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European monetary integration – from the beginnings to the EMS crisis of 1992–93

Abstract. In the world of Bretton Woods exchange rate system, monetary policy played a secondary and subservient role, which in the case of European integration was strengthened by a predominant role of politics. Therefore, the first institutional arrangements at the beginning of the European monetary integration process served a set of practical goals. But changing global economy as well as changing politics of the European government set new goals for monetary policy coordination, which finally resulted in the origin of the European Monetary System. The EMS lasted for the next 14 years, until liberalizing financial markets and German unification led to the most severe crisis in the history of European monetary integration.

As a decision concerning the pace and the path of monetary integration was an outcome of negotiations between main adversaries (Germany and France), it is crucial to look at the methodological context of the economist-monetarist discussion which set a mark on the institutional setup of the European monetary policy.

Keywords: monetary integration; economic policy; institutions; economist-monetarist debate; EMS crisis.

JEL codes: E42, E65, F33, N14.

1. Introduction

The aim of this paper is to present an overview over the milestones of the European monetary history during the European integration process.

It is important to understand what factors influenced the developments in that particular field. Therefore, an attempt was made to look at the integration from the stance of economist-monetarist debate, as it is important to understand the background of European monetary integration.

The article begins with a presentation of historical perspective of how the monetary integration has developed since World War 2. It passes on then to the creation

of the European Monetary System (EMS) which was the first formal and lasting arrangement pushing the European economy on the tracks of monetary cooperation. After the most important issues of the EMS have been presented, I will move on to the historical overview of events from 1979 to 1992.

The latter date has been a breakpoint for the development of the European monetary system. It was the date of the biggest EMS crisis which made the pound leave the system and the French franc widen the currency bands. The anatomy of the crisis is presented later on in this paper, as well as an analysis of the question if that turmoil could have been avoided – and if so, how.

2. Economist-monetarist discussion – the prologue

The 'economist-monetarist' debate seemed to lay historically at the very core of the discussion about the setup of common monetary policy (later also common currency) in Europe. It had a political (milestones of the European economic and monetary integration were set by politicians often against the advice of 'technicians'), economic (as far as the functioning of economies was concerned) as well as even a philosophical (role of a state in politics and economy – i.e. 'meta-cultural' beliefs) background.

The economist camp was represented by Germany, the Netherlands and Italy (only until 1970s). Their standpoint was to converge European economies in order to achieve a similar set of fundamentals[1] for every country and only then to start off with the integration of monetary policy. The latter should be a crown set on the top of sound economic bases.

The respective adversaries, i.e., the monetarists, were represented by France, Belgium and Italy (from 1970s). In their opinion, irrevocable fixing of exchange rates and common monetary policy should precede economic integration. (more detailed definition of both sides can be found e.g. in Molle, 2000).

Although many countries were involved in the dispute, it can be assumed, that the frontline ran between two biggest countries – France and Germany. The roots of the debate can be found already in the late 1940s with France trying to curb the revival of German economy (Arestis et al., 1999). German economic recovery was seen by France as a threat to national security. This was the reason why Jean Monnet maintained that only a crisis could undermine national sovereignty approach. He was also in favour of the idea that economic co-operation could only be achieved 'privately at the ministerial level, rather than by a congress of several hundred people' (Arestis et al., 1999, p. 5).

[1] E.g. to ensure converging inflation rates, which would not disturb conduct of common monetary policy.

The crisis, Monnet was waiting for came sooner than expected, as the Anglo-American policy shifted as a result of growing tensions in the world politics (beginnings of the Cold War). Soon, the Bizonia was created, and with the merger of the French zone, the Federal Republic of Germany was created. France was in need of policy reformulation. Monnet took advantage of his opportunity and the European Coal and Steel Community was created in 1951. The political shift did not fully reverse the French approach to Germany (and to the German economy) which was still contemptuous[2] for the next 20 years (Guyomarch, 1998). As Dyson and Featherstone (1999, p. 119) noticed, the pursuit and French motives "were to be understood in terms of political problems confronting French Presidents rather than in terms of any technical rationale". The aforementioned issues regarded the matters of both foreign policy – relationships with the USA and Germany – as well as internal French politics.

At that time French economists were mainly influenced by Keynesian economics. Especially the Planning Office in charge of the post-war economic recovery was employing activist measures in the French economy. On the other hand, German 'ordoliberalism'[3] was born, which created a sound framework for the recovery and development of the German economy (Maes, 2002, pp. 3-7). Those ideas associated in both countries with the post-war recovery were to become foundations of the 'economist-monetarist' dispute.

3. European monetary integration – the pre-ERM phase

3.1. The EPU (European Payments Union)

The idea of European monetary integration did not appear first after the Treaty of Rome, but it started soon after the World War 2. At that time Europe was mostly in ruins and had also undergone some serious damages to the multi- and bilateral trading agreements (Gros and Thygesen, 1998). Those concluded after the war provided special credit lines for the countries suffering current account deficits. Still, the European economies were quite weak and no one wanted to loosen insignificant gold reserves. The only solution then was to use the arsenal of high tariffs and quotas to restrict imports. However, the demand for imports, especially from the USA, exceeded the supply of exports by far. This was called 'the dollar gap' and was perceived as a structural problem of the European countries. No devalu-

[2] France considered strong Germany as a threat to the European balance of powers.

[3] "Ordoliberalism" was a child of the Freiburg School the prominent members of which were lawyers (Maes, 2002).

ation of any currency against the dollar was possible at that time. In such a situation negotiations started aiming to establish the European Payments Union (EPU). From the very beginning the idea was supported by the United States that had their interest in it, mainly because through the sterling and the French franc it embraced Asia and Africa as well. A detailed record of negotiations and operations of the EPU is provided by Kaplan and Schleiminger (1989). At this stage it is worth pointing out that the EPU was actually an escape from bilateralism as the deficits and surpluses were netted out vis-à-vis the Union (Gros, Thygesen; 1998). Since more details can be found in the literature, I just wish to mention that one of the most important issues of the system was the forced acceptance of interference in domestic economic policies of individual countries. It became clear for the fist time in the years1950-51, during the German crisis. Notwithstanding, in the following year the condition of the European economies improved so that they could announce full convertibility of their currencies in 1958, which in fact was the end of the EPU. As Triffin (1966) notes, there were 'arguments in favour of keeping the EPU in preference to moving unilaterally, though simultaneously, to global convertibility'. As such, the dissolution of the European Payments Union could be considered as a loss to European monetary integration. However, at that time, after years of post-war constraints, everybody looked for a free pursuit of economic policies. There was a need for enhanced autonomy.

