Committee of Governors of the
Central Banks of the Member States
of the European Economic Community

Secretariat/Economic Unit

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Confidential

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Policy dilemmas in the exchange rate mechanism in 1991

- Note for discussion -

I. Introduction

During the first ten months of 1990 the relative weakness of the Deutsche Mark within the exchange rate mechanism (ERM) allowed other members to narrow their interest differentials vis-à-vis Germany and to accumulate foreign exchange reserves. Since early November, however, signs of tension emerged in the system against the background of widening cyclical divergence between Community countries.

While there is full agreement that the overall monetary stance in the Community should promote progress towards price stability, recent changes in relative levels of economic activity in individual Community countries could call for a greater differentiation of national monetary policies without jeopardising the overall objective. However, given the exchange rate commitment under the ERM, there are in practice narrow limits to changes in the relative stances of monetary policies and central banks may therefore face a policy dilemma between internal and external objectives. In particular, if interest rates in Germany remain high, or increase further, because of strong demand pressures, this may add to strains in the ERM. In this event, higher interest rates elsewhere in the system would reduce exchange rate tension, but at the cost of exacerbating the economic slowdown.

The purpose of this note is to describe briefly the available policy options and to suggest some issues for discussion.

Recent developments

The Deutsche Mark has regained strength following the rise in the Lombard rate on 1st November 1990 (see Graph 1). Although this increase was largely technical, market participants seem to have perceived it as a reaffirmation of the Deutsche Bundesbank's commitment to pursue a non-accommodating monetary stance in the face of the buoyant demand and fiscal pressure stemming from unification. At the same time, recent economic indicators in other ERM countries suggest that economic activity may be weakening more rapidly than previously envisaged, despite the stimulus from German demand. Although the relative cyclical position of other ERM countries continues to differ (see Graph 4), the slowdown is fairly widespread, and is leading to downward revisions to growth forecasts in 1991. At the same time, several countries have experienced some downward pressure on their exchange rates. To date this has been countered by combinations of increases in interest rates, exchange market intervention and some downward movement of exchange rates within the respective bands (see Graphs 1, 2 and 3).

While these policy responses have so far succeeded in preserving stability within the ERM, there is a risk that recent tensions may mount in 1991 and that the EC central banks will be faced with difficult policy choices - even in the absence of further adverse external shocks, such as a rise in the oil price, a sharp depreciation of the US dollar or a recession in the United States. The choices for monetary policy depend to an important extent on the contribution fiscal policy can be expected to make.

II. Policy options and dilemmas

1. Fiscal policy

With monetary policy geared to the attainment of price stability, changes in the fiscal stance could in principle moderate the cyclical divergence and reduce exchange rate tensions. However, in practice fiscal policy is likely to be seriously constrained in 1991. In Germany where fiscal policy has recently been loosened considerably, greater fiscal restraint would reduce the pressure on monetary policy - not only in Germany but also in other Community countries. However, political

priorities seem to rule this an unlikely prospect in the near future. In most of the other ERM countries, the existing high fiscal burden (either in terms of the level of public debt or of the budget deficit) implies that there is little or no room for a fiscal easing to cushion the impact of a slowdown in growth (see Graph 5). If growth slows markedly, the automatic budgetary stabilisers, in the form of lower tax revenue and higher social welfare payments, may offer some relief, but the trend toward medium-term consolidation of the fiscal position should remain an important policy priority. Countries with low deficits and debt ratios, for example, France and the United Kingdom, may have some scope for easing fiscal policy to support activity, but there are clear limits if fiscal fine-tuning is to be avoided. Moreover, any perceived loss of fiscal discipline could have adverse effects on confidence in the foreign exchange market.

In conclusion, with little prospect of a significant contribution from fiscal policy, much of the task of reconciling conflicting objectives is likely to fall on monetary policy.

2. Monetary policy

If faced with a weakening cyclical situation and a possible build-up of tensions in the system, the central banks will have to address two interrelated questions. Firstly, should the overall stance of monetary policy (even though difficult to define in precise quantitative terms) be reconsidered? Secondly, how should the relative stance of monetary policy in individual countries be adjusted?

As regards the first question, all Community central banks have reaffirmed in the recent ex ante consultation their willingness to persevere with non-accommodating policies in 1991. While evidence of a more rapid economic slowdown in some Community countries may be seen to have widened the scope for a less restrictive overall stance, a departure from present policies could entail considerable risks at this juncture. Not only does the actual price performance in all Community countries (see Graph 6) fall short of the stated goals, there is still the need to forestall second-round effects from the oil price rise and to send signals to wage negotiators. Moreover, the great uncertainty regarding external developments cautions against an early reorientation of the Community's monetary policy.

If the overall stance remains broadly unchanged with respect to previously announced intentions, decisions on relative monetary policies will have to weigh domestic growth considerations against the maintenance of exchange rate stability. If a realignment is to be avoided, the exchange rate constraint obviously implies that strong currency countries may have to consider easing monetary conditions and/or monetary policy may have to be tightened further in countries experiencing downward pressure on their currencies.

On the assumption that the Deutsche Mark remains the principal strong currency, the first option would imply a relaxation of monetary policy by the Deutsche Bundesbank which could help to reduce tensions in the ERM by lowering (or at least preventing a further rise in) Deutsche Mark interest rates. However, given the strong domestic demand pressures and the high rate of capacity utilisation in Germany, such a policy change would not be compatible with the objective of price stability and may severely undermine the role of the Deutsche Mark as the nominal anchor of the ERM. Moreover, the easing of German monetary policy might be associated with a more general shift to a more accommodating policy stance in the Community and may thus have adverse repercussions for the process of convergence to a low level of inflation.

The second option would imply that the other ERM countries adjust their monetary policy in line with monetary conditions in Germany, i.e. raise interest rates if necessary to underpin their currencies' exchange rates vis-à-vis the Deutsche Mark. But this would, at least in the United Kingdom and, to a lesser extent, in France, Italy and some of the smaller ERM countries, reinforce the slowdown of economic activity and thus be considered inappropriate from a domestic point of view. Moreover, higher interest rates would tend to exacerbate the budgetary problems in countries with high public debt or large deficits. Nonetheless, to the extent that the economic costs with respect to output and fiscal positions can be accepted, this second option would enhance the anti-inflation credibility of the system. In particular, if the decision to keep interest rates in the ERM high is understood by markets as a signal of the strong commitment by the authorities to maintain existing central parities, even in such an uncertain environment, then the risk premium that investors require to hold non-Deutsche Mark currencies might well decrease, thus allowing an eventual reduction in interest rates vis-à-vis Germany.

3. Exchange rate flexibility

In the short run, countries may wish to make greater use of the room for exchange rate movement within the bands. However, account should be taken that, with the possible exception of the Spanish peseta, the available room for movement within the band may not be sufficient to cope with tensions. Moreover, this room may not be fully exploitable in the present environment of uncertainty. In particular, any attempt to let currencies move close to their limits may fuel market participants' expectations of a realignment and thus prove counterproductive in the sense that weak currencies would require higher interest rates to compensate for the perceived higher exchange rate risks.

If none of the policy choices described so far would be acceptable to the Community central banks as a group, the ultimate option would be a realignment of central parities. While a generalised realignment could stimulate economic activity in the devaluing countries and reduce inflationary pressures in the revaluing countries, this option is not without significant risks. In particular, it could damage the credibility of the "hard currency policy" in the ERM which has been built up in the past and which, despite some widening of interest rate spreads recently, has over time allowed a narrowing of interest rate differentials. Moreover, the realignment would add to inflationary pressures in the devaluing countries and, if the gain in competitiveness is not to be quickly eroded, this would not free them from following tighter monetary policies.

III. Issues for discussion

The previous section has shown that in the event of more pronounced and persistent tensions in the ERM the Community central banks will be confronted with very difficult policy choices. Indeed, all policy options have significant, albeit different, economic costs for individual countries and the Community as a whole.

It is against this background that the Committee of Governors may wish to address the following issues:

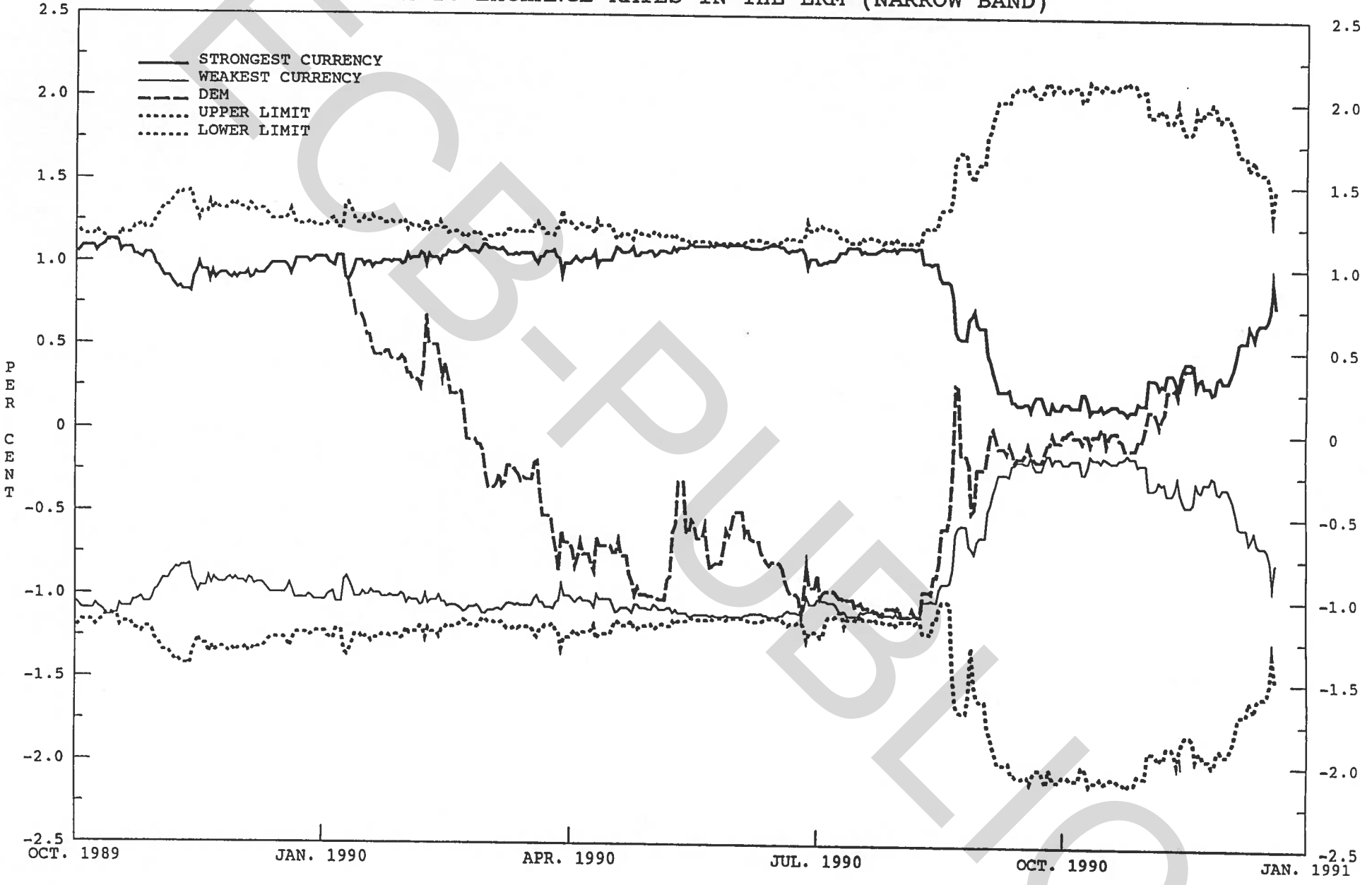
1. On the assumption that no contribution is made by German fiscal policy to relieve the burden on monetary policy (both in Germany

and elsewhere), what, if any, scope is there for the Deutsche Bundesbank to adjust monetary policy in the face of strong domestic demand pressures in Germany, and given the stated objective of achieving price stability in the Community?

