

Monetary and Exchange Rate Policy
Part 1

Introduction into Economic System of the EU

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R.Baldwin and C.Wyplosz: The Economics of European Integration, Ch.13 and 14

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18:00 – 20:25

Money and Exchange rate

- Money is anything that is generally accepted as payment for goods and services, and repayment of debts
 - The main uses of money are as
 - a medium of exchange
 - a unit of account, and
 - a store of value
 - Domestic and foreign money:
 - Domestic price = Foreign price x Exchange rate
 - Exchange rate converts foreign prices into domestic prices
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Money and Exchange Rate Connections

$$\frac{P_{DE}}{P_{FR}} = \text{ExchangeRate}_{F/DM}$$



P_{DE}

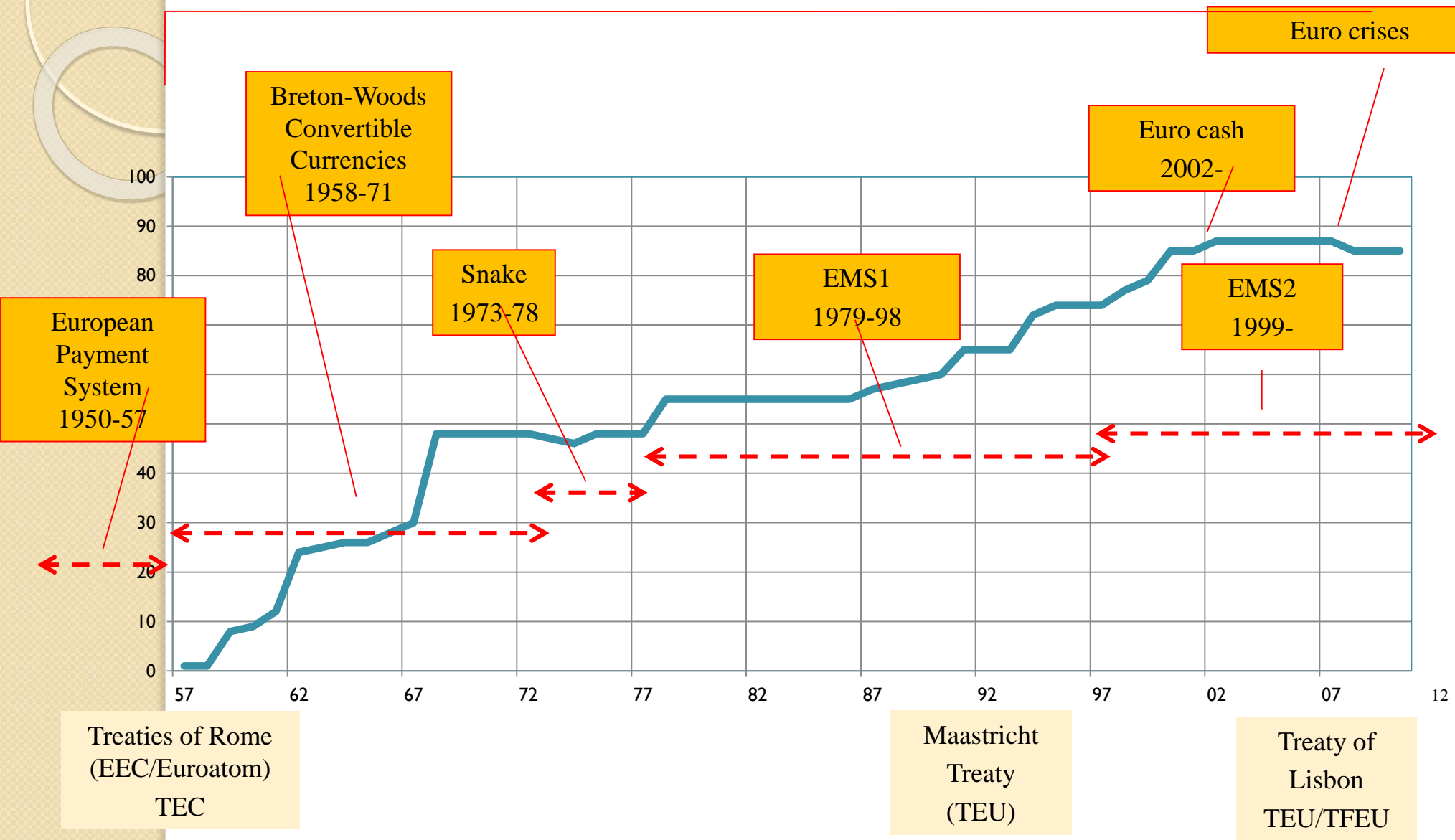


Banque de France



