

**From EMS to EMU: A Regime Analysis**

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## 1. Introduction.

In this paper we will discuss what insights that an approach which draws on the evolving "regime" literature can provide concerning the Community's present and future exchange rate arrangements. Consequently, we are interested in the status of the European Monetary System (EMS) as a regime, and we are interested in conjecturing about the status of Economic and Monetary Union (EMU) as a regime.

The present paper draws extensively on the analytical framework set out in two papers by Bulmer<sup>1</sup> and Armstrong<sup>2</sup>. Each of these two papers advance variants and clarifications on the regime analysis that became popular in the early 1980s. Two propositions or clarifications - one from each paper - are particularly helpful in establishing the broad intellectual framework within which the discussion about the EMS and EMU will be developed in this paper. First, Armstrong provides a concise statement of the nature and defining characteristics of a regime;

"Each regime will have an organisational profile (with its own constituency of actors, power relationships, with its own procedures for decision-making, its hierarchies, and its resources) and a normative context (a collection of rules, rights, norms and conventions) relating to the relationships between organisations, between socio-economic and political actors, and between organisations and socio-economic and political actors." (p3).

Quite clearly the EMS constitutes a regime in this sense, as does the proposed arrangements for EMU. As we note later, Armstrong's definition will strike a familiar chord with economists working in the area of exchange rate management.

What is particularly important, as Bulmer notes, is that in the regime as characterised by Armstrong there is no requirement at all that it should be "formally organised" (see Bulmer, p6). Clearly this is pertinent because the EMS is not formally a part of the European Community in that it is not governed by the Treaty of Rome, although it is formally organised in the sense of having a agreed set of operating procedures. However, assuming that the Maastricht Treaty on European Union will be ratified, monetary union will become a formal Community responsibility. We would define this event as constituting a "regime-shift", and one of the central purposes of this paper is to ask whether or not the provisions for this regime-shift as set out in the Treaty on European Union are sufficient to ensure the success of the new regime<sup>3</sup>.

The second proposition pertinent to this paper comes from Bulmer where he offers a clarification and reconciliation between

the twin notions of regimes and Community governance. He writes,

"...the aim is not to examine the EC as a regime, for it is more appropriately regarded as an organisation to which regimes may or may not be attached...Thus in a disaggregated approach, the collective governance of the member states is held to comprise a large number of discrete regimes reflecting different policy networks." (p6).

By suggesting that governance and regimes are related, and we would accept this proposition, a second point for analysis is suggested; should the nature of the regime change - that is, should there be a regime-shift or even the introduction of a new regime - then what does this imply for "the collective governance of member states"? One possibility is that regime-shifts constitute one element - if not the main element - among all the elements that together propel the Community towards a different structure of "collective governance". To the extent that collective governance represents a product of the existing constellation of discrete regimes, at the very least we would expect a regime-shift to destabilise the prevailing "collective governance". To go one step further, is it the case that the Community's governance structure is being pushed along by the dynamics of regime-shifts rather than responding to vague notions of enhanced democracy or a sense of Europeanism as federalists might prefer?<sup>4</sup> Fortunately that question lies outside the scope of the present paper.

The paper will proceed as follows. In the second section we consider the way in which economists conceptualise "regimes" and their understanding of the origins of such regimes. In the main, this section will be devoted to exchange rate regimes, and we will consider the lessons that the economics literature on exchange rate regimes has for the impending transition from EMS to EMU. Section 3 examines how the lessons that we draw from the operation of the EMS might be applied in designing the EMU regime, and consider whether the EMS regime reflects these lessons. Finally, in section 4 we offer some tentative conclusions on the usefulness of applying regime analysis to the Community's monetary arrangements and what this might imply for the Community's governance structure. In particular, we consider what criteria regime analysis would suggest have to be met to effect the transition to monetary union.

## 2. Regimes, Expectations and the EMS.

Economists are well used to discussing regimes - and the operating rules of these regimes - within the context of international monetary relations<sup>5</sup>. Thus, economists refer to the "Bretton Woods system", they describe the IMF and the GATT as the core "institutions" of the international economy, and they are often heard to invoke the "rules of the game" in discussions about the constraints imposed upon domestic economic policy as a consequence of membership of an exchange rate regime<sup>6</sup>. The theme of international monetary regimes is directly addressed in

McKinnon (1993) where the rules of the various arrangements (regimes) for exchange rate co-operation are explored. McKinnon takes as his starting point a quote from Mundell (1972) in which a distinction is drawn between a "system" and an "order". It is worth citing the quote in full:

"A system is an aggregation of diverse entities united by regular interaction according to some form of control. When we speak of the international monetary system we are concerned with the mechanisms governing the interactions between trading nations, and in particular the money and credit instruments of national communities in foreign exchange, capital and commodity markets. The control is exerted through policies at the national level interacting with one another in that loose form of supervision that we call co-operation.