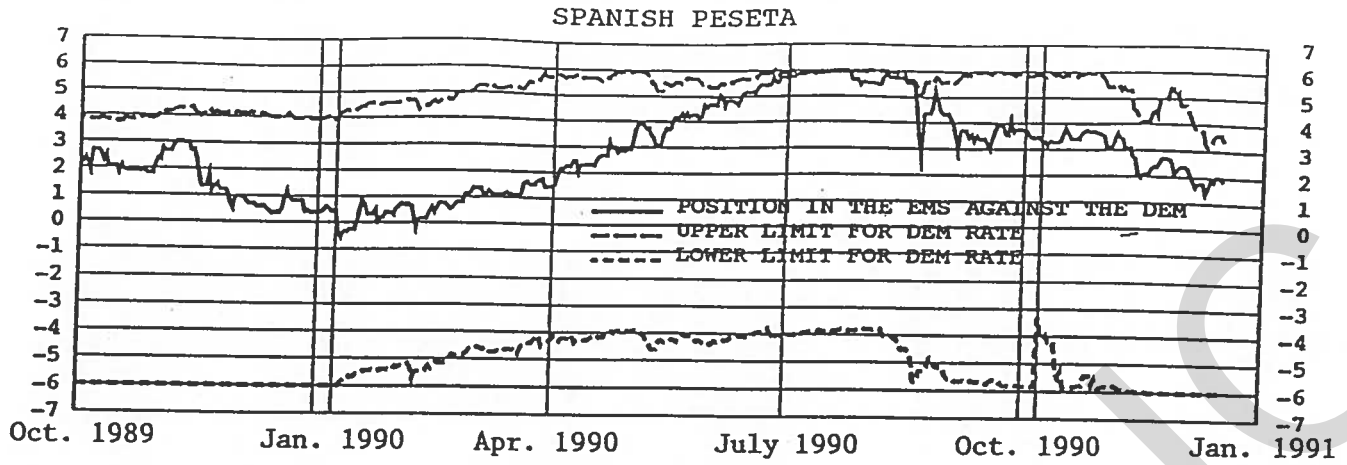
2. If fiscal policy on the whole is not expected to make a contribution and on the assumption that German monetary policy remains tight, the policy choices of other ERM countries would ultimately be confined to two options: either to follow German monetary policy (which would strengthen the disinflationary process although at the expense of a more rapid slowdown in economic activity) or to consider a realignment of ERM parities (involving a revaluation of the Deutsche Mark). Under the first alternative, the adjustment of monetary conditions in line with those of Germany is likely to raise domestic interest rates but may in the longer run help to reduce the differentials vis-à-vis German interest rates. Under the second alternative, a realignment might allow a temporary decoupling from German monetary policy, but there is also the risk that credibility will be undermined and increased exchange rate risk premiums will push up domestic interest rates outside of Germany. How do Governors weigh the economic benefits and costs of these alternative responses, in particular when effects on interest rates are taken into account?

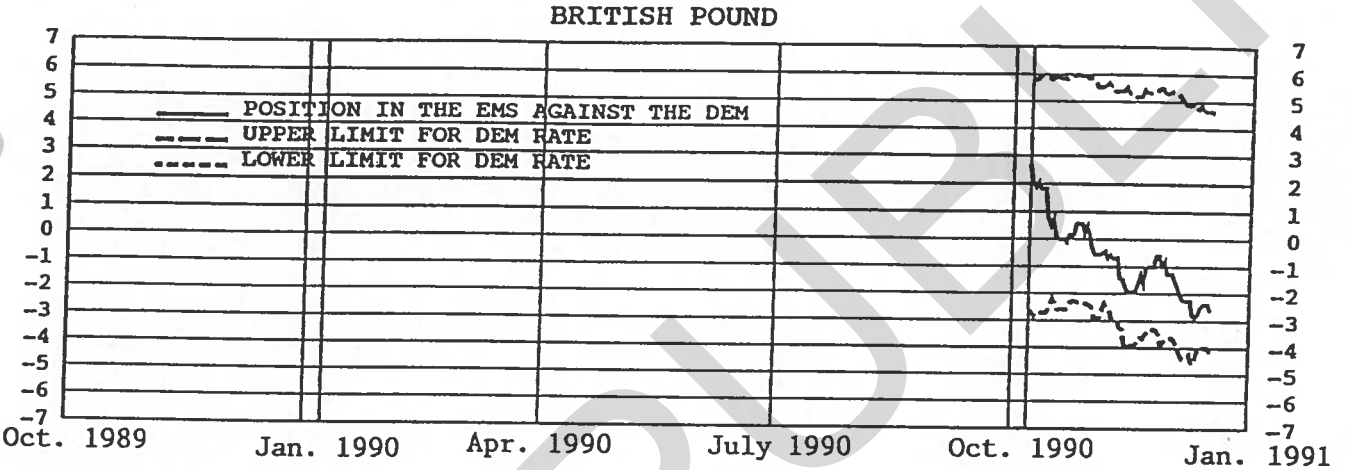
3. The policy problems outlined above have so far been manageable and whether the policy dilemma will become more acute in the future is impossible to predict. Much will depend on the duration and the extent of the cyclical divergence and on exchange market sentiment vis-à-vis individual Community currencies (especially the Deutsche Mark). External factors, such as oil prices, developments in the Gulf, movements of the US dollar and the economic situation in North America will also play an important role in the choice of policy responses. Given these uncertainties, would it be appropriate to maintain the present monetary policy stance for the time being but to stand ready for a closely co-ordinated response should the situation worsen?

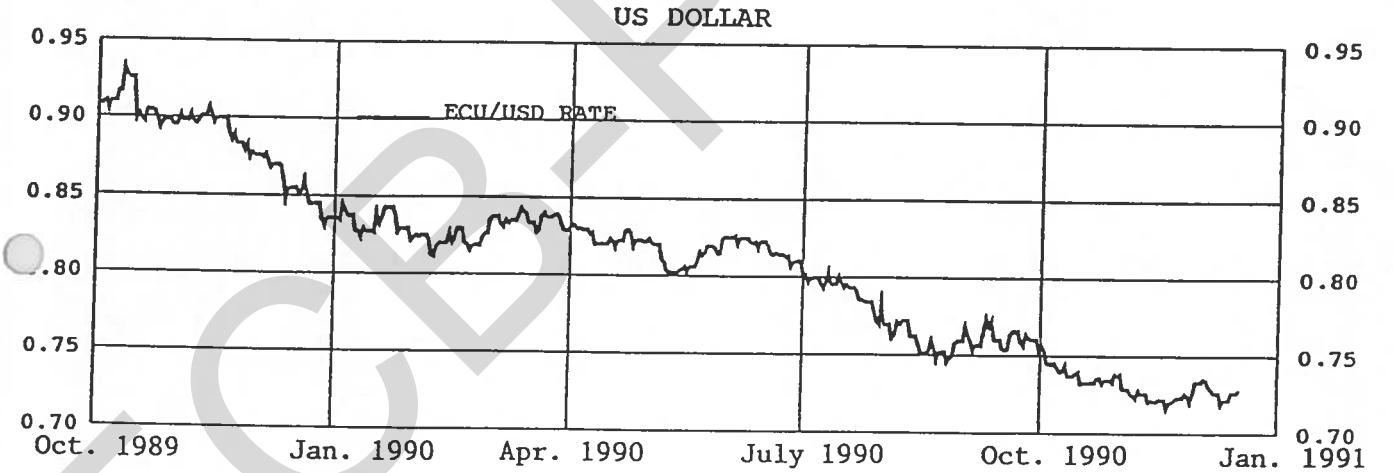
GRAPH 1: EXCHANGE RATES IN THE ERM (NARROW BAND)

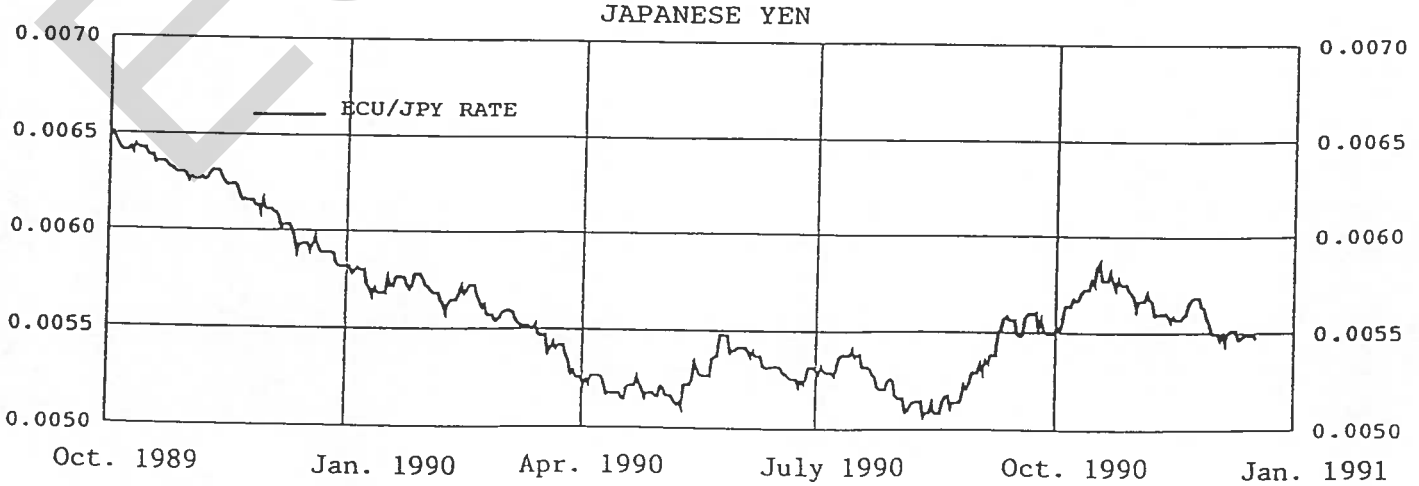


GRAPH 2: RECENT EVOLUTION OF WIDE BAND CURRENCIES, ECU/US DOLLAR AND ECU/YEN EXCHANGE RATES.

