Address given by Jean-Claude Juncker on the European Monetary System (5 March 1993)

Caption: On 5 March 1993, Jean-Claude Juncker, Luxembourg Finance Minister, analyses the crisis affecting the European Monetary System (EMS) and emphasises the implications of monetary integration in Europe.

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Highlights of the speech at the General Assembly of Forex Club Luxembourg, 5th March, by Mr. Jean-Claude Juncker

Does Europe need the European Monetary System ?

A year ago the Forex Club would probably never have considered the idea of asking me speak on the subject. "Does Europe need the European Monetary System?"

However following the events of the past year, which monetary policy terms too could be described as an "annus ibilis" and especially the change of direction in European exchange rate policy, the question is worth closer examination.

Indeed, in its 13th year of existence the EMS experienced turbulent changes that have shaken its very foundations. These events unfortunately, fresh in our minds.

September 14, 1992: devaluation of the Italian lira by 7 percent. September 17, 1992, just three days later: devaluation of the Spanish peseta by 5 percent and the withdrawal of the British pound and Italian lira from the exchange rate mechanism. November 23, 1992: devaluation of the Spanish peseta and Portuguese escudo by 6 percent each. And finally on February 1 of this year: devaluation of the Irish pound by 10 percent.

In addition the three Scandinavian countries, Finland, Norway and Sweden had to abandon their respective currencies ties with the ECU: Finland on September 8, Sweden on November 19 and Norway on December 10.

In the face of these events it is hardly that not a few observers have concluded that a return to a flexible exchange rate is pressing, whether through a broadening of the EMS band or even abandoning the system altogether; many commentators are calling for the introduction of freely floating exchange rates.

To anticipate your question, I am against such suggestions. The crisis of the last few months has shown that and well-functioning EMS is more necessary than ever. The escalation of changing monetary policies in the autumn and winter has also shown that we need the monetary union pressed by the Maastricht Treaty.

I must stress - the step towards flexible exchange rates desired by so many, in whatever form it might take, is neither politically nor economically responsible.

Politically such an undertaking would damage such European integration as has so far been achieved, and would throw us back into an age of national selfishness and increasing recklessness.

Economically the structural costs would for outweigh any short-term economic advantage. Europe would quickly revert to an inflationary community. It soon would lose sight of its goal of stability. It would lead to a domino-style devaluationary competition in which all member states would lose out.

Internal and external monetary instability would increase, the completion of the single market would be suspended, and the growth potential and resilience of national economies would collapse.

A brief survey of the monetary policy events of the past 35 years backs up this argument.

Turbulent History

The monetary integration of Europe has a long and turbulent history. Viewed as a whole it has made appreciable progress, but the path has been rocky and far from straight.

The Treaty of Rome, which established the European Economic Community, has as its primary goal the creation of a common market.

There were no concrete monetary plans in the treaty, which took effect on January 1, 1958.

Werner Plan

In the face of the signs of collapse of the Bretton Woods system at the end of the 1960s, which made the survival of a fixed exchange rate system ever more doubtful, closer European co-operation in exchange rate policy began to appear inevitable.

In view of this the 1969 EC summit in The Hague in 1969 established a working group with the brief of drawing up a plan for economic and monetary union (EMU).

The conclusion of this groups - best known as the Werner Plan after its president Pierre Werner - were submitted on October 8, 1970, and offered the first detailed plans for a step-by-step realisation of economic and monetary union.

It is certainly no accident that distinct elements of the Werner Plan also popped up in the Delors plan 18 years later. As noted earlier, the path to EMU was not always straight but on the whole, the policy was single-minded.

Despite a decision in principle by the Council of Ministers in 1971 to implement EMU by 1980, the Werner plan never took off.

However, to attribute the failure of this promising venture simply to a lack of common political will by the member states and a retreat to national interests is only in part supported by history.

The main cause of its failure is rather to be found in the accelerating collapse of the Bretton Woods system. On August 15, 1871 the United States abolished the convertibility of gold at to the official dollar rate, a decision which resulted in the coup de grace for the fixed exchange rate system two year later.

