

The Turbulent EMS in the 1990s: What Lessons for Today?

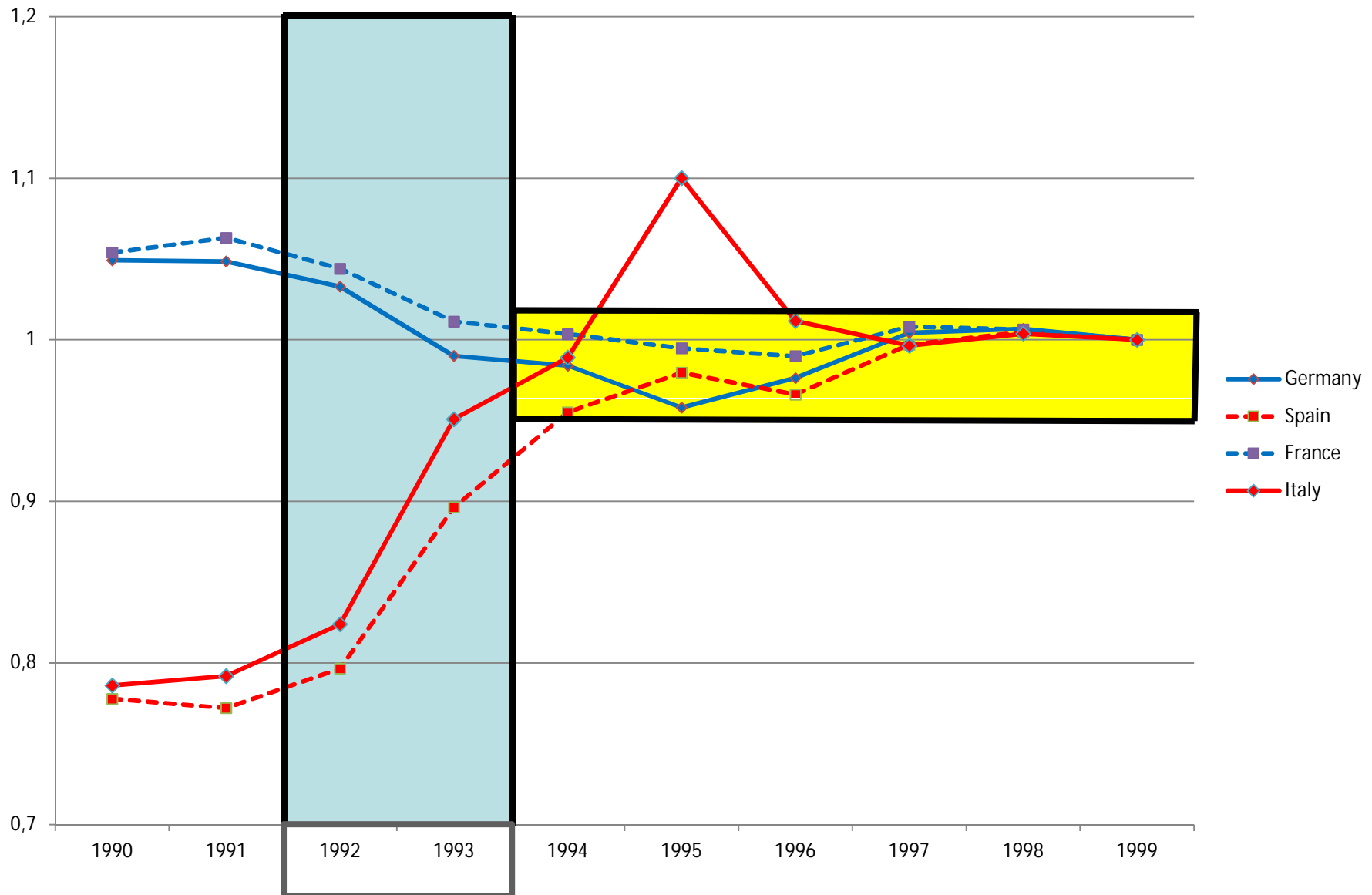
André Sapir

Professor of Economics, Université Libre de Bruxelles
Senior Fellow, Bruegel

The turbulent 1990s: the EMS incompatible trio

- July 1990: Full liberalization of capital movements between EU MS
- October 1990: German reunification
- The EMS incompatible trio after 1990:
 - » Fixed exchange rates
 - » Free capital movements
 - » Autonomous monetary policies
- [February 1992: Maastricht Treaty signed; June 1992: Danish referendum; September 1992: French referendum]
- September 1992: EMS/ERM crisis; July/August 1993: second EMS/ERM crisis