An order, as distinct from a system, represents the framework and setting in which the system operates. It is a framework of laws, conventions, regulations, and mores that establish the setting of the system and the understanding of the environment by the participants in it. A monetary order is to a monetary system somewhat like a constitution is to a political or electoral system. We can think of the monetary system as the modus operandi of the monetary order." (Mundell 1972, cited in McKinnon (1993).

Mundell's distinction between the 'system' and an 'order' has more than a passing similarity to the constituent parts of a regime as identified in Armstrong. The 'organisational profile' of the regime is close to Mundell's 'system' in that both refer to the day-to-day operation and management of the joint policy - the procedural aspects where these incorporate, among other things, power relations. The regime's 'normative context' approximates to Mundell's 'order' or Keynes' 'rules of the game', in that each refers to the agreed upon parameters of the policy. At the very least the 'order' or 'normative context' or 'rules of the game' will prohibit certain action on the grounds that they are incompatible with fundamental objectives of the policy. For instance, although a fixed exchange rate 'order' would not proscribe completely devaluation as a policy option, it would almost certainly regard this as a measure of the "last resort"; the general understanding would be that exchange rate adjustments between the participating currencies are infrequent events.

The European Monetary System (EMS) clearly represents a system according to the definition provided by Mundell and, if taken along with the rules and conventions concerning measures provided for to support the EMS, constitutes a regime in the sense of Bulmer and Armstrong. At the centre of the EMS is the exchange rate mechanism (ERM). This is the fixed exchange rate aspect to the regime and indicates the acceptable band of movement of each currency within the EMS around a central parity. The ERM is supported by a variety of intervention arrangements,

ranging from unlimited intervention to support a currency in the very short term, through to structured lending to the 'troubled currency' as part of a comprehensive macroeconomic reform package.

However, to sustain the declared parities within the ERM over time requires a degree of policy coordination between the participating countries. This is because the exchange rate is the price between two currencies; it is therefore a joint target in that no one country on its own can determine the exchange rate. In this sense the exchange rate becomes an intermediate target in that it requires prior agreement over coordination between countries concerning the primary variables that together determine the exchange rate. Monetary policy is generally regarded as the key determinant of the exchange rate over the medium term, as this will influence relative rates of national inflation generally understood as central to the determination of equilibrium exchange rate. In the short terms monetary policy matters too because of the direct influence it will have over domestic interest rates - this being one element of the total return to foreign currency holdings. However, it is important to recognise that changes in short term interest rates also are triggered by fiscal policy, implying that exchange rate stability requires some degree of convergence in fiscal policies conducted in each participating country.

The implication from this is that an exchange rate regime can be assessed as an exercise in macroeconomic coordination; that is, the study of coordination between those policies which impact upon the target variable - in this case the target variable is the exchange rate. Within the international monetary literature, the study of international policy coordination began in the 1960s and is most commonly associated with the work of Cooper and Hamada<sup>7</sup>. Policy coordination is defined by Currie et al (1989) in the following way;

"...the establishment of agreed rules of the game in the macroeconomic sphere that constrain, or determine, at least some instruments of macroeconomic policy is to be regarded as a form of policy coordination."

Examining the post war era, Currie et al identify a number of different phases of policy coordination within the international economy, each of which were associated with differing 'rules of the game' in the macroeconomic sphere. It is worth stressing that the 'policy coordination' approach to periodising the post-war global monetary arrangements is consistent with Mundell's 'orders' versus 'systems' approach. Policy coordination is the domestic means of conforming to the 'system'. Indeed, Mundell explicitly makes this point where he describes the 'system' as; "the mechanisms governing the interactions between trading nations...[where] the control is exerted through policies at the national level interacting with one another in that loose form of supervision we call co-operation".

Policy coordination can occur with differing intensities. Consider the EMS; what degree of policy coordination is required to sustain that particular exchange rate regime? As already noted, the EMS requires partial coordination of national economic policies to the extent needed to stabilise exchange rates within the permissible band of movement. Moreover, coordination in the sense of facilitating the proper functioning of the 'system' is promoted by the formal, institutional provisions agreed upon in 1978 (the 'order') that call for certain decisions to be reached jointly and which made explicit the response from national governments in the event that one currency found itself under pressure. Thus the EMS achieves coordination partly through the observation of these 'rules of the game'. However, as Guitan (1988) implies, the mere existence of 'rules' is unlikely to be a sufficiently strong motive to persuade countries to modify domestic economic policies in order to stabilise the exchange rate, should modification prove necessary. There has also to be a degree of consensus concerning the conduct of these policies between the participating countries. That is, the formal existence of 'rules' is neither a necessary nor a sufficient condition for an exchange rate regime to be successful. There also has to be a convergence of policy attitudes among the participating countries and a convergence of national policy actions<sup>8</sup>. However, the crucial point is that for a conversion to similar policy attitudes to occur, the gains from the coordination of domestic economic policies have to be distributed between all participants. In short, there has to be some advantage to all participants from policy coordination. If, on the other hand, the benefits from coordination are unevenly distributed then the regime may become less stable. In this case much will depend upon the enforceability of the 'rules'; this itself being defined in the general 'order'.

