Thus, there is no technical reason to imply that the termination of the financing mechanism mentioned in Article 23 would necessarily involve the termination of the ERM. Nor can it be argued that a legal impediment is to be found in Article 109 just because it makes no mention of the exchange rate relationship between ins and pre-ins, the reason being that this article deals with a different topic, namely the exchange rate relationship between EMU and non-community currencies. Thus, the omission cannot be construed to imply that an exchange rate agreement between ins and pre-ins is not feasible.

The Treaty moreover contains explicit language which refers to the continuation of an ERM among ins and pre-ins almost as a matter of fact, requiring not much of an elaboration. The first example relates to the language – already referred to above – concerning the fulfilment of the exchange rate convergence criterion by member states with a derogation: Article 109j(1) together with Article 109k(2) indicates that participation in the ERM would continue to be one of the criteria for participation in EMU also for members with a derogation. The implication is that, if membership of the ERM is a condition for EMU participation, there must be an ERM in existence to satisfy it. A similar implication can be drawn from Article 44 of the Statute of the ECB which stipulates that “the ECB shall take over those tasks of the EMI which, because of the derogations of one or more member states, still have to be performed in the third stage”; among the tasks to be taken over by the ECB there is also (Article 4.1 of the EMI Statute) “monitoring the functioning of the European Monetary System”. Moreover, Article 47 of the ECB Statute further stipulates that, within the ECB, “the General Council shall perform

the tasks referred to in Article 44”. Thus, the EMS would continue to exist in the third stage and it would be the ECB General Council, where the central banks of all EU members are represented, including those of members with a derogation, the instance empowered to act as a forum for policy coordination between EMU and the pre-ins, to monitor the functioning of the system and to take decisions relating to the administration of its mechanisms.<sup>4</sup>

On a more general level, there is the language of Article 109m which enjoins to each member state until the beginning of EMU to “treat its exchange rate policy as a matter of common interest. In doing so, member states shall take account of the experience acquired in cooperation within the framework of the EMS”. The same article specifies that after the beginning of EMU and for as long as a member state has a derogation, the above principle “shall apply by analogy to the exchange rate policy of that member state”. Several observers (Kenen 1995, Spaventa 1996a, Thygesen 1996a) consider this article as too vague to imply the obligation to perform exchange rate cooperation within the framework of a specific mechanism. But this interpretation from “outsiders” is not the only possible one: indeed an “insider” from Banca d’Italia (Schioppa 1995) has argued that Article 109m “establishes a continuum between the experience of the EMS [...] and the duties of countries with a derogation regarding their exchange rate policy in stage 3”; moreover – continues Schioppa – the reference in the Article to the EMS cooperation points toward a multilateral cooperative arrangement, implying that “a sum of unilateral peggings would not comply with the prescription of Article 109m(1)”.

It is therefore fair to say that the Treaty, despite its ambiguities, comes out sufficiently clearly in favour either of the continuation of the present ERM into the third stage or of its adaptation to the new institutional environment.<sup>5</sup> The latter course of action would not seem to pose any particular legal problem. The precedent of the establishment in 1979 of the EMS, which was not foreseen by the Treaty of Rome, seems easily applicable to the updating of the arrangement even if the Treaty of Maastricht had been entirely silent

<sup>4</sup> Kenen (1995) recognises that this is a possible interpretation of the Treaty but is not sure that “taking over the tasks” implies for the General Council the exercise of concrete powers.

<sup>5</sup> This is also the view of Gros (1996b).

of the matter. However, even if for some unthinkable reason the EMS precedent had been considered as not applicable, one could have resorted to Article 235 of the Treaty of Rome which allows the EU Council, subject to certain conditions, to take the appropriate measures to attain one of the objectives of the EU for which the Treaty has not provided the necessary powers.

The conclusion that ERM2 is legally possible still leaves unanswered the question of whether it is also desirable from an economic point of view. The main economic argument is that, in the absence of some framework for exchange rate cooperation, the co-existence of a single market without internal barriers to commercial and financial flows encompassing all 15 EU members and of an EMU with a more limited membership would be inherently unstable. The currencies of non-participating countries may be subject to strong downward pressures, irrespective of the degree of divergence of their economies from the Treaty criteria, just because of the very decision of not having been included in the euro. Competitive depreciations may lead to trade distortions which may in turn fuel protectionist pressures in the euro area countries, thus damaging the single market. This is not a purely hypothetical scenario: it almost came true after the episode of acute tensions that affected European currency markets in the first quarter of 1995, leading to a sharp depreciation of the free-floating currencies of the EMS.<sup>6</sup> The risk of suffering destabilizing pressures would be particularly acute for a currency that had not succeeded in entering EMU but had been participating in the ERM in the second stage since, in this case, that currency would experience a discontinuity in the nature of its exchange rate relationship with other EU currencies.

