EMU Prospects

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Two essays by
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Preface

This occasional paper contains two essays on prospects for Economic and Monetary Union (EMU) in Europe, one by Peter Kenen and one by Guillermo de la Dehesa. Both were circulated to the Group during its plenary meeting held in the fall of 1994 in Madrid.

These essays provide somewhat different up-to-date assessments of some of the central problems facing Europe as it moves toward EMU. Sr. de la Dehesa’s paper discusses seven different paradoxes which affect the transition to, and the eventual implementation of, monetary union. Professor Kenen’s paper stresses the importance of lessons from the 1993 ERM crisis. Both authors are broadly in favor of EMU in Europe, and look for its eventual implementation.

Both Sr. de la Dehesa and Professor Kenen are members of the Group of Thirty. Sr. de la Dehesa is the CEO of Banco Pastor and Vice Chairman of the Centre for Economic Policy Research (CEPR). Professor Kenen is Walker Professor of Economics and International Finance, Princeton University.
EMU Paradoxes
Guillermo de la Dehesa

Introduction
I should say, first, that I am a firm supporter of advancing the process of economic, monetary and political union in Europe. I believe that it is the only road forward, if Western Europe is to keep up with American and Asian economic dynamism. However, this will not stop me pointing out some inconsistencies in the conception, design and development of the European Economic and Monetary Union process—what I think of as the EMU paradoxes. Uncovering some important instances of muddled thinking and pointing out alternative paths forward is a constructive exercise and this is the purpose of this short essay.

Fixed Versus Floating Exchange Rates
One of the most important arguments which the European Commission has used to justify the need for monetary union is presented in the report edited by Michael Emerson "One Market, One Money" (1990). There, the Commission makes the point that exchange rate changes are virtually useless within Western Europe. Why? Because the national economies of the Union are very open toward each other and for many a high share of trade is intra-industry; any devaluation, as a result, is transmitted quickly and completely into domestic prices. There is no consequent gain in competitiveness; and thus
devaluations do not help achieve external balance in trade or the current account. The Commission concluded that a fixed exchange rate system is optimal, since nothing is lost from an adjustment viewpoint and it eliminates uncertainty and transaction costs between currencies, to the benefit of intra-community trade.

However, after the 1992/93 strains in the Exchange Rate Mechanism (ERM), the Commission inadvertently turned this argument on its head in 1993. For the ERM to survive at all in the face of market forces, it was necessary to opt for 15 percent bands, which meant that exchange rates could in effect float freely across a wide range of values. The Commission argued, however, that member countries should refrain from devaluation because competitive depreciation could undermine competition, something it felt was incompatible with the Single Market in the medium term.

Others have weighed into the debate. Alan Winters (1993) acknowledges that an individual devaluation may have some effect but argues that competitive devaluations are unlikely to be effective since the impact of one devaluation will be offset by the impact of another. Paul de Grauwe (1992) points out that an individual devaluation has real immediate costs in the Union since the price of agricultural exports must increase in domestic currency terms straight away. Otherwise, monetary compensation amounts (MCAs) are imposed on agricultural exports.

But, what are we to understand from the Commission? Do they believe devaluations are effective or not? If they do, how can the costs of giving them up be negligible? If the don't, what difference does it make if ERM member countries use the present latitude conferred by wide exchange rate bands? Its recent positions are inconsistent—and something of a paradox.

**ERM Versus the Single Market**

Another questionable aspect of the “One Market, One Money” argument is the assertion that a system of flexible exchange rates is incompatible with the Single Market. Theory and practice both show that this is not so: a single market can work well with flexible exchange rates or a single currency. The kind of system with which it really is incompatible is one like the ERM, a semi-fixed exchange rate system.

Freedom of movement of short-term capital is one of the “three legs” of the Single Market. It is these capital flows that create the problem for semi-fixed exchange rates.

Indeed, the earliest arguments on this subject suggested that anything except floating rates would pose a problem for a single
market with free movement of capital. When Mundell talked about the "Holy Trinity" of monetary policy, exchange rate policy and capital mobility, he made what was in effect a strong case for flexible exchange rates in a single market. For he pointed out that independent monetary policies were incompatible with fixed exchange rates and perfect capital mobility. Drawing on practical experience, Milton Friedman has argued repeatedly (most recently, in 1992) against semi-fixed systems as well as fixed. The "Smithsonian tunnel" of 1971 to 1973, the European "snake" of 1972 to 1979, and the EMS of 1979 to 1992 all developed strains and eventually fell apart. He concludes that semi-fixed exchange rates cannot be satisfactory for the long haul for groups of countries with independent political systems and autonomous monetary and fiscal policies.

But if countries are willing to sacrifice much of their monetary independence, which of course the members of the European Union are, a semi-fixed system is still infeasible. Alan Walters (1990a) has been very critical of "half baked" systems like the ERM. More recently, Forbes (1993) has argued the point forcefully. After the traumatic experience of 1992, the idea that total freedom of movement of capital is only compatible with a floating system of exchange rates or a single currency is widely accepted. Today, it would be very difficult for the Commission to argue that a single market is incompatible with floating exchange rates—if for no other reason than that is what we have!

Ex-Ante Convergence Versus Ex-Post Convergence

In the Maastricht Treaty, the members of the European Union have chosen a system of ex-ante macroeconomic convergence; that is, to achieve roughly comparable macroeconomic policies and performance first, then to reduce exchange rate fluctuations and finally to fix exchange rates. With this approach, a new exchange rate regime follows rather than leads monetary and fiscal policy harmonization. Under Maastricht, strict nominal convergence criteria have been put in place which must be fulfilled at each stage toward European Monetary Union.

However, most of the major countries of the European Union only recently agreed that the opposite was true. From its inception, the European Monetary System (EMS) was seen as a means toward convergence. Many EMS members felt that by joining that System they constrained themselves in the future by a de facto acceptance of Germany's leadership in monetary policy. Their currencies were tethered to the "anchor" of the German Mark so they could import price stability from Germany. The ERM imposed discipline in monetary
policy on its members, rather than being a benefit that flowed from their own temperance. It was the source of reduced cost and price expectations, lower inflation and greater competitiveness. In other words, a principal benefit of the exchange rate regime was the convergence in monetary—and to a lesser extent, fiscal—policy that it forced on its member countries.