The EMS has performed very successfully as a regime. It began in 1979 and has remained a key vehicle for coordination of macroeconomic policies throughout the EC for over 14 years. However, it is important to recognise that throughout this period the EMS regime has changed considerably. In the main, the changes that have occurred have been changes in the 'system' rather than changes in the 'order'; that is, the operating conditions of the EMS have changed while the "framework of laws, conventions, regulations and mores" has remained virtually unaltered<sup>9</sup>. McKinnon (1993) clarifies the manner in which the system has changes in two tables, each of which contains different variants of the operating procedures for the EMS. In one box he identifies the operating provisions as these were agreed upon in 1979 in which no currency would dominate, and in which the burden of adjustment would be shared between participating countries. Thus, for instance, should a currency come under pressure there was a presumption that the adjustment would be shared between that country and the stronger currency country. In the second table McKinnon shows how the regime actually has operated for much of the period with the evolution of the EMS into a Deutsche Mark zone. The key difference surrounds the asymmetry of the adjustment burden in the latter instance - where the weak currency country does all the adjusting - compared to what was

supposed to happen. Indeed, the Basle-Nyborg agreement was prompted by the weaker countries in an attempt to reduce the burden of adjustment that the system was imposing upon them. Seen in this way, the EMS did breach one of the main tenets from the policy coordination literature; namely that gains from coordination have to be evenly spread. This was tolerated mainly because other types of gain were being enjoyed by participants in the EMS. In particular, the anchor currency role that the Deutsche Mark was performing was providing a framework for the weaker countries to deliver stable prices, at least up to a point<sup>10</sup>.

It would, of course, be incorrect to say that the EMS as a regime has performed flawlessly since inception. There have been 13 major exchange rate adjustments, although from 1987 onwards there was not one of any significance (leaving aside the Lira adjustment in 1990 immediately before it moved in to the tight ERM band). One way of interpreting the pre-1987 experience would be to say that the exchange rate simply acted as a substitute for incomplete policy coordination over the crucial domestic policy instruments. In other words, the ERM operated much as we would expect a crawling-peg exchange rate regime to do. Does this imply, then, that the post-1987 stability of the EMS during which there was no exchange rate adjustments represents a period of enhanced domestic policy coordination such that inflation differentials between participating countries were eliminated? This is difficult to maintain. In fact, throughout the post-1987 period inflation differentials between ERM countries persisted, although these did not become significantly greater.

The preferred interpretation for exchange rate stability over this period is that the "old" ERM gave way to the "new" ERM (Giavazzi & Spaventa (1990)). Essentially the story is that high inflation countries had come to accept that domestic policy has to conform completely to the path required to eliminate the positive inflation differential; that is, to accept the full dose of discipline implied by a truly fixed exchange rate regime and that this decision was credible. Giavazzi and Spaventa write;

"The policy shift is signalled by the resolve of the authorities of the high inflation country to stick to the existing parity from now on, and to resist market pressures for a realignment. Over time, the authorities' commitment acquires credibility, and agents expectations shift." (p74).

Central to the operation of the "new" EMS is that the inflation differential which hitherto was accommodated by crawling-peg type nominal exchange rate adjustments is eliminated. As Giavazzi and Spaventa explain, the elimination of the positive inflation differential is achieved through the speedy adjustment of expectations in the high-inflation participant. Agents observe that the authorities are not altering the exchange rate and adjust their bargaining stance accordingly. With the authorities refusing to accommodate positive inflation differential by a

nominal exchange rate re-alignment, the high inflation country will experience an appreciation in its real exchange rate and a subsequent deterioration in the current account balance. This will introduce significant disinflationary pressures on that economy, forcing down the positive inflation differential. On the exchange markets, expectations are also prone to adjust. As market participants come to recognise that exchange rate fixity has increased, the credibility of the greater fixity will rise. The regime-shift from "old" to "new" EMS itself will produce a shift in exchange rate expectations, further reinforcing the movement to greater exchange rate fixity.

Of course, the regime-shift introduces other problems, one of which is the impact on the capital account. To the extent that the high inflation country has a positive interest rate differential against its low-inflation partners (and this is likely to be the case in an adjustable-peg arrangement given the use of interest rates to defend an exchange rate in a high inflation country) then if the "new" EMS indeed is credible, this interest rate differential will have to disappear. Either the authorities in the high inflation country will lower domestic interest rates (as occurred in the UK after ERM membership and in Italy post-January 1990) or capital will be attracted to the high interest rate country serving to lower rates there. In either instance, the consequence of the exchange rate fixity will be to swell the money supply in the already inflation-prone economy, thereby making it all the more difficult for that country to lower its inflation rate, or making the output costs of forced disinflation that much greater<sup>11</sup>.

It is evident that the proponents of the "new" EMS argument are, at the same time, expounding the view that 1987 witnessed a regime-shift such that the EMS became a vehicle not simply to propagate a "zone of monetary stability" throughout the EC, but a vehicle also for achieving a greater degree of exchange rate fixity between participating countries. At the heart of the regime-shift in this account lies changing expectations; changing expectations about the likely future course of exchange rate adjustments and the impact that this change in expectations had on the domestic inflationary process and the impact it had among foreign currency dealers. In short, the regime-shift in this narrative is very much of the bootstraps variety in that the underlying properties of the participating economies has not changed; instead the new regime relies entirely, at least in the short run, on the changed expectation of the actors involved.