The usefulness of an exchange rate mechanism in facilitating the efforts to join the euro on the part of pre-ins may however be limited if foreign exchange market participants consider the new ERM parity as an easy target for speculating against a country that had been officially certified as lagging behind in the convergence process. In other words, participation in an exchange rate agreement would be counterproductive as it may in fact lead to exchange rate instability. The implication of this position – which has been taken by the United Kingdom (see Lamfalussy 1996a) – is that it would be easier to arrive

<sup>6</sup> The issue has been examined by the European Commission in its note for the Monetary Committee entitled "The impact of exchange rate movements within the Single Market" (II/476/95 of 15 September 1995).

to monetary union from a floating exchange rate than from an adjustable peg regime. Whatever the economic merits of the proposition, its applicability is in practice very limited: to accept the validity of this argument for pre-ins would imply necessarily that membership in the ERM is no longer a criterion for participation in the third stage of EMU. The question then becomes to determine whether it would be possible to interpret the Treaty in the sense that the exchange rate criterion would be met by currencies that would have a record of *de facto* exchange rate stability (to be measured on the basis of some agreed indicator on an *ex post* basis), irrespective of whether or not they are participating in the ERM.<sup>7</sup> This question is highly controversial and no solution to it has yet been found in the numerous competent instances. For the time being, the European Council, while acknowledging that participation in a new ERM would be voluntary, has agreed that it was appropriate to proceed with the preparatory work for ERM2 so that its main features could be made known to all parties concerned, including market participants, well in advance of the inception of EMU.

In sum, legal, economic and practical considerations have combined in making possible, in a relatively short period of time, an agreement which recognises the need for continuity in exchange rate cooperation before and after EMU, while adapting the instruments and the procedures of cooperation to the new environment.

### 3. What's new in ERM2

#### 3.1. General aspects

The main differences between ERM1 and ERM2 are to be found: *i)* in the nature of the relationship among participating currencies and *ii)* in the linkage between the operational features of the system and the process of economic convergence among EMS participants.

*i)* In ERM1 each participating currency enjoys an equal status *vis-à-vis* the others and the rights and obligations of "strong"

<sup>7</sup> On this issue see Arrowsmith (1996) Goodhart (1996) and Thygesen (1996b).

currencies are symmetrical to those of "weak" currencies. This may be more a formality than a matter of substance, but it has played a not irrelevant role in the working of the EMS, particularly in the endless debates on the symmetrical sharing of the burden of adjustment of payments disequilibria between surplus and deficit countries (i.e. through a symmetrical change in official interest rates), on the public presentation of central parity realignments (frequently defined as the sum of a revaluation of the strong currency plus a devaluation of the weak currency *vis-à-vis* the ecu) and on the execution of intramarginal exchange market interventions. In ERM2 instead, the euro will explicitly enjoy the status of key currency in the system and this will be reflected in a number of operational features which will be illustrated below (Section 3.2); in other words, ERM2 will be "euro-centric" and asymmetrical, making it clear that it will be up to the other EU currencies to converge on the euro and not *vice versa*.

ii) In ERM2 the convergence process will be an important factor in determining the actual implementation of the arrangement. This is quite new, as the documents concerning ERM1, i.e. the European Council Resolution of December 1978 and the Central Bank Agreement of 1979, make no mention at all of the need to foster convergence of economic policies and performances, the emphasis being entirely on the objective of exchange rate stability.<sup>8</sup> In ERM2 the objective of "lasting convergence of economic fundamentals, in particular price stability" is clearly spelled out in the *EMI Report* and is also considered as "a prerequisite for sustainable exchange rate stability". The convergence-oriented nature of ERM2 is reflected not only in the central role assigned to the euro (as mentioned under point *i*) above), but also in the explicit recognition that exchange rate cooperation in ERM2 can assume closer and stronger forms "subject to progress in economic convergence" (this point will be further elaborated in Section 3.2 below).