Exchange rate parities against the ECU/Euro (1999=1)



Data source: AMECO

Crises: EMS vs. EMU (1)

- Two types of crises in EMS and EMU
 - » Crises of fundamentals, e.g. misalignment/competitiveness or government solvency
 - » Self-fulfilling liquidity crises

- The EMS had to avoid two types of mistakes [Gros and Thygesen (1998)] :
 - » Defend parities against speculative attacks when fundamentally misaligned
 - » Not to defend parities against speculative attacks when fundamentally sound

- Similarly, EMU has to avoid two types of mistakes [Gros (2014)] :
 - » Provide financing to countries whose governments are insolvent
 - » Not to provide financing to countries whose governments are solvent

Crises: EMS vs. EMU (2)

- In other words, the problem seems to have remained pretty much the same
- When fundamentals went wrong, crises occurred under both EMS and EMU regimes (with free capital movements). BUT: Could they have been avoided?
- We know that self-fulfilling liquidity crises can be avoided under both regimes, provided there is an appropriate LOLR (De Grauwe and Li, 2013)
 - » Money (and foreign exchange) market crises
 - » Government bond market crises

Lender of Last Resort : EMS vs. EMU

	EMS Before 1990				
Government bond market	National Central Banks				
Money (incl. FE) market	DE (Buba)				

Lender of Last Resort : EMS vs. EMU

	EMS Before 1990	EMS After 1990			
Government bond market	National Central Banks	National Central Banks			
Money (incl. FE) market	DE (Buba)	None			

Lender of Last Resort : EMS vs. EMU

	EMS Before 1990	EMS After 1990	EMU Before crisis		
Government bond market	National Central Banks	National Central Banks	None		
Money (incl. FE) market	DE (Buba)	None	Eurosystem (Target 2)		

Lender of Last Resort : EMS vs. EMU

	EMS Before 1990	EMS After 1990	EMU Before crisis		
Government bond market	National Central Banks	National Central Banks	None		
Money (incl. FE) market	DE (Buba)	None	Eurosystem (Target 2)		

Lender of Last Resort : EMS vs. EMU

	EMS Before 1990	EMS After 1990	EMU Before crisis	EMU Since crisis	
Government bond market	National Central Banks	National Central Banks	None	ECB ESM (But DE)	
Money (incl. FE) market	DE (Buba)	None	Eurosystem (Target 2)	Eurosystem (Target 2)	

Lender of Last Resort : EMS vs. EMU

	EMS Before 1990	EMS After 1990	EMU Before crisis	EMU Since crisis	
Government bond market	National Central Banks	National Central Banks	None	ECB ESM (But DE)	
Money (incl. FE) market	DE (Buba)	None	Eurosystem (Target 2)	Eurosystem (Target 2)	

Lender of Last Resort : EMS vs. EMU

	EMS Before 1990	EMS After 1990	EMU Before crisis	EMU Since crisis	GEMU
Government bond market	National Central Banks	National Central Banks	None	ECB ESM (But DE)	ECB Euro Treasury
Money (incl. FE) market	DE (Buba)	None	Eurosystem (Target 2)	Eurosystem (Target 2)	Eurosystem (Target 2)

Lesson 1

- The nature of the crisis needs to be clearly identified in order to solve it
- The EMS crisis of 1992 was not a crisis of liquidity, but a crisis of fundamentals
 - » Severe misalignment (GBP, ITL, ESP)
 - » Incoherence: incompatible trioHence it was right for the Buba to refuse acting as LOLR
- The Euro crisis in the summer of 2012 was a liquidity crisis, hence it was (economically) right for the ECB to take on the role of LOLR to governments (subjects to certain conditions) ; the OMT successfully changed expectations
 - » About the solvency of IT and ES
 - » About the incoherence in the system and the sustainability of the euro
- On the other hand, the earlier SMP for Greece turned out to be unsuccessful in changing expectations because public debt was unsustainable

Lesson 2

- Crises of fundamentals in EMS and EMU could have been avoided if the systems had been better designed

- There were three failures in both cases:
 - » Intellectual failure to fully appreciate the nature of the systems and of the risks
 - » Surveillance failure to detect the build up of imbalances
 - » Coordination failure to correct the imbalances in a cooperative manner and avoid the crises