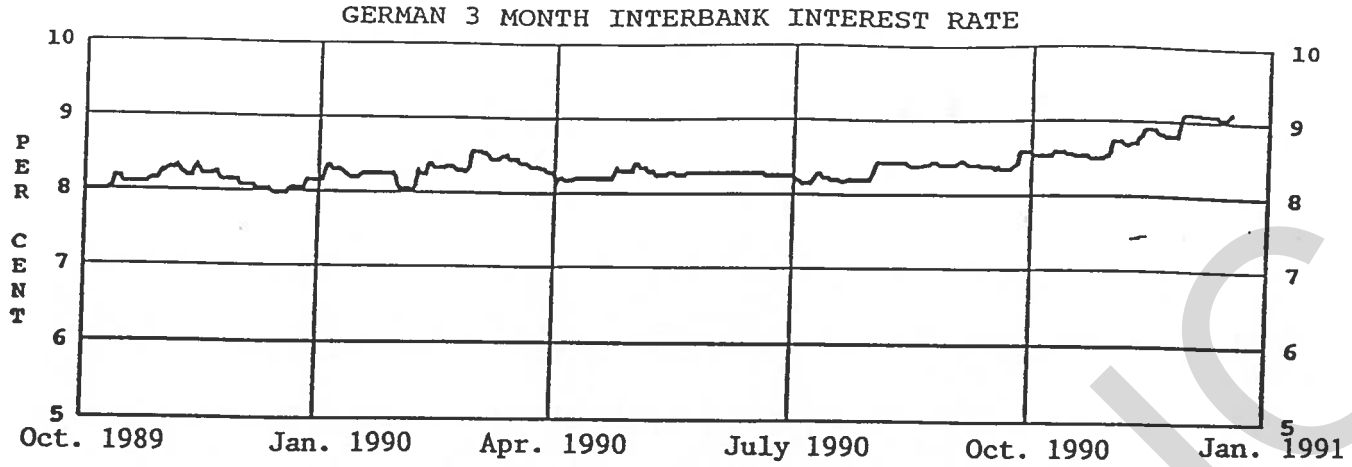


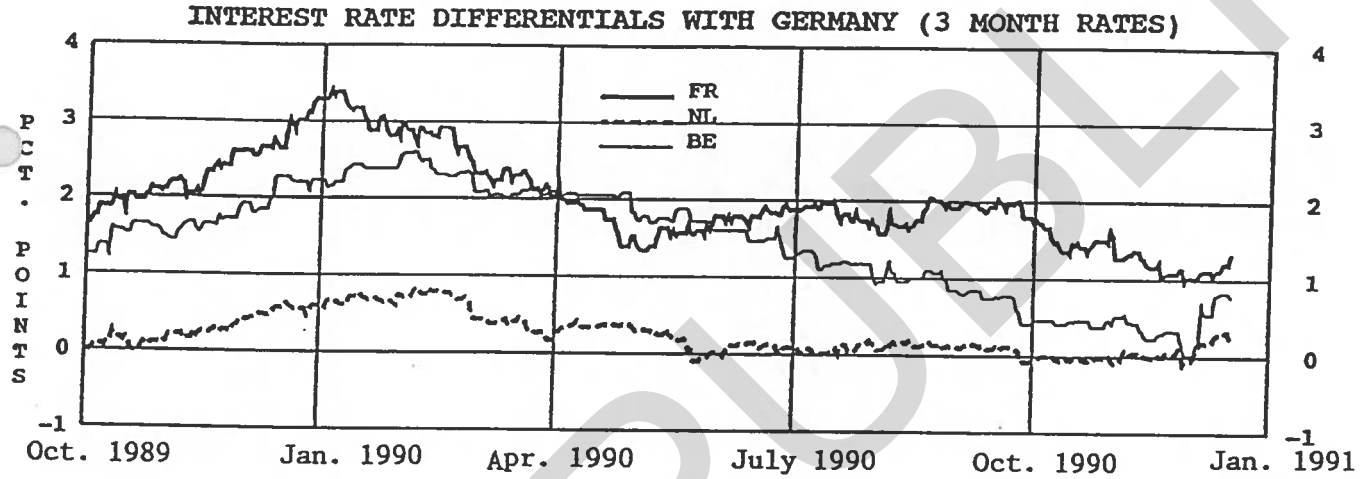


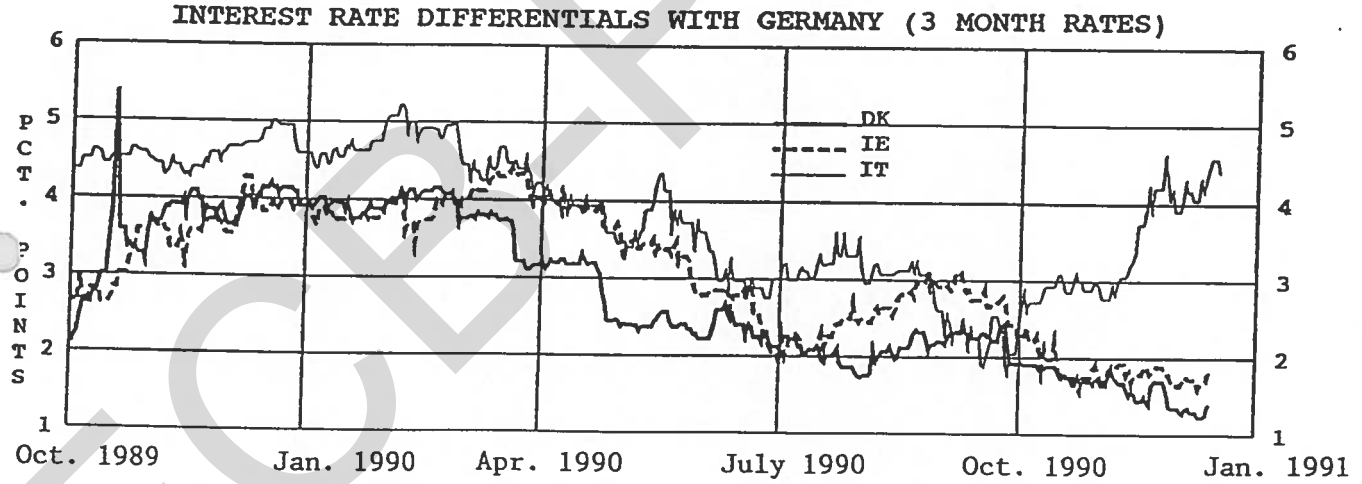


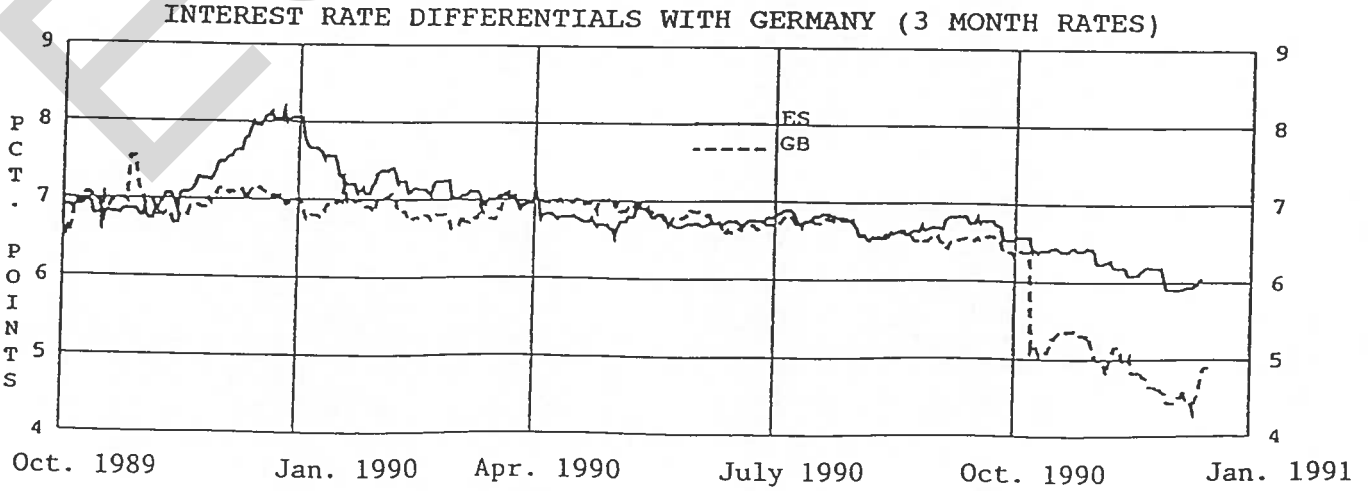


GRAPH 3: SHORT-TERM INTEREST DIFFERENTIALS

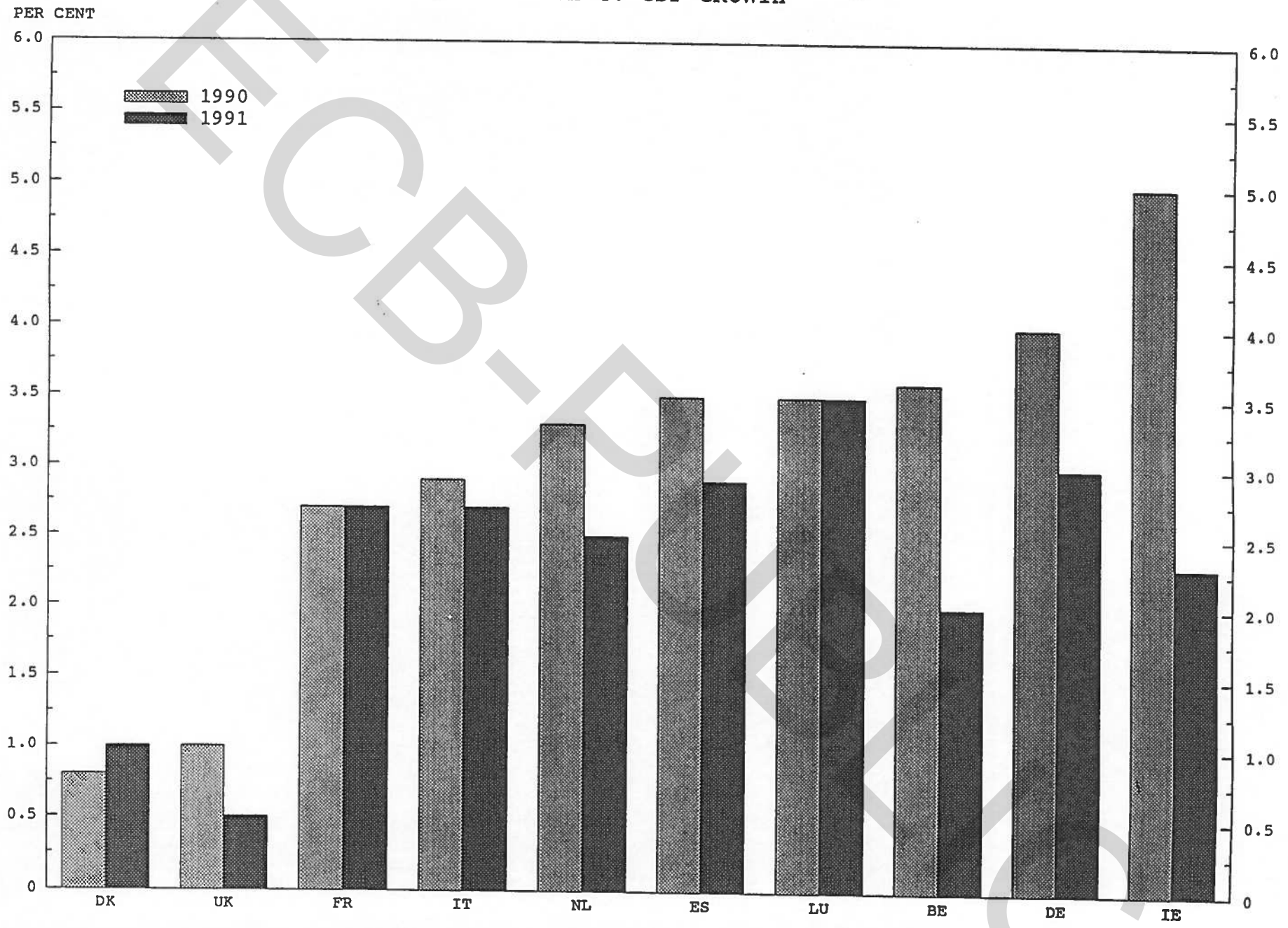






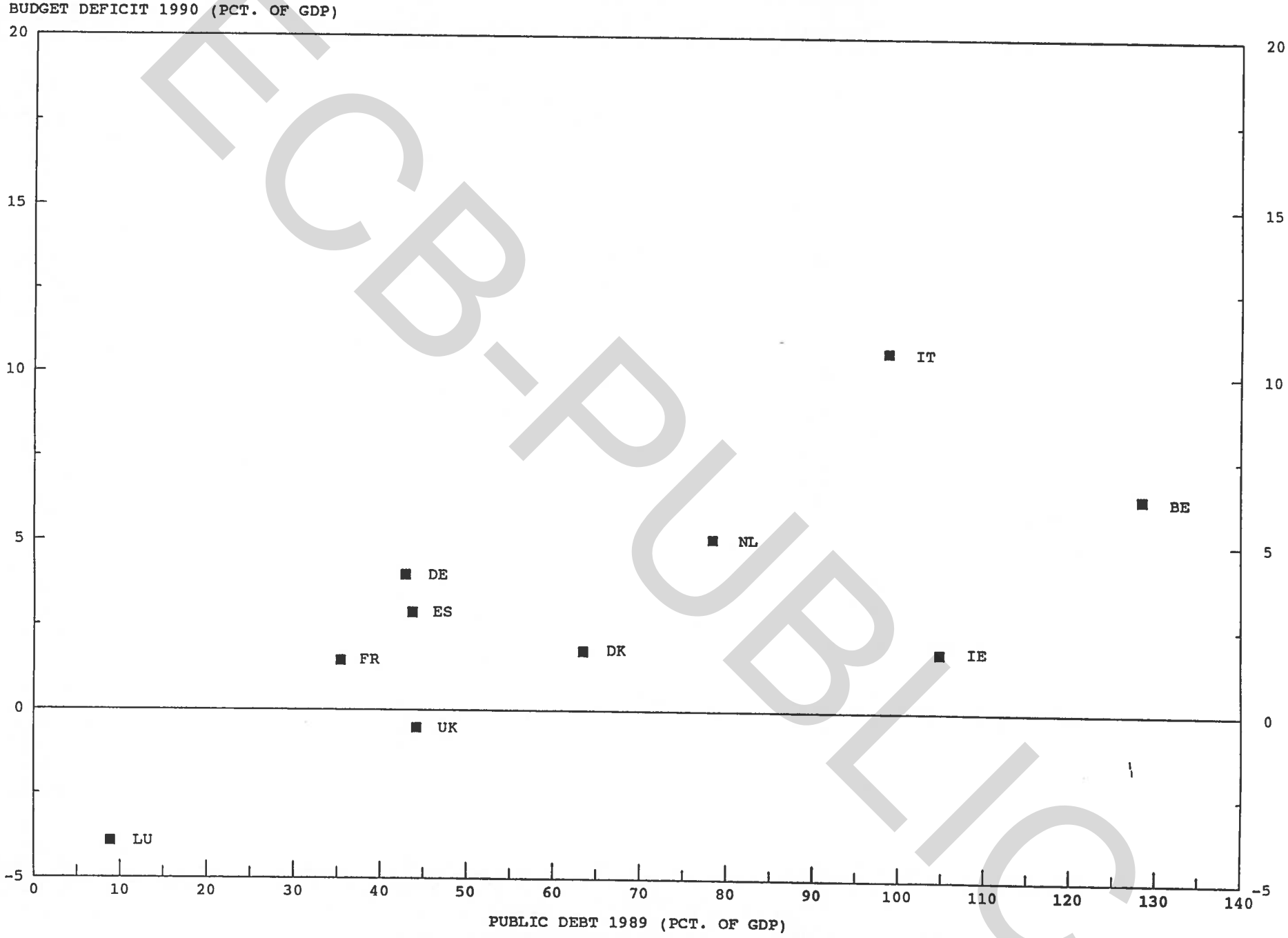


GRAPH 4: GDP GROWTH

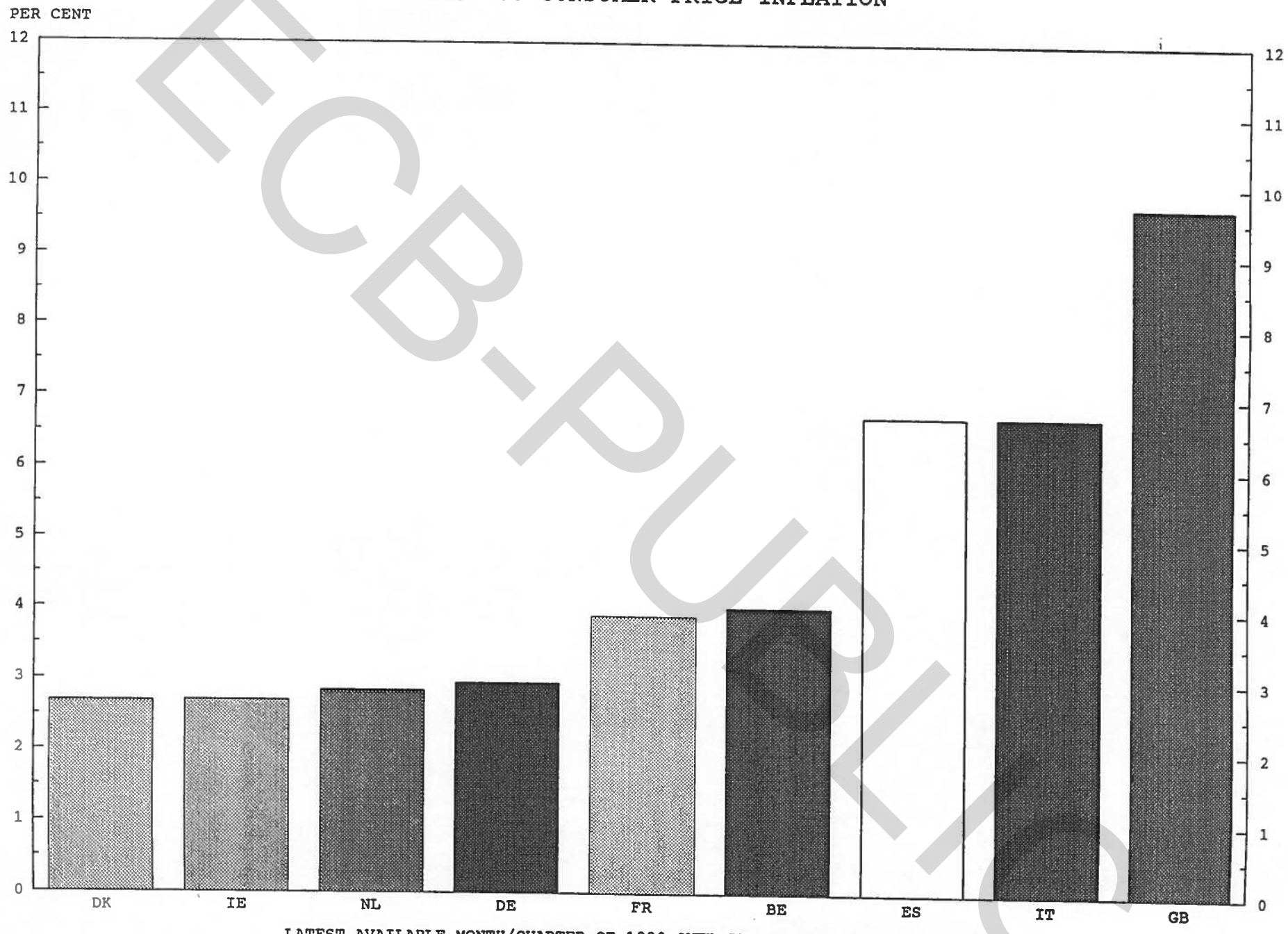


SOURCE: MONETARY POLICY SUB-COMMITTEE REPORT NO.1 (INCLUDING UPDATES SUPPLIED PRIOR TO THE GOVERNORS DISCUSSION IN DECEMBER)

GRAPH 5: FISCAL POLICY INDICATORS



GRAPH 6: CONSUMER PRICE INFLATION



POLICY DILEMMAS IN THE EXCHANGE RATE MECHANISM IN 1991

I INTRODUCTION

During the first ten months of 1990 the relative weakness of the Deutsche Mark within the exchange rate mechanism (ERM) allowed other members to narrow their interest differentials with Germany and to replenish their foreign exchange reserves, as the pressures in the system which had developed following the collapse of the Berlin Wall were released. Since early November, however, signs of tension in the system have re-emerged as the widening cyclical divergence between participants has been cast into sharper relief.