The aspects illustrated above point clearly in the direction of another basic difference between ERM1 and ERM2. The latter is clearly established as a temporary arrangement designed to facilitate the transition to EMU by countries that are initially lagging behind in the process of economic convergence. ERM1 was instead conceived as

<sup>8</sup> Even the move of a currency from the wide to the narrow fluctuation band did not require any particular progress in convergence as the EMS agreement in fact indicated that it should take place "as soon as economic conditions permit".

a permanent arrangement, whose provisions and procedures were to be further consolidated "into a final system".

### 3.2. Technical aspects

In this section the main operational features of ERM2 will be reviewed, drawing attention to the innovations introduced.

#### 3.2.1. Parities and margins

The main innovation in ERM2 concerns the structure of the exchange rate mechanism. In ERM1 each currency declares a central rate *vis-à-vis* the ecu from which a parity grid is derived to define central rates and bilateral intervention margins for each pair of participating currencies. In practice the ecu merely serves as a denominator of central rates, while intervention obligations at the margins are expressed in terms of participating currencies.

Although in ERM1 the oscillation margins are the same for each currency *vis-à-vis* any other participating currency, the actual room of manoeuvre for each currency will depend on its relative position within the oscillation band, which by definition sets the maximum spread that can be reached by two currencies in opposition. Thus if the width of the band is, as at present, 15 per cent and the two currencies in opposition are, say, the Irish punt and the French franc, while the Deutsche Mark is at the centre of the band, the currencies in opposition cannot avail themselves of the full room of manoeuvre *vis-à-vis* the Deutsche Mark potentially provided for by the bilateral limits (upwards for the Irish punt and downwards for the French franc).

In ERM2, the parity grid would be replaced by a set of central rates and intervention points would be defined only between the euro and the non-euro currencies. This is the so called "hub and spokes" set-up, in which the euro would form the "hub" to which non-euro currencies would be linked through "spokes".

This set-up has several implications. First of all, the euro will be at the centre of the arrangement, in a position that resembles that of the ecu in ERM1, but is in fact superior to it since the ecu has never been considered a real currency but rather a unit of account. Second, no bilateral margins (and hence intervention obligations) will be established between any pair of non-euro currencies. Assuming, for

example, that the Danish krona and sterling are not part of EMU but have joined the new ERM, and that the width of the band *vis-à-vis* the euro is 15 per cent, the maximum oscillation possible between sterling and krona would be 30 per cent. This aspect of the “hub and spokes” set-up, which is not particularly welcome, is not expected to materialise frequently in practice, as the euro would most likely be the strongest currency of ERM2. However, there is always the possibility that non-euro currencies may agree among themselves to contain currency movements within narrower bilateral limits. The third implication of the “hub and spokes” set-up is that the euro would be involved in any episode of obligatory intervention at the margins. In a parity grid set-up this would not be the case as there is no assurance that the euro would be necessarily one of the currencies in opposition.

As regards the width of the oscillation band, the *EMI Report* does not provide a precise definition, but simply indicates that “it is expected to be relatively wide”. This understanding reflects the positive judgement of the EMI concerning the functioning of the ERM since the widening of the band in August 1993. In fact, since then, the perception of a sizeable two-way risk by foreign exchange market participants has acted as a powerful deterrent for currency speculation. The novelty is that the *EMI Report* explicitly envisages the possibility to establish forms of “closer exchange rate cooperation”. Such closer links “may entail narrower fluctuation bands, which would be made public” or “alternatively, they may rely on informal narrower target ranges, which might be kept confidential”. This innovation, in fact, is a generalisation of the experience recorded by some ERM participants belonging to the so called “hard core” of the EMS. These countries (Austria, Belgium, Denmark and the Netherlands) have maintained closer links to the Deutsche Mark than those allowed under the standard provisions of the ERM. In particular, the Netherlands have formally announced, at the time of the widening of the ERM band to  $\pm 15$  per cent, that they would maintain a bilateral narrow band of  $\pm 2.25$  per cent *vis-à-vis* the Deutsche Mark involving the standard intervention and financing obligations. The understanding in the *EMI Report* is that proliferation of *ad hoc* arrangements should be avoided and that a “standard arrangement could be used as a reference for closer links with central banks of non-euro area member states which have achieved a sufficiently high degree of convergence”. Thus, as anticipated in

Section 3.1 above, the agreement envisages the possibility that the progress of a non-participating country toward EMU could be supported and assisted by progressively closer forms of exchange rate cooperation.

### 3.2.2. *Intervention and financing*

The technical innovations in the field of intervention and financing are limited. However, significant changes have been introduced in the underlying policy requirements for the activation of instruments and procedures.

