

## The Collapse of the EMS: Symptomatic of a Doomed EMU?

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Since 1970, the countries of the European Community (now European Union, or EU), have been pursuing a European Monetary Union (EMU) as part of the wider effort at European economic and political integration. The Maastricht Treaty of 1991 stands out as the most specific road map to this goal. The European Monetary System (EMS), which commenced in 1979, and was strengthened in 1987, has served as the economic launching pad for this monetary union (MU). For five years since 1987, this system of fixed but adjustable exchange rates pegged to each other at central parities and allowed to fluctuate within narrow bands experienced relative stability, with no significant realignments. The EMS appeared to offer to optimists justification for the larger goal of MU. However, in the fall of 1992, this system came under severe market pressure. The British Sterling and Italian Lira were removed from the system altogether, and several other currencies were devalued or severely attacked by speculators.

In the soul searching that has followed this tumult, observers and policy makers have been left wondering about the causes of the crisis, and pondering the way forward to EMU in the context of the Maastricht prescription. It is the contention of this paper that the need for monetary union is not completely justified on economic grounds, and that political considerations have played a large role in the formulation of the criteria for EMU. The paradox is that while the move toward MU and the path laid forth to achieve it embody political imperatives, decisions made on primarily political grounds created a system that was economically unsustainable; it is an ironic fact that a lack of continent-wide political support may have indeed played a large role in the 1992 crisis.

The remainder of the paper is organized as follows: Section 1 assesses the economic arguments for and against (MU); we conclude that the benefits may not unequivocally exceed the costs when considered in a purely economic sense. Section 2 examines the political motivations behind MU in general and the process of EMU specifically, with attention to the Maastricht Treaty; we suggest that the Maastricht process is more politically (and perhaps inappropriately) motivated. Section 3 examines the September 1992 currency crisis and argues that political factors stemming from the Maastricht treaty substantially aid in understanding the causes of the crisis. Concluding remarks follow, and we briefly assess the future of the Maastricht process.

### 1. On the Economic Need and Desirability of EMU

In this section we will present and assess the general economic arguments in favor of and against monetary union (and more specifically EMU).<sup>0</sup> Traditional (although in this case, difficult to analytically quantify) cost-benefit analysis suggests that the economic imperative for currency union, especially in the case of contemporary Europe, is hardly convincing. While on the surface, there do indeed appear to be some improvements in economic performance and efficiency to be reaped from pursuing such a policy, these gains are quite small when held up to economic analysis, and the factors weighing against MU appear difficult to dismiss. We shall consider each of the pros and cons in turn, beginning with those arguments in favor of MU.

### 1.1 The Economic Motivation

Below we consider the economic grounds for pursuing monetary union, starting with the most obvious and moving to the increasingly more complex. An assessment of each of these suggests that the later two arguments are more convincing, although neither is completely compelling.

#### i.) Lower transactions costs.

One of the most frequently advanced and intuitively appealing argument in favor of a currency union among highly integrated economies is that of a lowering of (or in the case of full monetary union -- outright elimination of) transactions costs associated with the conversion of currency when actors engage in cross-border trade or capital movements.

However large and grating the loss incurred by tourists (and others engaged in relatively small, often cash-based international transactions in Europe) from changing money, the relevant facts are not persuasive. Conversion costs within the EU are indeed high for travellers, roughly 2.5%. However, larger financial movements (over \$5 million) entail costs of less than 0.1%, often as low as 0.05%. (Eichengreen, 1993) The Commission of the EC (1990) estimates that total losses related to transactions costs are about 0.4% of EC-wide GDP.

#### ii.) Elimination of Exchange Rate Uncertainty.

A more sophisticated extension of the above argument suggests that by fixing exchange rates within the Community, the removal of exchange rate variability and the accompanying reduction of uncertainty due to currency risk may facilitate cross-border capital movements, acting as a supply-side impetus to economic growth. Risk averse agents, this theory maintains, will not face the threat of a drastic reduction in the values of their foreign assets, and will have less "noise" in price information, and can thus make better informed rational economic decisions. Indeed, the following quote from the 1989 Delors report holds arguments (i) and (ii) as key: "the creation of a single currency area would add to the potential benefits of an enlarged economic area because it would remove intra-Community exchange rate uncertainties and reduce transactions costs."