Chaotic transition

In 1971 the basis of a European exchange rate association were established - the so-called European currency snake in the dollar tunnel. This association was refined and politically cemented in March 1971 by a decision of the Council of Ministers and the Basle Agreement of the central banks.

The Bretton Woods system, which was no longer viable collapsed in March 1973 with the decision of the most important industrial nations to allow their currencies to float freely against the dollar.

Parallel to this the EC countries decided on stable internal European exchange rates, and the snake left the tunnel.

The relatively chaotic transition from the Bretton Woods system to a joint floating exchange rate was hardly avoidable, but surely a step in the wrong direction.

Indeed, one can say with 20 years' hindsight that hardly any of the expectations which accompanied this change were fulfilled.

Europe was forced to choose a regional solution. A sort of European group floating against the dollar and other currencies came into being. Economic divergence and incoherent national reactions to the oil crisis, however, led to an inconsistent exist and re-entry of some countries, particularly France, so the snake was unable to develop into a model of stability.

As a result the only countries remaining in the snake in 1978, shortly before the creation of the EMS were the Benelux countries, Denmark and Germany, which had de facto become a sort of D-Mark bloc.

Economic Growth

The open cracks in the dollar area, and the slow realisation that a system of fixed exchange rates on an international scale was not viable, led the EC Europeans to focus their resources on preventing monetary disintegration in Europe. The idea was to anchor internal European exchange rates more firmly than before and to bring as many member states as possible into the system.

This plan was favoured by the growing conviction that only stable and predicable monetary policy conditions would make possible lasting economic growth.

At the EC summit in Copenhagen in April 1978, a Franco-German initiative gave new impetus to the idea of a European Monetary System. The Bremen summit three months later saw the principle of the idea again official approval, and at the meeting of heads of state and government that December in Brussels the details were agreed.

The system went into effect on March 13, 1979. Only eight of the nine EC members actually took part in the most important part, so-called exchange rate mechanism, since the United Kingdom could not agree to immediate participation in the scheme.

The EMS is a system of fixed but adaptable exchange rates, that is, that fixed benchmark exchange rates can vary day-today within approved bands. The benchmark rates can be changed by unanimous decision.

The primary goal of the EMS, which still exists today, was to create a zone of monetary stability in Europe.

Many commentators in the late 1970s gave the EMS little chance of survival. Experts warned that without a certain degree of initial convergence, the system was doomed.

However, the EMS turned out to be a success story. Its success has surprised its initiators, and - for a time - abashed its critics. The EMS has been crowned with success, even though it never reached its second and final phase.

Structural changes

The third period lasted five-and-a-half years, from January 1987 to September 1992, that month last autumn when the EMS began to lose its way. A proper understanding of this period is necessary so as to grasp the exact implications of today's events and to draw the necessary lessons about the future shape of the EMS.

During this period there were no realignments (part from a technical realignment when the Italian lira moved from a wide to a normal band). This is a fact which many, probably rightly so, regret to this day.

At the same time, the period between 1987 and 1992 also saw structural changes in the EMS as well as in its environment.

In September 1987 the so-called Basle/Nyborg Agreement was concluded, involving a first reform of the technical - if not institutional-nature of the EMS. One of the most significant innovations of this agreement was easier access to short-term funds under a mechanism between central banks on mutual intervention.

During this period the EMS, or rather its exchange rate mechanism, welcomed new member currencies. In June 1989 the Spanish peseta entered in the 6 percent band, the British pound followed in October 1990, and the Portuguese escudo in April 1992.

As far as the pound is concerned, many observers now believe that neither the timing nor the benchmark rate at which it entered were correct, and that this, together with (with hindsight) premature transition of the lira to the normal band in January 1990, contributed to the later problems experienced by both countries.

Positive experience

The renaissance of the EMU idea, from 1988, can be explained by several factors. First, the positive experience of the EMS encouraged member states to take further steps. The system had proved an adequate answer to internal and external instability.

