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THE LIBERALIZATION OF CAPITAL AND THE STRENGTHENING OF THE EMS

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1. The ingredients of the EMS's success

I shall start by briefly recalling some of the key features of the structure and performance of the EMS since its inception, as the necessary basis for assessing future prospects and the need for change.

When the EMS was set up, two main principles were considered essential for its proper functioning and represented important departures from both Bretton Woods and the European "snake" of the seventies: first, a procedure for changing central rates based on joint, rather than unilateral, decisions; and second, explicit recognition that exchange rate cohesion would have to be based on macroeconomic policy convergence aimed at greater stability.

As it turned out, shortly after the inception of the system the second oil shock caused large imbalances to reappear in member countries' external payments and pushed inflation up, with relatively stronger effects on the weaker economies. All the EMS countries assigned top priority to the correction of these external imbalances and the reduction of inflation, which facilitated consensus on macro-policy objectives and their coordination in the early years. Collective realignment decisions and effective coordination of monetary policies have become characteristic features of the EMS.

The exchange rate constraint functioned as the basic reference and disciplinary device for national policies during the phase of disinflation. As a rule changes in central rates did not fully accommodate inflation differentials, so that most of the burden of adjustment was placed on domestic policies and continuous pressure was

maintained on domestic costs and prices in the higher inflation countries. The temptation to resort to competitive devaluations was avoided. In most cases realignments were accompanied by policy packages designed to remove external and domestic financial imbalances, and became vital check-points in a continuous process of mutual surveillance over national policies.

Against this background, interventions and monetary policies were used to maintain exchange rates within prescribed fluctuation margins between realignments; together with capital controls, the latter provided the leeway required to reconcile slowly converging rates of inflation and monetary expansion within the system. The fact that monetary conditions were generally consistent with the need to finance current external imbalances on international markets resulted in little use being made of the system's reserve and official credit mechanisms; this has been a main reason for their satisfactory functioning and the climate of trust that has been established among the participating central banks.

Over time the DM has emerged as the principal reserve and intervention currency of the system, and the Bundesbank's monetary policy has provided the anchor for monetary stability. The model of monetary coordination that has prevailed has been one in which the DM has played the n-th currency role, with the Bundesbank setting its monetary targets to achieve domestic price stability and the other participants intervening in foreign exchange markets and adapting domestic monetary conditions to meet the exchange rate constraint. Contrary to expectations, but in line with this model of coordination, an increasing proportion of interventions have been made before the compulsory intervention limits were reached (intramarginal interventions).

Consensus on basic policy objectives, coupled with pragmatic operation of the system at times of tension, have been the key to its good performance.

2. The legacy of disinflation

By 1985 inflation rates and differentials had been brought back to the levels of the sixties. In contrast with other industrial countries, EMS members achieved this result without giving up exchange rate stability; indeed, short-term exchange rate variability within the area has decreased continuously in a period of increased instability outside, and major real exchange rate misalignments were avoided.

However, the model of policy coordination adopted, centred on the disciplinary rôle of the exchange rate, has also produced side effects that will be important for the future performance of the EMS.

Since nominal exchange rate changes have not fully offset inflation differentials, there has been a tendency for the currencies of the low-inflation countries to depreciate in real effective terms, and for those of the high-inflation countries to appreciate. Cyclical factors combined with relative price changes to strengthen the already strong external position of the former countries since their domestic demand tended to expand at rates below the Community average. Between 1979 and 1987 the German and Dutch intra-EMS trade balances improved by 17 and 2.5 billion dollars respectively, while those of France and Italy worsened by 9 and 11 billion dollars.

Up until 1985 these growing imbalances within Europe were partly offset by the strong dollar and buoyant growth of US domestic demand, which caused America's trade balance to deteriorate with all the EMS countries. Since 1985, however, this tendency has been reversed: European countries have already seen their trade balance with the United States worsen considerably, and more of the same can be expected as the US external adjustment proceeds.

Persistent external surpluses within the EMS also

have monetary implications that should not be overlooked. Such surpluses are a direct source of (upward) pressure on already strong currencies; to the extent that surplus countries intervene to counter these pressures, they can lead to excessive monetary base creation. The EMS partners whose external current accounts are roughly in balance, are reluctant to raise their interest rates when these pressures materialize since they see the problem as being caused abroad. If the pivotal EMS central bank, the Bundesbank, is called upon to shoulder too much of the burden of adjustment, the system may lose its anchor of monetary stability.