While this may be true, empirical studies suggest that such benefits are quite small. (See, for example Cushman, 1988.) Eichengreen (1993) argues that in modern international financial markets traders and other investors have access to a variety of instruments (forwards and futures, exotic options, etc.) to hedge against currency risk. Furthermore, he argues, exchange rate uncertainty in highly integrated economies such as that of the EU may actually encourage cross-border investment; firms might be inclined to diversify their portfolios of financial as well as physical capital across many member states. Additionally, even if the reduction of exchange rate uncertainty is indeed a worthwhile economic goal, the EMS itself, short of full monetary union, has served this purpose well. (Fratianni and von Hagen, 1990; Giavazzi and Giovaninni, 1989). Indeed, this was one of the overt aims behind the initial creation of the system in the aftermath of the collapse of the Bretton Woods system in the mid-1970's.

#### iii.) Inflation reduction.

Another often expressed reason for EMU is that of providing an institutional structure (a European Central Bank (ECB) in the Maastricht scenario) to combat inflation.<sup>0</sup> Many European countries have experienced difficult periods of high inflation, especially in the mid-1970's, partly as a result of the world-wide oil-price shocks. The Bundesbank's political independence and historically (indeed constitutionally enforced) strong stance against inflation is a feature envied by governments and central banks throughout the continent. (Another often cited role of the EMS throughout its existence has been to allow members to "import" inflation-fighting credibility from the Bundesbank by essentially letting the DM serve as the anchor currency of the system, implicitly linking German monetary policy to the domestic economies through the fixed exchange rate.)

While this is a strong argument, and its appeal can be further seen by the Stage II provisions of the Maastricht Treaty, whereby members' national central banks are to become more independent and inflation rates are to converge to low (i.e. German-type) levels, it is not at all a fait accompli that the foreseen design of the ECB's decision-making apparatus will perform unequivocally well against inflation. Furthermore, when the issue of countering asymmetric shocks to output are considered, it is not clear that member countries will be well-served by relinquishing monetary autonomy to an EU-wide "superbank."

iv.) Alternative Currency Regimes in the Wake of the Abolition of Capital Controls.

As a condition of the 1986 Single European Act (SEA), capital controls on large cross-border currency transactions were eliminated in 1990. The rationale for such controls were to protect European central banks' reserves in the event of intervention to confront a speculative attack. However, with the removal of practically all limitations on factor flows (labor, capital, and goods) in order to complete the transition to a truly common market, restrictions on flows of funds were also necessarily eliminated.

In a system with no restrictions on capital movements and a commitment toward facilitating full factor mobility, the only viable alternatives appear to be either fully floating exchange rates (which most observers agree are not in the offing; below we quote Eichengreen and Frieden (1993): "...floating retains a bad name in Europe and raises political objections...") or completely fixed rates. Thus, the balance has been tipped in favor of the later, and ultimately full EMU. Once again, quoting from Eichengreen and Frieden (p. 91.):

In this sense, then, the Single European Act forced the issue. It required the removal of capital controls, which undermined the viability of the EMS and confronted the Community with the choice of reverting to floating or moving forward to monetary unification. Floating was incompatible with Europe's long-standing aversion to exchange rate variability. Monetary Unification was therefore a pre-requisite for reaping the benefits of the product- and factor-market integration foreseen by the Single European Act.