The upshot is that should expectations change once again, then the "new" regime will become unstable and a further regime-shift can be expected. Clearly the main elements of the regime shift that we are ascribing to the EMS post-1987 occurred within the 'systemic' part of the regime. Once again, there were no alterations to the 'order' itself; the operating principles of the EMS remained as they had been defined at the outset.

Assessing the EMS regime-shift from the perspective of the policy coordination literature, one would argue that the



expectations which were necessary to ensure the success of the "new" EMS (where success is taken to be dynamic stability of the arrangement) had to be continually reinforced by increased coordination of the national policies which together determine the exchange rate - which is a joint target meaning that policy in at least two countries has to be coordinated. If policy in any one participant is inconsistent with that joint target, then expectations will shift and the regime will become unstable.

The increased exchange rate fixity requires, at a minimum, a greater convergence of monetary policy between participating countries if it is to be a credible policy. This was made easier within the EMS because the regime operated very much along the lines of an N-1 model where in a world of N countries there can only be N-1 independent exchange rate targets. If exchange rates are to be stable then either the participating countries have to establish mutually agreed policies which will produce stable exchange rates (in principle this is how the EMS should operate) or responsibility for exchange rate stability is transferred to the strongest Nth country. Now the Nth country is responsible for setting the low-inflation monetary policy and the remaining countries achieve low inflation by pegging their currencies to the Nth currency. Where expectations are important, stability in such a regime requires monetary policy convergence around monetary policy in the Nth country. In practise this is the way in which the EMS did operate, with the Deutsche Mark performing the role of the Nth currency. For exchange rate stability to continue in such a regime two conditions had to be fulfilled. First, the remaining participants had to remain willing to adhere to the Nth country model. They had to remain passive respondents to monetary policy in the Nth country. Second, the policy in the Nth country had to continue to deliver low inflation. The crisis in the EMS in September occurred because both conditions were breached. The consequence was that the regime-shift that was heralded in the late 1980s was reversed.

There have been a number of alternative explanations offered for the crisis that hit the EMS in September 1992. The official UK position is that it pointed to fundamental fault lines in the EMS; while others suggest that the fault lies in the unwillingness of some member states to firmly commit themselves to the exchange rate policy. From our perspective we shall approach the question from a policy coordination perspective. The hypothesis is simple and is in two parts. It is, firstly, that policy coordination within the EMS is incomplete and this renders the system inherently unstable in its "new" format - i.e. post-1987 EMS. The second element in the hypothesis is that policy coordination, essential for the purposes of stabilising the exchange rate regime within the EMS, cannot be seen to be a costless exercise. During 1992 the costs of coordination began to outweigh the benefits - at least for some participating countries. This might be viewed as a breach of the coordination rule that all participants have to stand to gain from coordination. Otherwise it will be in their self-interest to default.

From the literature on policy coordination, one lesson from 1992 is that - from the perspective of exchange rate stability - fiscal policy does matter. Much of the international economic literature is dominated by what is referred to as the policy assignment rule. According to this rule, monetary policy would be assigned to external variables (exchange rate, balance of payments, etc.) leaving the fiscal policy instruments to target internal objectives (employment, income, growth). However, fiscal policy has a monetary component, or if not then it impacts upon monetary variables. This is because fiscal policy has to be paid for if a deficit is being incurred. And if monetary policy is not available then the only option to finance a budget deficit is for the government to borrow. Then the stability of the exchange rate regime begins to depend on how the markets view borrowing; in other words what interest rate effects the borrowing has subsequently. If borrowing is considered to be 'excessive' then concerns will surface as to how the government intends to service the debt and repay the capital. In this scenario, rational market operators will begin to examine the structure of fiscal policy and take a view on the consistency of that policy profile with the monetary policy which is simultaneously being pursued. But, as the N-1 model makes clear, monetary policy is being driven, through the exchange rate, by the lowest inflation performing Nth country. This suggests that domestic fiscal policy has to be consistent with, and credible with respect to, domestic monetary policy in the short term, but compatible with monetary policy in the Nth country over the medium term. In this sense, fiscal policy is not freely available to address domestic objectives. By the early 1990s fiscal policy within a number of ERM countries simply was not compatible with domestic monetary policy, raising doubts about the viability of domestic monetary policy and, therefore, the prevailing structure of exchange rates. In terms of regime analysis, this implication is that the 'system' rules of the EMS were inappropriate to bring dynamic stability to the "new" EMS. Note, this was not a problem with the "old" EMS where exchange rate changes would have sufficed to reconcile, to a degree, the disjointed fiscal-monetary policy mixes within and between ERM participants. Instead, the "new" ERM required a move to much fuller coordination, whereby fiscal and monetary policies in participating countries would be aligned. That this didn't happen is due, in large measure, to the changing economic circumstances of the period. As the recession arrived in the early part of 1990, EMS countries found themselves facing increasing fiscal deficits. For a number of countries (especially Italy, Ireland, Belgium and Spain) this cyclical element of fiscal debt was added to an already high outstanding structural level of public debt. Regardless of the cause of the recession, this resulted in an increase in the ratio of debt to GDP which required that an ever rising share of national income had to be devoted to debt servicing. With monetary policy restricted by the ERM commitment, countries sought to borrow from outside to close the fiscal deficit. This is the point at which fiscal policy collided with prevailing expectations about exchange rate movements. As lenders came to doubt the credibility of the structure of exchange rates, they began to demand higher premiums on interest payments to continue lending. This served further to