There is a risk that recent tensions may persist and indeed intensify in 1991. Interest rates in Germany are likely to remain high, tending to underpin interest rates elsewhere. Although this environment of high interest rates would promote more rapid disinflation in the face of high oil prices, countries undergoing a sharp cyclical slowdown may nevertheless be faced with a serious policy dilemma if exchange rates come under strain.

Recent Developments

The Deutsche Mark has come under renewed upward pressure following the rise in the Lombard rate on November 1. Although this increase was largely technical, it nevertheless underlined the Bundesbank's commitment to the pursuit of a non-accommodating monetary stance in the face of the intense demand and fiscal pressure stemming from unification. On the other hand, recent economic indicators in other ERM countries suggest that activity may be weakening more rapidly than previously envisaged despite the stimulus from German demand. This trend is fairly widespread, and is leading to downward revisions to growth forecasts in 1991. Although the relative cyclical position of other ERM countries continues to differ, in most of them there has been some downward pressure on the exchange rate. To date this has been countered by combinations of increases in interest rates, foreign exchange intervention and some downward movement of exchange rates within the respective bands.

The following sections examine the policy options for 1991, although decisions taken in the relatively near term will clearly be coloured by judgements surrounding the duration of the unification shock in

Germany, and of the prospective easing of demand pressures in 1992 and thereafter. The discussion is based initially on the assumption that there is no additional external shock, for example, from the dollar or the oil price.

II POLICY OPTIONS AND DILEMMAS

Fiscal Policy

Providing that monetary policy is geared to the attainment of price stability a more differentiated fiscal stance could in principle moderate the cyclical divergence and reduce exchange rate tensions, in practice fiscal policy is likely to be seriously constrained in 1991. A tightening of fiscal policy in Germany would be the preferable policy option, as it would reduce the pressure on monetary policy not only in Germany, but also in other Community countries. Nevertheless, political priorities rule this an unlikely prospect in the near future. In most of the other ERM countries, the existing high fiscal burden (either in terms of the level of public debt or of the budget deficit) implies that there is little or no room for a fiscal easing to cushion the impact of a slowdown in growth. If growth slows markedly, the automatic budgetary stabilisers, in the form of lower tax revenue and higher social welfare payments, may offer a little relief, but the trend towards medium term consolidation of the fiscal position is likely to remain an important policy priority. Countries with low deficits and debt ratios, for example, France and the United Kingdom, are better placed to consider an easing of fiscal policy to support activity, although this would run against the desire to avoid fiscal fine tuning. In addition, any perceived loss of fiscal discipline could have adverse effects on confidence in the foreign exchange market.

In the event that fiscal policy is severely constrained both in Germany and in the other ERM countries, other policy options ought to be considered if exchange rate pressures intensify.

Monetary Policy

One option, at least in theory, to help ease exchange rate tensions inside the ERM, would be a shift towards an accommodating monetary stance by the Bundesbank. However, this change in German monetary policy would be very costly both in terms of undermining price stability in

Germany and of severely reducing the ability of the Deutsche Mark to perform the role of nominal anchor in the ERM effectively. This policy would, therefore, have an adverse repercussion on the process of convergence towards price stability of Community countries in the transition to full Economic and Monetary Union.

An alternative option, provided Germany maintains a tight monetary policy, would be that the other ERM countries reinforce their non-accommodating monetary stance by following movements in German interest rates, and thereby eliminating exchange rate tensions. This would enhance the anti-inflation credibility of the system. Moreover, if the decision to keep interest rates in the ERM high is understood by markets as a signal of the strong commitment by the authorities to maintain existing central parities even in such an uncertain environment, then the risk premium that investors will require to hold non-Deutsche Mark currencies might well decrease, thus allowing an eventual reduction in interest rates vis-à-vis Germany.

Nevertheless, given the much weaker cyclical position of the other economies, the above policy may exacerbate the slowdown, as in France and Italy, or the recession, as in the United Kingdom. Furthermore, keeping interest rates high may also entail additional costs for those ERM countries with high public debt and/or deficits, for example Italy and Belgium. In these countries, there is likely to be upward pressures on the deficit not only from the automatic budget stabilisers, but also from the interest payments on the debt.

Exchange Rate Flexibility

Another option would be for ERM countries to accept some exchange rate flexibility, either by more fully exploiting the margin for movement inside the band or, if it proves necessary, by realigning central parities. However, account should be taken that, with the possible exception of the Spanish peseta, the available room for a depreciation within the band may not be sufficient to eliminate tensions.

Moreover, this room may not be fully exploitable in the present environment of uncertainty linked to the impact of German unification, the dollar, and the Iraq-Kuwait crisis. In particular, any attempt to bring currencies close to the lower limit of the band may cast doubts in the market that the "no realignment" policy followed in the past four years

will be maintained. In this event, holders of the weaker currencies would require higher interest rates to compensate for the higher risk. Given recent market behaviour, these tensions may be especially acute in the case of the British pound and, perhaps, also in the case of the Italian lira.

If more flexibility is required to counter the effects of the German unification shock, consideration might be given to a timely realignment of central parities with the intention of limiting the slowdown in the rest of the ERM while easing inflationary pressures in Germany. However, a generalised realignment entails serious risks. Specifically, it would exacerbate inflationary tensions in the devaluing countries and seriously damage the credibility of the authorities' commitment to maintain central parities. Whilst a supporting tightening of policies in the devaluing countries may limit the inflationary impulse, it will be very difficult to prevent markets from expecting further realignments and consequently asking for a higher risk premium on interest rates. These effects may offset, perhaps fully, the beneficial effects on activity.

Policy Dilemmas

As already noted, if the preferable solution of a reduction in the Germany budget deficit is not feasible in the near future, countries in the ERM are likely to be confronted with policy dilemmas, since none of the options presented are costless. Nevertheless, the options are not mutually exclusive and countries may contribute in different ways towards the easing of tensions, depending on initial economic conditions, preferences and policy constraints.

Dilemmas may become more or less acute depending on a number of developments. For instance, a further weakening of the dollar would compound the risk of a sharp economic slowdown by shifting world demand away from ERM countries. In turn, an expectation of a further strengthening of the Deutsche Mark vis-à-vis other ERM currencies would heighten the policy dilemma, whilst a less bullish expectation would have the opposite effect.

III ISSUES FOR DISCUSSION

1. Assumptions have been made that the non-accommodating monetary policy stance in Germany, in the face of relatively strong fiscal and demand pressure, may cause difficulties for other ERM countries in a much weaker cyclical position. Do Governors share the assessment that the constraints stemming from: (a) the commitment not to realign; (b) the limits on movements within the band; (c) high public debt and fiscal deficits, severely narrow the room for policy manoeuvre?

2. Assuming that the preferred solution of a German fiscal tightening is unlikely in the near term, how do Governors assess the desirability and likelihood of the policy options described in the note?

3. Would these conclusions be significantly modified if:

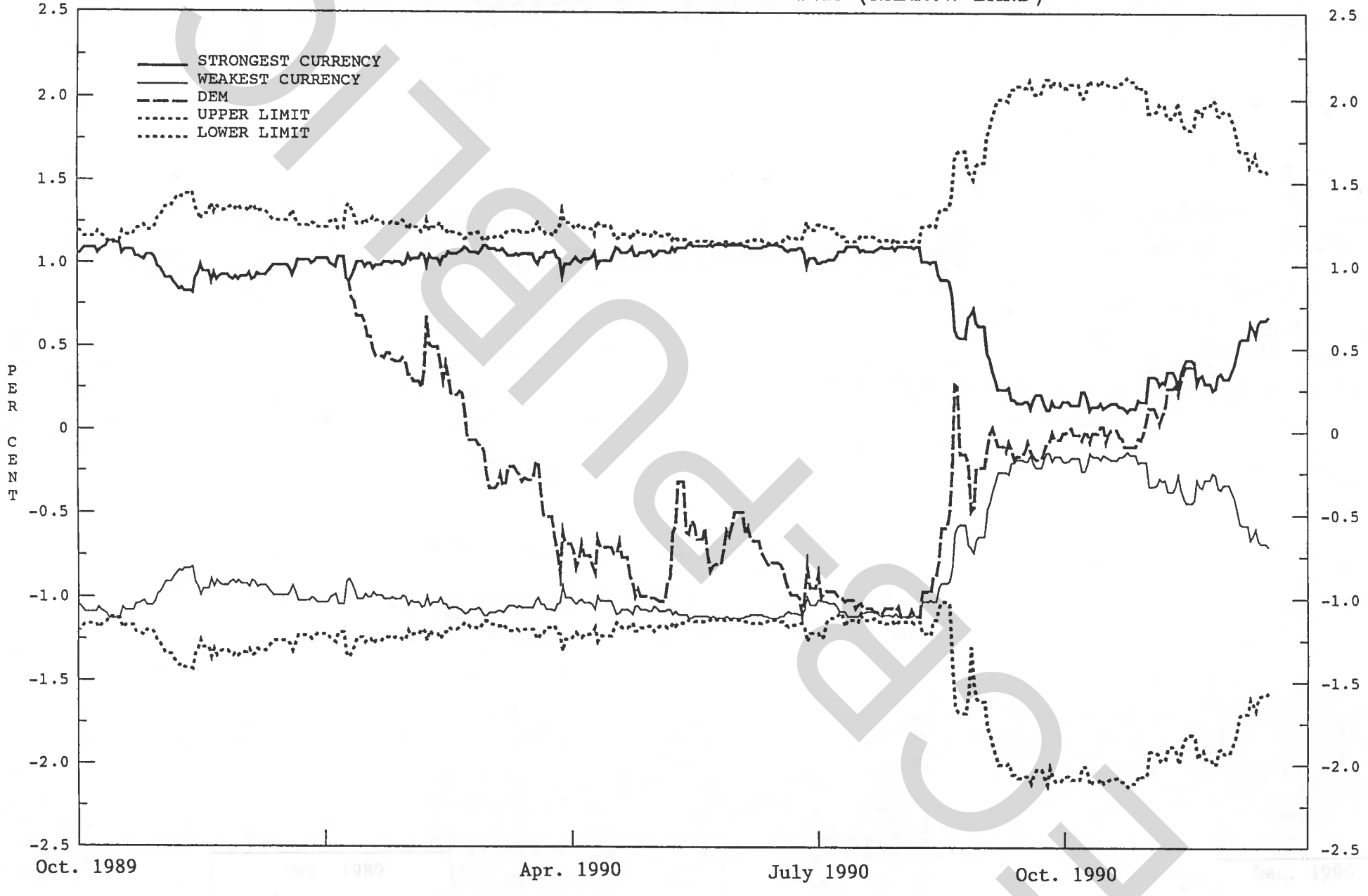
(a) the period of high interest rates in Germany, for example due to a sustained fiscal expansion, proved to be more protracted than currently envisaged;
(b) there were a sharp change in sentiment towards the Deutsche Mark in either direction;
(c) there were an adverse external shock arising, for example, from an additional sharp fall in the dollar.