Between 1987 and 1992, a "new" EMS (Giavazzi and Spaventa, 1990) emerged, with an emphasis on maintaining the central parities, and the EMS experienced relatively little turmoil; the central parities were not subjected to periodic realignment as they had been in the past. It appeared that the system had actually become de facto a multilateral fixed rate regime. The stability imparted by the Basle-Nyborg accord of 1987, (which allowed for greater multilateral defense of currencies through joint intervention), and the growing commitment (on the part of many policy makers) to maintaining the integrity of the pegs with a view toward eventual EMU appeared to be concomitant with the relaxation of capital controls. 0

While this may be the single strongest argument in favor of EMU, it does indeed appear that this is an issue laden with political rather than economic motivations. We will argue later that with the relaxation of capital controls, and the obvious reluctance to return to fully floating rates, the EU may have placed itself in an untenable position, especially when EMU has been placed on a path defined by the Maastricht criteria.

Hence, we have put forth four major arguments in favor of MU in general and have placed them in their contemporary European context. The first three, we assert, are not persuasive, and the fourth, while a strong argument as it stands, may not be strong enough, especially when we consider the Maastricht prescription for EMU. Below, we examine the two strongest arguments against monetary union and its specific European variant.

### 1.2 The Forces against EMU

The two main arguments against MU in the European context both center upon the surrendering of national economic autonomy of monetary and fiscal policies. The former is a direct implication of the Maastricht process, the latter appears to be implied by economic integration.

#### i.) Asymmetric shocks

The most celebrated argument against monetary union is that of the efficacy of domestic monetary policy and the possibility of addressing asymmetric shocks. Should economic disturbances (and the accompanying policy responses required by them) be evenly distributed to all members of a currency area, then one monetary policy may work to offset these shocks. However, should nations give up

their autonomy over domestic monetary policies (which is necessarily required by entering a monetary union) and be forced to face economic disturbances specific to their own country, they would be unable to use this policy option to respond to them.

Of course, this argument assumes both that monetary policy is indeed effective in generating output effects, and that there is no substantial flexibility elsewhere in the economy. The first issue is one of those at the heart of debate in modern macroeconomics. In the case of Europe, there indeed may be an argument for the effectiveness of monetary policy. In the presence of labor markets which display high degrees of unionization and rigidity, such as those in western Europe, there does seem to be some evidence that supply-side effects may be generated by active monetary policy.

Furthermore, this aforementioned rigidity in labor markets is also crucial to the second assumption. In more mobile economies like that of the United States, the real sector may be more flexible in responding to sector-specific disturbances. Cross-border flows of labor are indeed lower in Europe than in the United States (as is regional mobility within European states). (See Eichengreen, 1993.) The European economy also displays a higher degree of rigidity in the form of regulation, labor costs, and geographical specialization. While the SEA addresses these issues, we may conclude that the economies of Europe display a higher degree of inflexibility, hence country-specific shocks are less quickly and effectively dispersed through local market forces.

Returning to the initial point of this debate, we ask are shocks in Europe likely to be localized within countries or groups of countries, or are they likely to be "symmetric" in the sense that they would affect all economies equally? Again, the answer to this question lies in the international flexibility of labor and physical factors, and the degree of intra-industry geographical dispersion. We assert that the SEA notwithstanding, European nations still display a degree of local economic idiosyncrasy and many economic shocks may not be dispersed throughout the system, but may indeed be asymmetric. The 1990 German Economic and Monetary Unification (GEMU) may be viewed as an excellent example of highly localized asymmetric shock.

Then, when abandoning domestic control of monetary policy so as to pursue a fixed exchange rate or a monetary union, local economies which cannot rely upon internal flexible market forces may be subject to volatility in the real sector as economic events unfold. This implies that there are indeed high costs to MU and that economies will be able to face local economic conditions with one less policy instrument.

ii.) Loss of fiscal autonomy

If another policy instrument, namely local control of fiscal policy, is rendered irrelevant, then MU brings to bear one further impediment to local economic policy. As labor mobility increases with integration and the effects of the SEA, then governments may face much greater obstacles to pursuing domestic tax and spending decisions. Furthermore, the convergence criteria of the Maastricht Treaty places additional pressures (especially on the more profligate candidates for EMU) in that national debts and deficits must converge to EU-prescribed levels. Federal European fiscal decisions (similar to monetary policy decisions made by a federal ECB) may not reflect parochial interests as much as European ones, especially regarding regional transfers.

