

# III Exchange Rate Developments

## Overview

From its inception until 1983 the EMS was characterized by frequent periods of exchange market strain and numerous consequent realignments of central rates among currencies participating in the ERM (Tables 5–10). Realignments took place in September and November 1979, March and October 1981, February and June 1982, and March 1983. The general experience in these periods of strain suggested that resisting market pressure through intervention and short-term monetary measures could buy time for a weak currency by redirecting capital flows in favor of countries with high nominal interest rates, but that in the absence of appropriate and sufficient policy measures aimed at the underlying causes of weakness, exchange rate changes would eventually become inevitable. In these early years, the size and frequency of central rate realignments increased significantly, indicating that the needed drive for greater economic convergence to generate stable exchange rates had achieved only limited success (Chart 1).<sup>32</sup>

Since 1983, however, convergence of economic policies and developments among EMS countries have laid the groundwork for greater exchange rate stability (see Section V). Nevertheless, exchange rate developments in the EMS during the two years to mid-1985 also have to be seen in the light of the strong and rising dollar, which was in turn influenced by the mix of financial policies in the United States that led to high nominal and real U.S. interest rates, both in absolute terms and relative to other countries. The value of the ECU in terms of dollars, which had been as high as US\$1.44 at the end of 1979, had fallen to a little less than a dollar per ECU by the turn of 1982. With occasional mild interruptions the ECU continued to fall throughout 1983 and 1984 and the first two months of 1985, reaching a nadir of US\$0.67 in February 1985. Subsequently, the dollar weakened and the dollar value of the ECU rose to US\$0.83 by September

1985.<sup>33</sup> Since the Group of Five meeting in New York on September 22, 1985 and the announced intention of major countries to reduce the value of the dollar against other currencies, the EMS currencies have further strengthened against the dollar, reflecting the effect of both intervention by Group of Five central banks and narrowed interest differentials. By October 1986, the value of the ECU had advanced to US\$1.04.

Experience shows that periods of weakness of the dollar tend to coincide with increased tension in the EMS, since at such times capital appears to move disproportionately from dollars into deutsche mark.<sup>34</sup> Explanations offered include the limited role played by EMS currencies other than the deutsche mark as alternative reserve and investment currencies, along with the general perception of Germany as a low inflation country. By contrast, a strong dollar has in the past often been coincident with a lack of tension in the system. Against the background of this experience, it came as a surprise that the weakening of the dollar initially created only limited tension within the EMS. When it became clear, however, that the period of strength of the dollar was over, difficulties began to reemerge.

## Exchange Rate Developments in the EMS Since 1983

In early 1983, there was widespread speculation of a possible realignment, directed particularly against the Belgian and French currencies. Significant intervention was required by several central banks to support these currencies. Speculative activity increased after parliamentary elections in Germany and municipal elections in France in March, necessitating further intervention in support of the French and

