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The European Currency Crisis

The catalyst for the September currency crisis in Europe was the tension over the stance of monetary policy in Germany and other countries in the European Monetary System (EMS), the arrangement that limits exchange rate fluctuations among members. High German interest rates were blamed for limiting the prospects for an economic recovery in Europe by forcing other members to keep their own rates high in order to maintain the value of their currencies against the German mark. Market speculation against the parities set by the Exchange Rate Mechanism (ERM) of the EMS has resulted in the devaluation of several currencies against the mark, as well as the withdrawal of the United Kingdom and Italy from the ERM.

These developments have raised new questions about the current direction of German monetary policy, the future of the EMS, and the prospects of a European monetary union. This *Weekly Letter* reviews and interprets these developments.

The Bundesbank and the EMS

Because Germany is the largest economy in Europe, accounting for 25 percent of the European Community's output, its central bank, the Bundesbank, is de facto the dominant central bank in the EMS. The Bundesbank traditionally has adopted a conservative monetary policy stance and has gained credibility as an inflation fighter. In the late 1980s annual consumer price inflation in Germany averaged less than 2 percent. In recent years, most EMS member countries have linked their currencies to the German mark, because of the credibility it provides about long-run inflation expectations. The link effectively requires that they maintain their monetary policies roughly in line with Germany's. It has been generally felt that the gains in credibility are worth the cost of losing some discretion over domestic monetary policy.

This situation changed in mid-1990, however. The rise in fiscal expenditures to achieve reunification with East Germany caused Germany's general government budget deficit to grow from near balance in 1989 to 2.5 percent of GNP in 1990 and to 4.4 percent of GNP in 1991. A real demand shock of this nature generally leads to higher real interest rates and a real appreciation of a country's currency, which together reduce the strain on domestic resources. (The U.S. fiscal expansion of the early 1980s—namely, the tax cuts and defense buildup—and the associated dollar appreciation provides a similar example.) And, indeed, the mark has appreciated both in nominal and real terms against the dollar and yen.

However, the constraints of the EMS limited the nominal appreciation of the mark against the currencies of other member countries. Thus the pressure for a real appreciation of the mark within the EMS has taken the form of relatively higher inflation in Germany than in its neighbors.

But the Bundesbank has demonstrated its resolve to limit the amount of price inflation not only in the face of the costs of reunification, but also in light of wage settlements above 6 percent in 1991. The Bundesbank responded to these inflationary pressures by tightening monetary policy. The discount rate was raised roughly 3 percentage points between 1990 and mid-1992 to 8.75 percent, the highest level since 1948.

As a result, the burden of achieving the necessary real appreciation of the mark within the EMS fell on other member countries who were compelled to deflate in order to maintain their currencies' link to the mark; that is, to defend their currency parities with the mark, these countries matched the high German interest rates. From the fourth quarter of 1990 to the fourth quarter of 1991, consumer inflation increased by 1 percentage point in Germany, while decreasing almost 6 percentage points in the United Kingdom, and more than ½ percentage point in France and Italy. This deflationary trend has been accompanied by a severe recession in the United Kingdom and sluggish growth in France, Italy, and most other EMS members.

The exchange rate crisis

The catalyst for the exchange crisis was the tension between countries that want more stimulative policies to lift their economies out of recession or sluggish growth and the Bundesbank, which is concerned about domestic inflation and therefore wants high interest rates. Interestingly, the crisis actually was triggered by the devaluation of the Finnish markka on September 8, followed by market speculation against the Swedish krona, which the Swedish authorities defended by sharply raising interest rates. Though neither country is a member of the EMS, both have "shadowed" the mark, and both have experienced recessions. Then, just days before the September 20 French vote on the Maastricht Treaty on European economic and monetary union, market speculation focused on the core currencies of the EMS.

In response, on September 14 the Bundesbank reduced its discount rate by 50 basis points to 8¼ percent and the Lombard rate (the rate charged for supplemental bank borrowing) by 25 basis points to 9½ percent. At the same time the Italian lira was devalued by 7 percent to offset speculation against it. The German rate declines were below expectations, however, contributing to further foreign exchange speculation against the weaker currencies in the ERM. In response to these attacks, the United Kingdom and Italy both withdrew from the ERM and their currencies depreciated. The Spanish peseta also was devalued 5 percent.

