

**THE IMPLICATIONS AND LESSONS TO BE DRAWN FROM  
THE RECENT EXCHANGE RATE CRISIS  
- Report by the Committee of Governors -**

In response to the invitation of the European Council's special meeting in Birmingham, this report summarises the views of the Committee of Governors on the implications of, and the lessons from, the recent exchange rate crisis. The report is divided into four sections, dealing firstly, with the causes of the crisis; secondly, the assessment of the sustainability of central parities; thirdly, policy responses to stabilise exchange rates; and fourthly, institutional and technical arrangements in the EMS. The main conclusions are presented at the end of the report.

**I. THE CAUSES OF THE RECENT EXCHANGE RATE CRISIS**

A turnaround occurred in the summer of 1992 when a prolonged period without severe tensions in the ERM, giving at times the impression of a quasi monetary union, gave way to a new situation. There was a growing awareness that divergences in national economic trends had been building up for some time, as well as a growing awareness of differences in prospects and policy requirements, and, as a result, markets exerted massive destabilising pressures. There is broad consensus in the Committee that the exchange market crisis was brought about by a number of concurrent factors:

- for a number of years price and cost developments diverged and, in the face of stable nominal exchange rates, gave rise to changes in real exchange rates and in international competitive positions within the Community; this was due to excessive wage claims and to the insufficient correction of fiscal imbalances in several Community countries, resulting in an unbalanced policy-mix and an overburdening of monetary policy in its fight against inflation;
- the economic environment in the Community became more complex in the wake of German unification. Given the challenges of the process, the fiscal policy that was adopted, demand pressures and the behaviour of wages, a tight monetary stance was the necessary response for Germany to counter price increases, leaving little scope for interest rate reductions. In those Community countries where lower rates of inflation had been achieved, the prolonged weakness of economic activity and deteriorating labour market conditions were felt to warrant a lowering of interest rates. The conflict between domestic policy needs and the maintenance of ERM parities complicated monetary policy co-ordination in the Community. These policy dilemmas became more severe after

the rejection of the Maastricht Treaty in the Danish referendum when exchange market tensions began to mount and required interest rate increases in defence of the weaker currencies' position in the band. The room for interest rate increases was seen by markets to be particularly limited in those countries where higher official and money market rates threatened to be quickly transmitted to sensitive lending rates, particularly mortgage rates, or to have an immediate adverse impact on the debts of non-banks as well as on governments' budgetary position;

- markets seem to have been attentive to what they perceived as insufficiently co-ordinated responses of the authorities to the crisis. Public statements, in general, did little to alter this market sentiment. Policy actions, in particular regarding central rates, were taken on a piecemeal basis and after market pressure, with insufficient attention devoted to the restoration of the credibility of the parity grid as a whole;
- although the major causes of the recent exchange rate crisis were domestic, developments outside the Community also played a role. The very significant easing of US monetary policy, leading to an unprecedented widening of interest rate differentials with Germany, resulted in strong downward pressure on the US dollar vis-à-vis the ERM currencies, especially the Deutsche Mark, with implications for the parity grid. The turmoil in the Nordic countries' exchange markets added to the climate of market nervousness.

The impact which economic imbalances and/or policy dilemmas could normally be expected to have on exchange rate relationships was offset, prior to June 1992, by market expectations that the process towards EMU would reduce the likelihood of changes in central parities. These market expectations motivated large capital inflows into higher yielding EMS currencies since the late 1980s until the summer of 1992. Furthermore, at first the dominant impact of German unification on its partners was felt mainly through an increase in exports and a strengthening of their current-account positions, masking to a certain extent the importance of the imbalances accumulated since the last realignment. Serious attempts to correct imbalances were postponed and those domestic adjustment measures that were taken turned out to be insufficient. A break in market sentiment occurred after the outcome of the Danish referendum and the French referendum was seen as a reference date for an expected realignment and hence a focus for hedging against currency risks or for outright currency speculation.

As the crisis developed, it became evident that the liberalisation and deregulation of financial markets and their growing integration - which had greatly facilitated the flow of private capital to Community countries with financing needs - had also provided scope for capital movements of an unprecedented size. Within these capital movements, speculative operations proved at times to be a notable destabilising force giving rise to serious problems also for currencies of countries with sound economic fundamentals, thereby imposing sizeable costs on the countries concerned. Speculative operations also imposed a disproportionate burden on currencies of small countries.

Three broad conclusions could be drawn from this diagnosis.

Firstly, without sufficient progress in convergence central parities cannot be kept stable in the longer run and it would be premature to manage the EMS as a "de facto" monetary union as long as the necessary degree of convergence has not yet been achieved. Exchange rate adjustments remain a crucial feature of the EMS which, however, should not develop into a crawling-peg system which would weaken convergence. Instead, the EMS should remain a system of fixed but adjustable central parities and be operated within the rules of the Basle-Nyborg Agreement. In accordance with this Agreement there is a need for early recognition of fundamental disequilibria and when these are identified a realignment should be decided soon and before markets come to regard it as inevitable. The difficulties in reaching such judgements and implementing them before the markets reach their own conclusions should not be underestimated but it is vital that they should be addressed. This leads to the issue of the assessment of the sustainability of existing parities, which is examined in Section II.