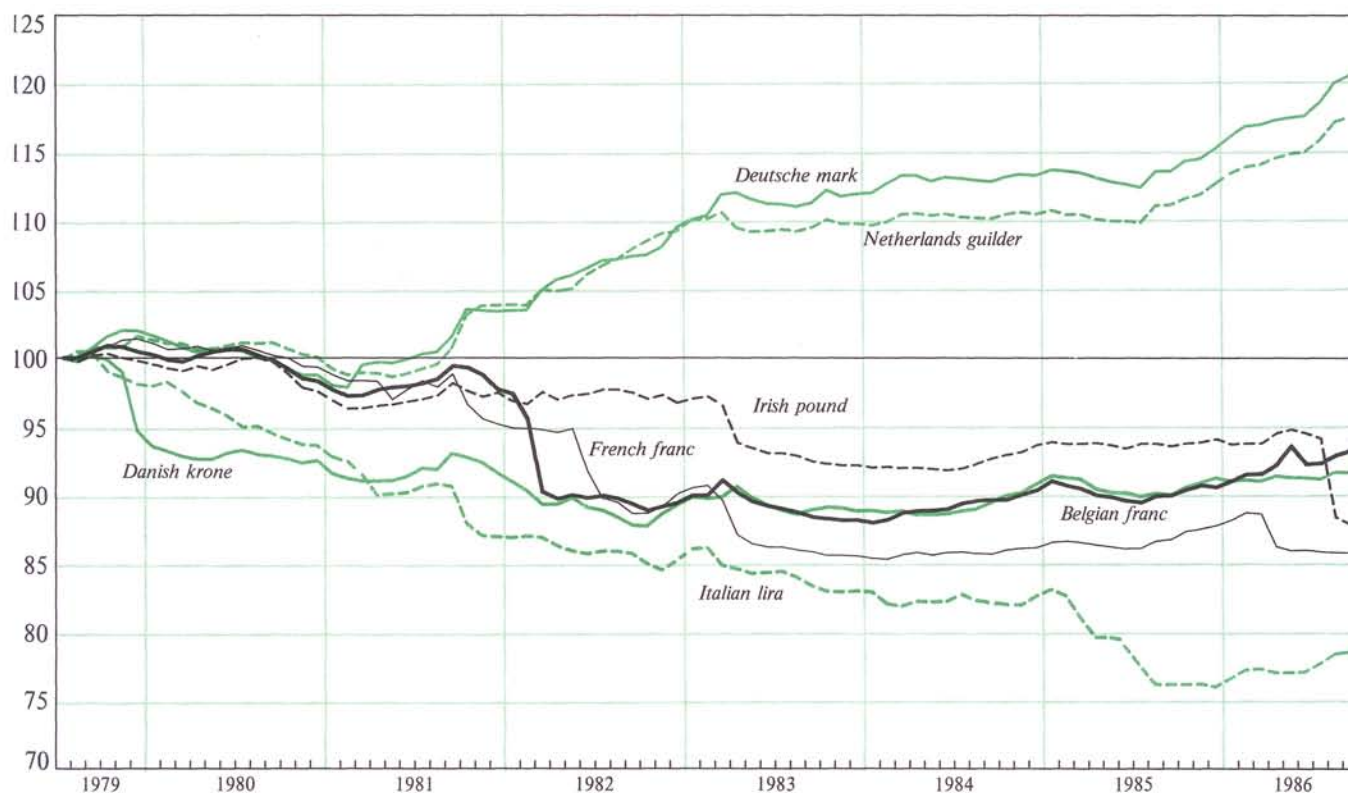
<sup>32</sup> For more details see Ungerer (1983), pp. 5–7.

<sup>33</sup> Figures for the U.S. dollar value of the ECU are monthly averages.

<sup>34</sup> M. Sarcinelli for example attributes a great weight to the dollar in explaining developments in the EMS. See M. Sarcinelli, "The EMS and the International Monetary System: Toward Greater Stability," *Quarterly Review*, Banca Nazionale del Lavoro (Rome), March 1986, pp. 57–83.

**Chart 1. Movement of EMS Currency Exchange Rates Against the ECU**

(Monthly averages, July 1979 = 100)

Source: International Monetary Fund, *International Financial Statistics*, various issues.

Belgian francs and the Italian lira. The Belgian, Danish, and Irish central banks raised key interest rates, and in France short-term interest rates were encouraged to rise substantially. Belgium announced emergency exchange controls. Over the weekend March 19–20 official discussions took place, but agreement was not reached and a realignment was effectively kept in abeyance.

On Monday, March 21, many European central banks suspended trading. Announcement of the agreed realignment was made in the afternoon of March 21 in Europe and became effective on March 22. The deutsche mark was revalued by 5.5 percent, the Netherlands guilder by 3.5 percent, the Danish krone by 2.5 percent, and the Belgian and Luxembourg francs by 1.5 percent, while the French and Italian currencies were devalued by 2.5 percent and the Irish pound by 3.5 percent. Like previous realignments, this realignment had become necessary as a result of the continued differences in the underlying strength of the participating countries' external positions, which reflected in turn divergences in economic policies and cost-price performance. These differences had generated expect-

tations of exchange rate changes and led to large speculative capital flows.

After the realignment, and as the result of a reversal of earlier capital flows, the deutsche mark and the Netherlands guilder moved to the bottom of the parity grid, while the French franc, the Irish pound and the Danish krone went to the top, with the Belgian franc in the middle. Interest rates returned to more normal levels, and suspicions that the French devaluation might have been too small subsided after the French authorities announced a program of restrictive financial measures.