Hence, the requirements imposed by economic integration and the specific conditions of the Maastricht Treaty will most likely dampen domestic governments' ability to pursue their preferred fiscal options. Once again the loss of policy autonomy implied may serve to reduce governments' ability to face local economic realities.

Indeed, the legal and economic requirements of economic integration, specifically monetary union and more specifically EMU, may impose substantial economic costs. From the above arguments, the balance is not assuredly in favor of the benefits of monetary union being greater than these potential costs. Furthermore, the absolute necessity of EMU is also not convincingly established on purely economic grounds. Hence, we look toward political economy arguments to explain the concerted effort at EMU.

## 2. On the Political Motivation for EMU and Maastricht Implications

In light of the less than completely persuasive economic arguments for EMU, we turn to political and political economy rationales. We first consider the extent to which the theory of optimum

currency areas can apply to the European case, then discuss the political motivation behind the drive toward European economic integration and EMU, and conclude this section with a brief discussion of the Maastricht Treaty implications, criteria, and political considerations therein.

### 2.1 Does the theory of Optimum Currency Areas apply to EMU?

The theory of optimum currency areas (see Mundell, 1961 for an early exposition of this idea. Kawai, 1987, provides a literature review.) attempts to assess the criteria (on purely economic grounds) which would be decisive when highly integrated economies choose monetary and exchange rate regimes. While most of this literature draws upon economic factors, Cohen (1993) points out that it focuses more on the factors involved in making the decision among regimes, not on the conditions and requirements that are integral in the long term sustainability of the currency arrangement.

On the surface, when one considers the factors often mentioned in considering the appropriateness of optimum currency areas such as balance of payments positions, flexibility of prices, degrees of factor mobility, trade patterns among nations, openness of the economies, and likelihood of facing common shocks, the EU may or may not appear to be a good candidate for a currency area, (especially when considering the more interesting question of sustainability versus initiation) depending upon which factors are considered most important.

However as we discussed above, purely economic factors alone do not seem to offer a convincing argument in favor of EMU. In Cohen's analysis of six earlier monetary unions which were implemented throughout the world in the past 125 years (some of which he deems "successful," others not), he concludes that the most important factor of analysis is neither economic, nor institutional, but rather political. In this regard there either existed a local hegemon willing to provide economic, institutional and political stability upon which the other members could rely, or a clear commonality of interests and objectives.

Hence, we may put forth the argument that a political rather than economic motivation is the essential factor when pursuing, implementing and sustaining the movement toward EMU. Furthermore, we may also assert, once we consider those political factors, especially as prescribed by the Maastricht accord, the EMS as it has evolved may embody the limits of those political and communal interests, and that EMU in its Maastricht embodiment may indeed be a quixotic quest in the name of the dream of a united Europe. Thus we turn now to consider those political motivations, as well as the Maastricht implications of the same factors.

### 2.2 Brief History of the Move to EMU and Maastricht

There exist any number of excellent surveys of the move toward EMU and the events and factors surrounding the negotiation, conclusion, and ratification process of the Maastricht Treaty on Economic and Monetary Union, signed in December, 1991 (European Council, 1991). We will attempt neither to improve upon nor reiterate this vast literature. Instead, we will consider the movement toward creating a highly integrated economic order in the EU as a process more political in its aims than economic.

The stages of economic integration generally follow a fairly regular and agreed upon pattern. The first step is generally the establishment of a free trade area, in which goods may flow among the member states either free of tariffs or at reduced rates. The next step in the process is typically the creation a customs union in which a common external tariff is adopted. A common market for products, labor, and capital would follow, in which almost free cross-border movement of these factors is adopted. A more integrated system, that of an economic union, where members adopt and attempt to implement common policy aims and actions, and harmonization of regulations and national laws would be the next stage of economic integration. Finally, a monetary union may emerge, where individual national monetary autonomy is surrendered to the collective authority, which is granted with institutional and political sanction to pursue monetary and financial decision making for the group.