Deutsche Bundesbank

Evolution of the Payment System



First Steps

- The Marshall plan, \$12 billion (1948-52)
- Organization for European Economic Cooperation (OEEC 1948) (Close to EU15)
 - OEEC coordinated aid distribution and prompted trade liberalisation
- European Payment System (EPU 1950-58)
 - No convertible local currencies
 - Clearing mechanism in a multilateral barter arrangement
 - Facilitated payments and fostered liberalisation
- Treaty of Rome (1957)
 - A road to common market
 - Bretton Woods system fully operates: convertible local currencies
- Fallout of Bretton Woods system (1971)

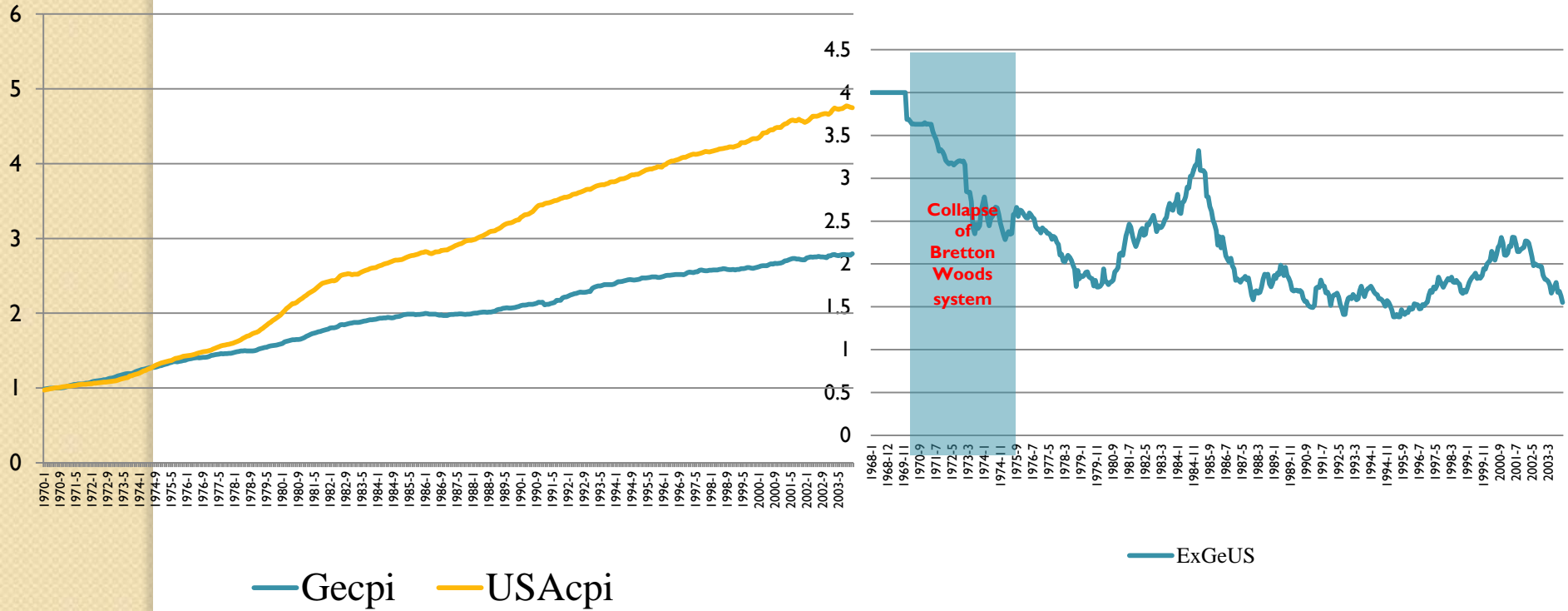
Next Steps: On the road to the Euro

- What is the way out after Breton Woods' collapse?
 - Free floats of European currencies, or a single currency?
 - Intermediate solution was a managed float of all currencies (Snake)