From the March 1983 realignment until February 1985, the U.S. dollar gradually appreciated relative to European currencies, and the EMS experienced a period of relative internal stability. In spite of favorable current account and price developments in Germany, the deutsche mark did not come under upward pressure within the EMS largely because of strong capital flows to the United States. The exchange rates of other participants did not fall under pressure either, in spite of considerable, though reduced, divergences in cost and price performance among EMS countries.



After reaching a peak of DM 3.47 per US\$1 on February 26, 1985, the U.S. dollar has been depreciating vis-à-vis the European currencies (Chart 2). The gradual depreciation of the dollar did not significantly affect the relative position of currencies within the EMS band in the first half of 1985: the Danish krone and the Irish pound remained in the upper half of the narrow band, while the Netherlands guilder and the deutsche mark remained in the lower half (Chart 3). The French franc, however, appreciated gradually and moved into the upper half of the narrow band in the second quarter of 1985, while the Italian lira, which had been in the upper half of the wide band in January–February 1985, moved to the lower part in March and remained there until July (Chart 4).

The performance of the Italian economy deteriorated in the first half of 1985, especially in the fiscal and

external accounts. The worsening of the current account reflected primarily the maintenance of a rate of growth in domestic demand higher than that of Italy's partners as well as the lagged effects of a significant loss of competitiveness vis-à-vis other EMS countries over the previous two years. To halt the deterioration of the external position, in July 1985 the Italian authorities called for a realignment of exchange rates within the EMS. Effective July 22, the lira was devalued by 6 percent, and the other participating currencies revalued by 2 percent, implying a devaluation of the lira by 7.8 percent in terms of foreign currency per lira.

The July 22 realignment was not preceded by severe pressure on the exchange rate of the lira or on reserves, except on July 19, 1985, when, with the Bank of Italy abstaining from intervention in anticipation of a realignment over the weekend, a thin market was temporarily upset by a sizeable transaction; at this point, the authorities decided to close the market early. Following the realignment, the Italian lira was kept in the upper half of the wide band until April 1986.

Toward the end of July and in early August 1985, there was some speculation of a further realignment involving the French and Belgian francs. This speculation pushed up forward discounts of those two currencies, and the respective central banks intervened to support their currencies. After these periods of tension, the French franc continued its upward movement in the band, but the Belgian franc remained at the bottom of the narrow band, though well within the permitted range, reflecting the continuing policy of intramarginal intervention. In contrast to developments after previous, general realignments, the deutsche mark and the Netherlands guilder moved to the upper part of the narrow band in August.