Secondly, a successful management of the System depends on an appropriate policy mix. Monetary policy alone cannot bear the burden of ensuring both price stability and exchange rate stability in the ERM. It needs adequate support from fiscal policy and other policies. This consideration is particularly important in the anchor country because it exerts a dominant influence on the monetary conditions in the countries participating in the ERM. But it also applies to the other countries because without adequate support from fiscal and other policies they will not be able to maintain central rates.

Thirdly, in a situation where financial markets have become closely integrated and full freedom of capital movement has been realised, massive speculative pressure may make the management of desirable realignments more difficult. Moreover, such pressure may arise even vis-à-vis currencies whose central parities are in line with economic fundamentals; this raises the issue of policy responses to stabilise exchange rates, which is examined in Section III.

## **II. THE ASSESSMENT OF THE SUSTAINABILITY OF CENTRAL PARITIES**

All central banks share the view that the assessment of the sustainability of existing central parities should be based on two major components: macro-economic performance and the credibility of policies in maintaining price stability.

### **1. Macro-economic performance**

There is broad agreement that the assessment of macro-economic performances in ERM countries should be based on a set of economic and financial indicators. However, there is little doubt that the exercise of assessing whether parities are in line with performances cannot be mechanistic but will have to be to a large extent judgmental.

The assessment would begin on the external side, with particular attention to international competitiveness. However, changes in real exchange rates will not necessarily call always for a realignment, and unchanged real exchange rates will not necessarily rule out the need for

a realignment. Therefore the assessment will also have to be based on an analysis of underlying macro-economic developments in each ERM country, with due regard to external accounts, private saving and investment, domestic growth, budgetary balances and the stance of monetary policy with respect to the objective of price stability. In addition, account should be taken of indicators which describe the economic situation at the Community level.

## 2. Credibility of policies

The sustainability of central parities does not only rest on macro-economic performance but also depends decisively on the credibility of national policies. The assessment of the credibility of policies thus constitutes an indispensable element of the authorities' surveillance of exchange rates.

The assessment of the credibility of the ERM countries' economic and financial policies while taking into account the past record should focus mainly on current and future policies. An important additional aspect should be the extent to which national policies, at the level of each country but also in combination and interaction, are conducive to maintaining the credibility of the System as a whole.

Particular attention should be paid to the track record of individual governments and central banks, respectively, in formulating realistic targets and in meeting them, the political consensus on the commitment to stability-oriented policies and on the exchange rate objective and the institutional status of the central bank.

The crucial element for the short-run credibility of a given central parity comes from the commitment of monetary policy in its defence. It is therefore important that there are no inhibitions to the use of interest rates preventing an effective defence of the currency against speculative attacks. The existence of constraints on nominal interest rates seems to be related to a number of factors; the size of public debt (in particular the share of floating rate debt) and deficits, the size of private debt, the extent to which GDP deviates from potential, the level of unemployment, the degree of fragility of the financial sector, the speed of transmission of official and money market interest rates to sensitive lending rates and the institutional status of the central bank.

## 3. Surveillance of exchange rate relationships

The Committee of Governors is fully aware that the assessment of ERM parities is an extremely difficult task. For this reason there is broad agreement that the primary purpose of the surveillance of exchange rate relationships is to function as an early warning system and to bring views closer as regards the sustainability of central rates or the desirability of a timely realignment. The Committee stands ready to play its role in this surveillance exercise and to devise procedures for communicating its views to the Ministers.

### **III. POLICY RESPONSES TO STABILISE EXCHANGE RATES**

There might be situations in which macro-economic performances and current and future policies would not warrant a change in parities in the judgement of the authorities, but where nonetheless market pressures arise. This raises two issues. The first is whether and to what extent

concerted action of strong and weak currency countries should be employed in the defence of the parities, and the second, how to use, in particular, the various instruments provided by the 1987 Basle-Nyborg Agreement.

1. Concerted action in the defence of central rates

The Governors emphasise that all Community countries benefit significantly from the EMS. While there is agreement that the defence of a currency's exchange rate remains primarily the responsibility of the country concerned, it is also recognised that central banks have a collective responsibility for the System and that there is thus a need for close co-operation.

The form of such co-operation in a situation where unwarranted market pressures arise cannot be easily defined in advance. On the one hand, the management of the System calls for a high degree of flexibility with due account to the prevailing circumstances and the objective of promoting price stability in the Community. For this reason, there cannot be an automatic and mechanistic response to market tensions, involving symmetrical action on the part of the authorities of countries with weak and strong currencies. On the other hand, there were situations in the recent past where concerted action in the field of intra-marginal intervention took place and proved helpful in countering market pressure. The Governors do not rule out the possibility of such action taking place on an ad hoc basis, provided that it does not jeopardise the control over domestic monetary conditions in the country issuing the intervention currency and that it is consistent with the primary objective of achieving price stability in the Community. The appropriateness of such action would have to be judged also in the light of the prevailing market situation and the accompanying measures to defend the currency in the country concerned.