3.2. The Werner plan

The exchange rate, the fourth corner of the magic quadrangle of economic stability, was not even mentioned in the Treaty of Rome (1957) (Ungerer, 1990). Towards the end of the 1960s, however, it became obvious that the economies of Europe slowly started to diverge (Kouparitsas 1999; Artis, Zhang 1999). Perhaps this caused Willy Brandt's initiative to formulate medium-term policy objectives and, in the long-run, to introduce a monetary union with permanently fixed exchange rates, to appear right after the Hague European Council summit in 1969 (Kloten, 1980). Almost a year after, a group chaired by Pierre Werner produced a report on how to achieve a monetary union in three stages by 1980. The report devised by the group was very particular with respect to the final goal of the European monetary integration. It presumed that the objective of the EMU would be reached by 1980 and would mark a total and irreversible convertibility of currencies, the elimination of fluctuation in exchange rates and a complete liberalization of capital movements (Werner, 1970). The report, however, did not include much detail on the institutional framework of monetary integration. It briefly read that a system of central banks[4] should be established in order to conduct an internal monetary

[4] One similar to the Federal Reserve System.

policy and exchange rate policy against other currencies. On the other hand, the Werner plan was much more detailed as far as the conduct of non-monetary policies is concerned. It foresaw a kind of a ‘centre’ that would deal with budgetary, regional, structural ad social policies in the EMU. As Gros and Thygesen (1998) show, the Werner plan dealt less with low inflation and convergence of future EMU members just because the period in which the plan emerged was a time of low global inflation. Nevertheless, it put much more emphasis on fiscal policy because of some serious concerns that due to possible regional and structural disequilibria, might cause tensions. Those tensions, in the long run, would further lead to the divergence of economic performance in European countries. Gros and Thygesen (1998) also point out that the easiness the commitments made was due to two other factors. The first one was ‘the softness of the constraints’ which had its roots in the lack of domestic policies’ co-ordination – transfer of authority was to be postponed to the last, third, stage of the Werner Plan. The other factor, thoroughly analysed by Baer and Padoa-Schioppa (1989) and Mortensen (1990), was the debate between economist and monetarist approaches to the European integration. German and Dutch policymakers mainly represented the former stance-to their minds, a voluntary co-ordination of domestic policies and convergence should precede the irrevocable fixing of the exchange rates. France, Belgium and Italy on the other hand, represented the latter viewpoint. According to the monetarist idea, one should first establish common monetary institutions and policies and the remaining issues would fall into place.

The last part of this paper will provide a closer insight into the background of those differences.

3.3. “Snake in the tunnel” and the European Monetary Co-operation Fund

The events that delayed the first step towards EMU were also crucial for the development of an exchange rate system called ‘the snake in the tunnel’. It started off with the floating[5] of the Deutsche mark and the Dutch guilder and with the US suspension of the obligation to convert the dollar holdings into gold. Those events of 1971, along with the “Smithsonian Agreement” of December 1971, were the cornerstones of a new monetary arrangement for Europe. Its origin was rather forced than planned as France and Italy did not want the Deutsche mark to float freely against the dollar. Thus, a system was created where the European currencies could fluctuate within a 4,5% band and finally 2,25% around bilateral central rates. However, after the dollar was free to float from March 1973, a tendency ap-

[5] Against the dollar.

peared for the snake participants to gather into weak[6] and strong[7] currency groups. Not only did it make the economies diverge ever stronger, but there was also a clear lack of any exchange rate policy and domestic policies' co-ordination. Both policies were clearly inconsistent. The developments in the world economy in the mid-1970s finally brought a solution to the problem of exchange rate management. Rising inflation in some of the participant countries caused heavy capital movements which became unsustainable for some of them (Gros, Thygesen; 1998). As the election was closer in Germany, the criticism against the Bundesbank interventions rose. This finally led to the so-called Frankfurt realignment of October 1979. It was the first realignment with the participation of more than one country. It also became a way to sort out the problems of weaker, relatively to the Deutsche mark, currencies within the snake (Thygesen, 1979). This event at least lead to a success in setting moderate exchange rate management as a policy instrument. That helped to avoid two extreme solutions – to treat exchange rates as untouchable or entirely market-determined.

According to the Werner plan, an institution that should have started its activity in the early 1970s, was the European Monetary Co-operation Fund (EMCF). It was finally set up in 1973 and was initially charged with monitoring the Community's exchange rate system and assuring the multilateral nature of net interventions of participating central banks in EC currencies (Gros, Thygesen; 1998). This institution, scheduled to be supervised by central bank governors, was right from the beginning subordinated to guidelines and directives of the ECOFIN Council, therefore was subject to political instructions and not suitable to perform a monetary policy (Pöhl, 1989). The example of the EMCF proved that a premature creation of an institution without genuine authority to perform its tasks was a wrong solution for Europe as the current policy making could still overrule long-term decisions.

4. The ERM phase

4.1. The creation of the European Monetary System (EMS)

The beginnings of the EMS were not easy whatsoever. Again, the first proposal made to unify an exchange rate system for a better co-ordination of monetary policies was split into two rival approaches. One came again from France, from the French Ministry of Finance that proposed the so-called "boa" – a system of wider margins around the snake. On the other hand, the Dutch Minister of Finance, today's ECB

[6] French and Belgium franc, Danish and Swedish krone.

[7] The DM, guilder and Norwegian krone.

governor, Duisenberg[8] suggested target zones for EC currencies (Ungerer, 1990). But at that time, it became dangerous for the European Union to debate again upon different approaches to the monetary union as the EC started to move backwards. It posed a challenge for the EC to get the integration process back on track, fight inflation and work out the way to greater stability of exchange rates. The then President of the EC Commission, Roy Jenkins, undertook the first serious step in Florence in 1977. He called for a fresh look on the perspective of a future economic and monetary union (Jenkins, 1977). Soon afterwards he was followed by the French President, V. G. d'Estaing, and the German Chancellor, Helmut Schmidt. They took the initiative to combine co-ordination of the exchange rate management and the domestic monetary and fiscal policies. Then, at the European Council summit in Bremen in July 1978 a 'scheme for the creation of closer monetary co-operation leading to a zone of monetary stability in Europe' was discussed, and at the next meeting in Brussels on December 4-5 1978, the Council agreed on the creation of the EMS so as to secure greater stability of home and foreign economic policies (Commission of the EC, 1979).