As in ERM1, foreign exchange intervention and financing at the standard wide band remain, in principle, automatic and unlimited. Recourse to coordinated intramarginal intervention, decided by mutual agreement between the ECB and individual non-euro area central banks would also continue to be possible. The present Very Short-Term Financing (VSTF) facility – through which EMS central banks extend to each other unlimited lines of credit to finance obligatory interventions at the margins – would be retained with some technical adjustments.<sup>9</sup> Access to the VSTF for intramarginal intervention would be possible under present rules. The Short-Term Monetary Support (STMS) facility – originally introduced before the birth of the EMS to provide short-term financing in the event of temporary balance of payments difficulties – will be abolished as it proved to be too cumbersome and limited in size compared with the VSTF and was in fact activated only once in 1974. ERM2 will also do away with the mechanism for creation of official ecus against conferment to the EMI by each member central bank of 20 per cent of their gold and dollars reserves. This implies that it will no longer be possible for debtor countries to settle obligations arising from the activation of the VSTF with such official ecus.<sup>10</sup>

<sup>9</sup> Outstanding balances under the VSTF would no longer be denominated in ecu but in the creditor's currency (i.e. most likely in euro as the financing would be provided by the ECB). This innovation stems from the experience recorded by creditor central banks in the EMS which, following the crisis of 1992, incurred foreign exchange losses on their ecu-denominated creditor positions because of the depreciation of the ecu caused by the exit of the lira and sterling from the ERM.

<sup>10</sup> The advantage of using this means of settlement is that the debtor country is *de facto* mobilising part of its gold reserves (without entering into a gold transaction) to the extent that the amount of ecus transferred is in excess of that created against conferment of dollar reserves. This method has been utilised by EMS members in various occasions, most recently in the aftermath of the 1992-93 crisis when official ecus were transferred to creditors in large amounts.

Aside from these technical changes, the important novelty regarding intervention and financing is the formal recognition of the right for the ECB and the other central banks of the non-euro area to suspend intervention and financing if these are in conflict with the objective of maintaining price stability. The existence of such safeguard clause obviously reduces the significance of the commitment for EMS central banks to carry out "unlimited" intervention at the margins and to provide to each other equally "unlimited" financing, with potential negative effects for the credibility of the new ERM in the eyes of market participants. Nevertheless some qualifications are in order. First of all, even under ERM1 the concept of "unlimited" intervention has not been interpreted to mean literally that debtor and creditor positions arising from intervention could be accumulated in amounts exceeding any conceivable variable of scale, even one as high as a country's money supply or GDP. In fact, the operational meaning of "unlimited" has not been "infinite" but rather "very large" and in any case large enough to avoid that a central bank might find itself without the means to continue its intervention activity during the normal operating time of the market. This interpretation, based on common sense, had found stronger support in the understanding reached at the time of the creation of ERM1 between the German government and the Deutsche Bundesbank. According to this understanding (which was supposed to remain secret but has been made public in 1986 in the memoirs of Otmar Emminger, President of the Bundesbank at the time of birth of the EMS), the German central bank would be allowed to unilaterally suspend intervention in support of another ERM currency if in its judgement this would imply a loss of monetary control in Germany.<sup>11</sup> Given this precedent, the acknowledgement of the right for the ECB to suspend interventions is not really a substantive innovation, but more a formalization of a *de facto* situation. Indeed, it may be even argued that by making explicit this safeguard for the ECB, the credibility of the arrangement has been strengthened, since the degree of arbitrariness of the procedures previously existing has in fact been reduced, and their transparency enhanced, through the requirement of greater accountability for the actors involved. The *EMI Report* in fact states that: "In deciding whether or not to resort to this safeguard clause, the ECB [...] would

<sup>11</sup> On the content and implications of the famous "Emminger letter" to the German government see Eichengreen and Wyplosz (1993).

take due account of all relevant factors, in particular the need to maintain price stability and the credible functioning of the new exchange rate mechanism. Without prejudice to its independent assessment [...] the ECB would base its decision on factual evidence and, in this context, also give consideration to any conclusion which may have been reached by other competent bodies". Thus, recourse to the safeguard clause by the ECB, although established on broader and firmer legal grounds than in the Bundesbank case, is likely to be exercised only in circumstances in which interventions pose a concrete threat to the internal price stability of the euro area (which are likely to be exceptional, given the different sizes of the euro area and any of the potential non-participating countries). In any case, in deciding the suspension due account will have to be taken by the ECB of the interests of the currency in support of which interventions are conducted and of the need to preserve the credibility of ERM2. In the context of this decision-making process the ECB would no doubt consult with the "other competent bodies" which would include the Ecofin Council, the Economic and Financial Committee (which in the third stage will be the new name of the present Monetary Committee) and the European Commission.