Despite these currency realignments within the EMS, the first since 1987, pressures persisted. The pound continued to float down freely as the U.K. reduced interest rates. By September 22, the Bank of England had lowered its base lending rate to 9 percent, down from a peak of 15 percent in the midst of the currency crisis and the lowest level since 1988. To defend the peseta, the Bank of Spain reinstituted capital controls on September 23. France's slim approval (51 percent) of the Maastricht Treaty did not significantly reduce speculative pressure on the French franc. In response, the Bank of France raised interest rates, and French officials repeatedly expressed their determination to avoid a devaluation of the franc, pointing to relatively strong French economic fundamentals (particularly inflation and government finances).

The direction of German monetary policy?
The recent crisis raised concerns about economic recovery in Europe, the future viability of the EMS, and the prospects of a European monetary union. German policymakers have been confronted with the need to balance the responsibilities of maintaining international arrangements against traditional domestic policy concerns. On the one hand, the German decision to lower interest rates may have been expected to ease exchange rate tensions in the EMS. Clearly, however, the markets viewed the German move as "too little, too late" to limit speculative currency pressures.

Perhaps more important, the reduction in German rates is consistent with concerns over a slowing economy and some easing of inflationary pressure. In 1991 (Q4/Q4) GNP growth was only 1 percent, and was in fact negative during each of the last three quarters of the year. In the first half of 1992 the German economy has not shown signs of resuming any significant growth. Real GNP fell at an annual rate of 1 percent in the second quarter, compared to a rise of over 7 percent in the first quarter. But the first quarter's apparently strong performance is attributed to an unusually mild winter which limited normal declines in outside business activity.

Other signs that Germany's economy is doing poorly include a 4.5 percent fall in industrial production reported in June over the preceding year, a 6.8 percent decline in retail sales, and a rise in unemployment to 6.7 percent in July, up from 6.2 percent at the beginning of the year. Moreover, although inflation remains a significant concern, recent inflation signs have been good. Consumer inflation fell from 4.3 percent in June, to 3.3 percent in July, and to 2.5 percent in August, measured as an average of the latest three months over the previous three months at an annual rate.

While the cut in German interest rates apparently represents a change in the direction of German monetary policy, there are reasons to believe that the Bundesbank may proceed cautiously. Concerns include the magnitude of the increasing government budget deficits, how they will be financed, and the emerging pattern of wage settlements for 1993.

Furthermore, the Bundesbank is concerned about the rapid growth of the broad money supply. Over the first eight months of 1992, Germany's M3 has grown at an annual rate of almost 9 percent, well above the Bundesbank's target range of 3.5–5.5 percent. However, there are reasons to attribute the overshooting of money growth targets to special factors that exaggerate the inflation potential. In particular, the inverted German yield curve, with short-term rates (9 percent) considerably above long-term rates (8.5 percent or less) has induced German savers to hold more short- and medium-term interest-bearing bank deposits. In addition, M3 may provide a less reliable yardstick of future inflation because much of the recent growth can be associated with an increase in bank credit through subsidized lending to eastern Germany where money transaction demand may be somewhat higher.

Future of EMS and the European Union?

The EMS was intended to provide European countries with the benefits of predictable currency rates at the cost of limited monetary independence. But trying to maintain the system of stable parities under the pressure of differing national economic fundamentals, in turn leading to shifts in equilibrium exchange rates, proved very difficult. The German unification shock was the most important fundamental shock, but additional tensions were bound to arise. First, the pound entered into the ERM (October 1990) during a period of double-digit inflation in the United Kingdom, and second, Italy has yet to resolve an unsustainable position of government deficits that exceed 10 percent of GDP and debt levels above 100 percent of GDP.

The currency crisis in Europe forced exchange rate parities to reflect more accurately the economic fundamentals, but it also may have slowed the creation of a single currency and a unified monetary policy for *all* EC members. The Maastricht Treaty, drafted by a special summit of EC leaders in December 1991, requires approval of all 12 members of the EC. It calls for establishing a European Monetary Institute to be run by the governors of national central banks with the goal of "coordinating" monetary policies and "preparing" for a common currency on January 1, 1994. It also calls for a single currency and an independent European central bank on January 1, 1997 if a majority of countries have achieved what the treaty calls "convergence" as measured in terms of a country's inflation, interest rates, and budget deficits. Otherwise, a single currency is to be created on January 1, 1999 by those countries that have met the convergence requirements.

In light of recent events, this timetable may be unachievable for the majority of members of the EMS. A likely scenario is a two-tier process. Those countries with the strongest currencies—Germany, the Benelux countries, and perhaps France—might link their currencies and monetary policies more tightly in the next few years and move, perhaps on the original timetable, towards a common currency. The others with weaker currencies, including the U.K., Spain, and Italy, would retain more monetary independence to focus on domestic economic conditions.

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