4.2. Institutional features of the EMS

The European Monetary System could be characterized by two features: Exchange Rate Mechanism (ERM) and European Currency Unit (ECU). Like the Bretton Woods system, the ERM was an 'adjustable peg' system. This meant that the currencies within the system were bound by an official exchange rate which could then float freely within a band +/-2.5% around the central rate. Only Italy and the newcomers[9] were allowed to use broader bands that were set at +/-6%. If the exchange rate had been about to reach the top or the bottom of band, central banks of the 'problematic'[10] currencies would have had to intervene at the foreign exchange markets in order to uphold the stability of exchange rate. The guarantee for the interventions was not absolute and, after consultation with other members, countries could realign within the system. Still, if any currency had diverged more than 75% of its band of fluctuation, there was room to assume that a respective country would have started a counter-action on its own, otherwise the whole basket could either appreciate or depreciate. There were also credit facilities provided if a country needed money for interventions.

Another feature of the EMS was the ECU which was basically defined as a basket of members' currencies. Every country had its ECU-fixed rate, hence the member currencies were bound with each other as well. The ECU itself had on the other

[8] Supported by Germans.

[9] Spain (1989) and UK (1990).

[10] The ones whose parities diverged from each other.

hand two interesting features. The first was that if a currency was to depreciate against other currencies, it would have depreciated against the ECU as well, thus the amount of that currency in the basket would have declined. It was the Maastricht treaty that froze the amount of every currency. Another thing was that if any currency had changed its value against any other, its relative change against the ECU would have been lesser (de Grauwe, 1994, pp. 98–103).

4.3. Phase one (1979–1986)

After Ungerer (1990), the first period might be called “a period of trial and consolidation”. At the beginnings of the EMS the economies of Europe were still quite divergent. It was especially striking in an analysis of consumer price indexes in Europe which grew on average by 8.9 percent. In Germany, however, they grew only by 4,7%, while in France and Italy by 10.7 and 16.4, respectively. Also the demand for domestic credit varied substantially – it declined in Germany, while remaining at previous high levels in France and Italy (Ungerer et al.; 1983). The consequences of such policies, along with a considerable expansionary shift in the French domestic economic policy after Mitterand’s success in the election of 1981, led to a series of seven realignments between 1979 and March 1983. Those realignments are presented in Table 1:

Table 1. EMS Realignments; Percentage Changes in Bilateral Central Rates

	Sept. 24 1979	Nov. 30 1979	Mar. 23 1981	Oct. 5 1981	Feb. 22 1982	June 14 1982	Mar. 21 1983	July 22 1985	Apr. 7 1986	Aug. 4 1986	Jan. 12 1987	Jan. 8 1990
Belgian and Luxembourg francs					–8.5		+1.5	+2.0	+1.0		+2.0	
Danish krone	–2.9	–4.8			–3.0		+2.5	+2.0	+1.0			
Deutsche mark	+2.0			+5.5		+4.25	+5.5	+2.0	+3.0		+3.0	
French franc				–3.0		–5.75	–2.5	+2.0	–3.0			
Italian lira			–6.0	3.0		–2.75	–2.5	–6.0				–3.7
Irish pound							–3.5	+2.0		–8.0		
Dutch guilder				+5.5		+4.25	+3.5	+2.0	+3.0		+3.0	

Source: Ungerer (1990, p.336)

Another two realignments (February 1982 and March 1983) were the first sign of reorientation and rethinking within the EMS. These were the first important joint decisions. Countries did not devalue just to improve their exports and make their neighbours poorer, but tried to improve economic co-operation within the system. Also, the hypothetical "line zero" was introduced against which currencies were de- or revalued. It was important actually from a psychological point of view as devaluation is always a carrier of a notion of defeat – the EMS participants tried to avoid it as it usually has an impact on governments' popularity. The changes of 1982-1983 were significant for France since, after the Keynesian experiments of the previous two years, France again entered a path of domestic cost and price stability.

The period after the realignments had three features: increasing convergence, Deutsche mark evolution as an anchor currency and the rise in intra-marginal interventions – all closely bound with each other. In the beginnings, the US dollar was the most common intervention currency, but then the preferences shifted towards the German currency. It was a clear proof for the acceptance of the German anti-inflationary policies, which was also reflected in anchoring the European currencies in the DM. The Bundesbank in particular appreciated the intra-marginal interventions as it made the whole system more stable and did not influence the German monetary policy so heavily anymore[11]. Still, the German central bank opposed the creation of common US dollar policy for fear of its domestic monetary policy targets being endangered.

Steinherr (1988) executed an interesting analysis of the role of the ECU (European Currency Unit). From the very outset, the role of the ECU seemed very dubious, which reflected the fact that the EMS was so designed as to support the emerging needs of domestic policies. Therefore, one may say that the policy of the EMS did not allow the ECU to play any greater role. On the other hand, it served well the private sector as an exchange rate risk mitigating currency and as a currency that helped investors to capitalise on higher interest rates of weaker EMS currencies. Thus, it becomes obvious that a currency such as ECU was rather an obsolete institution of the EMS.

4.4. Phase two (1986–1992)

In this period, as the following chart (see Figure 1) shows, low inflation rates became the primary goal of the EMS.

Finally, the merits of employing the Deutsche mark as an anchor currency were clearly visible since a possible loss of independence in conducting domestic policies was offset by the substantial degree of convergence as far as the inflation rates were concerned. Again, however, France and Italy started to question the policy

[11] Such interventions became crucial for the EMS stability in 1992–93.