increase the fiscal weight on the deficit country. It was by this chain of events that the fiscal and monetary policy mix became incompatible and the regime became unstable. Crucially, there was no provision in the EMS 'order' to provide for closer coordination of fiscal policies, or for measures to assist the fiscal problem afflicting certain participants.

The second part of the hypothesis is that coordination costs began to exceed coordination benefits during this period. It is to be recalled that the benefits of coordination derive when countries absent themselves from 'beggar-my-neighbour' policies, such as competitive exchange rate adjustments from which none benefits. In the case of the EC, further benefits derive from the cohesive influence that stable exchange rates have on market integration. Just how significant are these coordination benefits? One way of measuring these is to examine the conclusions of the EC study, "One Market, One Money", probably the most comprehensive estimate available. If we take exchange rate unification as equivalent to full coordination in national monetary policies, then the estimated gains from a single currency, according to the Commission study, amount to between 1.4% and 1.7% of Community GNP. And while this is a significant sum, it is well within the range of a normal macroeconomic forecasting error. The gains, though worthwhile, are small. Further, the benefits from complete coordination of monetary policy need to be distributed between participating countries<sup>12</sup>.

The real problem arises when we begin to compare the benefits from full monetary policy coordination (but partial policy coordination) with the potential costs. There are a number of coordination costs that are usually identified in the literature - costs arising from the risk of cheating, costs associated with misspecification of policy objectives, etc. - but the one that we focus on are the costs that afflict a fully monetary policy coordinated system in the event of an asymmetric shock hitting the regime as a whole. If a country-specific shock occurs then it is easy to show that minimising output and income loss for the area as a whole requires that the joint targets of policy - such as the exchange rate - can be adjusted<sup>13</sup>. Indeed precisely this problem manifest itself in the Community as a consequence of German unification. In this instance the optimal policy response would have been to allow the Deutsche Mark to appreciate against the other ERM currencies in the first instance - as the costs of unification drove domestic interest rates upwards - and to permit a Deutsche Mark devaluation subsequently to protect German exports of now higher priced products. Instead, the failure of the system to allow exchange rate adjustment - especially for the Nth currency country (see the demise of Bretton Woods) - meant that the high interest rates associated with capital shortage in Germany were transmitted to the other ERM countries at a time when this was inconsistent with underlying economic policy and problems in these countries. For the UK the inconsistency arose because of the recession that the country was in - ahead of the rest of the EC - while for other members the inconsistency arose due to the increased costs associated with servicing a high outstanding debt as higher

interest rates pushed upwards debt-servicing costs.

Consequently, if we conceptualise the "new" EMS as one in which monetary policy between the participating countries was fully coordinated, and that this is a precursor to the transition to monetary union, then the lessons from the September 1992 crisis for the design of monetary policy are considerable. We argue that the costs of coordinating monetary policy during 1992 for some countries (the UK and Italy especially) greatly exceeded the benefits derived from coordination. The EMS was unable to cope in such a situation, crucially because the regime was not designed to do so. The EMS regime was designed to deliver a zone of monetary stability in Europe - an expectation that was fulfilled throughout the 1980s. The much heralded regime-shift that occurred (sic) in 1987 destabilised the EMS, although this instability did not become noticeable until the system was shocked firstly by the growing fiscal indebtedness in some ERM countries and, second, by the asymmetric shock in the form of German unification. At that point the costs of maintaining monetary policy coordination for some countries increased dramatically, and the regime all but collapsed.

It is important to be clear that the problem was not that the ERM was subjected to a speculative attack which was problematic only because of the scale of the attack. Had this been the case then it is unlikely that the crisis would have reached the proportions it did, or that key players (especially Germany) would have responded as they did. Instead, we are positing that the "new" EMS was inherently an unstable formulation as neither the 'system' nor the 'order' was capable of immunising the arrangement from pathological outcomes. These pathological situations arose because a) coordination was provided for only over monetary policy and not fiscal policy, the latter being subject to only loose agreements for mutual discussion, and b) mechanisms that ensured the benefits from coordination were shared evenly amongst participants were completely absent from the EMS regime. Together these design faults in the EMS regime provided, and continue to provide, extremely fertile ground for instability in expectations within the foreign currency markets and within domestic factor markets. In short, the EMS as a regime is flawed because robust credibility on either internal policy and jointly determined external policy cannot be delivered.