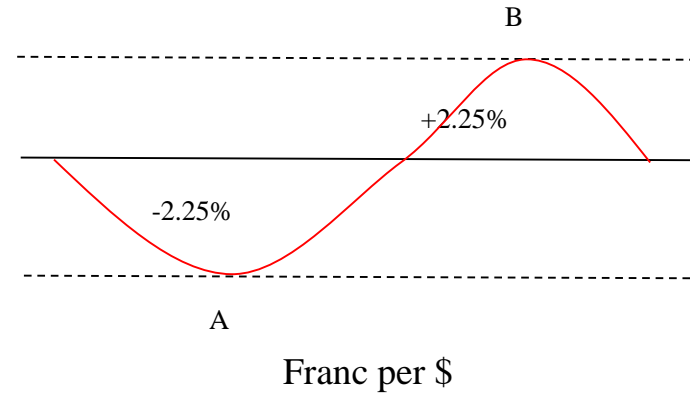
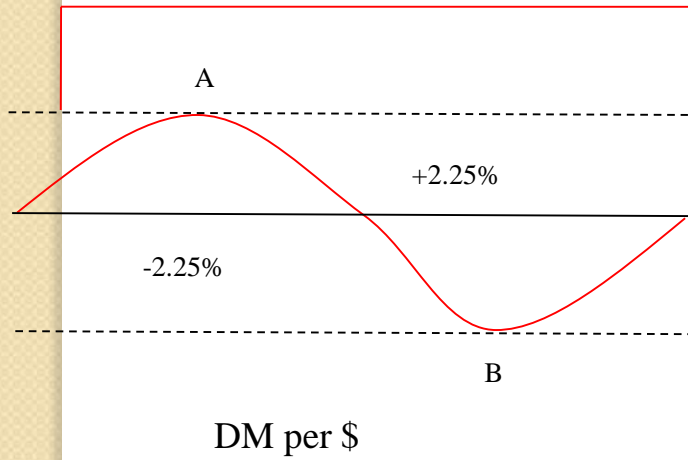
Towards Maastricht		From Maastricht to the Single Currency		The Single Currency	
1971/73	Snake	1997	Stability and Growth Pact	1999	Monetary Union
1979	EMS1	1998	Conversion rates set	1999	EMS2
1993	Maastricht Treaty ratified	1998	Creation of ECB	2002	EURO notes and coins

Prices and Exchange rate

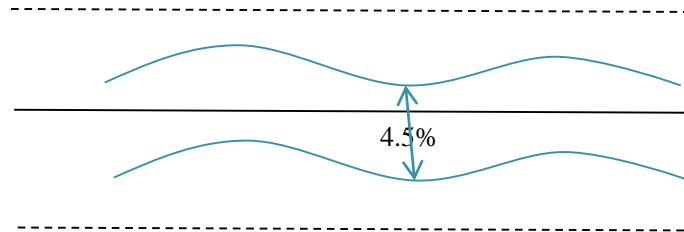
$$P_{\text{Ger}} = P_{\text{USA}} \cdot \text{Exchange Rate}_{\text{DM}/\$}$$