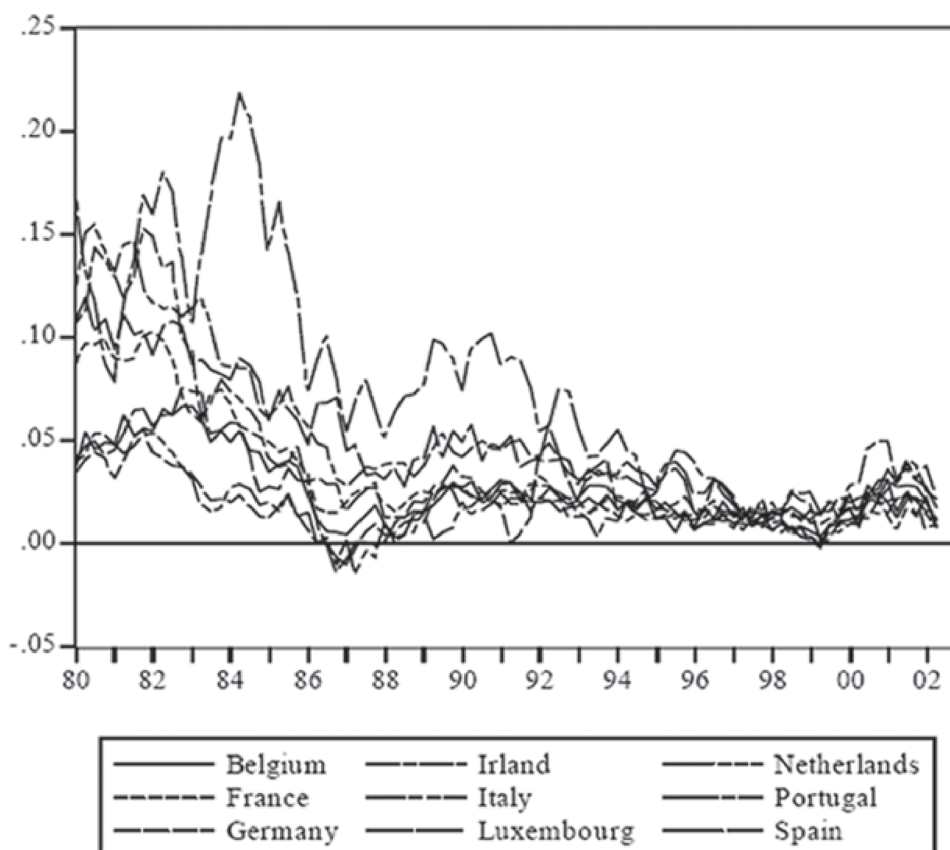

Figure 1. Rates of inflation (CPI) for individual ERM members
Source: Ungerer (1990, p. 343)

and the operational features of the EMS. They argued that Germany had too much economic power within the EMS, and there was too strong an emphasis on inflation neglecting a threat of unemployment and low economic growth (Wyplosz, 1988).

The Basle-Nyborg agreement was a response of the European communities to those charges. The main element of the agreement was a closer monitoring of monetary developments within the EMS, narrowing the inflation differentials, convergence towards price stabilization, a better interest rate policy and liberalization of rules for financing the intra-marginal interventions (Commission of the European Communities, 1989)[12]. The Basle-Nyborg agreement was welcome with mixed feelings. It was feared that focusing on financial provisions would only weaken the efforts of the weaker-currency countries in their conduct of monetary stabilization policies. Still, the EMS proved to be stable enough to sustain a serious test that

[12] More detailed description of the agreement is also to be found in this report.

occurred after the Wall Street crash in October 1987 – the stability between the French franc and the Deutsche mark could be sustained.

Furthermore, large budgetary deficits continued to exist in France and Italy, which led to questions on the future competitiveness of those economies. Therefore, the discussion shifted to the issue of moving to closer policy co-ordination with common institutions and currency. Only this solution would have been, as Padoa-Schioppa (1988) points out, compatible with free capital movements introduced in June 1988 by the EC Council of Ministers. This issue sparked again a discussion among economists and monetarists. Apparently, monetarists had the say in this case, as in June 1988, the European Council asked Jaques Delors to chair a committee that should have prepared a report on "concrete stages leading towards economic and monetary union" (Committee for the Study of Economic and Monetary Union, 1989). The monetary union should have been characterised by a total and irreversible convertibility of currencies, complete liberalisation of capital movements, full integration of financial markets, elimination of fluctuation margins and the irreversible locking of the exchange rates. The European Central Bank should have been federally organised, and should have pursued the price stability and support the Community's economic policies.

At stage one, greater economic convergence should have been achieved as well as monetary co-ordination, at stage two the European System of Central Banks should have been created[13] and the final, third stage should have commenced with a move to irrevocably lock the interest rates (Committee for the Study of Economic and Monetary Union, 1989).

However, before anything could be achieved, the European Communities had to approve the scheme proposed by Delors committee. It happened at the summit in Maastricht, where also a Treaty of the European Union was signed.

Baring (2000, pp. 216–219) states clearly in his book that the German approval of the European Monetary Union (EMU) was a political decision opposed to the opinion of the Bundesbank. It also seems that it was a price Germans would have had to pay – mainly to the French – for being allowed to reunify in 1991. Therefore, we have to understand that French problems with the ERM in 1992/93 (described below) were of particular importance and there was actually no political possibility of quitting or suspending (in full) the Exchange Rate Mechanism as such an incident could have threatened European monetary integration as such.

The treaty and the developments of 1992-1993 changed the operations and institutions of the EMS profoundly as the EMS was experiencing the worst crisis it had ever gone through. This crisis which I intend to describe caused the EMS to collapse and it changes the outlooks for further monetary policy developments in Europe.

[13] Now we know that at stage two only yhe European Monetary Institue was set up.

4.5. Analysis of the crisis

Before I embark on the crisis analysis, I wish to point out some problems that such an exchange rate system as the EMS has to cope with, because its credibility is in danger under some circumstances. The first problem appears when a country faces a supply shock, but commits itself to fixed rates automatically excluding one of the two instruments[14] of fighting off the outcome. Therefore, the market can expect that such a government will have plenty of incentives to devalue the currency from time to time. Hence, speculative crises may occur in such a case. The other danger lies in the difference in reputation of members of the systems like the EMS. This follows from the Barro-Gordon (1983) model, as well as from the rational expectations theory (Lucas, 1981). It says that the country with higher inflation may very well gain when it fixes its currency with a currency of a country with lower inflation, as was the case of Italy and Germany. However, what ensues is a concern of financial investors about Italian credibility and its commitment to defend the fixed exchange rate. It can be assumed by the financial agents that if Italy was not able to keep its inflation rate down[15], it probably would not be able to keep its fixed exchange rate either. Therefore, the market will expect slight devaluation over time leading to huge speculative attacks before any realignment.

As de Grauwe (1991, 1994) shows, it was very useful to choose Germany as a leader within the EMS, i.e. the country with the lowest inflation and the one whose currency will be the point of reference for the fixing of all other currencies. This choice, however, especially in the case of Germany, had a negative impact on the system in 1992. As in the n-country system there are only n-1 possible interest rates, if any country within the EMS had decided to follow the German disinflationary policies, it would have also had to give up some of its monetary independence and adjust money stock, so that it could fit the common interest rate. If there is any shock or speculative movement, countries can either co-operate to solve it, or one country can choose its policy single-handedly. Obviously, it was the case of Germany with its central bank being extremely independent and committed to low inflation. Notwithstanding, if any disturbance within the EMS had occurred, the Germans would have certainly intervened on the foreign exchange markets, hence expanding their monetary base[16]. Unfortunately for the EMS, the Germans did not take to the idea very much and they undertook a contrary open market operation at home, sterilising the inflows of capital in order to keep the money supply

[14] The other one are 'general demand policies'.