### 3. From EMS to EMU.

The central message from the previous section is that, as suggested by the policy coordination literature, the transition to monetary union, if it is to be successful, must be accompanied by closer coordination over a range of other policy measures and by a mechanism for ensuring that the costs and benefits from monetary union are evenly spread throughout the area. In our view the provisions incorporated in the Maastricht Treaty do not satisfy these conditions. This leads us to conclude that the EMU regime as envisaged in that Treaty is fundamentally weak.

It is worth making explicit the 'system' and 'order' arrangements for EMU. As before, the 'order' rules refer to the "framework of laws, conventions, regulations and mores that establish the setting of the system". These are set out in great detail in the Maastricht Treaty, and are extremely well known. There are new institutions with the creation of the European Monetary Institute (EMI) as a forerunner to the European Central Bank and the European System of Central Banks; there are carefully structured convergence criteria that participants have to conform to before being granted admission to the monetary union; there are certain provisions for sanctions to be taken against deviant countries during the run-up to EMU.

What is interesting from the perspective adopted in this paper is the question whether the provisions for full monetary union satisfy the conditions we propose have to be satisfied if full coordination is to be successful. Consider first the fiscal policy constraints to which the EMS fell victim in 1992; that is, the internal inconsistency between the fiscal and monetary policies being conducted within a member country as well as the inconsistency in the fiscal-monetary policy mix between participating countries. Do the conditions surrounding the construction of the monetary union regime address this question? Despite the provisions concerning "excessive deficits"<sup>14</sup>, the Maastricht Treaty offers no guarantee that fiscal policy between participating countries will not be destabilising for the regime as a whole even if the excessive budget criteria are being observed. The situation is quite easily shown if we imagine a situation in which one participant in the monetary union has zero outstanding debt, while the other has outstanding debt of 60% of GDP - the maximum permissible. Let us assume that, due to an exogenous shock, interest rates for the area as a whole increase by 1%. This will have a negligible impact on government spending in the no-debt country; even if that country is in a recession the added fiscal burden will be slight. In the indebted country, on the other hand, simply to service the present debt will require that economic growth (i.e. the growth of GDP) has to increase by 0.6 of 1% in the next year to ensure that revenues accruing to the government rise by a sufficient amount to pay the now higher debt servicing costs. On the other hand, the full amount of the additional growth in the no-debt country is available for current consumption or for increasing net investment. Of course, the problem is that if a country is at the upper end of the debt spectrum then it will be unable to raise funds through net new borrowing in order to service the fiscal debt. The only option in this event will be either to reduce expenditure as required to release resources to pay higher debt service costs, or increase to taxation. Either event will not only be unpopular, both may lead to output and employment losses which could have been avoided. The problem is that a common shock has hit a monetary union in which initial or starting conditions differ as between the constituent parts of that union, whilst prevailing policy constraints necessitate that each government respond as if the shock had had an equal impact in all areas. A 'better' short term response for the indebted country, of course, would be to lower interest rates. However, this would not be

possible under conditions of monetary union as it would precipitate a comprehensive capital outflow which the indebted country would be unable to finance.

In essence we are suggesting that under EMU fiscal policy in each member state will need to be more active than in the past, but that this will not be possible if countries begin at different fiscal positions<sup>15</sup>. The immediate problem raised here, therefore, is one in which stabilisation policy is unavailable to address exogenous shocks that disturb internal targets.

However, we can also point to fact that, equally, the fiscal constraints implied by monetary union will preclude some element of convergence (i.e. regional and social) policies being implemented at the national level; that is policies designed to address the regional and social problems that result from the shock. This becomes particularly important to the extent that the effects of an initial shock last for a considerable period of time. There is evidence that the impact of shocks does last a long time, and the reduction in the ability of a government to address the convergence problems arising, due to fiscal constraints, adds yet another element of instability to the model of monetary union posited by the EC.

The problem outlined in the preceding paragraph could be resolved, at least partly, by extending the degree of coordination over fiscal policy within the regime. Either centralised monetary policy could be eased, thereby lowering interest rates, or a fiscal transfer could be made to assist the funding problem confronting the indebted country. The fledgling constitution of the proposed monetary institutions of the European monetary union along with the recently concluded Delors II debate on the future financing of EC activities each go to considerable lengths to deny either option. Consequently, although external stability will derive from the transition to monetary union, this is likely to be achieved only at the expense of increasing the degree of internal instability. The key point here is whether or not the proposed monetary regime is capable of withstanding the probable increase in internal instability?

One answer, and the one preferred by the Commission of the EC, is to encourage a greater degree of adjustment flexibility within the troubled economies themselves. Thus, when confronted with the possibility that the adjustment of fiscal policy required to sustain membership of the monetary union will place a potentially explosive burden on the social fabric of certain member countries, the Commission responds by suggesting that a 'greater flexibility of markets' is necessary to make monetary union work. This is widely taken to mean increasing the degree of regional wage divergence within the EC. But, sadly, all the evidence (e.g. German unification) is that monetary union will tend to lead to the equalisation of wages rather than the opposite. If any reliance whatsoever is to be placed on regional wage divergence as an adjustment mechanism then the Commission is duty-bound to indicate by what mechanisms it expects this to occur.