We note here that the later stages, economic and monetary union, require a high degree of political commonality, more often a full-fledged political union. Turning to the experience of the United States, we observe integration at the highest stage. However, the United States is a de facto and de jure political union. On the other hand, the North American Free Trade area, consisting of Canada, the United States and Mexico, (and perhaps in the future other South American nations) is far short of an economic and monetary union; at present it simply represents a free-trade area. Certainly there are intermittent efforts at policy coordination in other areas, but a commitment to a common external tariff, completely free movements of factors, and full harmonization of business and monetary policies does not yet appear to be the goal. Separate political entities are committed to maintaining local authority

over such policies. Fratianni (1994) notes that without an explicit commitment to political union, economic and monetary union are rendered unattainable. The three elements of this "trinity" are "distinct yet inseparable."

The post-World War II European experience demonstrates this fact. Beginning with Manner's visionary European Coal and Steel Community and extending all the way up to the Maastricht process, the EU has embarked upon an effort at achieving all three elements of this "trinity." The establishment of the EEC by the Treaty of Rome in 1960 represented fulfillment of the three earlier stages of integration, and political integration among the states of the EU (and much of the rest of Western -- and now much of Eastern Europe) has rendered a general European war resembling the tragedies of the first two world wars unthinkable.

Movements toward the later phases, however, have deep historical and political underpinnings as well. A European monetary union has been suggested as far back as 1962. The Werner Report of 1970 (Council of the European Communities, 1970), set against the background of the then still operable but floundering Bretton Woods system, called for MU by 1980. In this we see early concerted prescriptions for MU. In 1972, to reduce exchange rate variability as the post-War international financial system began to break down, the well-known "snake," the first attempt to fix European currencies into discernable and predictable fluctuation bands was established. The 1978 Bremen Agreement led to the adoption, in March of 1979, of the EMS, still in operation today.

Efforts at further economic integration were formally codified in the 1986 Single European Act (SEA), which mandated, by 1993, the abolition of restrictions on factor movements among the EU. (This also provided the official basis for the establishment of the so called "new" EMS.) In this step, the previously cited removal of capital controls on cross-border financial flows was called for by 1990. In 1989, the Delors Report (Council of the European Communities, 1989) laid out a clear path to monetary integration. In many respects, this white-paper expressed a clear linkage between the political and economic motivation behind economic and monetary union. (See Fratianni, von Hagen, and Waller, 1993, for an excellent analysis of the parallel approach to Economic and Monetary union described by the Delors report.)

Much of the approach to achieving EMU described in the Delors Report was incorporated into the Maastricht Treaty of December 1991 (European Council, 1990). However, economists as well as other observers are less than convinced that the conditions spelled out in the Treaty, and that the design of the European Central Bank (ECB), are optimal. Furthermore, it can be said that the Maastricht Treaty represents the high-water mark in the hand-in-hand political and economic interplay in the move toward EMU. In the next section, we will briefly assess the Maastricht Accord's political implications and examine the convergence criteria laid out for EMU, and discuss the foreseen design of the ECB and its likely ability to achieve price stability.

### 2.3 The Maastricht Treaty, the Convergence Criteria, Anti-inflationary Prospects, and Political Support

At first glance, the Maastricht treaty appears to lay forth a gradual, measured path toward EMU, with an eye toward an ECB committed to the maintenance of EU-wide price stability. In effect, one may lead to infer that the Maastricht process is a movement toward imparting the German Bundesbank's discipline and anti-inflationary stance to a process of monetary integration which is to conclude with a single European currency, however unconvincing the economic need for MU. However, when more carefully reviewing the conditions for convergence spelled out by Maastricht, as well as the proposed design of the ECB's decision-making process, we may indeed conclude that on inflation-fighting, the ECB's mandate and structure may not offer a Bundesbank-like anti-inflation bias, and that the convergence criteria are neither written in stone, nor necessarily economically "correct."