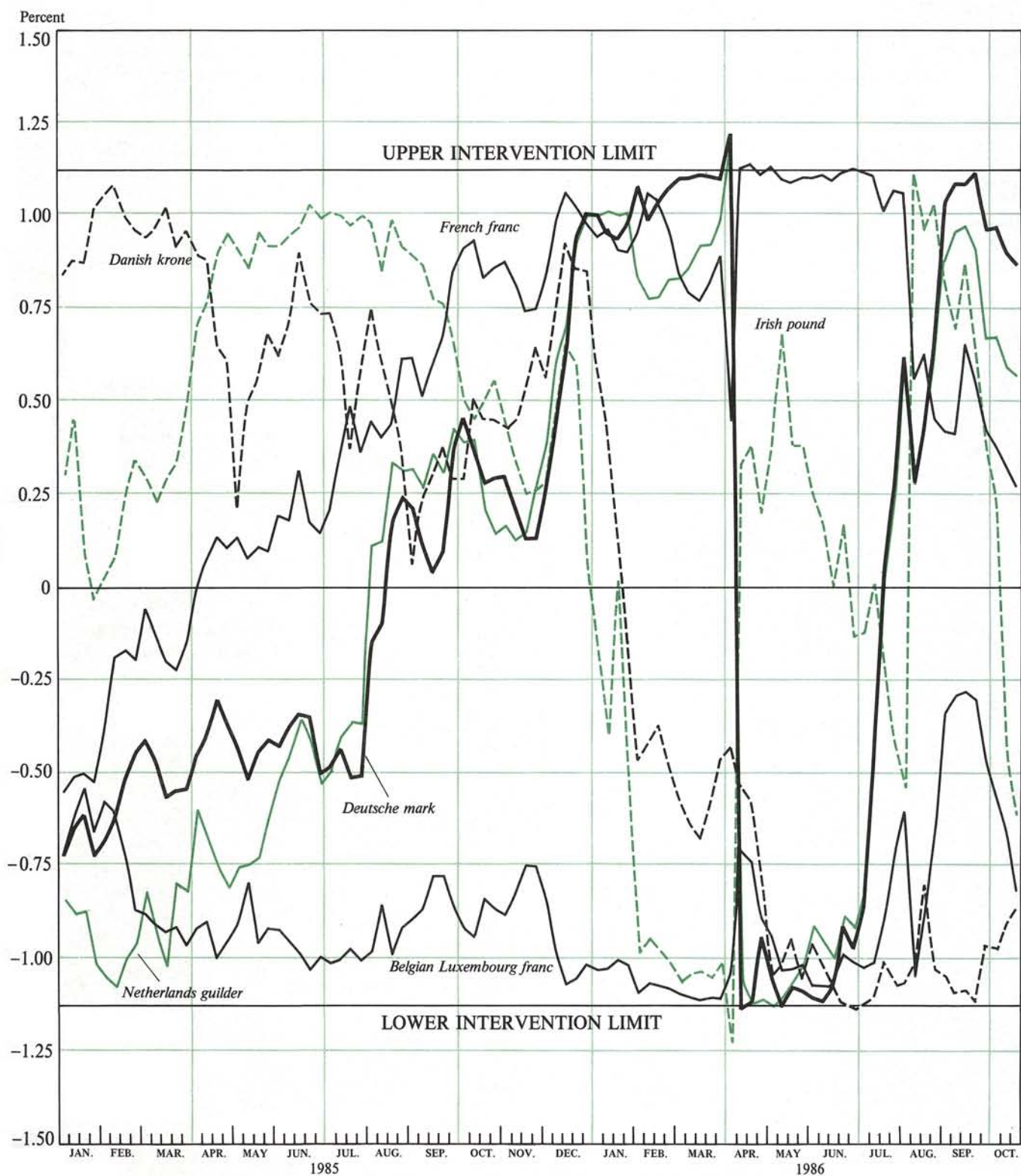
The exchange market reaction to the Group of Five communiqué of September 22, 1985 was swift. The EMS currencies appreciated by 6 percent against the U.S. dollar on September 23 and by a further ½ percent the following day. By the end of September, the joint float had appreciated by 7½ to 8 percent against the dollar compared with the rate on September 20. The continuous downward movement of the dollar did not affect the relative position of EMS currencies until about December 1985, when foreign exchange market participants apparently became convinced of the determination of Group of Five central banks to lower the dollar and also began to take account of the improved growth prospects for Europe, in particular for Germany. As was the case before when the U.S. dollar depreciated, the deutsche mark, together with the Netherlands guilder, moved sharply upward in the narrow band, and the currencies of the smaller EMS members, such as the Danish krone and the Irish

**Chart 2. Movements of the ECU Against the U.S. Dollar**

(U.S. dollar per ECU, monthly averages)



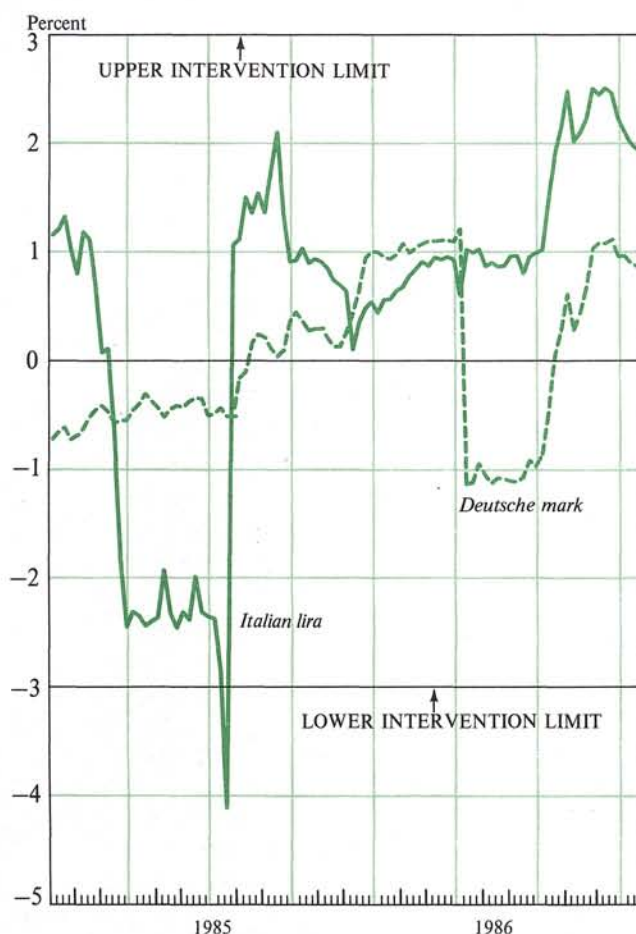
Source: International Monetary Fund, *International Financial Statistics*, various issues.

