

Exchange-Rate Regimes on the Road to EMU:
Lessons from Greece's Experience*

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*Luncheon Address, Seminar on "Monetary Strategies for Accession Countries", Hungarian Academy of Sciences, Budapest, February 28, 2003. I am grateful to George Tavlas for helpful comments.

Ladies and Gentlemen,

I would like to thank Magyar National Bank, the Institute of World Economics of the Hungarian Academy of Sciences, and the Center of European Integration Studies of the University of Bonn for inviting me to speak to you today.

In contemplating the subject of this seminar, one is struck by how dramatically things have changed in the course of a decade. In 1992 and 1993, when the Exchange Rate Mechanism - - or ERM - - underwent a series of speculative attacks, the prospects of a European monetary union were viewed, by many observers, with considerable skepticism. This skepticism was not without foundation. After all, hadn't there been previous false starts on the road to EMU? Hadn't the Werner Report prescribed a European monetary union by the end of 1970s? Yet, here we are today, having fulfilled the dreams of Pierre Werner and his colleagues and having celebrated the fourth birthday of EMU.

Today, I would like to address some lessons from the experience of Greece, the newest member of the euro area, in its quest for EMU membership. I will confront what appears to be a dilemma. As we have heard this morning, much of the economics profession appears to have been converted to the "hypothesis of the vanishing middle"; for economies well integrated into world capital markets, there is little, if any, middle ground between floating exchange rates and monetary unification. Effectively, this hypothesis rules out intermediate regimes. Yet, a requirement for entering the euro area is participation in ERM II, which is, after all, an intermediate regime. How can this dilemma be resolved?

The Retreat from Intermediate Regimes

Before I discuss Greece's experience, let me address the reasons underlying the retreat from intermediate regimes. What has caused this retreat? First, an explosive increase in capital flows during the 1990s has made the operation of intermediate regimes problematic. As has already been discussed at this seminar by Jorge Braga de Macedo and Helmut Reisen, according to the thesis of the Impossible Trinity, developed in the 1980s, under a system of pegged exchange rates and free capital mobility, it is not possible to pursue an independent monetary policy on a sustained basis. Eventually, current-account disequilibria and changes in reserves will provoke an attack on the exchange rate.

The enormous increase in capital flows has been accompanied by abrupt reversals of these flows. Whereas the logic of the thesis of the Impossible Trinity suggests that exchange-rate attacks typically originate in response to current-account disequilibria and build up gradually, in fact, recent speculative attacks have often originated in the capital account, have been sudden and difficult to predict, and have included the currencies of countries without substantial current-account imbalances. Capital-flow reversals have involved a progression of speculative attacks, mostly against pegged-exchange-rate arrangements. These reversals of capital inflows and resulting exchange-rate devaluations or depreciations have often been accompanied by sharp contractions in economic activity and have, at times, entailed "twin crises" - - crises in both the foreign-exchange market and the banking system.

Finally, there has been a tendency of instability in foreign-exchange markets to be transmitted from one pegged-exchange-rate regime to others in a

process that has come to be known as “contagion”. The victims of contagion have seemingly included innocent bystanders - - economies with sound fundamentals whose currencies might not have been attacked had they adopted one of the corner solutions.

This triad of factors - - (1) the difficulty of conducting an independent monetary policy when the exchange rate is pegged and the capital account open, (2) sudden capital-flow reversals, and (3) contagion - - have profoundly affected the way we think about exchange-rate regimes.

The Experience of Greece: Pre-ERM

The foregoing factors significantly affected the Greek economy in the 1990s. Through 1994, the performance of the Greek economy was pretty dismal. Growth was almost flat, and inflation and the fiscal deficit as a percentage of GDP, were in the double-digit levels throughout the period. Other EU countries were moving forward in their quests to become members of EMU while Greece was falling farther and farther behind. Clearly, a regime change was called for.

It came in 1995. The signing of the Maastricht Treaty in 1992 and the government’s publicly-stated objective of joining the euro area provided powerful incentives for mobilising broad public support for policy adjustment. Among the policy measures undertaken were the following:

- Fiscal policy was progressively tightened. The fiscal deficit, as a percentage of GDP, fell from over 10 per cent in 1995 to around 4 per cent in 1997.

- Financial deregulation, which had begun in the late 1980s, was completed and in 1994 the capital account was opened. The deregulated financial system facilitated the use of indirect instruments of monetary policy so that small, frequent changes in the instruments became feasible, enabling rapid policy responses.
- The Greek Parliament approved independence of the Bank of Greece and provided the Bank with a mandate to achieve price stability.

For its part, beginning in 1995, the Bank of Greece adopted what became known as a “hard drachma policy”, under which the exchange rate was used as a nominal anchor. For the first time, the Bank announced a specific exchange-rate target. Underlying this policy, both in Greece and elsewhere during the 1990s, was the belief that the adoption of a visible exchange-rate anchor could enhance the credibility of the disinflationary effort because (1) the traded-goods component of the price level could be stabilised and (2) wage-settling and price-setting behaviour were restrained.