The three stages toward EMU are well-documented; we need not delve into them here. Essentially, after achieving stability in the bilateral exchange rates in the EMS, the participating countries are required to achieve a convergence of national economic conditions, a tightening of monetary and fiscal policies, the creation and ensurance of independent central banks, and finally the irrevocable fixing of exchange rates. The final stage will lead to the establishment of an ECB and monetary union by 1999. The convergence criteria are somewhat arbitrary, and subject to future revision and amendment at the discretion of EU political leaders. The stringent fiscal requirements on budget deficits and government debt, for example, are not at all firm and unyielding. The European

Council reserves the right to apply discretion at each stage. It is not at all clear that when the issue becomes joined, the EU decision-makers will not abandon stringency in the quest for the "greater" (political) goal of EMU.

The requirement of retaining the fixed bilateral exchange rates throughout the conversion process also poses some questions. At the same time, national governments are supposed to create independent central banks, and move toward realizing the convergence criteria. As can be seen from the experiences of September 1992 and summer 1993, it is unclear that governments can be effective in simultaneously dealing with (or markets believe they can) local shocks and political realities, maintaining fixed exchange rates, and pursuing difficult to meet policy goals.

Furthermore, there is some question as to whether the convergence criteria even address the relevant economic issues. While maintaining some semblance of fixed exchange rates, the Treaty requires convergence in inflation rates (in the words of de Grauwe, 1993, "nominal" convergence) before achieving full MU. However, as de Grauwe argues, nominal convergence is very difficult to achieve in a fixed-rate regime with many national currencies, but easier to do so when MU is actually implemented. (Again witness the relatively small deviation of inflation among different regions of the United States, versus any fixed-rate system, such as Bretton Woods.) This further puts the integrity of the EMS in doubt during the process of implementing EMU.

The ECB, as described by Maastricht, does not necessarily promise anti-inflationary bias. While on the surface the ECB is supposed to embody the Bundesbank's aversion to inflation and to be granted a similar degree of political independence, the actual composition of the decision-making apparatus and its sanction calls this commitment to price stability and independence into question. The ECB Executive Board Council, which will be charged with monetary policy implementation, and the ECB Governing Council, which formulates monetary policy, will be comprised of national representatives and central bank governors. Whether or not these appointees will embody a wider European view or still bring more parochial interests to the decision-making process is hardly clear. Fratianni and von Hagen (1992) assert that national interests and even EU-wide regional interests (i.e. southern versus northern European) may predominate. Elsewhere (1993), they argue that the European Monetary Institute (the precursor to the ECB) and the ECB may offer sub-optimal solutions to the inflation-output dilemma and regional versus federal preferences. Thus, the inflation-fighting role of the ECB is indeterminate at the moment, and our anti-inflation argument put forth in Section 1, is not at all resolved. There exists no a priori credibility in the ECB's operation, hence financial markets in the 1990's necessarily incorporate these doubts into their information sets.

Garrett (1993) suggests that the Maastricht Treaty actually represents a weakening of the Bundesbank's hegemony relative to the EMS arrangement, and that Germany, for the sake of larger political harmony accepted anti-inflation standards lower than it currently assigns to the Bundesbank. Thus, as in the above discussion of optimum currency area theory, successful and sustainable MU requires a political commonality in addition to (indeed perhaps even superior to) economic commonality. The Maastricht conditions appear to be further evidence of this political and economic tradeoff.

The 1992 crisis highlights the Bundesbank's national outlook as opposed to its role in a greater EU-wide financial order. Seemingly oblivious to pressure from governments and market actors alike, the Bundesbank only at the very last moment appeared to sacrifice its role (by lowering the Lombard Rate) in stabilizing the shock of German Economic and Monetary Unification to the maintenance of the viability of the EMU. An ECB policy committee would most likely collectivize disparate national needs in the name of European monetary policy, also exacerbating asymmetries in economic imperatives across the EU.

