Commentary: Monetary Policy Implications of Increased Capital Flows

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The paper by Andrew Crockett nicely summarizes the current questions in the theory and practice of monetary policy. The paper focuses on the effects of increased international capital movements, a sign of increased international capital mobility, on the problem of coordinating monetary policies, on the choice of an exchange-rate regime and on the benefits of rules versus discretion.

These are the classical questions in international monetary policy and they have gained a new light after a rather extraordinary sequence of events that has affected especially European countries and European currencies over the past twelve months. Andrew Crockett touches upon these events, but prefers to discuss the general issues. In my comments, I will take the opposite perspective: I will comment on the recent events, and from them draw a few observations on the general issues. In particular, I will discuss the options now available to European countries in the wake of the most recent exchange rate mechanism (ERM) crisis.

The last twelve months have been the climax of a period of about thirteen years during which European countries embarked in a system of fixed exchange rates. Such a system, when it was conceived in a regime characterized by an extensive use of capital controls by almost all of its member countries, was meant to deliver more stability of relative prices by assuring more stable nominal exchange rates. Only in the early to mid-1980s did the ERM transform itself, in the language of academic economists, into a "commitment technology." In other words, in the early 1980s European policymakers saw the ERM as a device to produce an exchange-rate-based inflation stabilization. A commitment technology is a device that ensures the authorities' commitment to an announced plan, in this case the decrease of the inflation rate. It can do so if the authorities are bound to their promises. In the case of the ERM, the promise is not to change the exchange rate.

Such a promise was made increasingly credible by the decreasing frequency at which the realignment occurred, and by the increasing number of "chips" that authorities put on the table. The European Monetary System (EMS) was followed by the Single European Market program, itself followed by Economic and Monetary Union (EMU). In both cases, implicitly or explicitly, the stability of the European Monetary System was viewed as a pillar of these initiatives, thus gaining strength from them.

Now, what do we know about exchange-rate-based stabilizations? From the experience of many countries who followed such policies before the European Community (EC) member countries, we know that they usually do not last. Exchange-rate-based stabilizations are very successful in eliminating the first and largest chunk in the inflation differential vis-à-vis the reference currency, but usually cannot get rid of the last few percentage points of difference. Hence, after some time, the exchange-rate pegs are abandoned.

In the case of the EC, things were complicated by Economic and Monetary Union. The ERM became instrumental to EMU, by becoming the pillar of the gradual convergence plan envisioned in the Maastricht Treaty. Once again, the ERM was viewed--even though unofficially—as the cornerstone of the convergence plan. After EMU was announced, some important members of the ERM thought (probably correctly) that parity changes were not admissible, because they would have undermined convergence and would have destroyed whatever anti-inflation credibility they so strenuously acquired. If credibility had to be stably acquired, exchange rates were to be progressively abandoned, at all costs. The necessity of abandoning the exchange-rate "instrument" during the transition to EMU is both expressed in the Delors plan and in the Maastricht Treaty, according to which a convergence criterion is the absence of realignment of ERM parities.

Thus, the gradualism strategy of the Maastricht Treaty required that countries undertake significant stabilizations without using exchange rates. This strategy was sharply criticized by several observers, including this writer (see Giovannini, 1990a,b, 1991), on the grounds that—in general—major reforms, to be credible, cannot be gradual and that credibility is a key of the success of a reform that requires time. Hence—by this argument—the optimal period of time required to introduce a single currency in Europe collapses to zero. In other words, governments should not establish—ahead of the reform—hurdles whose difficulty is endogenously determined by the financial markets' assessment of the credibility of the reform itself.

There are a number of additional structural reasons why the gradualism strategy might be self-defeating. The first arises from the problem of exchange-rate-based inflation stabilizations. Consider a country pegging its nominal exchange rate to a partner, at the time when the differential in the inflation rate is still significant and relative prices (the real exchange rate, that is, the relative price of domestic goods in terms of foreign goods) are approximately in line. As the inflation rate converges—the inflation differential is progressively eliminated—the country loses competitiveness—the real exchange rate appreciates. Hence, in exchange-rate-based stabilizations, inflation differentials not only have to be eliminated, they also have to be "undone," that is, the real exchange rate appreciation produced by inflation differentials has to be undone.

The elimination of relative price distortions produced by exchange-rate-based inflation stabilizations can only be produced in either one of two ways:

—by keeping the exchange rate stable, and generating more inflation in the "reference" or "anchor" country than in the partner countries, or

—by depreciating the currency of the country attempting the convergence.