Why then do the Maastricht criteria call for the reduction of public indebtedness and deficits and inflation rates before the exchange rate is fixed? It is like saying to Domingo Cavallo that Argentina first had to reduce its inflation rate and only afterwards to fix its exchange rate with the US dollar. In fact, correctly, he chose to do the precise opposite.

Perhaps exchange rate fixity as a means to convergence is the obvious choice where hyper-inflation is ingrained. But surely it is still an appealing choice when there are smaller initial differences in macroeconomic performance. It was at the time the EMS was set up. Why not under Maastricht?

This sequencing argument is an old one. The so-called “economists” and “monetarists” took sides at the beginning of the seventies when the first serious attempts at monetary integration were made in Europe. The “economists” were then (as now) led by the Bundesbank, which wanted convergence in inflation rates before the introduction of narrow bands between exchange rates. The “monetarists” were then (but are not now) led by the Bank of France, which wanted to narrow the bands first in order to force convergence of inflation rates (Corden 1993).

However, German solidarity in support of the “economist” position broke down with German reunification. In the words of Robert Mundell (1993) “When the leaders of West and East Germany met to consider monetary union it was determined by a stroke of a pen!” No prior harmonization of economic performance, policies or structures was allowed to stand in the way. In 1990 Germany became monetarist in the twinkling of an eye, putting behind it all doubts about the viability of its monetary union without previous convergence. The paradox is that, although today it is “monetarist” at home, Germany continues to be “hard-line economist” when discussing EMU.

But perhaps this is not so strange. The only German institution that was always “economist”—even in the case of monetary reunification—was the Bundesbank. Despite its genuine independence, it simply was not strong enough to check the political imperative toward speedy and outright monetary union during German reunification. By contrast, the political issues in EMU are not so one-sided and the German federal government is more comfortable with
the Bundesbank’s position. In this arena, the Bundesbank has quite enough authority to carry the day.

ERM Versus Convergence
The free movement of short-term capital introduced in 1990 has meant that ERM has not been the instrument for nominal convergence that many expected (The Economist, 1989). While there may be good reasons to think it could induce convergence in the long term, it has often had the opposite effect in the medium and short term.

Alan Walters (1990 b) warned of this danger. When free to do so, large amounts of short-term capital will move in response to short-term profit prospects rather than in response to economic fundamentals like the bulk of movement in medium- and long-term capital. These profit expectations are determined by expectations of exchange rate changes and prevailing interest rates. Since, under the ERM, there was a very small chance exchange rates would in fact change on any particular day, differentials in interest rates have been the primary factor influencing short-term flows between currencies following capital account liberalization. This was illustrated forcefully by the 1993 episode in which there were repeated speculative attacks against the French Franc over several days, despite the fact that the French economy arguably had the best “fundamentals” in the European Union at that time.

Of course, countries with higher than average nominal interest rates are often those with higher than average inflation rates too. Thus, when short-term capital moved within the ERM to countries with higher nominal interest rates, it was often flowing into countries with relatively high inflation. And, because those inflows swelled the money supply, they tended to exacerbate inflation and confound anti-inflation policies. At the same time, they tended to move away from countries with lower than average inflation and interest rates, restraining the expansion of domestic demand there. In this way, the interplay between the ERM and short-term capital mobility has reduced rather than increased nominal convergence. The case of the Peseta has been perhaps the clearest confirmation of the “Walters Critique.”

This critique has disturbing implications for the Maastricht Treaty approach of convergence first and currency fixity later. During the 1993 speculative attacks on the French Franc, solid fundamentals in France meant strong convergence with Germany. So economic divergence is not needed for exchange rates to be unstable and economic convergence does not guarantee stability. There is, therefore, every reason to expect exchange rates will still
be subject to speculative attack, even if convergence is widely achieved in the run-up to complete Monetary Union (Rose 1994).

In fact there is evidence in Europe that freedom of movement of capital can cause real interest rates to diverge. Nominal interest rates may converge over time, but real rate differentials may rise at the same time, given different paths of inflation in different countries (Figures 1 and 2). Until the 1993 devaluations broke the ERM narrow-band system, the combination of semi-fixed exchange rates and free movement of short-term capital actually created an obstacle to greater convergence of inflation between the member countries. Figures 3 and 4 show that convergence between inflation rates has been less than that between nominal interest rates, so that the disparity of real interest rates has actually increased.

Figure 1. Nominal Bond Yields in the European Union, 1987-1994

Figure 2. Real Bond Yields in the European Union, 1987-1994
ERM Versus Prosperity

The reunification of Germany made a nonsense of the ERM for many member countries. They had joined in pursuit of prosperity, thinking that the low inflation and interest rates that flowed from anchoring to the Mark would lay the basis for sustained growth. Instead, with reunification, the Mark anchor became the transmission mechanism for policies that prolonged the recession of the early 1990s.

The reason for this perverse impact in much of Europe was that the German government decided to fund the public costs of reunification not by raising taxes, but by borrowing. The rapid expansion in the public deficit stimulated demand and the Bundesbank...
reacted by raising interest rates to check the accompanying acceleration in inflation. To maintain parity with the Mark, the other ERM member countries had to raise their interest rates too although most of them were in a recession at the time and faced no inflationary pressures of their own (Portes 1993). Germany's need for high interest rates to combat inflation came into conflict with the need for low interest rates in other countries to combat recession and unemployment. Attempting to save the ERM after German reunification deepened and lengthened the recessionary phase of the cycle in other member countries (Wyplosz, 1998).

The most vulnerable countries were those on the European periphery. In 1992, Alesina and Grilli had warned that their problems would be severe and they were right, particularly where, as in the case of Spain, rigid labor markets existed. Massive capital outflows forced these countries to maintain high interest rates. And then the demand shock from high interest rates combined with supply-side inflexibility in their domestic economies to deepen unemployment rather than lower wages and alter employment patterns.