**Chart 3. EMS: Position in the Narrow Band<sup>1</sup>**

Sources: International Monetary Fund, *International Financial Statistics*, various issues; and Fund staff estimates.

<sup>1</sup>Weekly averages; Italian lira not included. The chart measures deviations of currencies from their bilateral central rates in terms of logarithmic differences between spot exchange rates and bilateral central rates multiplied by 100.



**Chart 4. EMS: Position in the Wide Band<sup>1</sup>**

Sources: International Monetary Fund, *International Financial Statistics*, various issues; and Fund staff estimates.

<sup>1</sup> Weekly averages. The chart measures deviations of currencies from their bilateral central rates in terms of logarithmic differences between spot exchange rates and bilateral central rates multiplied by 100.

pound, weakened. While the Belgian franc remained in the lower part of the narrow band, the French franc remained strong, reflecting the improvement of the external position of the French economy, increased confidence in the anti-inflationary policies of the French Government, and the expectation that no realignment would take place until after the parliamentary elections in France in March 1986.

During the last few weeks of 1985 and in early 1986, the Belgian franc, the Irish pound, and the Italian lira came under renewed downward pressure. To defend the franc, which had been at the bottom of the narrow band since March 1985, the Belgian National Bank increased interest rates in December 1985 and intervened in foreign exchange markets. The Italian authorities tightened monetary policy and reinstated certain previously abolished foreign exchange control

measures in January 1986 to ease pressure on the lira. To stem the private capital outflow and relieve pressure against the Irish pound, the Central Bank of Ireland in the course of the first quarter of 1986 raised the interest rate at which it provides short-term support to the money market. As a result of these measures, as well as continuing intramarginal intervention, the Belgian franc and the Irish pound remained above the lower intervention limit, while the lira remained in the upper half of the wide band throughout the first quarter of 1986.

Exchange markets were generally calm during the remainder of the first quarter of 1986. The French franc weakened somewhat but remained in the upper half of the narrow band, while the Belgian franc and the Irish pound alternated at the bottom of the band. The Danish krone stabilized somewhat below its central rate, but well above the lower intervention limit. The deutsche mark and the Netherlands guilder were at the top of the band. The Italian lira, too, remained in the upper part of the wide band. Following the French elections on March 16, it appeared that markets considered an early exchange rate realignment and a devaluation of the French franc less likely, as the three-month forward discount of the franc fell from an average of 6 percent a year during the week before the elections to 4 percent a year in the week thereafter.

On Friday, April 4, 1986, EMS central banks suspended their official currency dealings after the Banque de France had informed them that it would not continue to support the franc. This created considerable movement in foreign exchange markets and caused the French franc and the Irish pound to fall below their (suspended) lower intervention limits, while the deutsche mark and the Netherlands guilder rose above their (suspended) upper intervention limits. Trading was thin on that day and the spread between buying and selling rates widened sharply. On April 6, 1986 the Ministers of Finance and Economics and the Central Bank Governors of the EC member countries decided on an adjustment of central rates within the EMS, which became effective on the following day. The deutsche mark and the Netherlands guilder were revalued by 3 percent, the Belgium/Luxembourg franc and the Danish krone were revalued by 1 percent, while the French franc was devalued by 3 percent. The Irish pound and the Italian lira did not move.