I will not go into details of the operation of the hard-drachma policy. Suffice it to say that, during the years 1995-97, real interest rates at the short-end were kept in the vicinity of 5 per cent. Fairly specific targets for the exchange rate were announced in each of the three years and were achieved. Importantly, inflation fell from about 11 per cent in 1994 to under 5 per cent at the end of 1997 while, in the first three years of the policy, real growth almost tripled compared with the rate of 1991-94.

Yet, as is typically the case with all nominal-anchor exchange-rate pegs, this regime produced difficulties. As predicted under the thesis of the Impossible Trinity, the ability to conduct an independent monetary policy under an

exchange-rate peg and open capital account became increasingly demanding. The wide interest-rate differentials in favour of drachma-denominated financial instruments led to a capital-inflows problem. The Bank of Greece responded by sterilising these inflows, limiting the appreciation of the nominal exchange rate, reducing the impact of the inflows on the monetary base, and buying time for other policies to adjust. Still, the sterilisation entailed quasi-fiscal costs and, by preventing domestic interest rates from falling, tended to maintain the yield differential that had given rise to the inflows. Additionally, the Greek economy experienced a fundamental problem associated with all exchange-rate nominal-anchor pegs during the move to lower inflation; the real exchange-rate appreciated significantly contributing, along with strong domestic demand, to a widening current-account deficit.

This circumstance brings me to the second and third of the triad of factors - - sudden capital-flow reversals and contagion. The widening current-account deficit, combined with rapid wage growth, fed market expectations that the drachma was overvalued and provided the basis for contagion from Asia, which commenced with the devaluation of the Thai baht in July 1997. The sharp rise in interest rates required to support the drachma increasingly undermined growth and fiscal targets. A further regime shift was needed.

That regime shift was provided by the ERM. Effective March 16, 1998, the drachma joined the ERM at a central rate that implied a 12.3 per cent devaluation against the ECU. As I will explain, entry into the ERM allowed Greece to orient its policies to stability, fostering convergence. Because participation in the ERM, without severe tensions, plays a role in the

convergence criteria for joining the euro area, it acts as testing phase for the central rate as well as for the sustainability of convergence in general.

Lessons from the ERM

Before I discuss the drachma's experience in the ERM, let me posit a question: What kind of an intermediate exchange-rate regime do we have in mind when we refer to the ERM? In my view, the present ERM system is the result of an evolutionary process. Like all Darwinian evolutions, several distinct versions of the species can be distinguished. To provide analytic focus, I think it useful to distinguish among the following.

ERM Mark 1. This species lasted from the inception of the EMS, in 1979, to 1987. Compared with the 2 per cent bands under the Bretton-Woods system, the ERM bands of fluctuation, at 4.5 per cent, were fairly wide and the system was supported by capital controls. For some currencies, the bands were even wider, at 12 per cent. Small realignments occurred frequently. Between March 1979, when the system started, and January 1987, realignments occurred on eleven occasions. The foregoing features of the system allowed France, for example, to devalue the franc by shifting the upper and lower limits of its band without affecting the market exchange rate, helping to forestall the possibility of the large profit opportunities that give rise to speculative attacks.

ERM Mark 2. What has been dubbed the "new EMS" began to take shape in 1987. Increasingly, the deutsche mark was used as a nominal anchor, with the Bundesbank's reputation as a stalwart inflation fighter supporting the monetary authorities of some participating countries in their efforts to attain anti-inflation credibility. Except for an implicit devaluation of the Italian lira in January 1990, when that currency moved from the wide band to the narrow band,

realignments ceased to be a characteristic of the system. In 1990, the remaining capital controls were eliminated by participating countries. German reunification required a tight monetary policy to counterbalance the large fiscal deficits generated by reunification. With other ERM countries in recession and requiring a loosening of monetary policy, the ERM was confronted with a classic (n-1) problem.

ERM Mark 3. Beginning in September 1992, many of the currencies participating in the ERM were subjected to attacks, eventuating in a series of devaluations and the suspension of the pound sterling and the Italian lira from the system. These attacks were sudden and massive. Thus, they were different from the currency realignments of the 1980s, which were mainly the result of pressures that had build up gradually in response to current-account disequilibria. With the lifting of capital controls, the attacks in 1992-93 arose on the capital account and sometimes infected the currencies of countries with seemingly-sound fundamentals, such as France. Several new terms made their way into the lexicon of economists: (1) capital-account-driven crises, (2) sudden-stops, and (3) contagion.

ERM Mark 4. In a last-ditch effort to rescue the system, in August 1993 the ERM bands were widened to ± 15 per cent. As things turned out, this move helped salvage the system. It provided necessary breathing space for nominal convergence to occur.