Most ERM governments were in an untenable position in the early 1990s. They had made an external commitment to the Exchange Rate Mechanism and an incompatible internal commitment to their electorates to end the recession as speedily as possible. This inconsistency was the root cause of the currency speculation against the ERM. France survived the strains during the Franc crisis in the fall of 1992 and, by sticking as firmly to its exchange rate policies as it did, demonstrated the strength of its political commitment to the idea of a united Europe. But for many of the peripheral countries, the strain was too much. In the words of Rudiger Dornbusch (1993), "On this occasion the speculators—who finally made the ERM system blow and forced interest rates down—were the best friends of the unemployed and, although they would not like to admit the fact, of [many] monetary authorities who had made unsustainable promises."

Maastricht Versus the ERM

The recent experience of the ERM crisis has demonstrated that, once total freedom of capital movements is introduced, it is very difficult to limit exchange rate movements inside fixed narrow bands. Either frequent realignments of the bands are needed, or the bands themselves have to be wide enough to make speculative attacks difficult—the option chosen in August 1992.

However, in the European context, this option creates a problem. The Maastricht Treaty lays down as one of the third stage convergence requirements that ERM member countries must be capable of keeping
their currencies within fixed and narrow bands for at least two years.

According to Eichengreen and Wyplosz (1993), this particular requirement was responsible for the ERM crisis. They argued that it increased the fierceness of speculation against the weaker currencies in the System. For speculators knew that ERM members whose currencies were under pressure would either succeed in defending them, or allow their currencies to devalue substantially. Since the prize of meeting the Stage Three criteria would be lost anyway with a small devaluation, there was no point in resisting a large one.

But what is going to happen now? Are member countries going to be obliged to re-narrow the bands to fulfill this Maastricht requirement? According to Artis (1994) this would be a practical impossibility unless the ERM system is reformed. He considers two mechanical reforms: either introducing capital controls or more flexibility and softness in the bands through a regular process of adjustment, such as automatic indexing against relative inflation rates; and one policy reform: that the Bundesbank accept EMI recommendations to guide its monetary policy more by European considerations than by German considerations.

It is not clear, however, that any of Artis’ reform proposals are feasible. It may be better to think of re-imposing narrow bands once recovery in Europe is well underway but keeping open the possibility of two potentially quite large realignment exercises. The first of these would come just before the ERM currencies entered the narrow band for two years. The second would come the day before entering Stage Three when exchange rates are irrevocably fixed. This might be the only way to succeed in reconciling the realities of the ERM with the convergence criteria of the Maastricht Treaty.

However, there is a loophole in the Treaty by which the criterion might also be avoided altogether. Kenen (1993) has pointed out that, while the rules do not permit a member country to devalue unilaterally, it may do so at the request of another member. So, if two members agree that one of them will devalue, the devaluation can proceed without a formal breach of the Maastricht criteria. If the members are prepared to disregard the spirit of this criterion, then the letter can be circumvented.

Maastricht Versus Maastricht

The Maastricht Treaty formally introduces the principle of subsidiarity as one of its most important features. Article 38 states that “in areas which do not fall within its exclusive competence, the Community shall take action, in accordance with the principle of subsidiarity,
only if and insofar as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community."

As a practical matter, this is a difficult principle with which to live. It is going to be difficult to decide when subsidiarity applies and when it does not. There is no explicit system or mechanism for assigning competence. It would not be appropriate to leave it to the European Court of Justice since it is clearly a political task—how political decision-making power is distributed—which falls outside its jurisdiction.

But, in my view, there are more fundamental problems with the principle of subsidiarity since it contradicts three other principles of the Maastricht Treaty: the convergence requirements for EMU, the cohesion principle and the Social Chapter.

Subsidiarity versus convergence

In accordance with the principle of subsidiarity, fiscal policy is left to national governments under the Maastricht Treaty. Each member state may use it as a basic stabilization instrument, expanding its budget deficit to combat recession and contracting it to rein in expansion.

However, the Treaty also imposes convergence criteria as part of the monetary union process that limit the size of government deficits to 3 percent of GDP and the level of public debt to 60 percent of GDP regardless of the stage of the business cycle.

There can be some exceptions: a deficit greater than 3 percent of GDP is permissible if it has declined substantially and continuously and reached a level close to 3 percent or, alternatively, if the excess over 3 percent is small, exceptional and temporary. Public debt over 60 percent of GDP is allowed if the debt to GDP ratio is falling toward 60 percent at a satisfactory pace.

But this does not really mitigate against the violation of the subsidiarity rule. For there is no conceivable economic justification for uniform reference values in the Treaty. Countries that are on a high growth path can sustain larger deficits than slow growing countries. Countries with high government debt should aim at deficits well below 3 percent of GDP or even surpluses. Countries with high levels of unemployment inevitably have higher deficits than countries with lower levels of unemployment. Moreover, the two fiscal requirements can easily be at odds with each other since a major reason for lowering levels of outstanding debt is to increase the room for fiscal manoeuvre in response to shocks and during
recessions. Achieving the debt target ought to lead to an easing of the deficit target.

At the same time, it is odd that there are no criteria for other aspects of economic performance in the Maastricht Treaty. For instance, it would make sense to include some standards of labor market flexibility and mobility in the Treaty, since labor mobility among regions and countries is a precondition for any group of countries forming an optimal currency area (Mundell, 1961).

The case for setting standards of this kind at the Union level seems stronger than it is for fiscal policy from the standpoint of efficient markets and the management of the business cycle.

Subsidiarity versus cohesion

However, weak Union-wide standards for fiscal policy would bring other problems. In particular, factor mobility can lead to fiscal competition between member countries, as Sinn (1993) has pointed out. This in turn will undermine “cohesion,” meaning the narrowing of disparities in real income within the Community (Article 2 of the Treaty). In fact fiscal competition already exists in the European Union: consider how much capital fled Germany for Luxembourg when Chancellor Kohl introduced a withholding tax on capital. Longer term, competition among member countries for attracting capital and qualified people could lead to significantly lower average tax across the Union rates and reduced resources at the national level for supporting the welfare state.