Persistent surpluses are also liable to strain the intervention and credit mechanisms; they may encourage requests for "greater symmetry" in their management, leading possibly to undesirable manipulation of the system's rules. For instance, the request for increased cross-holdings of EMS currencies as official reserves by the participating central banks can also be seen in this light.

3. The liberalization of capital movements

The conclusion of the phase of disinflation and the momentum created in the process of European integration by the 1985 Single Act have led to the decision to complete the removal of foreign exchange controls and restrictions on capital movements well in advance of the 1992 deadline for the internal market. Direct investment and long-term financial transactions have already been liberalized; the new liberalization directive (to be approved by the ECOFIN Council in October this year) will introduce complete freedom for short-term financial transactions (e.g., bank deposits and loans and short-term securities, etc.).

This step will fundamentally change the EMS. Economic theory and experience have established that within an integrated area it is not possible to have free trade,

free capital movements, fixed exchange rates and autonomous national policies at one and the same time. As I have already mentioned, in the early years of the EMS realignments and capital controls offered the leeway required to reconcile divergent (slowly converging) performances and policies. Full liberalization of capital will now remove much of that leeway; the impact will be strongest on monetary policy, since most of the scope for maintaining monetary conditions that are not in line with those of the other EMS countries will disappear. This is true even of the largest country in the system, Germany, since the elimination of foreign exchange restrictions will enormously increase the funds that can be moved at short notice into and out of DM-denominated monetary assets in response to changes in expected returns.

Destabilizing capital flows are likely to be particularly large whenever there are expectations of an impending realignment; speculation would be avoided only if exchange rates were credibly and irrevocably fixed. Short of this, markets will continue to expect inflation differentials and payments imbalances to impose realignments from time to time. Such expectations will be stronger when the system is struck by exogenous shocks such as wide swings in the dollar, which entail large portfolio shifts liable to affect the currencies of the EMS exchange arrangements differently.

In turn, heavy flows of capital for short-term portfolio reasons may cause large temporary departures from the intended monetary course or, alternatively, exchange rate changes unrelated to competitiveness. The allocative (trade) and disciplinary (macro-economic) functions of the exchange rate may thus be compromised, to the extent that financial forces take the lead in determining exchange rate behavior. Unless monetary policies can be fully coordinated in view of the exchange rate objective, there is a risk that the EMS exchange rate arrangement will evolve towards a crawling peg and that progress towards increased exchange rate fixity and monetary union will suffer a set-back.

I wish to underline once more that the problem posed by the complete liberalization of "monetary" capital is systemic, because no country in the EMS will be able to use monetary policy as a tool for the independent pursuit of national goals. Moreover, the EMS achievement of bringing exchange rates firmly back into official hands will be called into question and put to a severe new test.

4. Strengthening the EMS

The EMS exchange rate mechanism has performed remarkably well in a period of exceptional turbulence in international monetary relationships. This, however, should not lead to the conclusion that it will be able to cope equally well with ongoing changes in Europe and the world at large.

(a) The "real" underpinnings of the EMS

The major gains from exchange rate stability within the EMS have been in the domain of trade and the integration of the market for goods; more of the same gains are expected from the creation of the unified internal market, extending to services and financial intermediation. There have also been benefits on the macro-policy front, with high-inflation countries using the exchange rate constraint as the anchor for disinflation and the low-inflation countries enjoying a stimulus to growth through the foreign component of demand (exports). Effective macro-policy coordination has been restricted mainly to monetary policy; major imbalances remain in the public finances of some EMS members.

This "benefit balance" may now be changing. The EMS must tackle internal trade and fiscal imbalances, because they represent a source of strain for exchange rates and because they may cause a deflationary bias throughout the

area. Europe cannot expect much positive contribution to its growth from outside; indeed, the adjustment of the US trade deficit, aggressive competition by Japan and the NICs and the need for LDCs to reduce their external debt all involve foreign demand making a negative contribution to growth. At the same time it is essential to avoid placing improper burdens on monetary policies as a result of failure to cope with real imbalances.

An important contribution to internally-generated growth will have to come from effective supply side policies that both foster productivity and the geographical mobility of productive factors and encourage the flow of capital from high-saving to low-saving regions with the greatest need to grow. A sustained acceleration of demand in countries with large external surpluses and low inflation is also required, since other EMS countries still have to cope with excessive inflation, strained public finances or weak external positions. The need to fully integrate Spain, Greece and Portugal into the European economy and exchange rate mechanism makes the formulation of effective policies for adjustment and growth all the more urgent: the costs borne by these countries could become too high if Europe became a slow growth area.