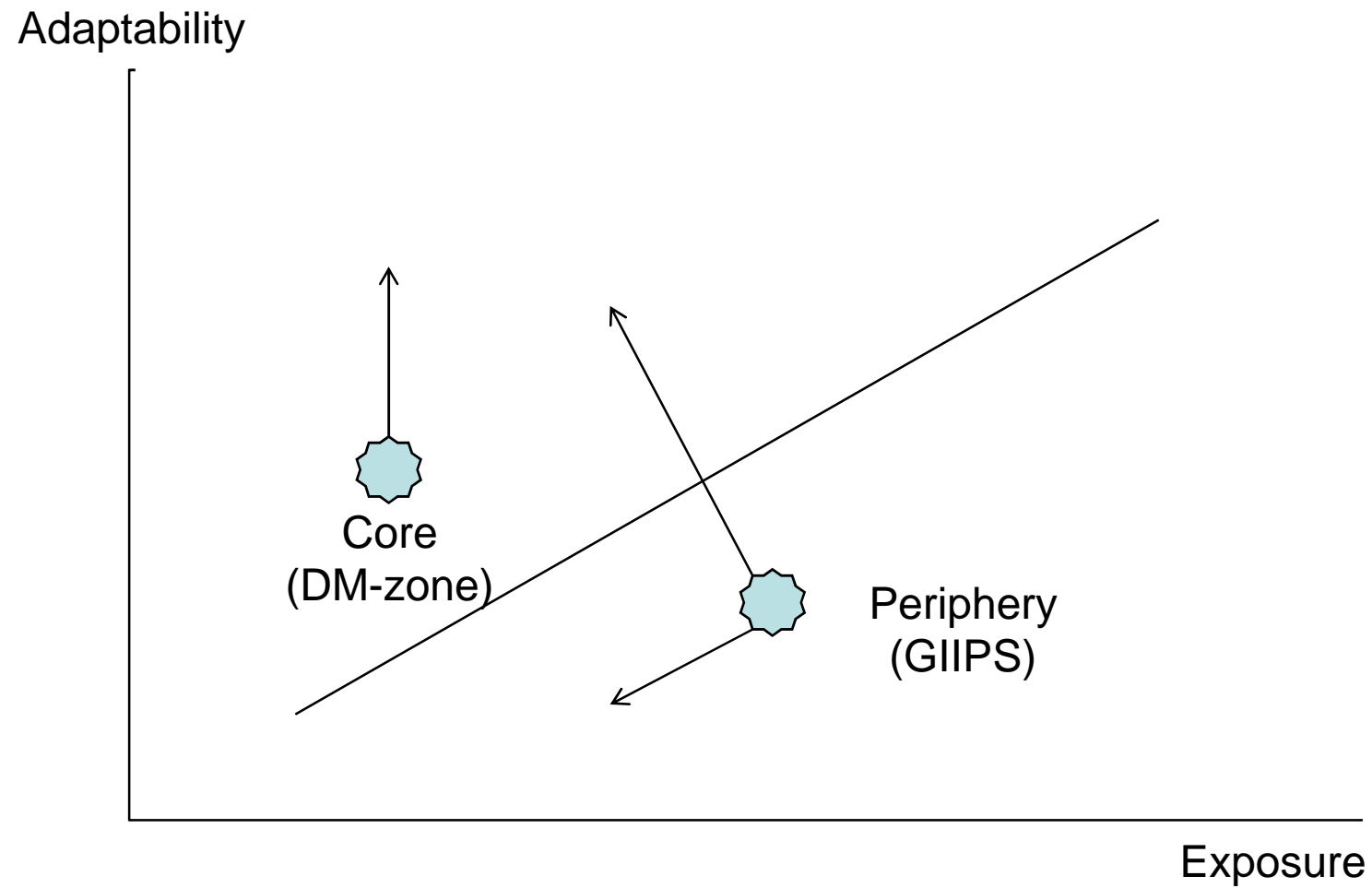
- Examine the three failures in the case of EMU