Furthermore, fiscal competition is likely to be directly regressive. For it leads to lower tax rates and higher expenditures on the more mobile factors of production at the expense of the less mobile: and the factors of production with the greatest mobility are capital, large corporations and high-income professionals. Taxes on fixed or less mobile factors like land, small and medium size companies and less well qualified labor, will tend to rise. Less mobile factors end up subsidizing more mobile factors.

So fiscal subsidiarity seems to bring it income redistribution from the poor to the rich and, in all likelihood, the minimization of the welfare state. Cohesion is likely to lose out unless there is harmonization of taxes on income and capital.

In fact, the experience of economic and monetary unions which have been operating successfully for more than a century across territories similar in size to the European Union suggests that something more may be needed—even central budget. This is certainly the experience of both the United States and Canada.
Why should this be so? The reason is that economic and monetary unions bring about a sectoral and spatial concentration of production as well as greater specialization. As the continental economy goes through business cycles and as its structure of production grows more specialized and concentrated, some regions inevitably suffer while others thrive. Central income taxation falls more heavily on booming regions, while central social expenditures fall on those in relative decline. So, if central budgets are large enough, these automatic stabilizers at the continental level achieve significant spatial income redistribution and can do much to alleviate serious regional and sectoral recessions (De la Dehesa and Krugman, 1992).

In Canada and in the United States, income tax and unemployment benefits are collected and distributed at the federal level. In the U.S., the federal budget is a little over half the size—55 percent—of the budgets of all state and local governments combined. To the extent that the per capita income in a region or a state falls below the national average, changing patterns of federal government taxation and expenditure automatically offset nearly 40 percent of the decline (Sachs and Sala i Martín, 1991). The rest of the adjustment is carried out by reductions in real wages, increases in unemployment and through emigration.

In the European Union, the Community budget scarcely equals 3 percent of the combined budgets of its members. (Moreover, 55 percent of this 3 percent is dedicated to agriculture and therefore benefits only 6 percent of the Community population.) If there were economic and monetary union today, changing patterns of Community taxation and expenditure could offset at most 1 percent of any local decline in income below the average of the Union. This means that 99 percent of the adjustment would have to be made in other ways and, given the rigidity of European labor markets, means there is little scope for migration or reductions in real wages, increases in unemployment in some regions are likely to be large (Eichengreen, 1990).

The protocol of the Maastricht Treaty creating the Cohesion Funds is supposed to address this problem but it does not do it very well. First, the Funds are small in relation to the GDP of the poorer member countries. Second, the Funds have to be spent mostly on physical and human infrastructure projects which disburse relatively slowly. Third, the Funds have a “conditionality convergence clause” that stipulates a member country or region suffering an asymmetric shock has to reduce its general government deficit to qualify, when in general the contrary ought to happen; its deficit should be allowed to expand while it receives Cohesion Funds so that both the
local and the central fiscal responses work together to make the adjustment process less traumatic.

Subsidiarity versus the Social Chapter

Finally, the so-called "Social Chapter" of the Maastricht Treaty is completely at odds with the principle of subsidiarity.

This Chapter calls for the progressive harmonization of labor market conditions. Behind this seems to lie a fear of "social dumping" in the richer member countries.

At present, the diversity among member countries is very wide. For example: social expenditure in terms of GDP varies from 16 percent to 30 percent; government contributions to social security payments ranges from 16 percent to 80 percent; annual working time goes from 1,700 hours to 2,025 hours; minimum wages are between 30 percent and 60 percent of average wages; and, to be eligible for minimum wage protection, workers have to be anywhere from 18 years old in some countries to 23 in others.

A case can be made for harmonizing health and safety conditions in the workplace. But to harmonize other labor market conditions will undermine the comparative advantage of the poorer member states in labor intensive goods and services. Given free play, this comparative advantage will expand labor demand and lead to higher wages in the poorer regions of the Union over time. The resulting convergence of income levels is the essence of cohesion.

If differences in labor costs are eliminated through the harmonization of labor market conditions, then the comparative advantage of poor regions in labor-intensive activities will go too. Worse still, if workers in these regions are less productive than average and firms are forced to employ them on the same terms, these firms will often fail in a single European marketplace. The result will be chronic regional recession and unemployment—like Eastern Germany after reunification, but on a larger scale.

The Social Chapter goes against both social cohesion and subsidiarity. It may benefit some low-skill workers in richer regions, but it will penalize more workers in the poorer member countries of the Union.

So the Maastricht Treaty embodies the principles of convergence and cohesion and gives great weight to the ideas of the Social Chapter, all of which are hard to square with the idea of subsidiarity in a monetary union. The fiscal convergence criteria will constrain fiscal subsidiarity. Yet, even so fiscal subsidiarity is likely to lead to fiscal competition and economic and social cohesion may well suffer as a result. And the social chapter, by imposing the harmonization
of labor market conditions, far from benefiting workers in the poorer regions of the Union, is likely to set cohesion back by undermining comparative advantage.

The ideas behind subsidiarity, convergence, cohesion and the Social Chapter may all be worthy ones but they are hardly compatible with true economic and monetary union in the form they appear in the Maastricht Treaty. When strong asymmetrical shocks disturb the European economy, the interplay of rules and principles embodied in the Treaty may not help the peripheral countries of the Union at all and may indeed worsen their plight.

Conclusion

These flaws in the Maastricht Treaty to do with subsidiarity are long term in nature. But otherwise the paradoxes discussed here are transitory ones. As Tommaso Padoa-Schioppa (1993) has pointed out, if the EMS is the problem, the single currency is the solution. The challenge is to know how to implement the solution as quickly and painlessly as possible.

One implementation issue is: Should a monetary union be formed as soon as possible by those who meet the convergence criteria, while others join later as they qualify? The Maastricht Treaty allows for such a two-speed solution after 1999. But this approach is not popular, lest it damage social cohesion to little purpose. Bayoumi (1994) has shown that as long as it lasted, such a currency union might raise the welfare of countries within it, but it would definitely lower the welfare of those left outside.