[15] As it may be assumed, because its government was 'wet', i.e. less committed to the fulfilment of economic targets.

[16] Just because if a peripheral country faced a shock, it had to buy its own currency while selling the one of the leading country in order to maintain its own exchange rate. Thus, the amount of currency of the latter increases, expanding the monetary base as well.

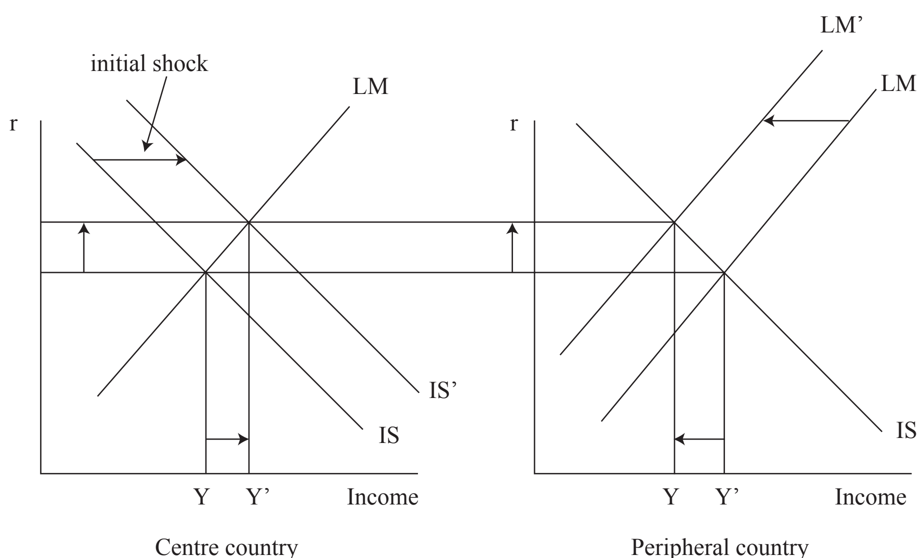

Figure 2. The effects of a boom in the centre under the asymmetric regime
Source: Sardelis (1993, p.45)

and interest rates at steady levels. This, however, according to what was said previously, led to a much more dramatic adjustment at the periphery, as they had to do all the adjustment while reducing the money supply even further, which raised interest rate much above the German ones. As most of Europe[17] entered the trough of a business cycle in 1992, the legitimacy of an assumption that 'the asymmetric systems cannot survive in the long-run' (de Grauwe, 1994, p.114) could easily be proved. Such a proof can be obtained, because the effects of a recession in the peripheral countries of the EMS would be strengthened through monetary contraction described above. Apparently, this was the case in September 1992 where it was not any more possible for Italy, Britain (both quit), Spain and Ireland (both devalued their currencies) to stay any longer without damaging their economies, although the reasons for individual countries to change their policies were different. The following figure (see Fig. 2) shows how the asymmetric system works if a positive real shock occurs in the centre (e.g. Germany).

A positive shock in the centre leads to higher output and higher interest rates. As no shock occurs at the periphery, a country intending to maintain the common interest rate has to raise its own interest rate, possibly causing undesired recession.

Figure 3 shows, on the other hand, what happens to a periphery economy under an asymmetric regime if a shock occurs there. The result is also unfavorable for

[17] Germany faced the peak of boom at this time, which was due to German unification.

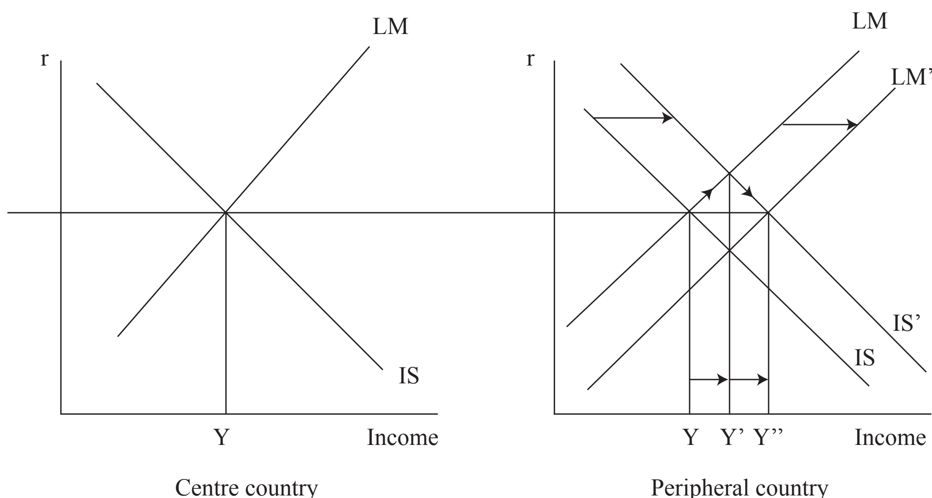

Figure 3. The effects of a boom in the periphery under the asymmetric regime
Source: Sardelis (1993, p. 46)

the periphery as easing the monetary policy (expressed by a shift in a LM curve to the right) might cause strong inflationary pressures.

Italy and Spain mainly had problems with the foundations of their economic systems as they did not manage to lower their inflation to German levels after they committed themselves to stop realignments after 1987. Such a policy inevitably led to a permanent loss of international competitiveness of both economies, as prices in Italy and Spain rose at a faster pace than in Germany. Devaluation incentives became so strong that an exchange rate crisis could be anticipated by the markets. The competitiveness problem is shown in Figure 4.

France and Britain followed a different pattern. Both countries had sound economic (especially monetary) foundations and therefore some other reason for the problem of their currencies has to be found. France, as well as Britain, found itself in a severe recession which actually called for the loosening of monetary policy in both countries. However, even though they were bound within the EMS, a conflict between them and Germany which wanted to maintain high interest rates and tight monetary policy, arose.

The difference in the nature of the Lira/Peseta and Franc/Pound crises is reflected in the literature under the first (Krugman, 1979) and the second (Obstfeld, 1986) generation models of speculative crises. A brief explanation on the subject can be found in Kowalski (1999).