It enabled participating countries to establish satisfactory exchange rate stability, and at least in the core group led to appreciable price stability.

Second, the so-called imbalance of the EMS was becoming a target for criticism. The EMS had attempted to avoid this problem by not designating a lead currency. However, the system had in fact developed not as an ECU-oriented one, but rather one based on bilateral lead currencies.

Third, the realisation was starting to down that the triple ideal of free movement of capital, fixed exchange rates and national monetary autonomy was, taken together, contradictory. If one wants free movement of capital and fixed exchange rates, it is advisable to unify monetary policy as far as possible.

Against this backdrop, the French memorandum of January 1988 came out strongly in favour of a European monetary area with a single currency.

The then German foreign minister (Hans-Dietrich) Genscher, to general surprise, took up the French proposal and joined the call for early creation of a European Central Bank.

Three–Phase EMU

The markets followed the negotiating process meticulously. Those involved in the foreign exchange markets watched the Maastricht result not without apprehension. They were interested not only in the eventual European monetary structure, but perhaps even more in its implications for their very own field of activity.

Naturally one must ask how the turbulence and divisions we have observed could come about? The explanation, obviously, is a complex one.

Several factors are to blame for the partial explosion of the EMS in autumn 1992: the inconsistent strategic response of Europeans, indeed all Western industrial countries, to the upheavals in eastern Europe; the questions which remain unanswered today about the financing of German unity and the consequent restrictive German monetary policy; the unexpected problems of acceptance for the Maastricht treaty in nearly all member states, which caught governments completely unprepared and which have led to a confidence-draining delay in ratification of the treaty; the already growing pressure to realign within the EMS; the overheating and over-reaction of currency markets; and, above all, less than perfect political crisis management last autumn.

None of these factors, taken if isolation, is a sufficient explanation for the partial collapse of the EMS. Together though, they are the stuff of which monetary crises are made.

I would like to examine a few of these factors further. A main cause of the monetary crisis was the pressure to realign on EMS. Both politicians and markets had come to see the EMS as a de facto monetary union before its time, in which benchmark rate adjustments seemed no longer appropriate. The pressure to realign which had slowly built up since the last realignment in 1987 was overlooked.

There is no question that the countries with high inflation rates did not take strong enough steps to halt their progressive loss of competitiveness vis-à-vis the core countries of the EMS. This loss in competitiveness - taking the years 1987-91 - translates to around 15 percent for Italy and Britain, and double that for Spain.

These countries saw the relative overvaluation of their currencies as a weapon against inflation. A strategy of this kind can be successful, but only on condition that it proves sustainable and unshakeable, that is, the governments in question make clear efforts to adapt a balanced policy mix and are prepared to undertake a radical budgetary cleansing.

Credibility Gap

The markets must be convinced of the credibility of the policy. They have a long-term memory, and therefore a credible consolidation process always takes a matter of years. That is why France needed several years to give its strategy for competitive deflation the seal of credibility.

It is obvious that other countries had not achieved the same level of credibility when the autumn storms of last year wreaked their havoc.

However, the credibility gap alone cannot explain the monetary earthquake. Above all, the monetary seismographs reacted with unusual sensitivity to the negative Danish vote on the Maastricht treaty.

The Danish "no" the negative opinion polls ahead of the French referendum, the weak "yes" of the French on September 20 and continuing British hesitancy all contributed to a loss of faith which led to total insecurity and finally the fall of the EMS into uncontrolled crisis.

Along with this lack of faith and the pressure for realignment of the EMS came added to all the other ills a restrictive German monetary policy with continent-wide repercussions.

German reunification - a political highlight of the close of the century, over which one should rejoice rather than mourn - has unsurprisingly brought structural adjustment shocks and set Germany very difficult economic and financial policy problems.

High German interest rates only strengthened the existing economic slowdown in partner countries, and drew massive criticism from Germany's neighbours. In Germany itself the high interest rate policy was questioned, and condemned by many as economically damaging.

In Europe the accusation was made loud and clear that German monetary policy should take account not only of internal German problems, but that should also keep an eye out for the needs and requirements of its currency partners.