A very similar problem arises for those countries unable to gain membership of the EMU first time around due to their fiscal position. If there are gains from membership of the single currency club, then presumably this is a goal worth pursuing. However, for those countries to achieve membership requires not only that economic developments within their own economy are propitious, but that the independent monetary authority does not make life more difficult by changing policy to make monetary conditions more restrictive (i.e. raising interest rates) in the meantime. If that was to happen then, due to higher debt service costs, fiscal convergence would be all the more difficult for the non-participating country. And the longer a country remained outside the monetary union, the more difficult it might be to sustain the type of domestic policies that were required to enable it to meet the convergence criteria.

All of this revolves around a situation in which either the initial conditions between countries are different, or where we have a series of asymmetric exogenous disturbances, or where the monetary authority operates as if conditions were identical in each constituent part of the union whereas in fact this is not the case. The implication from this analysis is that the monetary union regime envisaged by the Maastricht Treaty is unstable as it offers no mechanism whereby fiscal conditions between participating countries can be brought into alignment. Consequently, there is every likelihood that both the costs and the benefits from monetary policy coordination will be unevenly distributed. This is almost certain to result in heightened tensions between EC member countries.

The solution would be for the 'order' governing the monetary union regime to provide for a common fiscal policy. That is, the situation would be one in which the regime provided for comprehensive policy coordination over all the entire range of interdependent policy instruments rather than a regime in which we have full coordination of only one policy instrument. Such a regime would avoid the considerable problems of implementing a joint policy over a variable (interest rates) which impacts upon policy areas over which there is inadequate coordination. However, for a regime of this type we would require a transition to a degree of fiscal federalism not envisaged within the EC at the present time.

In such a regime, however, one option would be to implement a joint fiscal policy to be managed by a single centralised budget for the EC as a whole. This would provide a degree of automatic stabilisation which would ensure that the output and employment consequences of asymmetric shocks, or of common shocks with asymmetric effects, were no greater for individual countries (and probably much less) under a common monetary regime than they were for individual countries with partial coordination of independent monetary policies. Crucially, both countries under the full policy coordination regime have the possibility of benefiting from such a regime - as shocks are equally likely to hit any country with the result that the stabilisation and convergence flows can go in either direction.

Another option would be to redesign the EMU 'order' in such a way that the requirement for coordination over fiscal policy was eliminated. This could be achieved by removing the twin criteria surrounding the fiscal conditions in participating countries. Such a move could be defended on the grounds that capital markets work efficiently, and that this would prevent any indebted country from over-extending itself to the detriment of the monetary union. At the same time a mechanism for the transfer of (stabilisation) funds between a surplus country and a deficit country would be established. There are, however, two objections to this option. First, the assumption of perfect capital markets is one that can be contested. There are many instances in which a country (or city) has been not been prevented from over-borrowing by the capital markets. Second, the deficit countries would be required to borrow capital at a rate of interest adjusted for the perceived risk of the investment. Given that the borrowing country is, by definition, one that is experiencing economic difficulties, the capital markets are likely to impose a significant risk premium on borrowing. Conceivably the added costs of borrowing within a monetary union might well exceed the microeconomic benefits associated with membership of the monetary union. Moreover, continual borrowing, if the markets permitted this, would result in union-wide interest rates being driven upwards.

Yet another solution would be that control over monetary policy would be exercised with regard having been given to the economic situation in each member state. However, this is an unsatisfactory option in that it would increase the vulnerability of the area as a whole to inflationary pressures. Finally, we could imagine a situation where the fiscal problems sketched in this paper were addressed through a regional equalisation fund working along the lines of the prevailing German arrangement. However, there is little sign of this being regarded as a serious proposal for EC member states.

In conclusion, therefore, the proposed 'order' for European monetary union is, in our opinion, profoundly flawed. Just as the ultimate cause of the September crisis in the EMS was policy incompatibility in the sense that the costs and benefits of policy coordination were being unevenly divided, the provisions for monetary union as these stand will formalise such a situation. It is difficult to imagine that such a regime will be stable. The EMS survived through the 1980s principally as a zone of stability. The much vaunted regime-shift of 1987 occurred during a phase of buoyant economic performance within the EC and a period during which economic policy continued to converge, albeit slowly. The result that the "new" regime remained untested. However, with German unification and the onset of recession the costs of partial policy coordination began to vists participants and a second regime-shift occurred in September 1992. The main danger for the EC is that the lessons from the 1992 currency crisis are not learned, and that an overly hasty transition to full monetary union is initiated. One of the main messages that we draw is that the EMU regime is flawed as it does not provide for full policy coordination, but only for full



coordination over one instrument of policy.