4. If ERM countries outside Germany adjust monetary policies to avoid a realignment, how quickly will they benefit from enhanced anti-inflation credibility, both in terms of permitting a reduction in interest rates vis-à-vis Germany, and in terms of improving conditions for sustained non-inflationary growth?

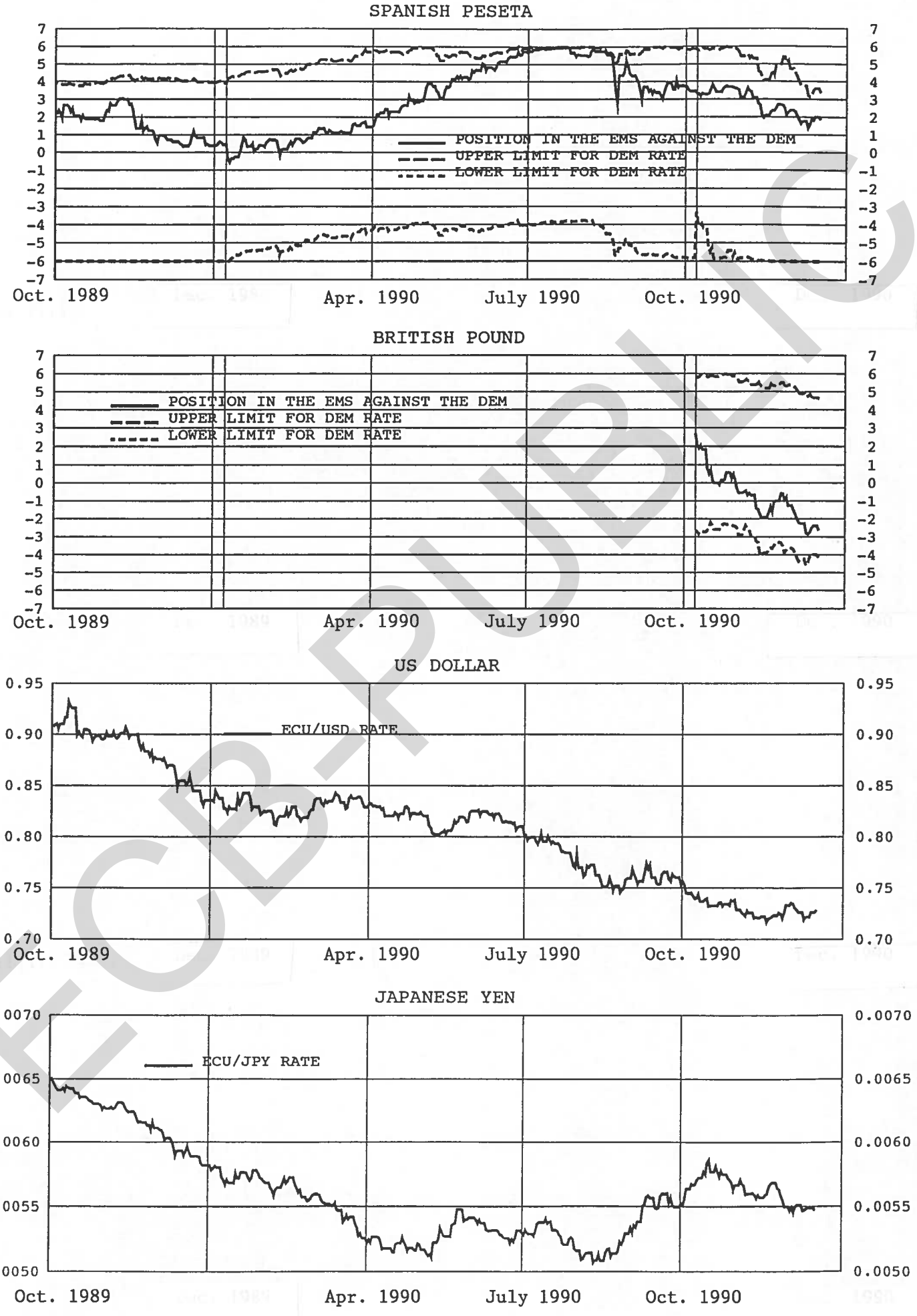
5. In the event that a realignment proves to be necessary, can this be undertaken even in an environment of cyclical weakness without seriously undermining inflation discipline and creating expectations of further realignments? To what extent would a supporting tightening of policy in the devaluing countries and complementary policy changes in Germany limit these dangers?

CHARTS

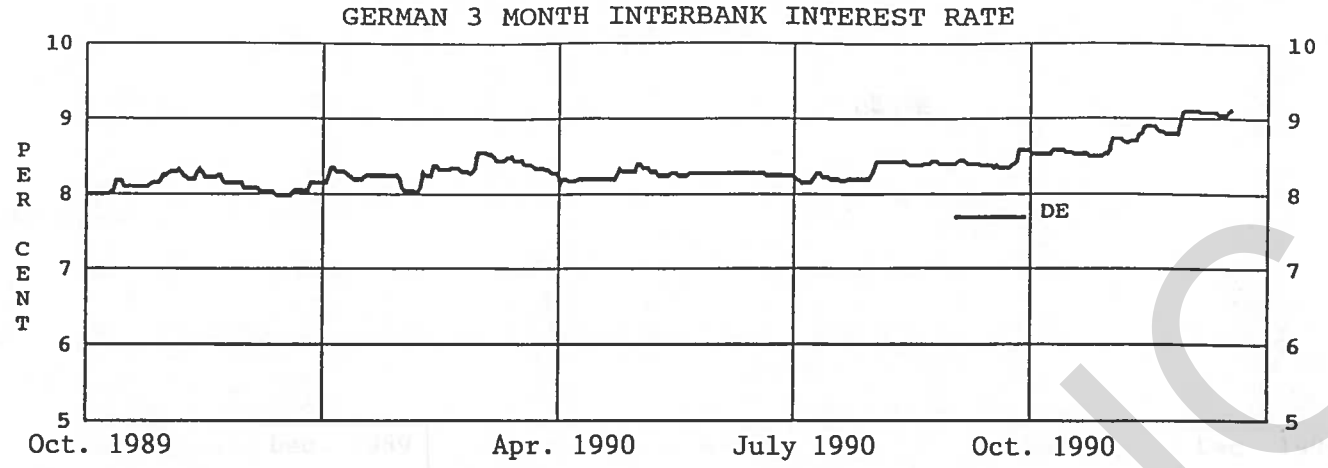
GRAPH 1: EXCHANGE RATES IN THE ERM (NARROW BAND)

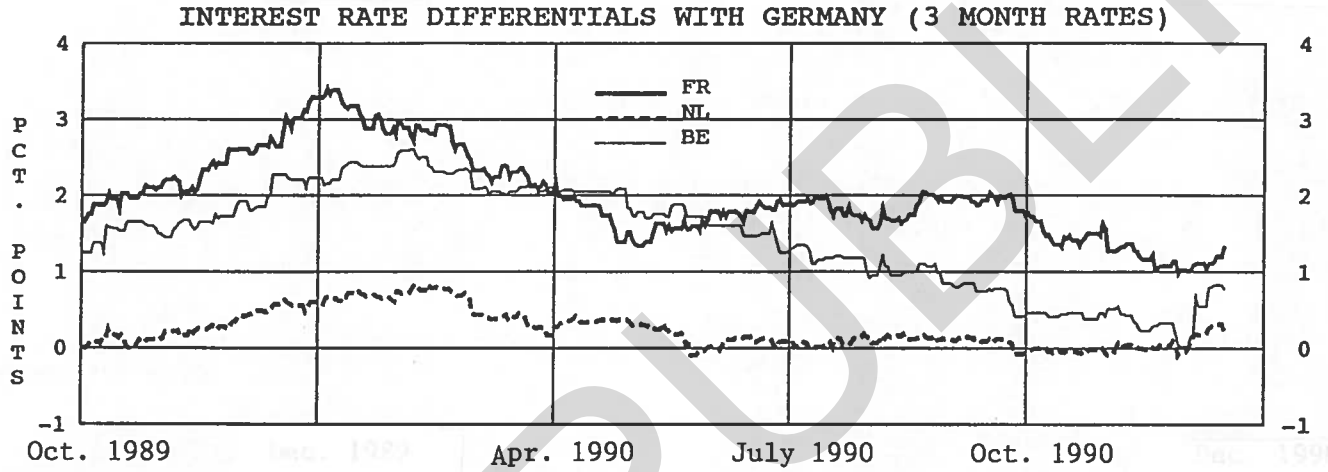


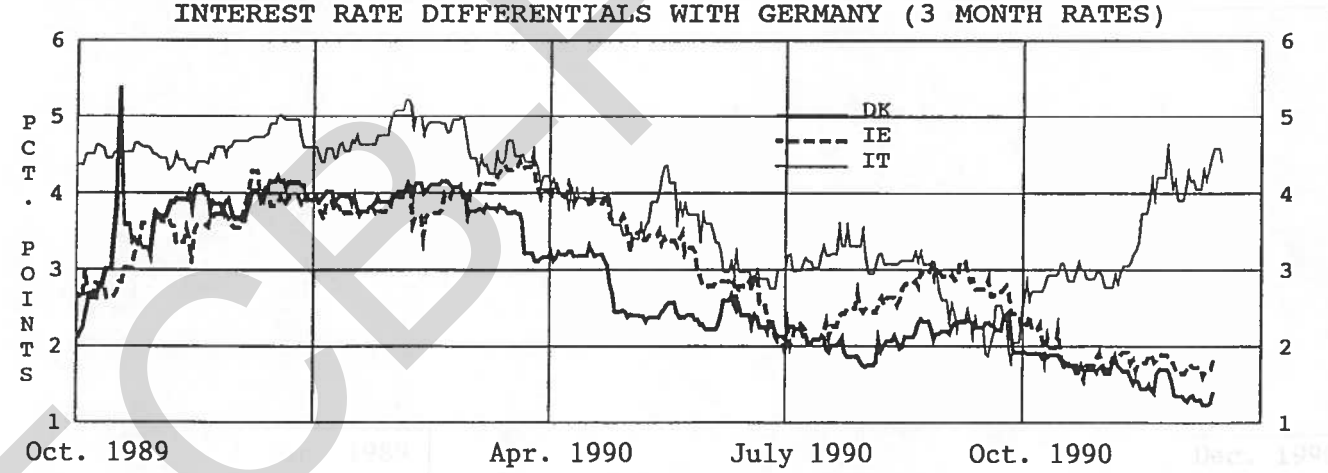
GRAPH 2: RECENT EVOLUTION OF WIDE BAND CURRENCIES, ECU/US DOLLAR AND ECU/YEN EXCHANGE RATES.