2. The desirable mix of the Basle-Nyborg instruments

The recent ERM crisis has confirmed that interventions alone - whether intramarginal or at the margin - have a limited effectiveness in containing tensions and may even exacerbate them, if market operators perceive that they are large and continue over a prolonged period. Letting a currency depreciate within the band and reach the lower limit may also encourage speculation although in the recent past this has on some occasions proved to be an efficient way of handling market pressure. Timely increases in interest rates remain the most promising course to counter market pressure, although if interest rates have to be kept at very high levels over a prolonged period of time, they may not be sustainable in the light of domestic economic and financial conditions.

The Governors feel that it would not be advisable to lay down precise rules on how to employ the Basle/Nyborg instruments in a situation of market pressure. Rather, the use of the instruments should be decided in line with the objective of achieving price stability, taking into account the prevailing market circumstances and previous experiences with defending the exchange rate.

There is full agreement among the Governors that making market operators aware of the risks of, and possible losses from, speculation is a critical element in the successful management of the System. To this end, in certain cases it may be advisable to allow a currency to strengthen within

the band when market pressures ease and to make less predictable the conditions at which central banks will offset the liquidity impact of exchange market intervention on the money market.

3. The usefulness of public statements

The Committee of Governors has strong doubts about the usefulness of collective public statements in support of the existing central parities if not backed by immediate action. Experience has shown that such statements may fail to have a positive impact on market expectations and could also be damaging to the credibility of the authorities. However, where combined with decisive and visible action, demonstrating the authorities' determination to defend central rates, statements may play a useful, complementary role.

**IV. INSTITUTIONAL AND TECHNICAL ARRANGEMENTS GOVERNING  
CENTRAL BANK CO-OPERATION IN THE FRAMEWORK OF THE EMS**

There is no evidence that the institutional and technical features of the EMS have as such been instrumental in bringing about the recent exchange crisis. Current arrangements remain on the whole appropriate. The Committee, however, examined two particular issues: the first is related to decisions on the width of the fluctuation bands, and the second, to the denomination of VSTF balances.

1. Fluctuation bands

While under the EMS Agreement the establishment of, and changes in, central rates are subject to mutual agreement, decisions regarding the fluctuation bands are left to the respective national authorities. These rules have been in effect since 1979. Experience with operating the EMS has shown that the width of the fluctuation band must be regarded as a matter of common concern. The Committee is in full agreement that decisions pertaining to the size of the band should continue to be made in accordance with the rules in effect since 1979 and should be preceded by close consultation taking due account of the same factors as those considered when the sustainability of the parity grid is examined.

2. Denomination of VSTF balances

In the context of the recent large-scale interventions financed through the VSTF, the ECU-denomination of VSTF balances had resulted in substantial exchange losses for participating countries. All Governors agreed that this matter deserved further consideration and the Committee intends to study various possibilities of changing the present arrangement, taking due account of the need to preserve an ECU-based system, the requirements of the multilateralisation within the EMCF, the fairness and predictability of the results and simplicity of the arrangement.

## V. MAIN CONCLUSIONS

Three main conclusions can be drawn from this report. Firstly, the examination of the causes underlying the recent crisis in the ERM suggests that the emergence of unprecedented turbulence must be essentially ascribed to insufficient progress in economic convergence, the effects of which were compounded by a deteriorating cyclical situation and growing policy conflicts. Moreover, structural changes in financial markets have greatly increased the scope for capital movements and speculative operations proved at times to be a notable destabilising force. There is full agreement among Governors that, for central parities to remain credible, they must be supported by sound underlying economic conditions and credible national policies. Realignment of central rates remain an important feature of the System and provision must be made for timely realignments when parities have become unsustainable in the light of a country's macro-economic performance and its current and future policies. It is therefore of crucial importance to assess on a regular basis and in a candid and frank manner the sustainability of the existing ERM parities.

Secondly, the existing general rules governing the management of the System remain appropriate. When a currency comes under unwarranted market pressure, the country concerned should use all instruments provided by the 1987 Basle-Nyborg Agreement in defending the exchange rate. Particular attention should be given to making market operators aware of the risks of, and possible losses from, speculation. However, it would not be desirable to lay down precise rules on the desirable mix of the instruments which should be decided in the light of the prevailing market circumstances and individual country experiences.

The defence of the exchange rate remains primarily a national responsibility but it is recognised that the authorities have also a collective responsibility for the System and there is thus a need for close co-operation. In the recent past, on some occasions concerted action was undertaken and proved helpful in countering market pressure. However, the circumstances in which such a course should be followed cannot be defined in advance. Concerted action can therefore take place only on an ad hoc basis and provided that it does not conflict with the primary objective of achieving price stability in the participating countries.

Thirdly, while current institutional and technical arrangements in the EMS remain on the whole appropriate, the Committee of Governors intends to study possible changes in the present arrangement with respect to the denomination of VSTF balances with a view to adapting the sharing of exchange rate risks among central banks.