Couched in a larger climate of widespread "Euro-skepticism," various degrees of domestic opposition emerged in Europe to the Maastricht Treaty as well as to a federal "United States of Europe," and political support at a grass roots level (as opposed to the outlook of many -- but not all -- national leaders) has been indeterminate to say the least. The United Kingdom's deep rooted "Island mentality" and desire to preserve British sovereignty in many aspects of European affairs, the Danes' fear of German dominance and their initial rejection of Maastricht in the summer of 1992, the French domestic division and less than overwhelming vote for Maastricht ratification in September of 1992, and the German public's new "Mittel-Europa" angst and reluctance to part with the beloved Deutsche Mark, all represent significant obstacles to European integration and EMU in particular. Financial markets are keenly sensitive to these fears, and at least in part, bet with this reluctance in the

September 1992 crisis. Below, we offer a political-economy argument to explain the 1992 crisis and to further cast doubt on the viability of successful EMU.

### 3. On the Political Economy of the 1992 Currency Crisis and the role of Maastricht

Many observers explain the crisis of 1992 as a text-book example of the argument we put forth in part (i) of section 1.2 above. GEMU in 1990 represented a large asymmetric shock to the members of the EMS in that a large increase in aggregate demand was felt in Germany as a result of unification and the associated rebuilding of eastern Germany's infrastructure and absorption into the FRG. The Bundesbank's refusal to lower interest rates to preserve the integrity of the EMS, instead preferring to focus on its domestic role of guarding against demand pull inflation touched off by GEMU and fiscal expansion of the federal budget required to redirect resources to the east, exacerbated the asymmetry of the shock, especially as Europe was entering a deep recession.

The possible explanation for the economic tension is fairly straightforward, but by no means does it unequivocally offer a complete rationale for the events of the fall of 1992. Eichengreen and Wyplosz (1993) and de Grauwe (1993) among others put forth a model seemingly consistent with the facts. The demand side response put upward pressure on the real exchange rate, forcing the nominal rate to also rise. Eichengreen and Wyplosz also mention that a concurrent supply-side effect was for returns in Germany to rise to attract the needed capital inflows for restructuring. As early as 1989, the Bundesbank requested a revaluation of the EMS central parities. France, one of the main motivators of European integration, with an avowed commitment to the franc-fort policy as a central pillar of EMU, resisted. Thus, a revaluation not in the offing, the only "lever" remaining to preserve the implicit parity of the system, interest rates, would have needed to converge. However, Europe was entering the deep and world-wide recession of the early 1990's, and interest rate flexibility also began to appear to be out of the question.

Seemingly immune to outside calls for a reduction in the cross-border rates of return in the EMS, the Bundesbank persisted in keeping rates high at the cost of exchange rate pressures in the United Kingdom, Italy, France and elsewhere. Only very late, as the pressure continued to mount, intensify, and spread through the EMS, did the Bundesbank look toward reducing rates. The other members of the system, forced to choose between defending their currencies by keeping domestic rates high, and lowering them to fight recession at home, and respond to domestic political pressures, watched as their currencies fell under severe speculative attack.

Reluctant to officially devalue their currencies for fear of signalling a retreat from the goal of EMU and losing political prestige, governments watched the markets wreak havoc. At the end of the month, Sterling and the Lira were removed from the EMS, and Ireland, Portugal and Spain tightened their existing capital controls. By the end of January 1993, the Punt, Escudo and Peseta were devalued. (Furthermore, three non-EMS currencies, the Norwegian Krone, Swedish Krona and Finnish Markka had abandoned their own pegs to the ecu.) Political blame laying was widespread and rhetoric was sharp and biting.

Some troubling issues remain with this reasoning as it stands. Since GEMU occurred in 1990, it is difficult to entertain the notion that two years needed to pass until the strains built up enough to trigger a crisis. Financial markets are forward-looking and rational, as well as deep, fast-acting, and highly liquid. Why, then, would traders wait for two years for the pressures to build up when they could have forced the issue and reaped profits earlier?