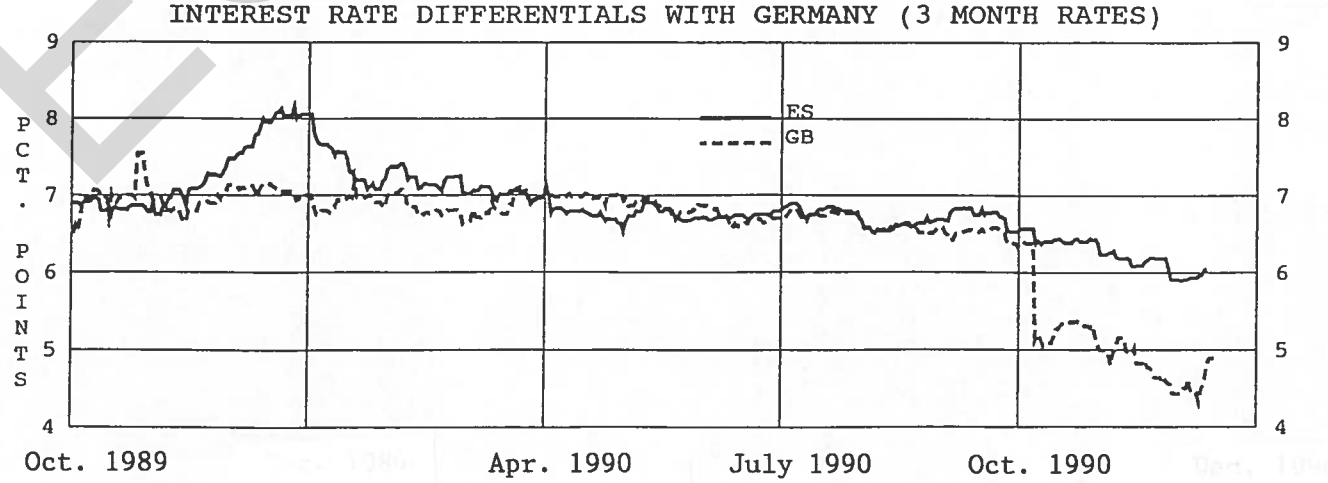


GRAPH 3: SHORT-TERM INTEREST DIFFERENTIALS









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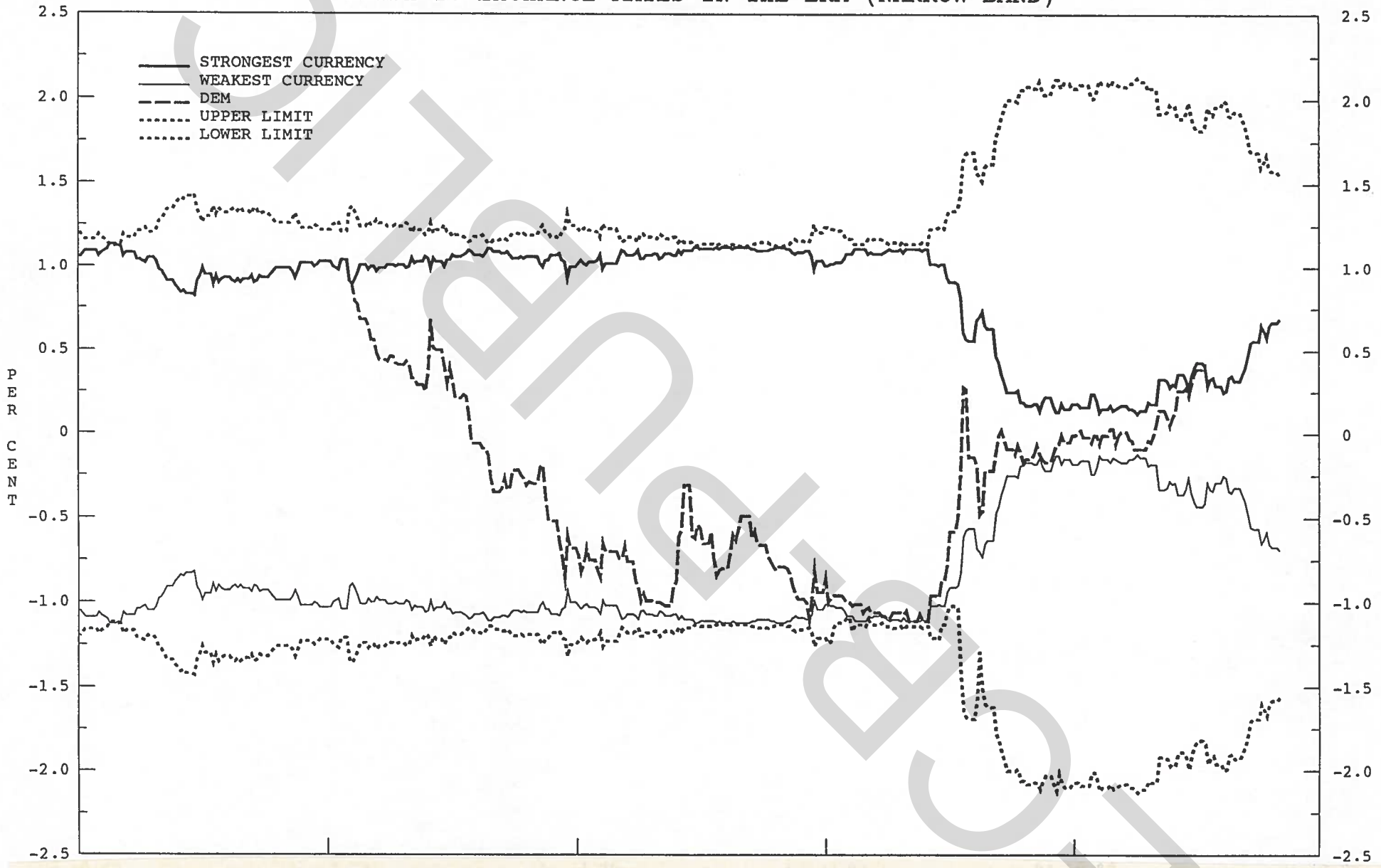

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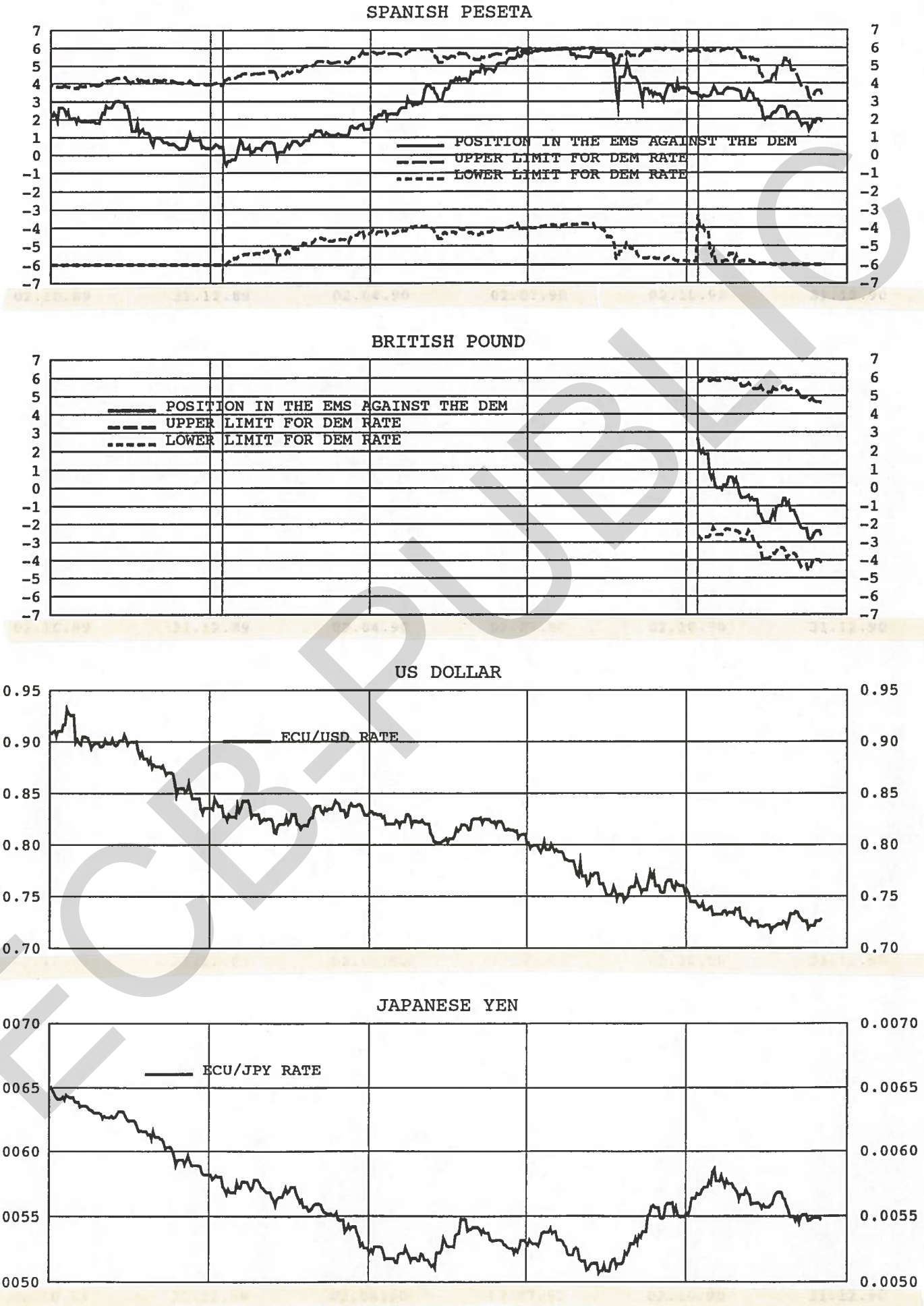
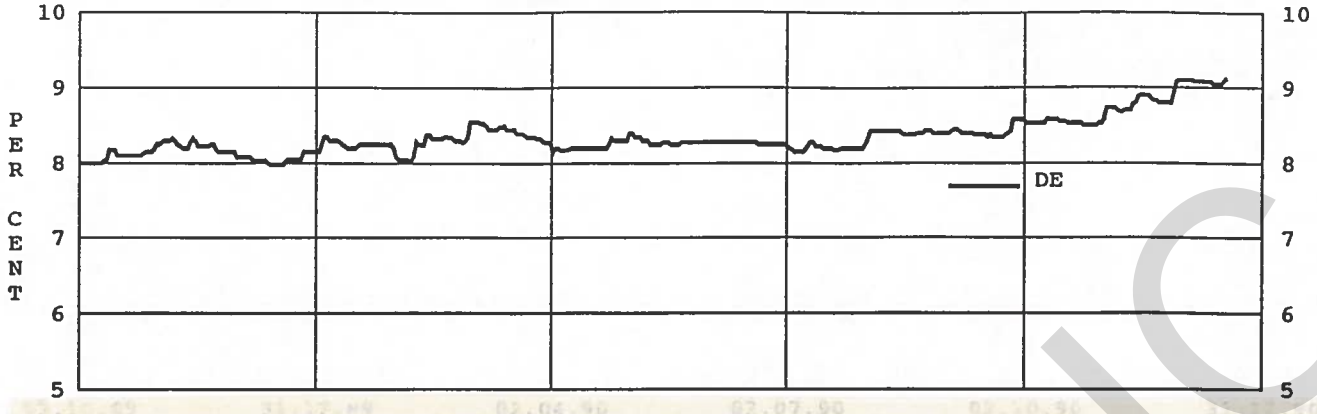
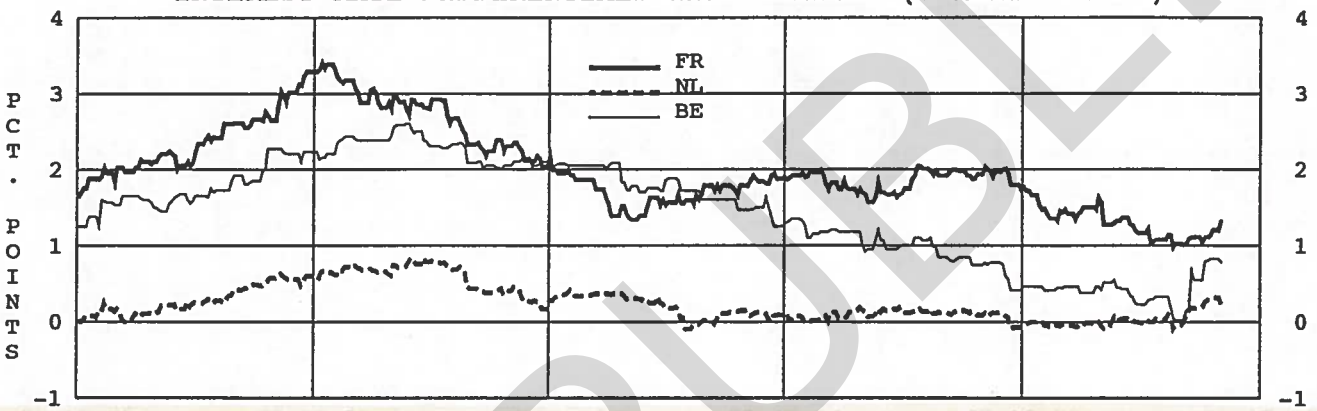