Let me stress this point. Growth and effective adjustment policies are not something that can be asked of an exchange rate arrangement; however, they are an essential real underpinning for any such arrangement. Unless they are brought about by appropriate economic policies, the burden of adjustment will be placed improperly on exchange rates and monetary policies. Growth, price stability and the exchange rate arrangement itself, will all suffer.

(b) Exchange rates and monetary coordination

Over the next few years the main challenge to the EMS exchange rate mechanism, the challenge that will

determine whether the system can actually survive and evolve towards fully-fledged monetary union, is posed by the liberalization of capital movements.

Full capital mobility is not consistent with the present degree of monetary policy coordination in Europe; unless we move ahead in this domain, exchange rate cohesion will be undermined. Here we find a paradox: the looser the exchange rate constraint, the greater the possibility for destabilizing portfolio shifts involving currency substitution and "jumps" in national money demands. In other words, in order to reduce the risk of financial instability inherent in the integration of financial markets, we need to move towards increased exchange rate fixity, to "tighten the screws" of the exchange rate mechanism. This, however, will also entail tighter constraints on national monetary policies.

Significant progress towards closer monetary coordination has been made with the Bâle-Nyborg agreement. In addition to making very-short-term financing available for intramarginal interventions, and thus increasing the system's flexibility, this agreement provided for changes in EMS management techniques, namely: (i) that participants will be readier to move domestic interest rates -- that is, adapt monetary policies -- symmetrically and in a coordinated manner, consistent with the need to resist exchange rate pressures; and (ii) that central rate changes will be kept within the band width, thereby ensuring that discontinuities in market rates at the time of realignments are avoided as far as possible and minimizing the incentive to take up open positions.

If in the new environment of capital mobility we want to preserve what has been achieved, further steps along this road must be envisaged. One such major step could be the decision, publicly announced, that the range of permitted changes in central rates would be progressively narrowed to zero over a number of years (say, five), thus making explicit

the commitment to eventual fixity of exchange rates. The positive effects on expectations would be reinforced by the discipline that all countries would thus impose on their domestic costs and prices.

A commitment to "tightening the exchange rate screws" would only be credible, however, if it were accompanied by the adoption of consistent objectives for monetary expansion. Perfect capital mobility will not allow independent national objectives to be maintained or be credible when announced, unless they are mutually consistent, and, indeed, fully coordinated. In other words, monetary coordination must go beyond day-to-day management, to the joint setting of ex-ante monetary objectives. This task should be entrusted to the Committee of Governors of the EEC, which already performs regular reviews of monetary and exchange rate developments in member countries and discusses their mutual consistency.

It will also be necessary for monetary management to move further in the direction of greater interest rate flexibility in response to emerging exchange rate pressures. Basically, this will require an understanding on avoiding the sterilization of interventions in foreign exchange markets, so that they will be reflected in domestic monetary conditions.

Finally, in the view of the Italian authorities the credit mechanisms of the EMS should be strengthened with the introduction of a new facility specifically designed to deal with large, destabilizing capital flows that are unrelated to members' economic policies. Such shocks could arise, for instance, as a result of large swings in the dollar leading to portfolio shifts with asymmetrical effects on the European currencies. This possibility is implicit in the fact that some of these currencies perform as international reserve currencies while others do not. The financing facility would be designed to accommodate the relative shifts in demand for EMS currencies by bringing about a matching change in supply;

money market conditions in the countries concerned would thus not be modified. It is worth stressing that the activation of the facility would involve a joint judgement by the Committee of Governors that the system was facing a "purely financial" speculative disturbance, exogenous to the system.

5. Monetary unification and the European central bank

The recent interest in these issues, after many years of almost complete neglect, stems both from the success of the EMS itself -- reflected in the decision to move ahead with capital liberalization -- and more broadly from the renewed political momentum given to European integration by the 1985 Single Act.

Doubtless, monetary union would be an important complement of the internal market and full economic integration, and it would require a centralized monetary institution and (eventually) a single currency. While it is true that setting up a European central bank is not one of the priority needs of the EMS, we are coming to the stage of making decisions in the monetary and exchange rate fields that are likely to have far reaching implications for the future. For this reason it would be useful, and perhaps crucial, to reach agreement on the basic institutional features of the European monetary union, thereby allowing decisions in this field to be placed in a longer-term perspective. Furthermore, some of the steps required by monetary union may entail changes in national institutional arrangements, which should be recognized well in advance.