### 3.2.3. *Monitoring the functioning of ERM2*

The institutional set-up for supervising the functioning of ERM2 will continue to involve a number of different actors. The surveillance of economic performances and policies will be entrusted to the Economic and Financial Committee and the European Commission;<sup>12</sup> the monitoring of the exchange rate mechanism will be carried out by the ECB (which will take over the functions of the EMI); the General Council of the ECB (which comprises the central banks of all EU member states, including those with a derogation) will act as a forum for monetary and exchange rate policy coordination as well as for the management of the intervention and financing mechanisms.

If, on the surface, the set-up appears broadly similar to the present one, the establishment of the ECB will alter significantly the distribution of roles among the various actors. Because of its insti-

<sup>12</sup> The Commission has sent to the Ecofin Council a Communication (COM96-498 of 16 October 1996) in which advocates the introduction of "reinforced convergence procedures" in the context of the new exchange rate arrangement given the linkage existing between exchange rate stability and convergence.

tutional prerogatives and objectives, clearly spelled out in the Treaty, the ECB is likely to perform a leading role in the assessment of the sustainability of the exchange rate relationship embodied in ERM2. The ECB will have the right to initiate a confidential procedure aimed at reconsidering central rates and, as mentioned in Section 3.2.2 above, the right to suspend intervention. It could be argued that a similar role was *de facto* assigned in ERM1 to the Bundesbank, but the analogy is not really convincing since the EMS Agreement did not recognise any special role to the central bank issuing the anchor currency of the System. This may seem a formal detail, but it is essential in understanding the working of ERM1. It is widely recognised that one of the major factors behind the EMS crisis of 1992-93 (see Collignon 1994, which contains a comprehensive analysis of the crisis as seen from the official side) was the inability of the System to promote a timely readjustment of central rates in the face of growing domestic and external imbalances in member countries during the period 1987-92. It cannot be excluded that political factors may play a role in delaying necessary adjustment measures also in the future, as they did in the run-up to the 1992 EMS crisis, but the presence of a strong, supranational and independent institution, constitutionally obliged to pursue stability-oriented policies, is likely to minimize that risk, as the ECB will no doubt constitute a permanent source of critical reappraisal of the sustainability of exchange rate relationships in ERM2.

#### 4. A tentative assessment

A comprehensive critical assessment of the adequacy of the proposed ERM2 in satisfying the demand for monetary and exchange rate cooperation in the EU after the inception of EMU would be possible only after the full texts of the European Council Resolution and of the Central Bank Agreement will be approved by the competent bodies and made public. The Resolution is expected to be approved in June 1997; a draft of the Central Bank Agreement will be prepared by the EMI and then submitted for approval to the ECB when it would start operating, i.e. sometime after the Spring of 1998. Even then, however, it may still be too soon to arrive at a definitive

judgement. The creation of EMU would be such a dramatic "shift of regime" in European monetary affairs that it is difficult to foresee its spill-over effects on the other currencies of the EU. In the event, the crucial factor would be the reaction of financial markets and this in turn will depend on the degree of convergence of the pre-ins towards EMU and on their political willingness to adopt the necessary policy measures. A country very near to reaching the Treaty criteria for participation and openly committed to join EMU may be presumed by the market to qualify for the ECB support needed to protect the link-up process from unwarranted speculative pressures. In this case market participants may in fact discount the eventual full participation in EMU and refrain from challenging the central rate or may even enter into "convergence trades" with positive effects on the exchange rate and the domestic bond market of the pre-in country. Conversely, the reaction of markets might be different in regard of countries that were judged as lagging behind in convergence or inadequately committed to pursue stability-oriented policies; different again would be the reaction *vis-à-vis* countries not willing to join EMU and/or not willing to participate in the new exchange rate mechanism. In any event the mere presence of a monetary pole of continental dimension is likely to exert such a powerful attraction on economic agents and financial market participants that it may be difficult for any EMU neighbour to pursue an independent economic strategy.