GRAPH 3: SHORT-TERM INTEREST DIFFERENTIALS

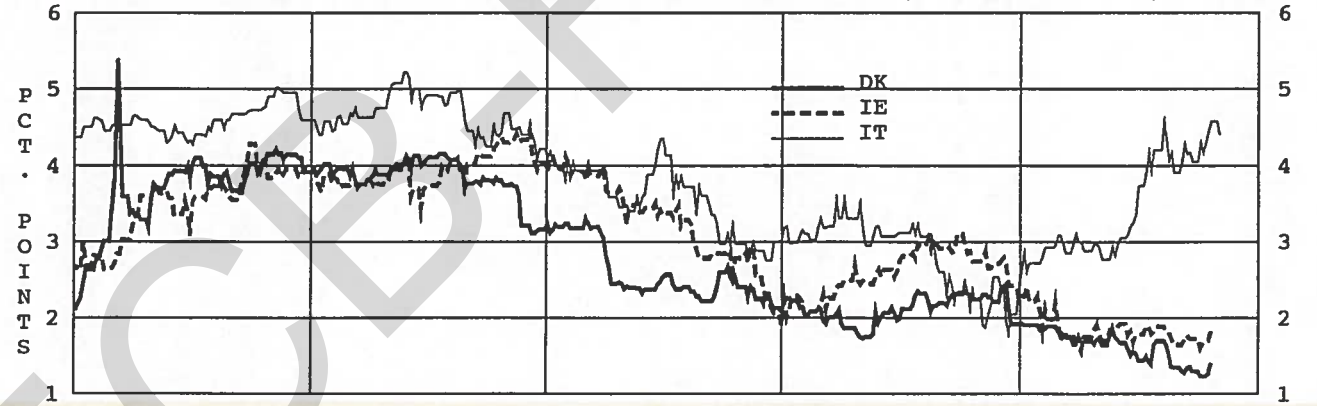
GERMAN 3 MONTH INTERBANK INTEREST RATE



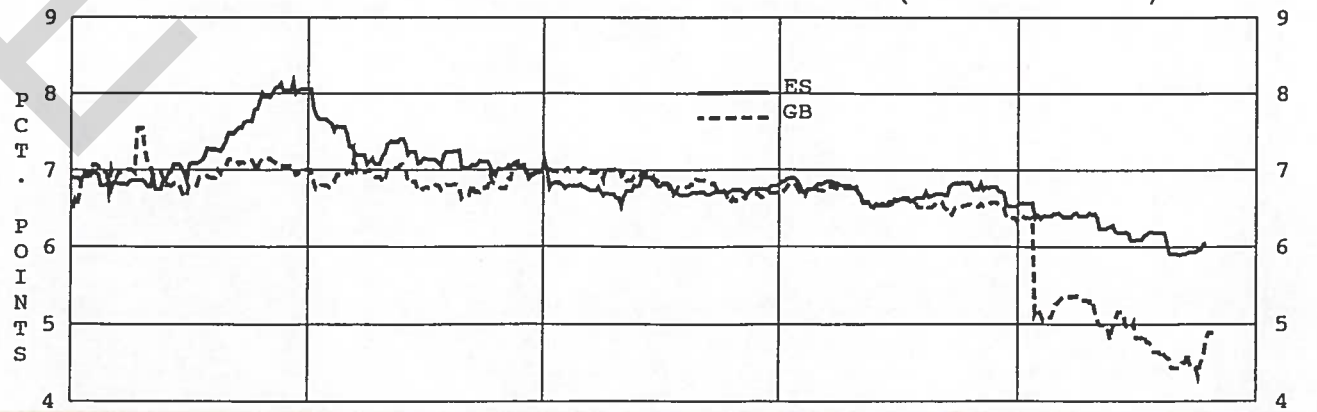
INTEREST RATE DIFFERENTIALS WITH GERMANY (3 MONTH RATES)



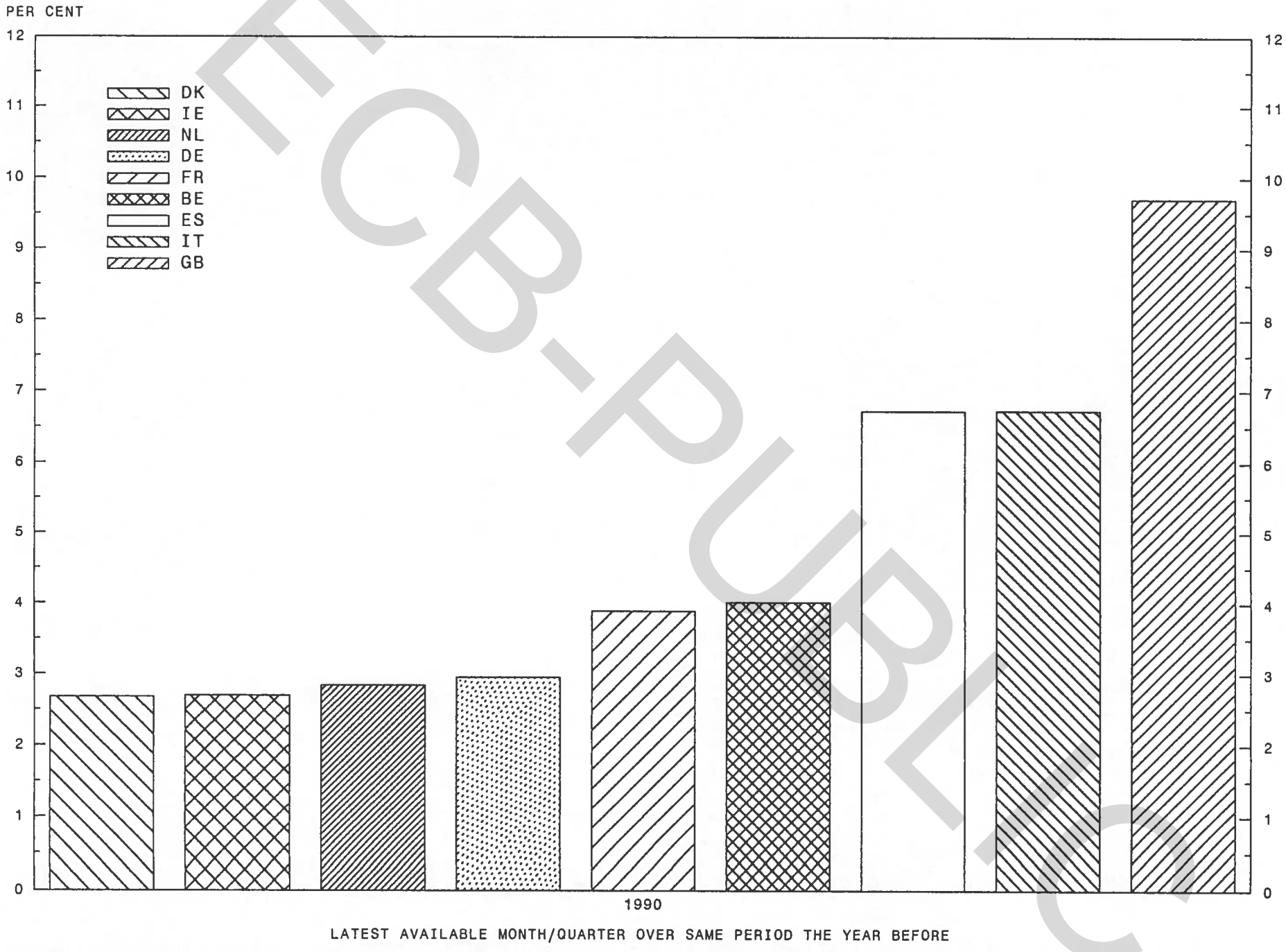
INTEREST RATE DIFFERENTIALS WITH GERMANY (3 MONTH RATES)



INTEREST RATE DIFFERENTIALS WITH GERMANY (3 MONTH RATES)



GRAPH 6: INFLATION



LATEST AVAILABLE MONTH/QUARTER OVER SAME PERIOD THE YEAR BEFORE