The measured approach of the Maastricht Treaty, incorporating the possibility of two speeds, was a politically expedient one when the Treaty was signed, but it did not address satisfactorily several of the economic paradoxes discussed here. The radical alternative, which is to “dive into the pool” and to adopt a single currency quickly, may appeal to some economists but it poses serious political problems: of sovereignty for the United Kingdom and Denmark; of monetary hegemony for Germany and France; and of lost opportunities for exchange rate adjustment for peripheral countries such as Spain and Portugal.

Some, such as Paul de Grauwe (1993), believe that the radical approach is possible for all the Union’s membership. De Grauwe considers it would make economic sense to go for monetary union without the convergence criteria. But he suspects that German insistence on convergence reflects their desire to restrict the number of countries participating in Union institutions and to maintain a dominant position for the Bundesbank in monetary decisions.
Indeed, it is easy to see why every member government that contemplates the loss of sovereignty involved in Economic and Monetary Union would shy away from an all-or-nothing, one step approach. And yet, at the same time, that loss of sovereignty seems to be a key element in resolving some of the enduring paradoxes of monetary union. For experience tells us that, without a strong central government, it is difficult for continental monetary unions to provide for regional adjustments to the inevitable economic shocks.

Perhaps the central EMU paradox is that the economic problems of transition call for one political solution, but the political problems of accession to the Treaty call for a different economic solution. Although I am confident that EMU will come about, it remains to be seen just how the economic and political obstacles to a satisfactory union will be overcome before the end of this century.
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Can the EMU Fly?
Peter B. Kenen

Introduction
The recent crises of the European Monetary System (EMS) have ignited a new debate about the plan for Economic and Monetary Union (EMU) contained in the Maastricht Treaty. Many say the plan is dead, and some are happy to say so—those who have always believed that the plan was unworkable and those who believe that EMU itself is undesirable. Others insist that the plan is alive and are equally happy to say so; they believe that the EMS crises have revealed the strength of the basic case for EMU, and they are probably right. But the 1992 crisis showed that the plan was unworkable in its original form, and it cannot be made to work unless the EU governments learn what they should from the 1993 crisis.

A Tale of Two Crises
If you have decided to read this essay, you already know what happened to the European Monetary System in 1992-93. But you may not be as familiar with another episode, the collapse of the Bretton Woods System in 1971-73, and there are remarkable similarities.

In both cases, the game played between governments and markets had made the exchange-rate regime very rigid, although the architects of both systems had sought to combine short-term stability with long-term flexibility. In the Bretton Woods System, there were only four exchange-rate changes in the 1960s involving
the key countries’ currencies,7 and there were no realignments in the EMS after the one in early 1987.

In both cases, the country at the center of the monetary system experienced a large political shock, underestimated its fiscal implications, and was then reluctant to pay the political price of correcting its mistake. In the first case, the political shock was the Vietnam war. In the second, it was German reunification. The exchange-rate effects were different, however, because the central banks responded very differently. As the costs of the Vietnam war became clear, there was at first a tightening of monetary policy in the United States, which ran a balance-of-payments surplus in 1968-69, but monetary policy was reversed thereafter, and the balance of payments moved back into deficit in 1970. In Germany, by contrast, the Bundesbank started to tighten monetary policy right after reunification, and it did not begin to reduce German interest rates until the eve of the EMS crisis in September 1992.

In both cases, moreover, the country at the center of the system was unable to negotiate an exchange-rate realignment, and it turned instead to methods that damaged the system itself. The methods were different, but the outcomes were similar. The United States acted provocatively in 1971 by closing the gold window and imposing an import tax. The Bundesbank acted surreptitiously in 1992 by questioning the viability of certain EMS exchange rates and thus using market forces to bring pressure on those rates.

Finally, there is a distressing similarity between the conclusions drawn by the official community after the crises were over. In the wake of the 1971 crisis, governments agreed to establish the Committee of Twenty and asked it to devise a system of “stable but adjustable” exchange rates. In the wake of the 1992 crisis, two EU bodies, the Monetary Committee and the Committee of Central Bank Governors, issued reports that called for more “timely” exchange-rate realignments to protect the EMS against future crises.8

The Aftermath of the 1992 Crisis

The two reports on the 1992 crisis were quite candid about the ambitious nature of the change they were proposing. It is never easy for governments to agree on the need to change exchange rates before market forces make them do so. Nevertheless, the two reports failed to explain how governments can contemplate “timely” realignments without first reinforcing the EMS against speculative pressures. The governors’ report raised the issue obliquely when it stressed the need to make market operators “aware of the risks of, and possible losses from, speculation,” but it did not go on to ask
whether, with a narrow band and more frequent realignments, the costs of speculation can be raised sufficiently.

Furthermore, the two reports were obliged to concede that the 1992 crisis had exposed a fundamental flaw in the defenses of the EMS. During the crisis, the Bundesbank drew attention to the so-called Emminger letter of 1978, by which it had obtained assurances from the German government concerning the extent of the Bundesbank’s obligations. The autonomy in monetary policies of the Bundesbank would particularly be put into jeopardy if strong imbalances within the future EMS resulted in obligations of extreme interventions which would then threaten the stability of our currency. This would make it impossible for the Bundesbank to carry out its legal obligations. Referring to the repeated assurances from the Chancellor and the Finance Minister, the Bundesbank starts from the premise that, if need be, the German government will safeguard the Bundesbank from such a constraint, either by a correction of the exchange rate in the EMS or, if necessary, by discharging the Bundesbank from its intervention obligation.

In other words, the Bundesbank could not be required to support its partners’ currencies, although any failure to do so would violate the rules of the EMS.

The two reports did not cite this reservation explicitly, but they came very close. In the words of the governors’ report, “there cannot be an automatic and mechanistic response to market tensions, involving symmetrical action on the part of the authorities of countries with weak and strong currencies.” The governors did not rule out voluntary action, such as concerted intramarginal intervention, provided it does not interfere with “control over domestic monetary conditions in the country issuing the intervention currency” and “is consistent with the primary objective of achieving price stability in the Community.”

Thygesen (1993, p. 50) has criticized the two reports for failing to affirm support for the post-crisis EMS parties and has cited this same passage in the governors’ report, saying that it was not “apt to convince market participants of any great firmness in the defense of the parity grid.” He misses the point. There could no longer be such firmness after the Bundesbank invoked the Emminger letter and thus opted out of mandatory intervention.