A tentative assessment of the adequacy of ERM2 in performing the assigned tasks is, however, possible on the basis of the experience of the EMS. The question has been addressed by several authors and their analysis has in common the consideration that the type of exchange rate arrangements that is both possible under the Treaty and politically acceptable by EU member states would not differ very much from the one that was found so critically wanting in 1992. It is even argued that ERM2 would be more fragile than ERM1 because of the intrinsic incompatibility of the objectives of maintaining price stability *and* exchange rate stability: trying to achieve the latter, through unlimited foreign exchange intervention, may compromise achieving the former. In practice, the conflict may be resolved by limiting interventions which would impair the credibility of the ERM. Thus, it is suggested that any such arrangement be supplemented with or replaced by institutional devices more suitable to ensure convergence and exchange rate stability for the pre-ins. Among the pro-



posals currently debated in the literature the following seem especially relevant:

*i)* pre-ins should seek the status of EMU associate members (without any voting power in the ECB), renouncing any form of monetary autonomy and establishing a currency board to link their monetary policy to that of the ECB (Gros 1996b, Basevi 1996, Thygesen 1996a);

*ii)* a EU-wide system of mandatory inflation targets (covering also countries with an EMU opting-out clause) should be introduced in the EU instead of an exchange rate arrangement to reconcile exchange rate stability and price stability (Persson and Tabellini 1996);

*iii)* an agreement should be reached in the context of ERM2 whereby foreign exchange intervention by the ECB in support of pre-in currencies would be unlimited but conditional upon strict adherence to a convergence program (Wyplosz 1996).

It is beyond the scope of this paper to analyse in detail these specific proposals.<sup>13</sup> Some general comments may however be made with reference to the crucial issue of the fragility of the exchange rate mechanism and its attendant undefensibility. The starting point of the studies quoted above seems to be the disappointing experience of the EMS in 1992. This is undeniable, although it would certainly be wrong to infer from that experience that *any* exchange rate arrangement under *any* circumstances is bound to fail. A more balanced view of the events of 1992-93 (see also Collignon 1994, Padoa-Schioppa 1994 and Gros 1996a) would be that:

– under the exceptional circumstances that prevailed in that period, such as the shock of German unification and the rapid succession in financial markets of EMU euphoria (signing of the Treaty) and EMU pessimism (Danish and French *referenda*), exchange rate relationships in the EMS were kept unchanged despite growing imbalances in some member countries;

– when the crisis erupted, exchange rate adjustments were belatedly allowed to take place in a disorderly manner in countries

<sup>13</sup> These proposals have been analysed, among others, by Sarcinelli (1996), Spaventa (1996b) and Portes (1996).

where they were needed; however, central rates were successfully defended in countries with sound fundamentals through a comprehensive strategy of market pressure containment, involving *inter alia* intramarginal intervention in unlimited amounts (this was the case of the parities of the French franc and of the Danish krona in support of which also explicit techniques of coordinated intervention were adopted);

– following the widening of ERM margins in 1993, greater reliance on exchange rate flexibility has enhanced the perception of a two-way risk among market participants thereby contributing to the defence of a central rate in countries with sound fundamentals.

The “lessons” from the full experience of the EMS would then be that its crisis was essentially due to a “coordination failure” (Padoa-Schioppa 1994) and that an exchange rate mechanism could satisfactorily function provided that: *a)* there is a collective monitoring to ensure that central rates are adjusted in a timely manner in a framework of stability-oriented monetary and fiscal policies; *b)* oscillation margins are kept sufficiently wide to absorb temporary market pressures; *c)* the central rates of currencies that are deemed to be fundamentally sound in the framework of the collective monitoring would be supported by coordinated and unlimited intervention.

The first two ingredients seem to be adequately included in the proposed ERM2. The third ingredient is missing, although some oblique references to it are present in the *EMI Report* and, more conspicuously, in the Communication of the Commission to the Ecofin Council of October 16, 1996.<sup>14</sup> The commitment to defend currencies with sound fundamentals could be spelled out more clearly in the Council Resolution and in the Central Bank Agreement now in preparation, by in fact formalizing and generalizing the positive experience gained in the support of the French franc and the Danish krona. This commitment would resemble very closely to the proposal by Wyplosz (point *iii*) above) for “unlimited conditional intervention” and would significantly contribute to enhance the credibility of ERM2 in the eyes of the market as an instrument to promote convergence

<sup>14</sup> In paragraph 2.3 of the Communication it is stated that “the progress achieved by a pre-in towards its convergence objectives might be used as a reference in deciding on the sustainability of central rates. A favourable performance [...] would be expected to strengthen the case for support for a pre-in currency in the event of speculative pressures”.

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