

CONTENTS

List of charts	ix
List of tables	x
Preface	xii
Executive Summary	xvii
INTRODUCTION	1
I THE HISTORY OF THE EMS AND CONVERGENCE	7
I.1 Monetary events leading up to the EMS	7
Bretton Woods	9
Supply shocks in the 1970s	12
I.2 The mechanisms of the EMS	13
The Ecu	16
The Exchange Rate Mechanism	20
The ERM in practice	27
I.3 Performance and appraisal of the EMS	33
Six phases for the EMS	33
II ECONOMIC CONVERGENCE IN THE EMS	40
II.1 Nominal convergence	44
Inflation convergence under the EMS	44
Price level divergence	48
Inflation of unit labour costs	52
Effects of ERM membership	53
Prospects for inflation convergence	58
Application of the price stability criterion	58
Interest rates and economic activity	67
II.2 Real convergence	69
Fiscal deficits in the ERM	69
Future fiscal prospects	75
The hidden agenda of convergence criteria	76
Conclusions	86

III THE SINGLE MARKET AND FREE CAPITAL FLOWS	87
III.1 The logic of the Single Market	87
Of markets and monies	87
The integration of European product markets	91
III.2 Deregulation and the integration of capital markets	94
On arbitrage and speculation	94
Europe's capital markets	101
Financial deregulation and market efficiency in the EC	103
The growth of financial markets	105
The private Ecu market	106
International portfolio diversification	109
Demand for currencies in the foreign exchange market	110
Market participants and their motivations	112
Are markets rational?	119
 IV ECONOMIC CONVERGENCE AND UNINTEGRATED LABOUR MARKETS	 122
IV.1 The EMS as a deflationary mechanism?	123
Introduction	123
Denmark	129
Belgium	130
France	131
Lessons	133
IV.2 European unemployment	134
Introduction	134
External competitiveness	138
Internal competitiveness	141
On flexibility in labour markets	142
On wage bargaining behaviour and unemployment	144
Implications for a European policy for incomes	150
 V THE EMS CRISIS, DM ANCHOR AND THE DANGERS OF TRANSITION	 153
V.1 The dilemma of the inconsistent quartet	154
The speculative attacks in the autumn 1992 EMS crisis	155
Defensive action by monetary authorities	157
Limitations of official intervention	159
Limitations of defensive interest rate policies	161
V.2 The role of the DM as the anchor currency	169
The DM as a regional key currency	170

The Ecu as an alternative anchor of the EMS?	173
The French franc as a reserve currency?	176
Prospects for the German economy	176
V.3 Monetary policy in the transition to EMU Stage III	181
The long term objective	181
Problems of the indirect coordination approach	183
Direct monetary coordination by the EMI	184
VI OFFICIAL POLICIES FOR THE EMS AND THEIR SHORTCOMINGS	186
VI.1 Reform proposals incompatible with the final objective of EMU	187
Mistaken anticipation of EMU	189
Earlier realignments as a cure?	189
Surprising speculators by early devaluation?	190
More flexibility by means of wider margins?	192
More stability by restraining capital flows?	194
Imposing a Tobin tax?	196
VI.2 The official view on ERM reform: maintaining the status quo	197
Divergence of key economic variables	197
The impact of financial market integration	198
Ineffectiveness of intervention?	199
The difficulty of defensive interest rate policies	201
A critique of the official reports	203
VII POLICY RECOMMENDATIONS FOR THE TRANSITION TO EMU	205
VII.1 Which way to EMU?	206
Three options	206
Economic convergence for better growth and employment	208
VII.2 Improving monetary cooperation	210
A two-speed Europe?	211
Strengthening the ERM core by modifying the asset settlement obligation	212
VII.3 Broadening the anchor (Stefan Collignon)	220
Gradual transition to Stage III	222
Monetary policy rules	223
Diffusing financial shocks by greater integration	224
Integrating the latecomers	224

Realignments	225
Re-entry of the lira and sterling	226
The Ecu in the transition to Stage III	227
Third currencies	229
References and bibliography	230

CHARTS

Chart A:	Yields of 10-year government bonds	10
Chart B:	Inflation convergence in the ERM	45
Chart C:	Long term interest rates in the ERM	66
Chart D:	Fiscal deficits in the ERM	70
Chart E:	Public debt stocks in the ERM	72
Chart F:	Public debt as a proportion of EC public debt	74
Chart G:	Balances of payments in the ERM	78
Chart H:	Economic growth in the ERM	82
Chart J:	Unemployment in the ERM	83
Chart K:	Long term link between price stability and unemployment	90
Chart L:	Futures Contracts: LIFFE – MATIF, Oct. 1989–Dec. 1992, daily turnover	107
Chart M:	Theoretical vs market rates spreads: 1990–June 1993	108
Chart N:	Sacrifice ratios in two periods of disflation	128
Chart O:	Major industrial countries' output gaps	135
Chart P:	Actual and potential rate of growth in the EC	136
Chart Q:	Unemployment rates in OECD regions, 1960–1994	137
Chart R:	Employment growth in OECD regions, 1960–1994	138
Chart S:	Short run real wage rigidity and unemployment increase	145

TABLES

Table 1:	Chronological history of the snake	14
Table 2:	Basket revisions in the EMS: new definitions of the Ecu basket	17
Table 3:	Effect of a 1 per cent revaluation of Ecu/DM central rate (fictitious examples)	18
Table 4:	Central bank interventions in the EMS, 1979-1989	21
Table 5:	EMS realignments: percentage changes in bilateral central rates	26
Table 6:	M1 and foreign exchange reserves in the EC	29
Table 7:	Inflation convergence in the ERM	46-7
Table 8:	Inflation divergence in the ERM	50-1
Table 9:	Wage inflation convergence in the ERM	54-5
Table 10:	Wage inflation divergence in the ERM	56-7
Table 11:	Long term interest rate convergence in the ERM	64-5
Table 12:	Interest rate yield curves in the ERM	68
Table 13:	Fiscal deficits in the ERM	71
Table 14:	Public debt stocks in the ERM	73
Table 15:	Balances of payments in the ERM	77
Table 16:	Economic growth in the ERM	80-1
Table 17:	Unemployment in the ERM	84-5
Table 18:	Imports as share of GDP	92
Table 19:	EC share in world production, per branch	92
Table 20:	Net international capital flows of major industrial countries, 1970-1988	97
Table 21:	Financing in international markets 1973-1992	98-100
Table 22:	Bid-ask spreads on Eurocurrency deposits	104
Table 23:	Foreign penetration of national government bond markets	109

Table 24: Growth of institutional investors' assets	111
Table 25: Total gross reported foreign exchange turnover involving selected currencies on one side of transactions	113
Table 26: Total net reported foreign exchange turnover by currency pairs in April 1992	114
Table 27: Official foreign exchange reserves of selected industrial countries' central banks, 1992	118
Table 28: Manufacturing unit labour costs and export unit values	147
Table 29: Debt-income ratio: central government	163
Table 30: Debt-income ratio: public sector	164
Table 31: Debt-income ratio: households	165
Table 32: Debt-income ratio: non-financial corporate and quasi-corporate enterprises	166
Table 33: Gross debt as a percentage of operating surplus	167
Table 34: Trend in the external assets of major industrial countries	168