#### 4. EMU, Regimes and Governance.

As discussed at the outset, one of the main themes coming through the regime literature is that regimes affect governance, although not in any predictable manner. The governance of the EC has much to do with the constellation of regimes that surround the Community at any one moment in time. Further, the precise nature of governance will depend, in part, upon the internal workings of these regimes. Regimes where there is a weak 'order' are those where the regime's 'system' similarly is weak and unlikely to withstand significant shocks. An example might be to look at the lack of progress made during the 1970s in the area of harmonisation of technical standards. In this case the 'order' was weak, consisting of negotiations to harmonise national standards around an EC norm. The 'system' for so-doing, Community standards agencies, was weak and lacking in enforcement powers. All of this changed with the ECJ decision which opened the door to mutual recognition as a means of acquiring market access. This constituted a 'regime-shift' in that the regime's 'order' was transformed and acquired a status supported by EC law. At a stroke the regime governing market access (the single market programme) became a dominant regime within the EC. All attention focused on the single market programme and the policy process surrounding completion of the internal market became the key process within Community governance.

How does this illuminate on Europe's evolving monetary arrangements? During the 1980s the EMS constituted an important regime for delivering low inflation. However, the 'order' was comparatively weak in that it quickly became clear that the EMS was in reality operating along quite different lines to those set out in the founding agreement. Instead of being a regime of equal players in which policy was coordinated between equal partners, the EMS came to be driven by the currency role played by the Deutsche Mark. At the same time, the EMS did not formally impinge upon EC governance as it remained extra-Community. Informally, of course, the EMS was crucial in that it was the principal cohesive force between West Germany and France. The proposal now is to formalise the Community's currency arrangements under the regime set down in the Maastricht Treaty. We see this as inevitably altering the balance of EC regimes, with considerable weight being given to developments within the monetary regime. In essence, by formalising the EMS and monetary union as a regime within the EC institutional structure, we expect governance of the EC to become increasingly focused on developments within this regime.

The danger with that is that the monetary regime, for all the reasons discussed in this paper, appears to be inherently unstable. Consequently, we would expect monetary union, as presently envisaged, to be destabilising from the perspective of the EC as a whole.

## Notes

1. Bulmer (1993); 'Community Governance and Regulatory Regimes', paper presented to the ECSA conference, May 1993.
2. Armstrong (1993), 'Regulatory Regimes within the Single Market', paper presented to ECSA conference, Washington, May 1993.
3. A regime-shift can be defined as a change in either or both of the organisational profile of the regime or the normative context of the regime. The transition from EMS to EMU, as envisaged, will alter both.
4. Although the echo of neo-functionalism appears to be quite strong in this analysis, our focus is on the evolving regime rather than on the function over which the regime mediates national actions. So it is the regime and not the function that matters, albeit clearly distinguishing between the function and the regime is difficult. However, as we discuss later, there are significant spillover elements to regimes which may well operate along the broad lines proposed by the neo-functionalist school.
5. See McKinnon (1993) for an excellent account of the 'rules of the game' under the various exchange rate arrangements from the gold standard in the 19th C to the EMS in the 1990s.
6. There is a wide range of examples of international regimes within the economic sphere. The GATT regime for the management of international trade policy is one of the most developed.
7. For a review of this literature see in particular Hamada (1979) and Currie et al (1989). For an interesting discussion of policy coordination within the EMS see Guitain (1988).
8. Of course, if convergence in policy attitudes is complete then 'rules' can be dispensed with. Sandholtz (1993) contains an interesting discussion on the conversion to macroeconomic discipline (i.e. convergence in policy attitudes) between the participating countries in the EMS. As this conversion proceeds, the regime will become increasingly stable.
9. It is a matter of debate as to whether the Basle-Nyborg agreement constituted a change to the 'system' or the 'order'. We interpret this agreement as formalising changes to the 'system', leaving the 'order' more or less intact.
10. Inflation rates within the ERM countries continued to diverge throughout the period since 1979. To the extent that nominal exchange rate adjustments occurred, real exchange rates did not get too far out of line. From 1987 onwards, however, real exchange rates did change considerably with the inflation-prone countries suffering a loss of competitiveness due to real exchange rate appreciation. However, it is also recognised that the EMS did contribute to the considerable convergence that was observed in EC rates of inflation during the 1980s, although it has to be noted that the most successful disinflation country in the 1980s was the UK, not a member of the ERM.

11. This is, of course, the essence of the Walters' critique of the ERM which argued that exchange rate fixity would simply reinforce inflation pressures in the inflation-prone countries.

12. We are ignoring here the supposed macroeconomic gains associated with a single currency such as lower inflation and higher investment. The Commission, though proclaiming the existence of these additional benefits, provide no persuasive case why, for instance, the rate of EC-wide inflation under a single central bank should be lower than it is under the present arrangements.

13. See especially Hughes Hallett and Vines (1992) and Minford et al (1991).

14. The Treaty defines an excessive deficit as one where either the annual deficit exceeds 3% of GDP or where the ratio of outstanding public debt to GDP exceeds 60%.

15. Even if the initial conditions are equivalent between countries the impact of asymmetric shocks is bound to create unequal fiscal positions fairly soon.