Concerning the basic characteristics of a European central bank, I share many of the views put forward by President Poehl: it should be made independent of national governments, the European Council and the Commission, although obviously not insensitive to the objectives of their policies; and it should be responsible for the creation and

regulation of the common currency, with a high priority assigned to preserving its internal value or, in other words, to price stability.

These simple principles are obviously far from easy to implement; for one thing, they are in contrast with current practice in a number of EEC countries, where central bank functions are closely coordinated with, if not actually subordinated to, the policies of the government.

This issue of central bank independence is closely tied up with the degree and timing of the centralization of other policy functions. A decision to centralize monetary policy at the European level before or without some centralization of budgetary functions already implies a choice in favour of an independent central bank. On this issue, I will only note that in principle there is no need for the transfer of sovereignty in these two different domains to take place at the same time; indeed, history offers examples of monetary unions (federal states) accompanied by extensive decentralization of budgetary functions. When such a model prevails, of course, the possibility for "regional" governments to influence monetary creation or to control revenues from seignorage is nil.

An agreement on the basic principles of a monetary constitution for Europe is necessary not only to know where we intend to go but also because these principles will have to be incorporated in the Treaty before any further step can be taken. This does not mean, however, that the creation of a European central bank should be conceived as a one-time-jump to be made when all the conditions are ripe. Rather, it seems to me that we should envisage an evolutionary process involving a gradual centralization of monetary functions in an area of increasingly fixed exchange rates between a plurality of increasingly substitutable currencies.

The complete liberalization of capital movements, as I have argued, sounds a powerful call for further early progress on the front of monetary coordination. Such an

advance will already take us some way towards a centralized monetary policy. In this regard the Committee of EEC Governors should play a central role not only in the joint setting and management of monetary objectives, but also more broadly in deciding the steps and rate of progress towards the centralization of monetary policy.

A European central bank would only make sense if there was a European currency to manage. A nucleus of such a common currency already exists, i.e. the ECU, and we should build upon it rather than looking for alternative, abstract solutions. Of course, the basket definition of the ECU will not be consistent with making the European central bank fully responsible for its management; at some stage, therefore, the ECU will have to take up a life of its own as a currency completely independent of its present component parts.

Before this stage is reached, however, there is plenty of time and scope for strengthening the ECU we have and fostering its use. Two aspects are of relevance in this regard. First, so-called official ECUs -- those recorded in the books of the EMS central banks as the counterpart of reserve (gold and dollar) swaps with the EMCF -- could be made into a permanent asset, perhaps starting with a gradual lengthening of the swap period (at present, three months). Second, today's completely separate official and commercial ECU circuits (the latter involving ECU-denominated assets and liabilities issued by commercial banks and other private intermediaries) could be connected, thus creating the possibility for EMS central banks to use their official ECUs for intervention in both money and foreign exchange markets. Concern has been expressed that these steps may lead to increased monetary creation and a loosening of monetary discipline. I will only note that this is certainly not the objective of the proposals and that therefore it should not be difficult, as in similar cases in the past, to create appropriate checks against such a danger.

Turning the ECU into a fully-fledged reserve asset

would, of course, require the development of liquid and deep financial markets in ECU-denominated instruments. After showing considerable dynamism for a number of years, the commercial ECU markets seem to have exhausted their capacity for endogenous expansion.

Their development may still be hampered by rules and administrative practices which need to be removed. Beyond this, however, more active use of the ECU in the operations of European governments and public sectors at large seems desirable if these markets are to make the required "leap" both in size and quality. In particular, increased resort to issues of ECU-denominated Treasury bills would create a large market of high quality securities and the promotion of the ECU for the denomination of international contracts by large public and private corporations would help build the basis for an active bank, and interbank, market in ECU-denominated paper.

To the extent that the ECU were seen as the nucleus of the future common currency, it would be appropriate to subject commercial ECU markets to the joint, and increasingly active, surveillance of the Committee of Governors. To this end, however, the position of neutrality that this Committee has maintained so far vis-à-vis commercial-ECU markets should be replaced by one of active interest in their development and orderly functioning. These functions, together with those assigned to the Governors in the joint setting and management of monetary objectives, could in due course be the first tasks assigned to the centralized European monetary institution, once this is established, even if only in some initial, rudimentary form.