The former are about fundamentals, the latter about expectations. The second generation models namely describe a possible crisis as a shift in devaluation expectations by investors. The question why investors perform such shifts,

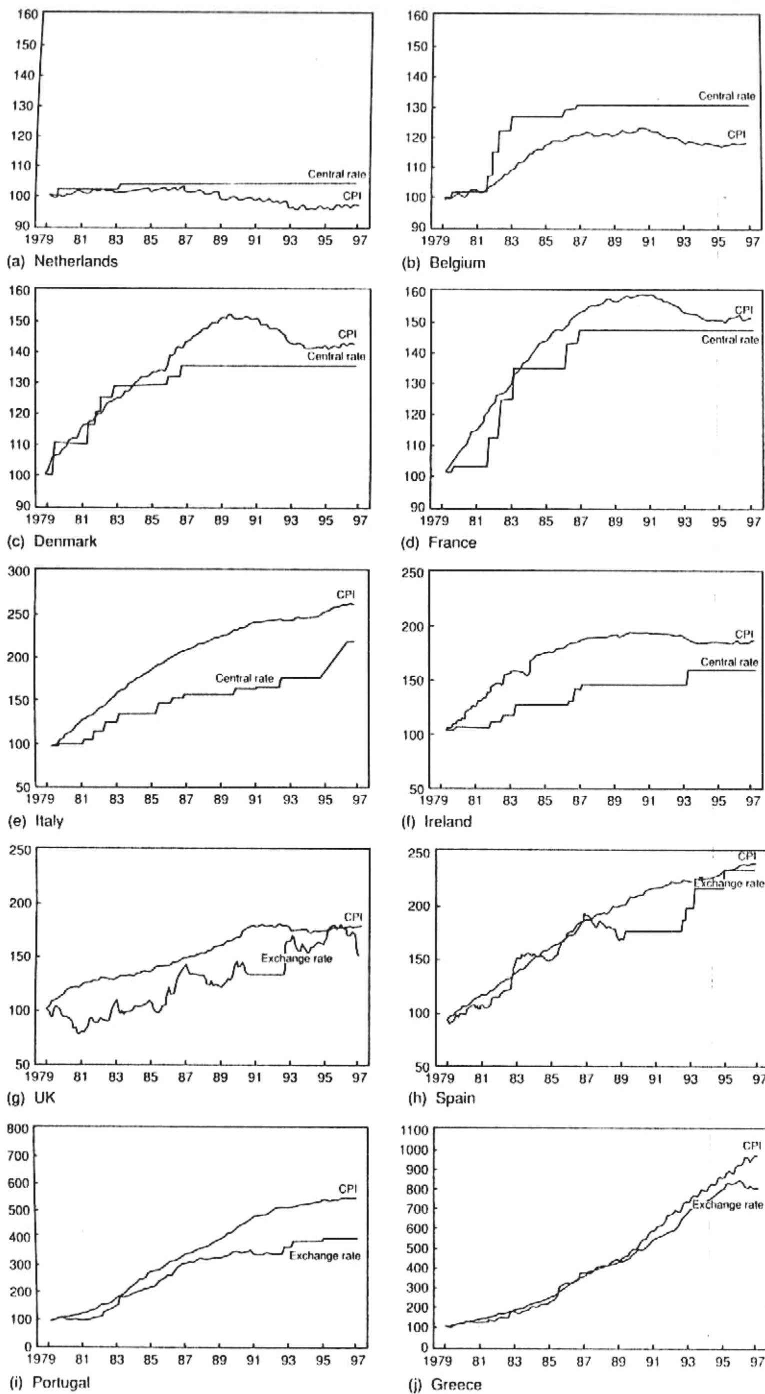

Figure 4. Bilateral exchange rates (central rates against the DM) and the cumulative price level differentials vis-à-vis Germany

Source: Gros and Thygesen (1998, p. 78)

still remains unclear. As it is put in the Pesenti's (Pesenti, Tille; 2000) paper: "the theory remains silent on the determinants of the losses of confidence that are the cornerstone of the analysis". It might only be a weak assumption, but it is not to rule out that, again, this is somehow due to the political process and to the commitment of local authorities to pursue goals set by former government, which takes us to the problem related to the issue of political business cycles (e.g. Kowalski 2001).

An effort in this subject was made by Freeman et al (1999) who tested two contrary propositions on how politics influences switches (which in some cases might lead to second-generation currency crises) in the exchange rate regimes. The first proposition was that the agents anticipate and hedge policy outcomes and decisions, hence it is already incorporated in market equilibriums. Contrary to that is the other proposition that the democratic process is a source of currency market 'equilibration'. The authors find much evidence on the latter proposition that trades are more efficient at collecting and processing economic information in comparison with the process of 'translating' democratic politics. Some 'new' information makes them revise their assumptions and reevaluate their decision making processes.

This is what exactly happened in France and the UK, which made pound withdraw from the EMS and caused serious problems to the franc. France could not just quit the system[18] as a country that is perceived a core of European integration. Hence, the finance ministers decided to broaden the band to +/-15%, which rather transformed it into a 'quasi-floating' system.

The fact that the market forces anticipated the problems in the European Monetary System has been mentioned several times. We will now have a look at what the data for the described period looked like and if it is justified to say that financial agents could have foreseen the crisis.

The first evidence (rather 'long run'-related) is brought by de Grauwe (1994 a) and it features calculations of one-year and five-year forward rates of Francs, Lira and Guilder against the German mark. Forward rates of all currencies, apart from the Dutch guilder, were set at such levels that they could reflect expectations of 5% yearly devaluation, therefore were set above the mark of 25%. Still, if we consider commitments and the legal framework of the system and remember that this was an 'adjustable-peg' system, it is somehow confusing that, according to the market data, it was never considered as credible[19]. These data also show that the 1992 crisis was anticipated, which means that market participants saw an increasing devaluation risk before September 1992. Also a paper by Mizrach (1996) provides evidence for the market perception of currency crisis in Europe. He only analyses the behaviour of the French franc and the British pound, but his evidence for a significant risk in option prices in relation to those two currencies shows that markets

[18] See the argument by Baring (p.11)

[19] Apart from the guilder-deutschmark link.

participants rather followed their own convictions that both countries were at the brink of devaluation[20].

Other authors such as Bladen-Hovell (1997) also concentrate on the impact of lifting capital controls after 1988[21] and on the problems that arose around the Maastricht treaty. As for the first issue, the capital controls were finally removed close to the deadline which had been set at the end of 1991. By that time, the EMS countries had not regained the necessary credibility to convince financial agents that they would not devalue or change their fixed rates and the gains from speculative attacks were extremely high and equalled overnight deposits of over 100% interest rates. Therefore, it was a very profitable business for exchange market participants to start speculation after capital flows were at last removed. Also Padoa-Schioppa (1998) argues that there is an 'inconsistent quartet' of four features of the international financial system: free trade, free capital movements, national policy autonomy and fixed exchange rates. Before 1992 it was possible to maintain the system somehow, because of existing capital controls and frequent realignment. Afterwards, however, it became impossible as countries would then have had to give up their policy autonomy and they did not want to go that far in 1992. Bladen-Hovell (1997) also recognizes that the problems within the EMS were caused by confusion around the referendum on the Maastricht treaty in Denmark. Its rejection immediately resulted in the strengthening of the German mark and hence put British and Italian currencies under severe pressure. The Italian case is particularly interesting, because the Maastricht treaty set the macroeconomic criteria for the monetary integration in Europe[22]. At that moment Italy had a huge public debt and excessive budget deficit that contributed to the pressures. According to Burnside et al. (2000), it is just the large, unfunded prospective deficits that are the prime source of currency crises.