Unfortunately, the two reports did not draw the obvious inference. The EMS band had to be widened, as that is the only sensible way to raise the cost of speculation. But that did not happen until the 1993 crisis, when the band was widened hugely, from 4.5 percent to 30 percent. The decision was viewed at the time as a temporary
measure aimed at defusing the crisis. It is now widely seen, however, as the best defense of the weakened EMS.

The Crises and the Maastricht Treaty

The durability of the rigid EMS is commonly ascribed to the remarkably rapid progress toward monetary union made in the three years following the Delors Report. It is equally clear that the Danes' rejection of the Maastricht Treaty and, more importantly, the threat of a "no" in the impending French referendum helped to trigger the 1992 crisis. By raising doubts about the likelihood of EMU, they had two strong effects on foreign-exchange markets.

First, they made it seem less likely that Italy would adopt and implement the tough fiscal reforms that would be required by the Maastricht Treaty. If Italy failed to do that, moreover, its competitive position would continue to deteriorate, and a devaluation of the lira would be unavoidable. Second, they made it seem less likely that any EU country would be willing to endure high interest rates in order to defend its exchange rate against speculation.

It is less important today, however, to explain how the tribulations of the treaty contributed to the EMS crises than to understand the implications of those crises for the ultimate implementation of the treaty.

The first lesson is glaringly obvious. The path to EMU in the treaty is mined with deadlines for decisions much like the date of the French referendum, which are virtually certain to trigger speculation against certain currencies. The one most often cited is the final deadline—the date on which exchange rates will be locked, ruling out subsequent realignments. Governments deny that there will be a final realignment on the eve of EMU, and they may keep their word, but they cannot expect markets to believe them. Other deadlines in the Treaty are also worrisome. Sometime soon, for example, the Council of Ministers must decide whether any EU country is running an "excessive budget deficit" (see Box I). Before the end of 1996, moreover, the Council must decide which EU countries have satisfied the so-called convergence criteria, whether a majority of countries has satisfied them and, if so, when the final stage of EMU should start (see Box II). These deadlines will also provoke speculation—which will, of course, begin before the actual deadlines arrive.

The second lesson follows clearly from the first. It would be faddishly for the EMS countries to return to a narrow exchange-rate band at any time before the final locking of exchange rates. They must move to the third stage of EMU directly from the present wide
band. Does the Maastricht Treaty permit them to do that? Many people have said no, which is why they have concluded that the Maastricht plan for EMU is unworkable. Some have then suggested that EMU be reached by a different route; see, e.g., De Graauw (1994). Others have concluded that theEMU provisions of the Maastricht Treaty must be revised by the intergovernmental conference which will meet to review the treaty in 1996; see, e.g., Ludlow (1993). All of them are wrong.11

The Maastricht Treaty is not fun to read. The Delors Report is easier to follow. But many appear to believe that they are very similar, and they recall or invoke the report when they should look at the treaty. Those documents are quite different, and two of the key differences are relevant here. First, the Delors Report recommended that the European System of Central Banks (ESCB) be created at the start of the second (transitional) stage, so that there might be a

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**Box I. Defining an Excessive Deficit**

The Commission shall monitor the development of the budgetary situation and of the stock of government debt in the Member States with a view to identifying gross errors. In particular it shall examine compliance with budgetary discipline on the basis of the following two criteria:

(a) whether the ratio of the planned or actual government deficit to gross domestic product exceeds a reference value [3 per cent], unless:
   
   - either the ratio has declined substantially and continuously and has reached a level that comes close to the reference value;
   
   - or, alternatively, the excess over the reference value is only exceptional and temporary and the deficit remains close to the reference value;

(b) whether the ratio of government debt to gross domestic product exceeds a reference value [60 per cent], unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

If a Member State does not meet one of both criteria, the Commission must prepare a report, which shall also consider whether the government deficit exceeds government investment and shall take into account all other relevant factors, including the medium-term economic and budgetary position.

If the Commission considers that an excessive deficit exists or may occur, it shall address an opinion to the Council of Ministers. The Council shall, acting by a qualified majority on a recommendation from the Commission... decide after an overall assessment whether an excessive deficit exists.

Source: Treaty on European Union, Article 104c. Italicized passages are quotations from the Treaty, numbers in brackets come from the Protocol on the Excessive Deficit Procedure.
gradual transfer of decision-making power to the new institution. Thus,

...general monetary orientations would be set for the Community as a whole, with an understanding that national monetary policy would be executed in accordance with these global guidelines. Moreover, while the ultimate responsibility for monetary policy decisions would remain with national authorities, the operational framework necessary for deciding and implementing a common monetary policy would be created and experimented with.

There would thus be a seamless transition to EMU, and it would underpin another recommendation. Exchange-rate realignments would not be ruled out completely during the transition to EMU, but they would be made only in "exceptional" circumstances. Furthermore, "the margins of fluctuation ... would be narrowed as a move toward the final stage of the monetary union, in which they would be reduced to zero."[12]

Box II. Starting the Third Stage

The Council of Ministers, having received reports from the Commission and the EMI and acting on a recommendation from the Commission, shall assess

— for each Member State, whether it fulfils the necessary conditions for the adoption of a single currency;
— whether a majority of the Member States fulfill the necessary conditions....

Taking account of these assessments and the opinion of European Parliament and acting by 31 December 1996, the Council must then decide:... whether a majority of the Member States fulfill the necessary conditions for the adoption of a single currency; whether it is appropriate for the Community to enter the third stage, and if so the date for the beginning of the third stage. If by the end of 1997 the date for beginning the third stage has not been set, the third stage shall start on 1 January 1999, whether or not a majority of Member States meet the conditions for entering that stage. But the Council must first repeat the process outlined above to decide the eligibility of each Member State, and the process must be completed by 1 July 1998.

The decisions listed above will be taken by qualified majority voting. At the start of the third stage, however, the Member States that are entering that stage must decide unanimously to adopt the conversion rates at which their currencies will be linked and at which they will be replaced by the eau.