This choice highlights the wrong incentives implicit in gradualism. The country attempting stabilization will be unwilling to depreciate its currency to bring back relative prices into line, because it will view that as a loss of reputation. Similarly, the "anchor" country will try to force the former one to devalue, to avoid higher inflation at home—again a loss of credibility from its own perspective. In sum, the credibility game implicit in exchange-rate-based stabilizations is a zero-sum game: the credibility gained by one country is at the expense of the loss of credibility in its partners. It is hard to believe that such a system would be capable of delivering a smooth path to successful monetary union!

In the case of Europe, things were further complicated by the German unification which, according to many observers, required a further real appreciation of the deutsche mark vis-à-vis its partners, thus exacerbating the relative price distortions accumulated by those countries that did not change their exchange rates since 1987, and yet experienced higher inflation than Germany.

Finally, the process of ratification of the Maastricht Treaty provided additional focus in the foreign exchange markets, both on the countries for which ratification was not warranted and on the countries whose compliance of the convergence criteria, prospectively, was considered to be problematic.

Now, however, the treaty is ratified. In a sense, the deep concerns about the feasibility of monetary union should have been largely removed by the completion of the ratification process. More importantly, the ratification, by submitting the choice of a single currency in Europe to national electorates or to their representatives, has immensely strengthened the support for such an endeavor. Ironically the Maastricht Treaty is currently enjoying the lowest popularity ever, but it would be a mistake to underestimate the importance of its acceptance by the majority of the European electorate.

The completion of the ratification and the dismemberment of the narrow-band ERM that occurred in early August make it appropriate to discuss the options currently open to European countries. I would consider three options: re-establishment of the narrow-band ERM; modified narrow-band ERM with acceleration option; wide-band ERM, as suggested by Andrew Crockett in his paper.

The re-establishment of the narrow-band ERM is the most obvious alternative available to EC countries. This could be done after an adjustment of the French franc/deutsche mark parity, and of other parities in the ERM, as it may seem fit. After all, if the crisis was justified by "fundamental disequilibria" as pointed out by so many observers, the adjustment of parities would be considered, by these same observers, the appropriate answer to the crisis.

That the narrow bands have not been re-established soon after the crisis is, in my opinion, more of a signal that countries fear a more serious flaw with the narrow-band ERM, than a signal that some countries, like France for example, are unwilling to change the deutsche mark parity value of their own currency. And this is consistent with my own interpretation of the currency crisis. On the other hand, the abandonment of the narrow-band ERM poses two problems. The first is devising new intermediate targets for monetary policy. The second is the problem of countries like Belgium. It is my own opinion that Belgium has gained significantly by pegging its currency to the deutsche mark in terms of low costs of debt financing. The abandonment of the narrow band could mean, for that country, a significant increase of the cost of financing of public debt, with negative impact on their public finances. Thus, the return to the narrow-band ERM has attractions and drawbacks.

A second option is the establishment of a narrow-band ERM with acceleration option, as I suggested in my Princeton Essay (Giovannini, 1990b), and as was recently proposed by French authorities (see Commissariat General du Plan, 1993). The logic of that proposal was to eliminate the dangers of gradualism, by announcing that any destabilizing foreign exchange speculation was to be met with an acceleration of monetary union, rather than a slowdown. This, in equilibrium, would still allow countries slow convergence, but would deter speculation driven by the awareness of the potential of multiple equilibria. The acceleration option is obviously attractive to those who intend to implement the (popular) mandate to introduce a single currency in Europe, but may be difficult to implement in practice, given the constraints imposed by the Maastricht Treaty, which fixes rigidly all dates and procedures. Thus the acceleration option could only be adopted voluntarily and outside the Maastricht framework by any given group of (at least two) countries.

The last option is what I will call, for ease of exposition, the Crockett proposal. That option is to maintain the wide band, induce further convergence of inflation, interest rates and public finances through the independent actions of individual countries' monetary and fiscal authorities, and call the wide bands the "normal bands" mentioned in article 3 of the Protocol on Convergence Criteria of the Maastricht Treaty. By leaving room for exchange rates to fluctuate, it provides some insurance against destabilizing speculation. In sum, this strategy kills gradualism, and at the same time leaves intact all options open on whether or not to pursue monetary union.

The problem with this strategy is monetary management. Many countries have gotten used to the practice of managing money through the exchange-rate target, which in Europe retains significant importance, given the openness of all economies. Abandoning the exchange rate altogether may be impossible even in the absence of any requirement to peg it.

In sum, there is not an unambiguous argument for any one of the options described above. Each of them has its strengths and costs. Whichever option is chosen, however, most European authorities will have to deal with a basic challenge, egregiously met by their U.S. colleagues: to bring down ex-post real interest rates, without jeopardizing the achievements on the inflation front. It is well known that historical experience suggests that such an endeavor is a difficult one to achieve. It is especially difficult in Europe, which I hope will soon enter a recovery, at a time of high nominal interest rates, with little room for controlling overheating with interest-rate policy.

References

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