The realignment took place at the initiative of the French authorities, who sought a devaluation of the French franc as part of a package of measures designed to liberalize the French economy and strengthen its competitiveness. In support of the exchange rate adjustment, the French authorities took steps to slow nominal wage growth and to reduce the budget deficit and announced their objective of eliminating the non-

interest component of the central government deficit in the course of the next three years. The target of containing the growth of M3 below 5 percent throughout the year was reasserted, and the authorities indicated their intention to support this target with a prudent interest rate policy, even though it implied continued relatively high real interest rates. Exchange controls were to be further relaxed, especially for business transactions, and the remaining price controls on industrial products were to be abolished.

When foreign exchange markets reopened after the realignment, the deutsche mark and the Netherlands guilder moved to the lower part of the narrow band—as usual in these circumstances—while the Italian lira moved to the upper part of the wide band and the French franc and the Irish pound moved to the upper part of the narrow band. The Belgian franc and the Danish krone remained in the lower part of the narrow band. In the wake of the realignment, interest rates fell in several countries as speculative trends were halted or reversed. The Central Bank of Ireland lowered the interest rate at which it provides short-term support to the money market by 1¼ percentage points immediately after the realignment, thus partly reversing an earlier increase. In Belgium, official rates were reduced in several steps in April and May. In Italy, the authorities lifted the foreign exchange restrictions introduced earlier to defend the lira and took additional measures to liberalize international capital movements. For several months following the realignment, the French franc remained strong with its divergence indicator above its upper threshold, while the deutsche mark and the Netherlands guilder alternated at the bottom of the narrow band. This opened in May the possibility for lower interest rates in France, but also required at times sizable obligatory exchange market interventions at the margin in support of the deutsche mark.<sup>35</sup> The Belgian franc and the Danish krone remained in the lower part of the narrow band in the three months after the realignment; the Irish pound, which had moved to the upper part of the narrow band, weakened subsequently, while the Italian lira remained almost unchanged in the upper part of the wide band. At the end of June, the deutsche mark and the Netherlands guilder began to strengthen and moved to the upper part of the narrow band in July. The

Danish krone remained weak, and the Belgian franc moved somewhat higher.

On August 2, 1986, the Irish authorities requested a devaluation of the Irish pound by 8 percent vis-à-vis the other participating currencies, and the devaluation became effective on August 4. The Irish authorities had viewed with concern the decline in external competitiveness stemming from the sizeable appreciation of the Irish pound against the currencies of the United Kingdom and the United States since the April realignment, since these nations account for about 50 percent of Ireland's total external trade. Significant capital outflows occurred beginning in late June, and gross official reserves declined. Conditions in financial markets were somewhat unsettled in the period immediately preceding the realignment and money market interest rates, which had fallen considerably between April and June, tended to firm. In the first nine days following the realignment, the Irish pound moved to the top of the narrow band, and its exchange rate fell by 4½ percent against sterling and around 5 percent against the U.S. dollar.

An assessment of international competitiveness and its development in ERM countries since the inception of the system is fraught with many methodological difficulties. An often-used method is to look at the development of real effective exchange rates in terms of relative unit labor costs, GNP deflators, or consumer prices. This method can, of course, be criticized for not taking into account other than price-related determinants of international competitiveness (e.g., technology and marketing). Despite these limitations, it is noteworthy that exchange rate adjustments during the first eight years of operation of the EMS approximately offset or more than offset the changes in unit labor costs in the manufacturing sector and in consumer prices relative to ERM partner countries in Belgium, Denmark, France, the Federal Republic of Germany, and the Netherlands (Tables 11 and 13). The realignments did not, however, compensate the large accumulated unit labor cost and consumer price inflation differentials in Ireland and Italy. Relative to a broader sample of 16 industrial countries, however, the picture is less clear (Tables 12 and 14). While none of the ERM countries seems to have experienced a dramatic loss in international competitiveness as measured by relative unit labor costs adjusted for exchange rate changes, adjustments in exchange rates were not large enough in Ireland and Italy to compensate the increases in consumer prices vis-à-vis partner countries (Table 14).

<sup>35</sup> Only a small part of the debt stemming from these interventions was settled by the Bundesbank in official ECUs; the majority of the debt was settled later by the Bundesbank in U.S. dollars.