4.6. Could it have been saved?

I think that the European Monetary System could not have been saved from the crisis of 1992-1993 and from its breakdown on August 2nd 1993. Still, I am also of the opinion that it is rather a question of political and legal nature than of economic character. While discussing that, I will focus on two sides of the problems in the EMS – on Germany and than on Europe and its future.

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[20] In fact after both the crises, the franc as well as the pound were devalued.

[21] It was the year when European Commission issued the Capital Liberalisation Directive.

[22] It seemed that the criteria set in the Stability Pact were intended to keep the weaker or periphery countries out. Again, it was a French wish to see Italy and Spain joining in (in the end it was only Greece, who – apart from countries that decided to opt out – was kept away from the EMU) (Baring 2000).

Some may argue that Germany played a negative role in the 1992 crisis and that perhaps if it had worked differently, much of the system could have been saved. I will discuss the question of how it might have worked, but let us first concentrate on the question *if* it could have worked otherwise. I think not, primarily because the German monetary policy is run by a very independent institution such as Bundesbank[23] and its goal to maintain price stability. Bundesbank's independence is legally enforced and through the years it has acquired a status of almost constitutional gravity. Therefore, it was not possible, either politically or legally, to influence the conduct of monetary policy in Germany. And for sure there was no time whatsoever (and it would have rather been a bad idea) to change the fundamentals of the German legal and economic system. The second feature of the German economy at that time, the German integration, also deserves our attention. It was seen as a great achievement of Mr. Kohl and his government to obtain a permission for unification, or rather, for "swallowing" East Germany. In order to bring the living standards and infrastructure to equal level, billions of Deutsche marks had to be fed into the five new lands, thus boosting the interest rates and changing economic conditions in Germany. However, as it was considered as a political process, there was no chance whatsoever to change it before the next elections due in 1994.

From the European point of view, the issue that influenced the behavior of the European governments was the commitment to the next stage of integration within the European Union. As the UK was not truly committed to the integration, it became much more difficult for France to quit the ERM as France was perceived as the founder of European Communities and its leave would have significantly questioned the process of future integration. That is why it was decided rather to broaden the bands to 15% than to let France leave.

From the economic point of view, the EMS could have perhaps been saved. Still, for that to have happened, the then circumstances would have had to be so extraordinary that this idea may practically be abolished. According to de Grauwe (October 1994), the salvation would have been thinkable if there had existed a European central bank at that time. Such an institution would not have pursued asymmetric policies but it would have tried to act in favour of all, hence the periphery would only have had to face half the rise in money stocks and the effects of business cycles would not have strengthened that much. Such a concept is also forwarded by Sardelis (1993, pp. 45-48) who shows that under a symmetric regime the peripheral countries would have been better off and the tension would not have arisen. The following figure presents the workings of a symmetric system.

The other way out for the salvation to succeed would have been for Germany to stop sterilising its policies and to allow the inflation rate to soar for longer. However, the fiscal expansion that Germany faced at that time would have obviously called

[23] Institutional features of the Bundesbank can be found in Kennedy (1990)

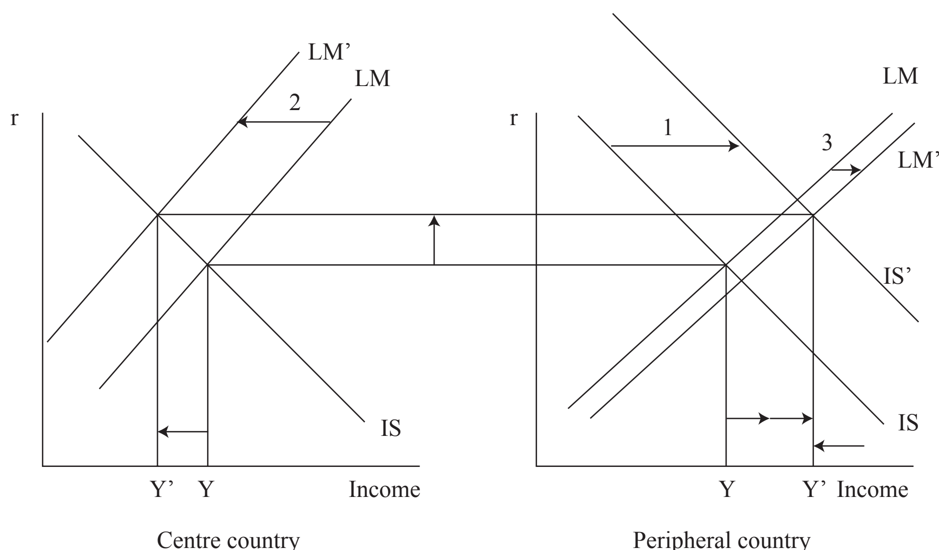

Figure 5. The effects of a boom in the periphery under a symmetric regime
Source: Sardelis (1993, p. 47)

for higher debt repayments in the future, which would have possibly thwarted Germany's attempts to fulfill the Maastricht criteria. There is also another concept of a rather retrospective nature, advanced by Canzoneri et al. (1997). They suggest that instead of fixing the exchange rates to the German mark, the countries of the European Monetary System should have, prior to the crisis, switched to the direct inflation targeting, which would have had almost the same impact on their credibility with a much lower cost of abandoning policy independence. Those concepts do not assume that the EMS could have been saved, but perhaps the recession of 1992-93 could have been made much milder.

Generally speaking, the level of commitment that the member states, especially Germany, would have had to undertake in order to save the European Monetary System would have been too high, therefore EMS members did not dare to save the system in the form it was before 1992.

5. 'Economist-monetarist' debate – a summary

It is already the first years of European integration that showed differences in the approach to economic issues. French proposals and activities, e.g. those laid down in the Rome Treaties, (Maes, 2002, p.10) had sectoral and centralist imprint, whereas Germany opted for a strong competition policy as well as for a free movement

of capital, labour, services and goods. It seemed that countries employing activist policies wished to preserve control over economic policy instruments on the one hand. On the other, they tried to curb particularly the free movement of capital, as this 'would undermine the effectiveness of national monetary instruments' (Arestis et al., 1999).

