

Comment by Wolfgang Rieke

1. I cannot hope to do justice to Professor Thygesen's paper partly because of a time constraint in the preparation of my comments, but also because of the wealth of material laid out in the attempt to deal with a not very easy question. It would not be difficult to pass quickly on the question. One need only point to a few figures such as provided in Table 1 for inflation rates, or in Table 2 for growth, inflation, employment and current accounts, to conclude that convergence has been lacking and is not in sight as far as one can look ahead.

The lack of progress in various crucial areas of national economic performance is, of course, a serious matter *per se*. But it is also serious in the EMS context, because it constantly poses the risk of exchange market crises, threatening the cohesion of EMS central rates that have been agreed upon. In the two years that have passed the consequences of divergent performance in areas that are crucial for exchange rate stability between EMS member currencies have only been mitigated by the weakness of the DM relative to the dollar, which has come as a surprise to most observers.

It is true that the EMS has in its initial phase weathered some especially rude external shocks, i.e., the second oil shock, and the effects of rather volatile interest rates in the United States; and it may well be able to weather what might be called internal EMS shocks when they occur. But it has weathered them well partly due to the fact that both shocks seem to have affected the DM more unpleasantly than other EMS currencies. I am not, of course, saying that other EMS countries have been less hurt by higher oil prices, or high and volatile U.S. interest rates (though in some cases this may indeed be true). But their currencies have somehow been able to escape the fates of a currency that has come to be a more obvious alternative choice to the dollar as an international currency, especially an investment currency. Given the surge of OPEC surpluses in 1979-80 that are seeking investment, renewed preference for the dollar was likely to be felt more adversely by the DM than by other less prominent investment and reserve currencies.

There are several factors that account for the weakness of the DM, among them the exceptionally sharp turn into current account deficit, and the relatively low level of interest rates. The weakness may be longer-lasting than some would be inclined to think. But then U.S.

interest rates may come down somewhat eventually, the German current account may begin to improve, confidence in the DM as an alternative currency option to the dollar (or pound sterling) for surplus funds may again recover. In such circumstances the lack of economic convergence among community countries in those areas that determine exchange rates (relative to the dollar and hence within EMS) will again become critical, and the prospect of realignment of central rates may arise. Fortunately this is expressly provided for in the EMS, and is not an obvious disaster, especially if adjustments can be brought about promptly.

2. The most interesting phase of past experience has been that of last year, and leading into 1981, the period coinciding with the general recognition — with considerable lag — of a 'DM problem'. In a sense the existence of EMS helped in that phase, as it seemed at the time, to prevent a more pronounced depreciation of the DM than was considered justified when looking at relative inflation rates.

Even if it is assumed that the position of the whole set of EMS currencies (or the ECU, as some will prefer) vis-à-vis the dollar will be largely determined by the position taken by the DM, the existence of the EMS may in turn have kept the DM from falling earlier to where it fell later on — and where some economic experts in Germany would have liked to see it go. With hindsight one is tempted to say, however, that if without EMS the DM had fallen more against the dollar (and on a weighted basis), this might have prompted action earlier to deal with some of the factors underlying its weakness, for instance too low DM interest rates.

There is, of course, also the thesis that the fixed rate illusion of the EMS caused capital flows to be attracted more exclusively by nominal interest rates than by exchange rate expectations and risks involved, favouring high inflation countries, while causing the DM to be glued to the bottom of the band. This would suggest then that some EMS countries might have needed higher interest rates to maintain their exchange rate at an equivalent level had the EMS not existed. And if it is true that France and the Netherlands only lowered their interest rates late in 1980 to ease tensions within EMS, then one would have to conclude that the existence of EMS encouraged divergent domestic policies and raised the possibility of internal vs. external conflict in those countries.

The above reasoning is in part speculative — not untypical of much economic reasoning —, but it would help explain why some EMS partners felt Germany should have raised interest rates sooner rather than later, with a view to easing tensions within EMS, thus obviating the need for others to lower their own interest rates and ease monetary policy accordingly. Some of them appear to have had the right feeling, that their interest rates were not all that high after all (viz. the level of real rates of interest in France). Which again takes one back to the question: what would have happened had the EMS not existed?

3. Thygesen argues in his paper that recently the EMS has been seen by Germany as accentuating a severe policy conflict. So it seemed at some moments, and to some people. Two questions need to be asked here, and not only from hindsight: a) was there a severe policy conflict? b) did the existence of EMS really accentuate it?

No one will want to deny that the slowing of economic activity and the rise of unemployment everywhere give cause for great concern, and that any available room for manoeuvre should be used on the monetary front to help alleviate that situation. Indeed, in Germany the slowing of inflation since mid-year seemed to provide somewhat more room for manoeuvre. The problem was (and still is), of course, that the current account situation and the pressure on the DM resulting from it (and from other factors) could not simply be dismissed as a lesser constraint. It is not simply a matter of weighing domestic against external constraints, even in the special circumstances in which we live now due to the persistence of large oil surpluses and what follows from them for the pattern of world payments. The fact that current account deficits no more than domestic inflation in many industrial countries are not primarily demand determined at this time does not make them non-problems for monetary policy. To the extent that there is a conflict, it is energy policy, fiscal policy and incomes policy that one is looking for to help solve it in Germany as much as in other countries.

Now to the second question: "Did the EMS accentuate the conflict?" The intervention figures are no clear indication that it has indeed done so, though a further lowering of interest rates and easing of monetary policy (as called for by some observers) would surely have added to the already substantial amounts committed to the support of the DM. However, as far as intervention in the exchange markets is concerned, two things are worth mentioning:

- a) the period we are looking at in this phase saw considerable DM-intervention by the U.S. authorities in addition to that undertaken by the *Bundesbank* itself (and for its own account). In part U.S. intervention was motivated by a desire to build up DM claims towards the repayment of outstanding DM-denominated "Carter-notes and -bonds";
- b) the domestic monetary effects of the considerable reserve losses suffered by the *Bundesbank* were on the whole offset by various monetary measures (reducing reserve requirements, swap transactions etc).

This raises once again critical issues as to the interrelationship between exchange market intervention and monetary policy which have not been adequately dealt with as far as I can judge. Inter-

vention is all too often regarded as a prime instrument of exchange rate stabilization, without due regard to its monetary implications as well as to its obvious limitations unless supported by monetary policy.

4. There is one further cause for dissatisfaction with the workings of the EMS. Contrary to the express intentions of the Heads of State and Government, the relative stability of EMS exchange rates has not been adequately supported by domestic policies designed to reduce inflation rates in partner countries quickly enough to permit a concerted shift of policy to a more expansionary stance. Given Germany's own inflation record, the *Bundesbank* felt last year that it might be able to lower interest rates somewhat eventually so as to help support economic activity. There could be no question of Germany playing the role of 'locomotive' again (as in 1978), and nobody is asking Germany to do that. It would be sheer folly as well to ask others with much higher inflation rates to do so now.

But in their own interests and in that of their partners, it would be desirable that high inflation countries should be successful in their anti-inflationary endeavours more promptly, so as to create a sound basis from which all countries — or most of them — may hope to move forward again on to a growth path. This in a sense is at the heart of the convergence issue. But, of course, this is easier said than done.