Speculative attack-based arguments (either of the traditional variety or the "self-fulfilling" nature argued by Eichengreen and Wyplosz) shed further light on a full explanation. Financial actors, realizing the untenable position the combination of conditions placed domestic policy-makers in, sold large amounts of the "weak" currencies, since the artificially tight monetary policies of these countries (maintained to defend the EMS) were unsustainable; thus the solution to the crisis was forced by market mechanisms, instead of by political leaders.

Herein lies the role of the Maastricht criteria in the crisis. The commitment by the signatories to maintain the EMS free of "severe tensions" and realignments and the demonstrated adherence to that ideal in 1989 left no "official" way to resolve the tensions. That is, there was no mutually accepted political solution to the apparent need for revaluation. Hence, with the exchange rate removed from



the equation, capital controls no longer in effect, and clearly divergent political imperatives in Germany and the rest of the EMS (the Bundesbank's ignoring of both domestic and foreign leaders to pursue expansionary monetary policy and local economies' facing recession and in some cases domestic discontent with Maastricht), speculators, further bolstered by clearly perceived grass-roots doubt about monetary union, were the only actors with flexibility, motive and liquid resources to reach a solution.<sup>0</sup> As Willett argues (1994, p. 208):

If national authorities adjusted monetary or exchange rate policies quickly as disequilibrium begins to emerge, an EMS type system can work. But ... given the political cost of adjustments, in an uncertain world officials will tend to be biased toward hoping the situation will improve and that the adoption of policy adjustments can be avoided. Meanwhile all that is needed to create incentives for substantial shifts of private funds is that there be a reasonable chance -- not virtual certainty -- of there being an exchange rate adjustment. Given the difference in incentive structures facing officials and private market participants, efforts to operate an adjustable pegged exchange rate system are almost bound to generate speculative crises.

The rigidity imposed by a political commitment toward EMU (however dubious the economic arguments may be) since the Delors report and codified by the Maastricht Treaty created a system that was inflexible to economic realities. The EMS may have worked well if left to perform the job of reducing uncertainty and transmitting monetary policy credibility, but again to quote Willett: A system [such as the "new" EMS and the Maastricht implications for it] which will work only with no disturbances is not viable. (Parenthetical remarks inserted by the author.)

#### 4. Concluding Remarks

In the summer of 1993, after the French Franc again suffered heavy speculative pressure, the EMS fluctuation bands were widened to 15%. Soul searching and second guessing has been widespread. However, the way forward to EMU of some kind continues to be pursued.

Many observers have suggested alternative approaches to EMU, mostly resembling a two-tiered, multi-speed version of Maastricht, consisting of group of "core" countries (usually those of northern Europe) who would continue down the path of EMU, and a "periphery" of the rest of the nations. In some ways however, the very notion of a two-speed approach highlights the flaws of the arguments in favor of EMU. If not all the countries are pursuing monetary union, yet the process continues to go forward in others, is EMU truly needed to complete the transition to a fully integrated system?

Maintaining the wider exchange rate bands would return a measure of flexibility to the member countries of the EMS, and may ease the transition while independent central banks are established and other convergence criteria are met. However, the wider fluctuation bands seem to belie the very convergence criteria spelled out in Maastricht, and also undermine the assumptions behind the initial impetus to EMU.

Can we say then, that the Maastricht process has been derailed, victim to its own ambition? Will EMU ever be realized? While it is not our sanction to engage in fortune telling, we can perhaps garner some idea of the terrain ahead by reviewing the lessons of the first part of this decade.

The case for EMU is not economically compelling, and the European drive toward MU has roots in a political process as well as an economic one. However, the political nature of this pursuit rendered the Maastricht prescription dubious, and broader political support appears not to exist; these facts may have contributed in large part to the 1992 currency crisis. This crisis has forced policy makers to reassess the entire process. Unless a more realistic approach, with less of a political motivation, is adopted, the possibility of a 1992-type situation still exists.

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