Source: Treaty on European Union, Article 109. Italicsized passages are quotations from the Treaty.
Both of these recommendations were rejected before or during the negotiations on the Maastricht Treaty. The first was rejected in deference to the “indivisibility of responsibility” for monetary policy. The creation of the ESCB was deferred until the third stage, and the European Monetary Institute (EMI) was established by the treaty to coordinate national monetary policies during the transition. But the EMI cannot issue instructions or compel cooperation, and the Bundesbank has rejected emphatically all of the many proposals made recently to simulate the “gradual transfer” recommended by the Delors Report. The progressive narrowing of the EMS band was considered briefly during the negotiations, but it was rejected precisely because it might limit national autonomy during the transition.

Article 109 of the treaty, which sets out the convergence criteria that countries must satisfy in order to enter EMU, does require participation in the exchange-rate mechanism of the EMS. But the language of the treaty and the corresponding protocol are remarkably loose (see Box III). In the two years before the decision on entry, a country must keep its currency within the “normal” EMS band “without severe tensions” and must refrain from devaluing its currency “on its own initiative.” But there is no numerical definition of the “normal” band, and the limitation on devaluation is not very strict. (Italy did not devalue “on its own initiative” in September 1992; Germany proposed the devaluation.)

If it can, of course, be argued that “normal” must mean 4.5 percent; no one involved in drafting the treaty had anything else in mind, certainly not 30 percent. (In fact, the only reason for using the term “normal” was to distinguish the 4.5 percent band from the transitional 12 percent band used by new entrants to the EMS—by Italy until 1990, and by Spain, Portugal, and Britain thereafter.) But nothing can prevent the EU countries from amending the EMS agreements to declare that 30 percent is now the “normal” band; they would have to agree unanimously on any such declaration, but there would be no need to submit it for ratification in each EU country, as would be the case if they chose instead to amend the treaty or the protocol.

The Path Ahead: A Proposal

If the band should not be narrowed before the decision to enter the final stage of EMU, what should be done when that happens? Should exchange rates be locked at their central rates or at the actual market rates prevailing on that date? Consider a proposal that would help meet three objectives: defending the EMS against
speculative pressures; giving the private sector as much lead time as possible to plan and prepare for the locking of exchange rates; and simplifying the structure of exchange rates at which the locking will take place. 14

The EU governments should announce immediately that they will not narrow the band and will not alter any central rate by more than 10 percent. At the same time, they should undertake a general realignment designed to round off the values of their currencies in

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**Box III. The Convergence Criteria**

Before 31 December 1996, the Commission and the EMI must report to the Council on the progress made by Member States in meeting their obligations regarding the achievement of economic and monetary union. The report shall examine the achievement of a high degree of sustainable convergence by reference to the fulfillment of the following criteria:

- The achievement of a high degree of price stability, which the protocol on the convergence criteria interprets as meaning "an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1 percentage points that of, at most, the three best performing Member States in terms of price stability."

- The sustainability of the government financial position, which the protocol interprets as meaning "that at the time of the examination the Member State is not the subject of a Council decision that an excessive deficit exists."

- The observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System, for at least two years, without deviating against the currency of any other Member State, which the protocol interprets as meaning that the Member State has respected the normal margins "without severe tension" and has not devalued "on its own initiative."

- The durability of convergence achieved by the Member State and of its participation in the exchange-rate mechanism, which the protocol interprets as meaning that "over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than two percentage points that of, at most, the three best performing Member States in terms of price stability.

The Commission and EMI shall also consider the development of the ECU, the results of the integration of markets, the situation and development of the balance of payments on current account, and an examination of the development of unit labour costs and other price indices.

Source: Treaty on European Union, Article 109. Italicized passages are quotations from the Treaty.
terms of the ECU. Finally, they should announce that the locking of exchange rates, if it occurs on a date chosen in January 1997, will take place at the central rates prevailing on 30 June 1996, thus promising not to realign exchange rates during the final run-up to EMU. If this declaration is widely believed, market rates will converge to the corresponding central rates during the run-up to EMU, if not for all EU currencies, at least for those of the “core” countries—the ones that are commonly seen to be the strongest candidates for entering EMU as soon as it begins. Markets will have no reason to expect one more realignment on the eve of the third stage, and no government will be allowed to engineer a depreciation of its currency in order to secure a competitive advantage before the locking of exchange rates.

What should governments say if they decide in 1997 not to set a date for starting the third stage? They need not say anything. They will probably face severe exchange-market pressures if they delay the decision, no matter what they say, but they can resist them more easily if they stay with the wide band rather than move back to the old narrow band. If they can fend off those pressures, moreover, they will be able to promise again that there will be no realignment in the six months before the locking of exchange rates that must take place on January 1, 1999.

There is room within this framework for individual governments to adopt their own exchange-rate policies. Some governments might choose to follow the French example by keeping the market rates for their currencies close to the prevailing central rates. Some might choose to keep the two together by altering their central rates, and they would not be barred from doing that if they did not violate the injunction against big realignments, if they obtained their partners’ consent, and if they made no changes during the run-up to EMU. Finally, some governments might be content to let market and central rates diverge and thus count on market forces to bring them back together before the start of the third stage.

De Grauwe (1994) would like us to learn another lesson from the recent EMS crises. The irrevocable locking of exchange rates may not be perfectly credible. Therefore, he wants EMU to start with a full-fledged currency reform; the ECU would replace the national currencies on the first day of the third stage. His concern, however, derives from his belief that the locking of exchange rates will be maintained in the usual way—official intervention on the foreign-exchange market. That should not and need not be true.

It must be remembered that the locking of exchange rates will be accompanied by the creation of the ESCB, which will start at once.
to implement a single monetary policy for the ESCB countries. It cannot do that, however, unless certain steps are taken immediately to unify the payment systems of the ESCB countries and thus create a single interbank market for central-bank money. To this end, the convertibility of each national currency into ecu and, by implication, into all other ESCB currencies must be maintained at par, over the counter, by the national central banks, not through the foreign-exchange market, and no national central bank can be allowed to opt out of that obligation. It can, in fact, have no reason for wanting to opt out, because it will have no basis for concern about the money-supply effects of its operations in its partners’ currencies (or about its “reserve” position vis-à-vis the rest of the ESCB). There will be no national money supplies in any meaningful sense, even though national currencies will still be used at the “retail” level. As I have pointed out before (Kenen, 1992), the effects of swapping one national currency for another will be no different from the effects of a switch between the Federal Reserve Notes issued by different Federal Reserve Banks in the United States.

