Chapter 16
The European Monetary System

Overview
- EMS + ERM
- Evolution: From Symmetry to DM Zone
- Euro + ERM-2 (current system)

The EMS: Past and Present
- EMS originally a solution to the end of the Bretton Woods System.
- Over the years it became a kind of DM area, with the Bundesbank very much in command.
- This, and the speculative crisis of 1993, made the monetary union option attractive.
- Now the EMS is mostly the entry point for future monetary union members.

A fine distinction: EMS vs. ERM
- EMS = European Monetary System
  - all EU members are part of it
- ERM = Exchange Rate Mechanism
  - Grid of agreed bilateral exchange rates
  - Mutual support
  - Joint realignment decisions
  - ECU
- The UK and Sweden did not want ERM membership
- All the others adopted ERM and Euro sooner or later

Preview: The Four Incarnations of the EMS
- 1979-82: ERM-1 with narrow bands of fluctuation (±2.25%) and symmetric.
  - Frequent realignments → ‘fixed rates’ only symbolically!
- 1993-99: ERM-1 with wide bands (±15%).
  - DM got stronger and stronger
  - German unification + Treaty of Maastricht concerns → wave of speculative attacks
- 1999: ERM-2, asymmetric, on the way to euro area.

EMS before the Euro (DM/FrF in ERM)
The ECU
A basket of all EU currencies.

<table>
<thead>
<tr>
<th>Currency</th>
<th>Amount in ECU</th>
<th>Weight (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgian franc</td>
<td>3.447100</td>
<td>8.21</td>
</tr>
<tr>
<td>Danish krone</td>
<td>0.103500</td>
<td>2.37</td>
</tr>
<tr>
<td>Deutsche mark</td>
<td>0.664100</td>
<td>36.08</td>
</tr>
<tr>
<td>Dutch guilder</td>
<td>0.219500</td>
<td>10.21</td>
</tr>
<tr>
<td>French franc</td>
<td>1.332300</td>
<td>20.73</td>
</tr>
<tr>
<td>Greek drachma</td>
<td>1.436000</td>
<td>3.45</td>
</tr>
<tr>
<td>Italian lira</td>
<td>151.808000</td>
<td>3.21</td>
</tr>
<tr>
<td>Irish punt</td>
<td>0.008500</td>
<td>0.08</td>
</tr>
<tr>
<td>Portuguese escudo</td>
<td>1.193900</td>
<td>0.71</td>
</tr>
<tr>
<td>Spanish pesetas</td>
<td>0.697100</td>
<td>4.54</td>
</tr>
<tr>
<td>UK pound sterling</td>
<td>0.827846</td>
<td>11.12</td>
</tr>
</tbody>
</table>

The ERM: Interpretation and Assessment

- The impossible trinity:
  - widespread capital controls to preserve at least the ability to have different inflation rates.

The impossible trinity:

- Fixed Exchange Rate
- Monetary Independence
- Full Capital Mobility
- EMS
- Monetary union

Evolution: From Symmetry to DM Zone

- First a flexible arrangement:
  - different inflation rates: long run monetary policy independence
  - frequent realignments.

Evolution: From Symmetry to DM Zone

- Realignments and inflation in between with real appreciation

But: realignments:
- barely compensated accumulated inflation differences
- were easy to guess by markets
- weak currency/high inflation countries on the spot:
  - Continuing current account deficits
  - Speculative attacks.

The symmetry was broken de facto.

The Bundesbank became the example to follow.

What shadowing the Bundesbank required:
- giving up much what was left of monetary policy independence
- aiming at a low inflation rate
- avoiding realignments to gain credibility.

Evolution: From Symmetry to DM Zone

- Breakdown of the DM zone

- Bad design:
  - full capital mobility established in 1990: ERM in contradiction with impossible trinity

- Bad luck:
  - German unification: a big shock that called for very tight monetary policy
  - the Danish referendum on the Maastricht Treaty

- A wave of speculative attacks in 1992-3:
  - the Bundesbank sets limits to unlimited support → UK and Italy leave the ERM
ERM-2 ceased to exist on 1 January 1999 with the launch of the Euro.

ERM-2 was created to:
- host currencies of existing EU members who cannot/don’t want to join euro area:
  - Denmark and the UK have a derogation, but Denmark has adopted the new ERM
  - Sweden has no derogation but has declined to adopt the new ERM

ERM-2 and new EU members
- Hosts currencies of new EU members before they are admitted into euro area:
  - 4 have already exited and entered Euro area (Slovenia, Cyprus, Malta and Slovakia)
  - Further 3 members of ERM 2 committed to join by end of decade
  - Romania and Bulgaria: capital mobility but later ERM membership

ERM-2 and new EU members

How Does ERM-2 Differ From ERM-1?

<table>
<thead>
<tr>
<th>ERM-1</th>
<th>ERM-2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Symmetric, no anchor currency</td>
<td>Asymmetric, all parities defined vis-a-vis euro</td>
</tr>
<tr>
<td>Margin explicitly set</td>
<td>Normal (±2.25%) and &quot;standard&quot; (±15%) bands</td>
</tr>
<tr>
<td>Automatic unlimited interventions</td>
<td>ERM explicitly allowed to suspend intervention</td>
</tr>
</tbody>
</table>

Current ERM membership

<table>
<thead>
<tr>
<th>Country</th>
<th>Date of ERM 2 membership</th>
<th>Band of fluctuation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Denmark</td>
<td>1 Jan. 1999</td>
<td>±2.25%</td>
</tr>
<tr>
<td>Estonia</td>
<td>27 June 2004</td>
<td>±15%</td>
</tr>
<tr>
<td>Lithuania</td>
<td>27 June 2004</td>
<td>±15%</td>
</tr>
<tr>
<td>Latvia</td>
<td>2 May 2005</td>
<td>±15%</td>
</tr>
</tbody>
</table>

A Revival of The EMS?
- In principle, ERM membership is compulsory for the all new members.
- They must stay at least two years in the ERM before joining the euro area.
- They must also eliminate all capital controls.
- The impossible trinity says that they will have to fully give up monetary policy.

Outside the Eurozone

Inflation rates by ERM commitments