Snake in the tunnel



DM per Franc +/- 4.5%



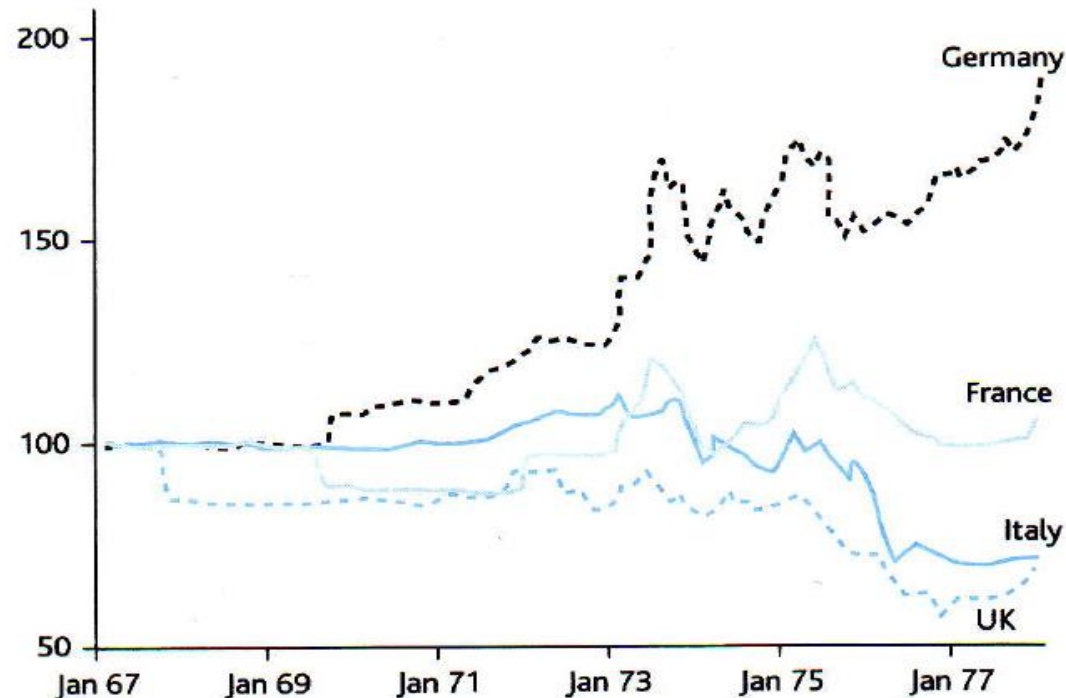
Snake in the tunnel

The snake in the tunnel: Properties

- Improving on the Snake to stabilize intra-European exchange rates
 - Mutual support
 - Realignment unanimity rule
 - Respecting the EU equalitarian approach
 - No centre currency
 - Bilateral interventions by strong and weak currency central banks
 - No role for the US dollar: Europe on its own
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Snake in the tunnel: Achievements

- Agreeing on stabilizing intra-European bilateral parities
- No enforcement mechanism: too fragile to survive



Dollar exchange rates

The EMS-1: Super-Snake

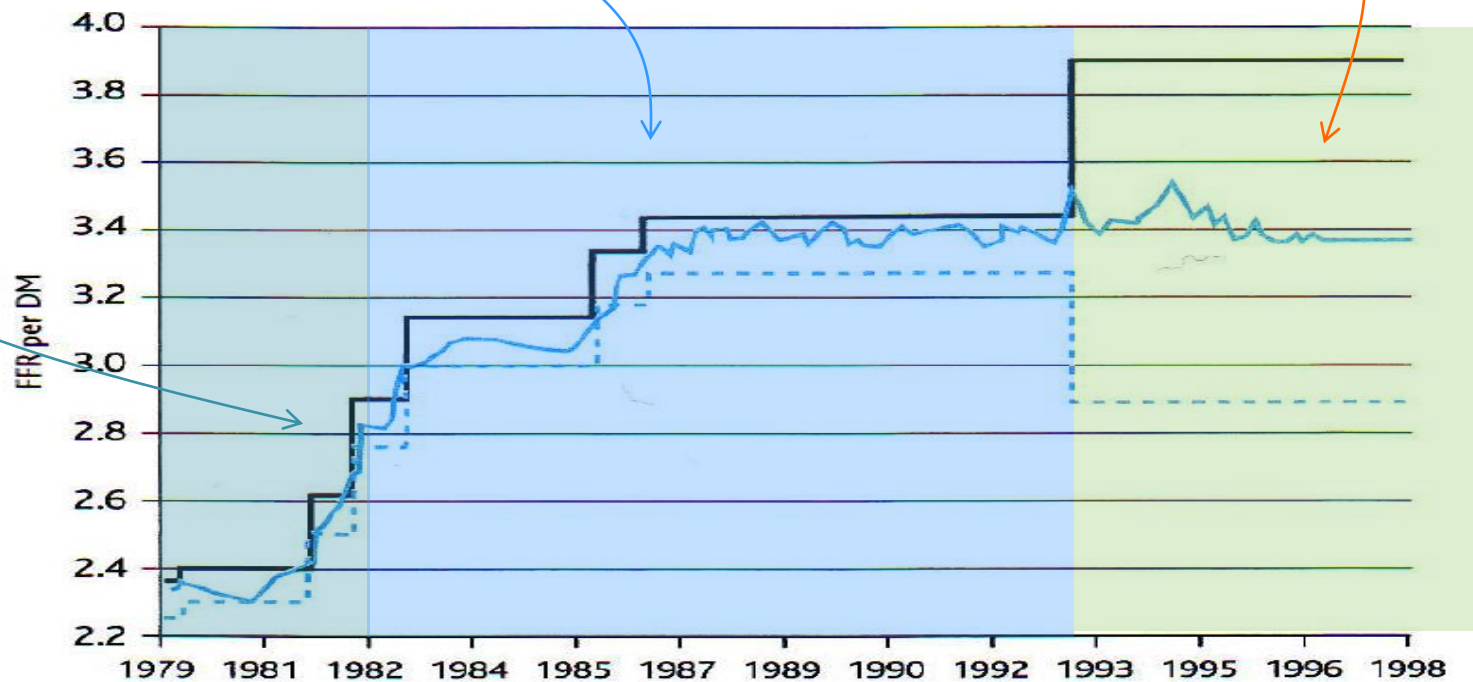
- A parity grid
 - Bilateral central parities
 - Associated margins of fluctuations
 - Mutual unlimited support
 - Exchange market interventions
 - Short-term loans
 - Realignments
 - Tolerated, if not encouraged
 - Require unanimity agreement
 - The E.C.U.
 - Not a currency, just a unit of account
 - Took some life on private markets
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The EMS: past and present