Reunification advantage

Allow me to make a point here. I admit that one can see German monetary policy and the attitude of the Bundesbank as altogether too doctrinaire, too strict and too much geared to Germany's interests. I see things in part that way, too.

But it is not right to attribute all European problems to German mistakes and neglect. All EC countries have taken advantage of German reunification. Without the expansion of the export market to Eastern Germany the recession would have hit our national economies much earlier.

One can also not hold Germany responsible for the fact that the governments of other countries, in defiance of all economic understanding and reason, for domestic political reasons failed to realign the exchange rates in the EMS.

And one must be aware that no-one in Europe can have any interest in too high on inflation rate in Germany. Objective criticism of Germany can only be acceptable and credible if it is accompanied by national self-criticism.

Those politicians who, in the face of a monetary crisis, save their harshest criticism for Germany and the financial markets, are not carrying out their duty of analysis properly.

External factors

It is no easy task to unravel the original tangle that led to the events of autumn and winter on the monetary front. I have offered some explanations in what I admit is a somewhat superficial account. There may be other reasons, technical explanations which you know better than me.

Even more difficult, and risky than an attempt to explain is to deal with the conclusions that may be drawn from the crisis, but some initial conclusion may be drawn.

One first conclusions that the EMS as such did not fail: the factors which led to the turbulence are to a large extent to be found outside the EMS and its exchange rate mechanism.

Realignments in the EMS are in reality neither abnormal nor unknown to the system. In a system of fixed but adaptable exchange rates realignments should - and must - be carried out when these are economically necessary. The EMS must be able to breathe if it is to avoid being chocked to death.

It should be noted that the Maastricht treaty does not exclude the benchmark rate realignments. The treaty as such will not abolish the EMS. What is foreseen is the freezing of the components of the ECU currency basket after the entry into force of the treaty.

To this is added that each candidate for participation in to the third phase of EMU will not be allowed to devalue unilaterally during the last two years before entry to the third phase. Realignments must be based on collective decisions.

However, the treaty in no way alters the principle rules of the EMS. Sometimes one has to remember this. On the whole the rules have proved their worth over the past decade. Now priority must be given to ensure the rules are correctly applied.

Speculation defence

There is no convincing reason for reform of the EMS. I am convinced all the finance ministers will eventually come to the same conclusion, although I cannot exclude the possibility that some technical details could be examined.

I am also confident about the immediate future of the EMS. I assume that unwarranted market movements will be opposed in the manner of the Franco-German model of defensive reaction over the past few months.

The defence of the Danish krone against speculation, too, has shown that the need for concerted action has been recognised by all although in Ireland the regret is understandable that the concerted effort in Denmark's case was not implemented a week earlier.

I say, a well-functioning EMS will speed up the monetary convergence efforts of the member states.

That key word convergence leads me to the observation that the recent currency problems should in no way be used as an excuse to lessen the strict convergence criteria laid down in the Maastricht Treaty.

Every country willing to participate must document its capability and determination to meeting these criteria. Europe needs a well-functioning EMS to make the leap to its monetary future. And the EMS needs the undiminished perspective of EMU.

The Maastricht EMU offer is available to all member states which are prepared subject themselves to the required convergence discipline.

That is the message from Maastricht - one offer to all.

Speculation as to whether it would be possible to implement already a smaller EMU consisting of the hard currency countries, and at the same time to abandon the Treaty perspectives, namely the offer to all, are premature and do not conform with the treaty.

This sort of speculation only damages credibility and increases uncertainty. If however - and I don't believe this will happen - the treaty fails to be implemented, then a smaller monetary union would be better than none at all, and Luxembourg would have no other conceivable option than to join such a union from the start.

Over the last few months I haven't been able to avoid the impression it would have been better for the EMS had the finance ministers talked less and, during an agreed period of silence, agreed on a plan to deal with the situation. I have only spoken now because you asked me to.

This article is the translation of a speech by Jean-Claude Juncker to the general assembly or the Forex Club Luxembourg on March 5.