The Hard Part

I have argued that the EMS crises and the widening of the band need not deflect the EU countries from the path to monetary union defined by the Maastricht Treaty. The crises themselves, moreover, have strengthened the basic case for EMU. They have shown that narrowly pegged exchange rates cannot be maintained indefinitely in a world of high capital mobility. Hence, the EU countries must either learn to live with the loose form of the EMS to which they retreated in 1993 or move on to monetary union as rapidly as possible. Those conclusions, however, do not imply that the Maastricht Treaty can lead easily to EMU. There is another obstacle. No EU country will be allowed to enter EMU if it is subject to a finding by the Council of Ministers that it has an “excessive” budget deficit. The Council must make such a finding, moreover, whenever a country fails to meet one or both criteria set forth in the treaty (see Box 1), and if those criteria were applied today, only one country (Luxembourg) could satisfy them fully.

This is not the place to debate the underlying analytical issue—whether “excessive deficits” should be prohibited because they are harmful intrinsically or could limit the independence of the ECB and interfere with the pursuit of price stability. But two points should be made.

Those who insist that the fiscal provisions of the treaty must be applied “narrowly and strictly” have to be reminded that the clauses
qualifying each criterion are themselves parts of the treaty and cannot be ignored. A country having a government debt larger than 60 percent of its gross domestic product can claim to have met the debt criterion strictly if its debt ratio “is sufficiently diminishing and approaching the reference value at a satisfactory pace.” Furthermore, the Council of Ministers must make an “overall assessment” rather than apply the criteria mechanically.

Nevertheless, the fiscal provisions of the treaty took effect at the start of the second stage, on 1 January 1994, and the implementation of the “excessive deficit procedure” cannot be delayed until budget deficits have started to shrink and debt ratios have started to fall. Once a finding is made, moreover, it will be hard to rescind unless the country concerned has made very visible progress. It is therefore extremely difficult to see how EMU can start before 1999 unless the fiscal provisions of the treaty are revised or rescinded in 1996. It is equally hard to believe, however, that this vexing issue can be reopened in 1996 without reopening other EMU-related issues, including the 1999 deadline. Hence, 1996 may come to be another landmine in the path to EMU and, therefore, another reason for not narrowing the band.
Endnotes

1 Those who want to refresh their memories should consult the brief account and detailed chronology in the International Monetary Fund's World Economic Outlook, October 1993.

2 The 1961 revaluation of the Deutschemark (and Dutch guilder), the 1967 devaluation of the pound, the 1969 devaluation of the French franc, and the 1969 revaluation of the Deutschemark (following a brief float).

3 Monetary Committee of the European Community, Lessons to be Drawn from the Disturbances on the Foreign Exchange Markets (26 May 1993), and Committee of Governors of the Central Banks of the Member States of the European Economic Community, The Implications and Lessons to be Drawn from the Recent Exchange Rate Crisis (22 May 1993).

4 Emminger (1986). The translation given here is the one provided by Begg and Wyllie (1993, p. 18), who also quote a statement by the Minister of Economics that the Bundesbank "has the responsibility to intervene, and the option not to intervene if it is its opinion that it is not able to do so" (Begg and Wyllie, 1993, p. 11). They then ask how the German government could make two different commitments—one to the Bundesbank and the second to the other EMS participants. Conversations with participants in the EMS negotiations of 1976-79 lead me to conclude that the other participants were not notified formally of the agreement with the Bundesbank, although they were surely aware of the Minister's statement.

5 The same objection applies to the proposals by Collignon et al. (1993), under which "core" EU countries moving rapidly to EMU would not have to repay reserve credit drawn during the transition. That would merely reinforce the Bundesbank's reluctance to provide such credit.

6 Williamson (1992) made this point at the time, but he combined it with other suggestions that diminished its appeal; see the comments by Fortes (1993). According to Britton (1993), the Bundesbank favored a temporary widening of the band during the discussion of the two reports.

7 The EMS band is usually defined by the distance between a currency's central rate and the edge of the band, which was 2.25 percent initially but was widened to 15 percent. The width of the whole band, above and below the central rate, is thus twice that distance.

This is, of course, the sense in which the EMS crises reflected the effects of "self-fulfilling expectations." The concept is developed formally by Eichengreen and Wyplosz (1993) and articulated even more clearly by Eichengreen (1993); see also Obstfeld (1994).

This point was made by Freoet and Rogoff (1992), who argued that the high-debt EU countries would want to reduce their real debts by devaluing their currencies. See also Kenen (1992), where I argued that there might be need for a fiscal realignment to restore the competitive positions of the high-inflation countries even if inflation rates had converged completely before the locking of exchange rates. Thygesen (1994) points out that the recent realignments have reduced this risk by offsetting previous price-level divergences, but competitive positions may diverge again if exchange rates are not locked until 1999.

Some recent writers, notably Artis (1994), have taken the position developed below, that the treaty allows a leap from a wide band directly to EMU. Others favor such a leap but believe it to be incompatible with the treaty. They include Fratianni, von Hagen, and Waller (1992), who favor freely floating rates during the transition to EMU, because they fear that governments will reimpose exchange controls to defend the EMS, and that prospect horrifies them.


See Deutsche Bundesbank (1992) and Rieke (1994); the recent proposals include those of Artis (1994), Collignon et al. (1993), Ludlew (1993), and Thygesen (1994), some of which would use an EU monetary aggregate to coordinate national monetary policies.


On the lead time required for the conversion, see Burridge and Mayes (1994); on the importance of rounding, see Giovannini (1991) and Goodhart (1993).

It should be possible to do that for several currencies without changing any bilateral exchange rate by more than five percent.

The quoted phrase comes from the resolution adopted by the Bundestag when it ratified the Maastricht Treaty.
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