- The EMS was originally conceived as the solution to the end of the Bretton Woods System
- Over the years, its nature changed and it became a kind of DM area, with the Bundesbank very much in command
- Breakdown of the DM zone
 - Bad design
 - Full capital mobility established in 1990 as part of the Single Act: EMS in contradiction with impossible trinity unless all monetary independence relinquished
 - Bad luck
 - German unification: a big shock that called for very tight monetary policy
 - The Danish referendum on the Maastricht Treaty
 - A wave of speculative attacks in 1992-93
 - The Bundesbank sets limits to unlimited support
- This, and the speculative crisis of 1993, made the monetary union option attractive
- Now the EMS2 is mostly the entry point for future monetary union members

Four incarnations of the EMSs

- 1979-82: EMS-1 with narrow bands of fluctuation ($\pm 2.25\%$) and symmetric
- 1982-93: EMS-1 centered on the DM, ignored realignments
- 1993-99: EMS-1 with wide bands ($\pm 15\%$)
- 1999- : EMS-2, asymmetric, on the way to euro area
- 2002 – Euro area



The ECU

- A basket of all EU currencies

	Amount in ECU 1	Weight %
Belgian franc	3.431	8.71
Danish krone	0.197	2.71
Deutschmark	0.624	32.68
Dutch guilder	0.219	10.21
French franc	1.332	20.79
Greek drachma	1.440	0.49
Italian lira	151.800	7.21
Irish punt	0.008	1.08
Portuguese escudo	1.393	0.71
Spanish peseta	6.885	4.24
UK pound sterling	0.087	11.17

The EMS-2

- EMS-1 ceased to exist on Jan. 1, 1999 with the launch of the Euro
 - EMS-2 was created to:
 - Host currencies of existing EU members who cannot/don't want to join euro area
 - Denmark and the UK have a derogation, but Denmark has adopted the new ERM
 - Sweden has no derogation but has declined to adopt the new ERM
 - Host currencies of new EU members before they are admitted into euro area
 - New potential members,
 - The euro area has 18 members right now.
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How does EMS-2 differ from EMS-1?

EMS-1	EMS-2
Symmetric, no anchor currency	Asymmetric, all parities defined vis a vis euro
Margin explicitly set	“Normal” ($\pm 2.25\%$) and “standard” ($\pm 15\%$) bands
Automatic unlimited interventions	ECB explicitly allowed to suspend intervention

Free float and dirty float exchange rates

- USA dollar (against EUR) is a free float exchange rate,



- Pound sterling (against EUR) has a dirty float.



Seemingly hard peg exchange rates

- Danish krone fluctuates around the historic average by the second decimal point,



- Bulgarian lev is a hard peg keeping the same exchange rate against the euro since 2006.