Intellectual failure

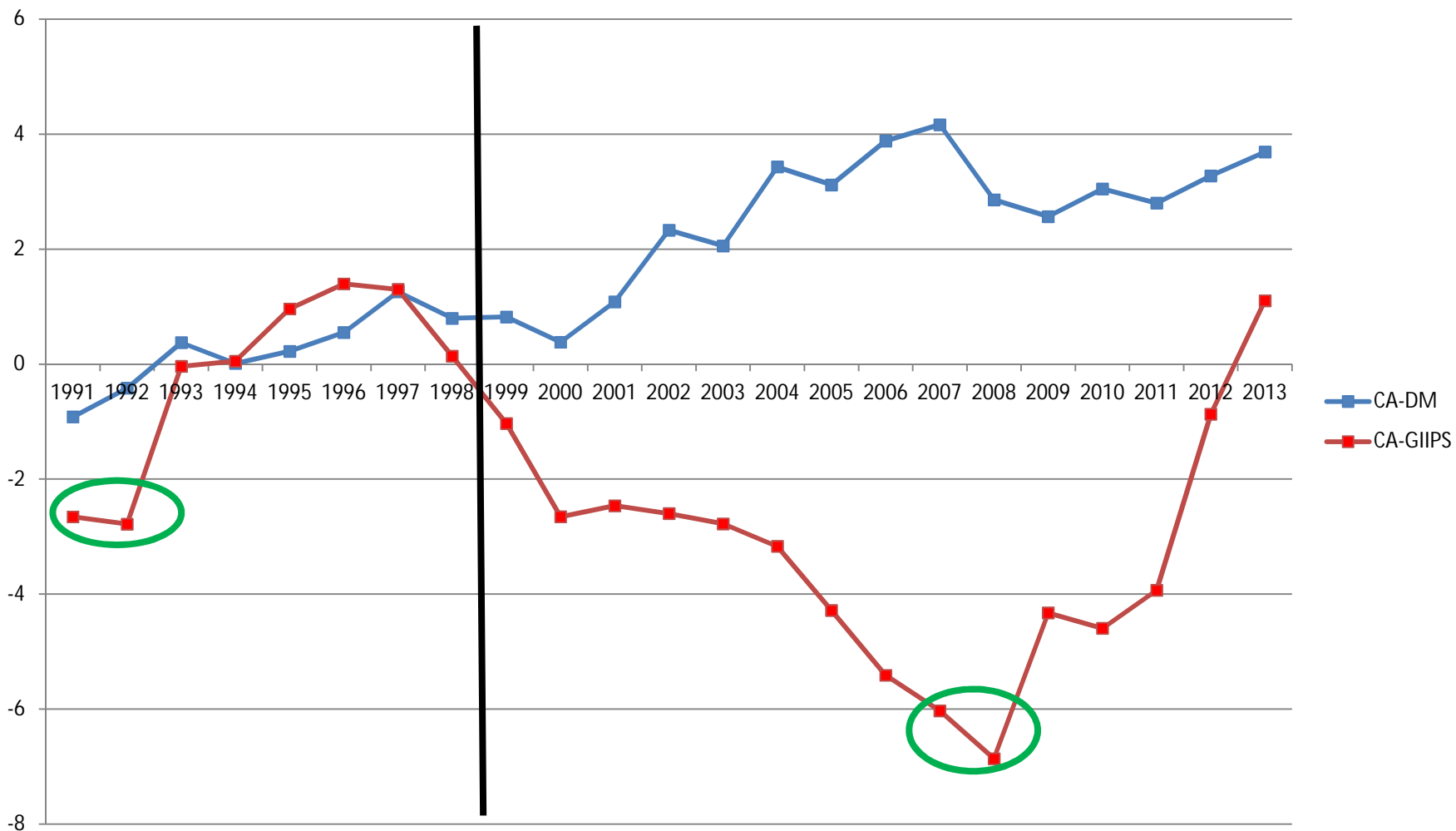
- Like the EMS, EMU also faces an incompatible trio

- An EMU with
 - » Important economic and social differences between countries
 - » Financial integration
 - » Lack of common fiscal and banking policies and institutionsis what led to the EZ sovereign debt and banking crisis