Subsequently, the first conflict between the developing monetarist and economist forces was at doors. After 1969 (France) and 1970 (Germany) elections, more pro-European politicians came to power. Intending to trade-off their turn towards "Ostpolitik"[24], the Germans proposed a closer co-operation in the field of monetary integration. Thus, the question for the best track towards integration appeared. One has to bear in mind that monetary issues were considered as a step towards full (or fuller) economic and political integration. Germany, with the strongest economy in Europe at that time (Puślecki, 1990, pp. 33-34) and with ordoliberal framework of economy, favoured the co-ordination (divergence) path. France however,

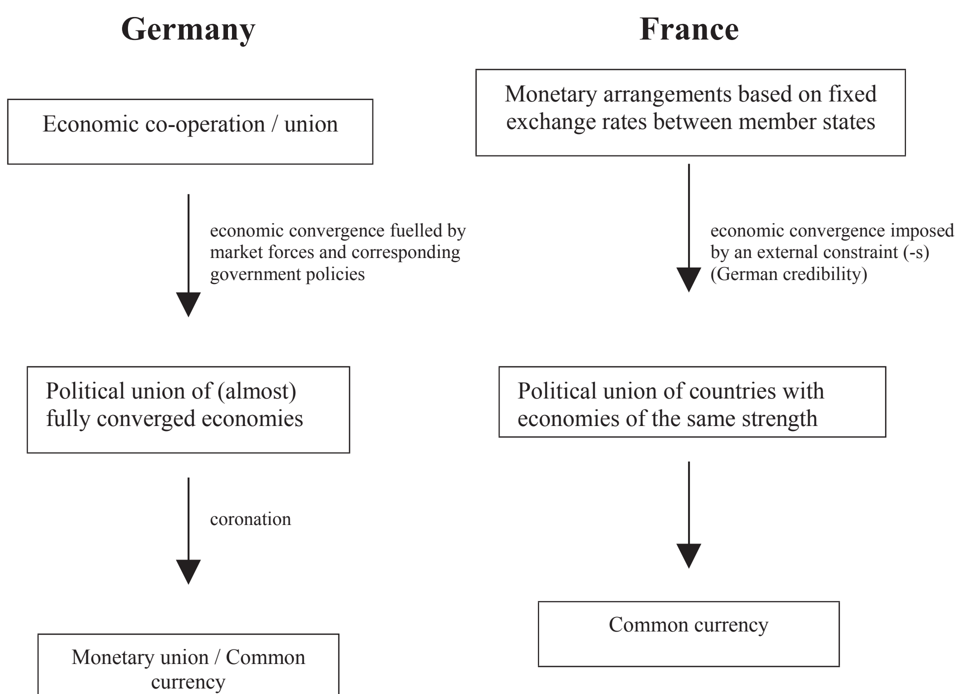

Figure 6. German and French approaches
Source: the author's adaptation

[24] It is another testimony for the words of Monnet that integration politics are made by single politicians (Artis et al., 1999, p. 3); Baring (2000) also supports a trade-off view of the European integration.

with Keynesian-activist policies and centralist approach preferred the monetary (exchange-rate) path. Hence, one common goal, but two different paths. Giavazzi and Pagano (1986) pointed out that France[25] had to consider more variables that differentiated economist and monetarist approaches. The governments would not have been able to start adapting their policies and to contain forces[26] that contribute to a higher inflation rate, without an external constraint. A fixed exchange rate would have been the constraint in this case.

The above Figure outlines the differences in integration paths of both countries. Although they both had similar ultimate goals, it was the limitations set by internal and external country policies that altered the approach strategies.

The Italian example provides an even better explanation. The Italian lira was considered a strong currency in 1960s (Maes, 2003, p. 12), but following the social and political changes in 1969, the Italian economy experienced inflationary pressures. The lira was weakened and that led to a real depreciation of the Italian currency. Policy-makers at the Banca d'Italia were convinced that the fundamentals were too divergent and that the EMS could therefore not enjoy their support, as the system was not credible. It was only in the late 1980s (Maes, 2003, p.14) that the strong exchange-rate policy around the EMS introduced external constraints into the conduct of Italian politics, thus helping to achieve a sound fiscal policy and to curb inflation.

The 1970s are the years of a special legacy in relation to the further development of the European monetary integration. Previously, the monetary project was mainly developed by politicians in respective Ministries of Finance. What needed to be done in order to bring the two main adversaries closer was to convince each other about the commitment and the final goal of monetary integration. Although Giscard and Barre managed to narrow the gap between German and French objectives (Dyson and Featherstone, 1999), they had a difficult task at home to convince Gaullist politicians that they were not selling French national interests to Germany.

On the other hand, it was Chancellor Schmidt's great achievement to bring the Bundesbank into the game. Germany saw itself committed to the political unification of Europe which could and should be achieved through economic and monetary[27] integration. It seemed that no monetary arrangement in Europe would have functioned well without a support of the Bundesbank. Chancellor Schmidt managed to 'invite' Bundesbank into the role of one of the leading bodies in designing the shape of European monetary institutions and systems. With Kohl as Chancellor, the German central bank "gained an overwhelming authority for its view on the EMU" (Dyson and Featherstone, 1999, p. 285).

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[25] As well as Belgium and Italy.

[26] Activist-biased politicians and trade unions.

[27] According to the so-called 'coronation theory' which said that monetary integration should be a topping over completed economic convergence of European economies.

6. Conclusions

European monetary integration has been developing for over forty years now. Originally, its main goal was to sort out Europe's most important economic problems of the post-war time. Along with the creation of the EU, it began its shift towards a more political medium. As it has been shown, the institutional features of both the EMS as well as the EMU have political roots. Economics seemed to rank second.

There was not only one path of integration and the dispute between economists and monetarists over the years of European integration showed it very clearly. Still, it was one of the cases where politicians finally seemed to agree that without a technical support and sound economic basics, no expansion of the Union would have been possible.

Moreover, the European monetary integration was always a part of international currency arrangements, which sometimes (e.g. Bretton Woods, changes in the 70s) moved the integration on to another track. One must not forget that the 'real' events influence the development of monetary integration. Sometimes it seems to be incompatible with the politicians' goal, which in turn could become a source of severe economic problems. Although the European economies tended to converge over time (Kouparitsas 1999; Artis, Zhang 1999) due to the membership in the EMS, which made the governing monetary issues easier, they still had to cope with severe currency crisis of 1992/93. It would be wise to remember the roots of that crisis, just to avoid similar mistakes in the future – concerning both the actual EMU members as well as the new entrants.

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