Heterogeneity at the start of EMU

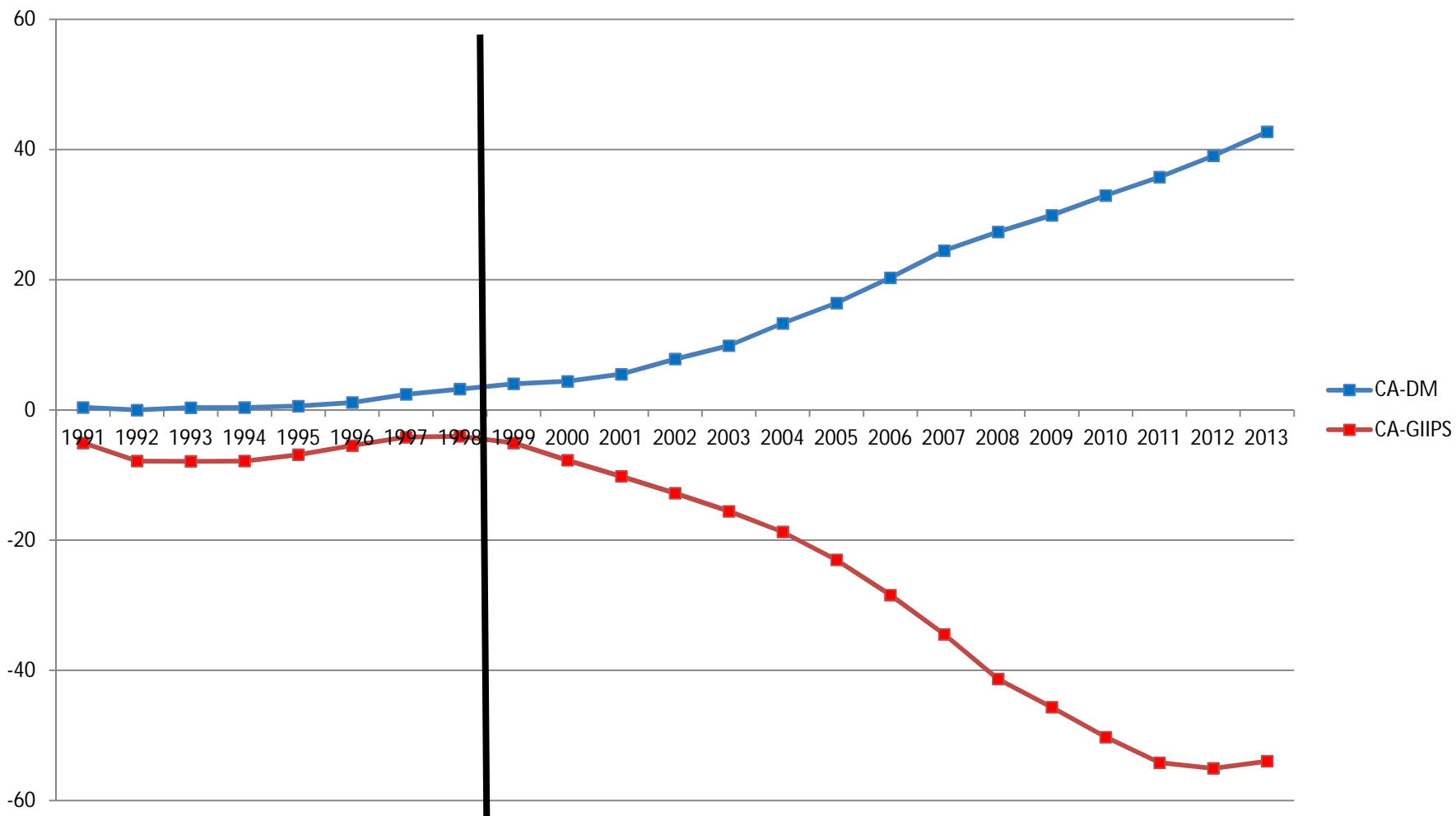


Surveillance failure 1: Current accounts as % of GDP

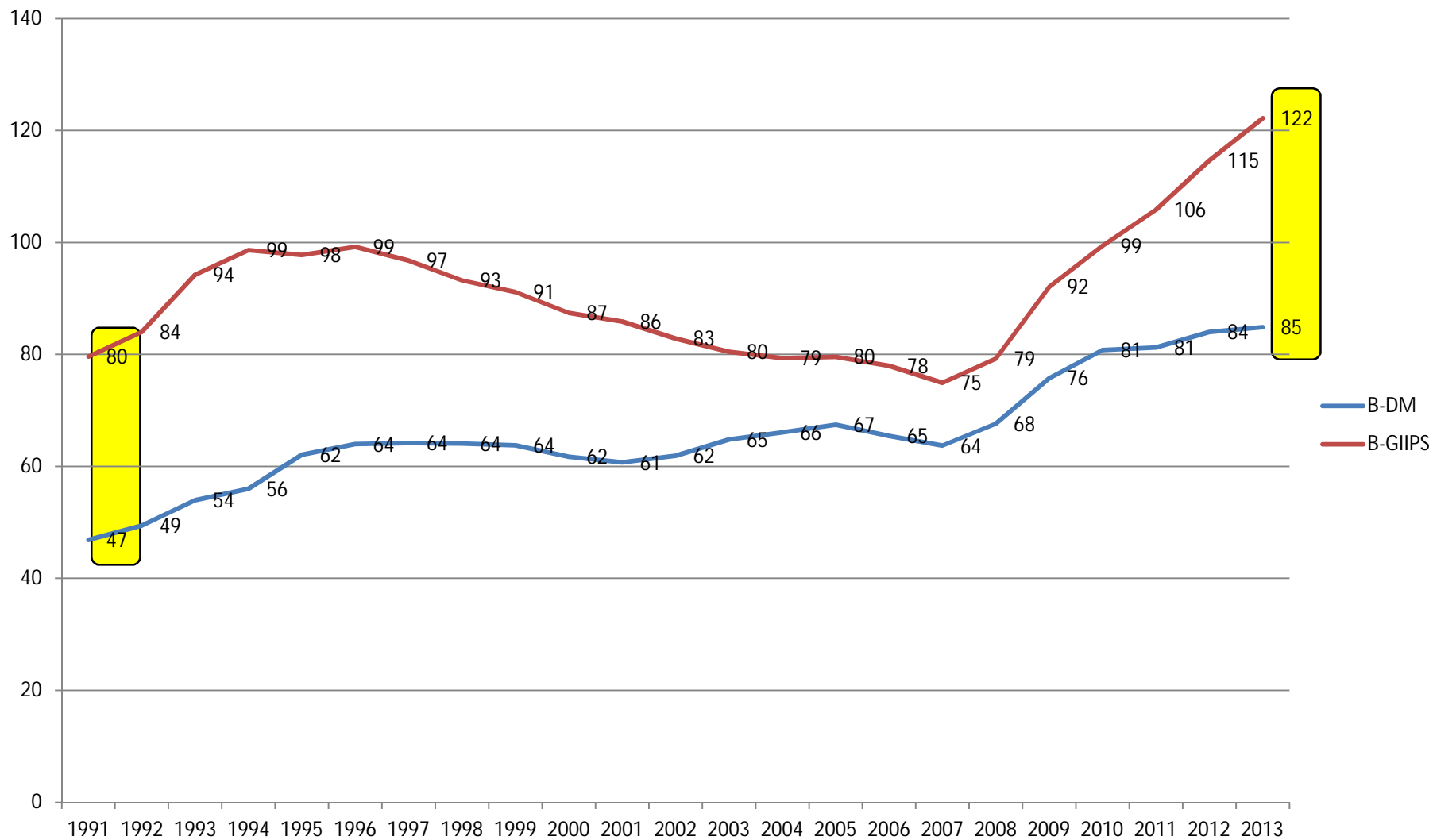


Data source: AMECO

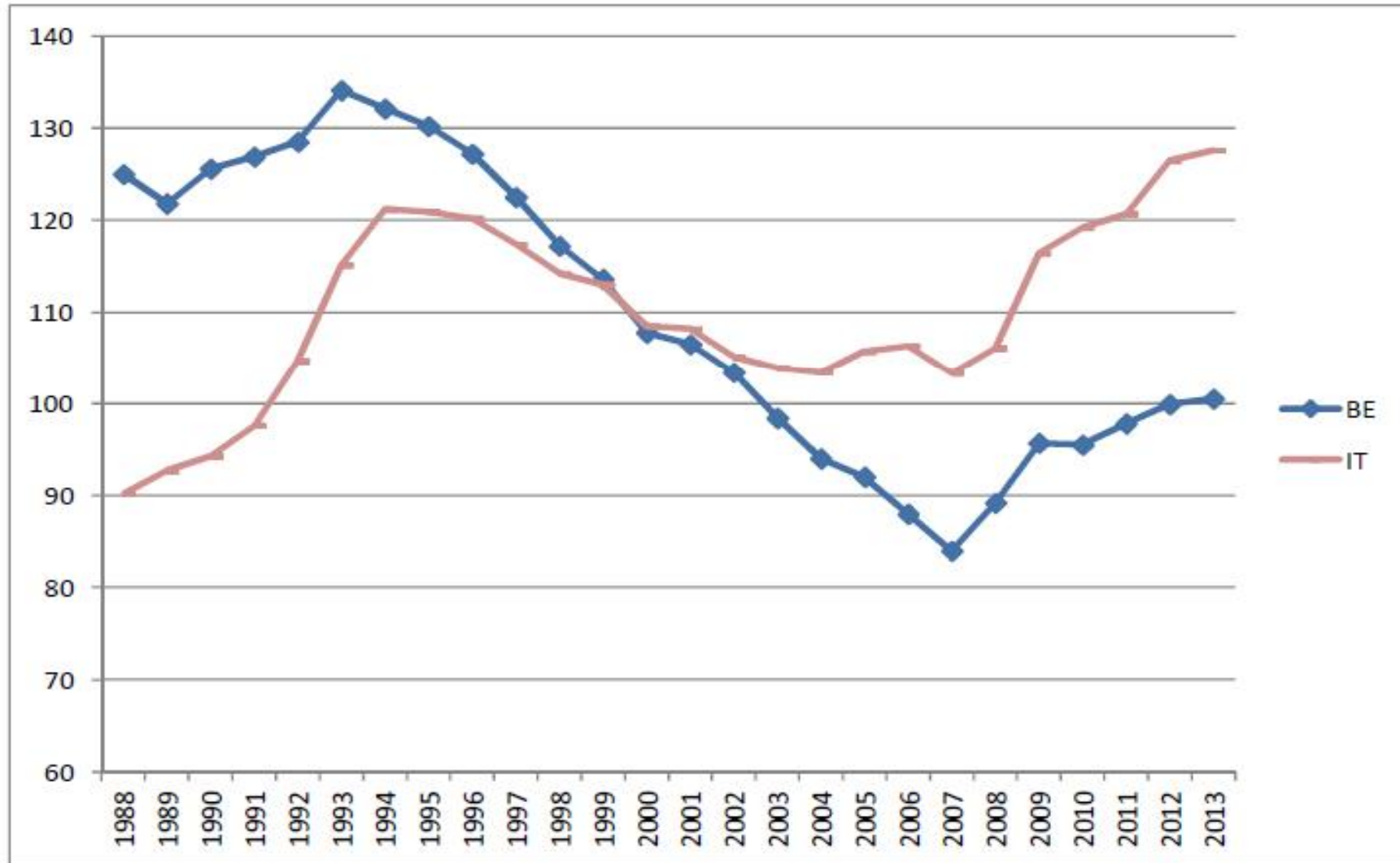
Surveillance failure 1: Cumulative current accounts as % of GDP (1989=0)



Surveillance failure 2: Government debts as % of GDP



Surveillance failure 2: Government debts as % of GDP – Belgium vs. Italy



Improving surveillance

- EMU surveillance has been improved with
 - » Macroeconomic imbalance procedure
 - » European semester

- But this is not sufficient

- Surveillance should focus on fewer items and be the joint responsibility of the EU and the MS

- It should be carried out by a surveillance network comprising of
 - » A European body (DG ECFIN)
 - » National authorities

Beyond macroeconomic surveillance

- Fiscal and macroeconomic surveillance are important but insufficient given the heterogeneity of the EZ

Eurozone economies	Ease of Doing Business Rank 2014
Finland	12
Ireland	15
Germany	21
Estonia	22
Netherlands	28
Austria	30
Portugal	31
Slovenia	33
Belgium	36
France	38
Slovak Republic	49
Spain	52
Italy	65
Greece	72

Coordination failure

- Core-periphery divide in terms of
 - » Competitiveness
 - » Debt overhang
 - » Hence other variables, including credit conditions and unemployment

- In the 1990s, the non-cooperative response to the tensions to the EMS resulting from German reunification and free capital movements, led to the crises of 1992 and 1993

- Similarly, insufficient cooperation (“every country has to put order into his own house”) in response to the tensions in the EZ after the financial crisis and the Greek problem is what led to the crises in 2011 and 2012

Conclusion

- The EMS crises of 1992-1993 were the result of 3 failures that were carried over to EMU and led to the recent crisis
- Since the start of the crisis, a number of improvements in the governance of EMU have taken place, including the banking union
- But we are still far from a GEMU, including the in banking union
- We need to go beyond a “single currency” and create the conditions for a “common currency”, which are twofold:
 - » More cooperation to deal with legacy problems
 - » More cooperation to transform the periphery and reduce EZ heterogeneity