ERM Mark 5, or formally, ERM II. Under the present arrangement, exchange-rate stability is explicitly subordinated to the primary objective of price stability for all participating currencies and obligations under the system are deliberately more asymmetric than under the previous ERM. The notion of

asymmetry is particularly important in underlining the principle that it is the country whose currency comes under pressure that has to undertake the necessary policy adjustments.

Let me now return to the case of the drachma and the ERM. By the time that the drachma entered the ERM, in March 1998, the participating countries had demonstrated their determination to form a monetary union by attaining considerable nominal convergence, as specified in the Maastricht criteria. This convergence took place under a backdrop of market-based economies that could compete effectively in an open economic and financial system. In these conditions, the system built up a considerable amount of trust. As Otmar Issing has pointed out in several recent papers, the trust evoked by governments, including in their ability to deliver credible, non-inflationary policies, is a prerequisite for the existence of a stable currency, both internally and externally.¹

When the drachma entered the ERM, it became a beneficiary of the credibility established in the system over the previous years. It also benefited from the market's knowledge of the availability of the system's mutual support facilities, such as the Very Short-Term Financing Facility. Yet, Greece's participation was not a free ticket. The other participants in the system did not wish to endanger the credibility that had taken so long to achieve. They rightly asked for an entry fee. This fee included the following elements.

- The new central rate - - which as I have noted, involved a 12.3 per cent devaluation - - had been agreed by all members.

¹ See, for example, Issing (2001).

- The devaluation of the drachma was both backward looking and forward looking. The magnitude of the devaluation took account of both past inflation differentials between Greece and other EU countries and prospective differentials in the period leading up to Greece's expected entry into the euro area. Thus, the new central rate was meant to be sustainable.
- A package of supportive fiscal and structural measure was announced. Efforts to restructure public enterprises were stepped up. The aim of the measures was to ensure the sustainability of the drachma's new central rate. In other words, the ERM was meant to be a testing phase for EMU participation, not a free pass into the euro area.

Unlike many other devaluations of the mid-1990s and late-1990s, the drachma's devaluation was not followed by further rounds of speculative attacks, nor by a financial crisis. Unlike other devaluations, it was not followed by contraction in economic activity, but by an acceleration. Moreover, and again in contrast with the other devaluations of this period, the impact of the drachma's devaluation on inflation was strictly contained. What accounts for the drachma's successful exit from one central rate to another? In my view, the key ingredients of the successful devaluation were the following.

- Unlike other currencies that were devalued during the mid-1990s and late 1990s, the drachma exited a unilateral peg and entered a systems' arrangement, benefiting from the credibility of the ERM.
- Fiscal tightening continued following the devaluation. The fiscal deficit, as a per cent of GDP, fell to about 1 per cent in 1999, from 4

per cent in 1997. Labour-market policy gradually adjusted to the needs for fiscal discipline and for enhancing international competitiveness.

- Prudential regulation and supervision of the banking system had been strictly enforced and there was no net foreign exposure of the banking system. Thus, there was no currency-mismatching problem - - i.e., large, uncovered foreign-currency positions, which, under conditions of currency devaluations, raise the debt burden of domestic foreign-currency borrowers, resulting in bankruptcies and financial crises.

In addition to placing the Bank of Greece's disinflation strategy within a new institutional framework that gave it added credibility, the ERM provided another important advantage. Entry at the standard fluctuation bands of ± 15 per cent gave the Bank ample room for manoeuvre. Thus, when capital inflows resumed following ERM entry, the Bank allowed the exchange rate to appreciate relative to its central rate, helping to maintain the tight monetary-policy stance and to contain the inflationary impact of the devaluation. The exchange rate remained appreciated relative to its central rate throughout the rest of 1998 and for all of 1999. In 1999, for example, the drachma traded (on average) 7.7 per cent above its central rate while, for most of that year, the three-month interbank rate stood about 700 basis points above the corresponding German rate. As a result of the tightened and consistent policy mix, inflation reached a low of 2 per cent during the second half of 1999. Then, in order to limit the degree of depreciation that would be required for the market rate to reach its central rate and the resulting inflationary pressures, the central rate was revalued by 3.5 per cent in January

2000. The rest, as they say, is history; having fulfilled all the Maastricht criteria, on January 1, 2001 Greece became the 12th member of the euro area.

Concluding Remarks

What are the key lessons that emerge from Greece's experience?

Let me highlight the following.

First, an intermediate exchange rate regime can be viable in today's world of high capital mobility provided that (1) the participants adhere to sound and sustainable policies, including those that ensure the existence of a well-functioning market economy, and, (2) the intermediate regime is used as a transitional arrangement on the road to the corner solution of a monetary union. There is no contradiction between the existence of ERM II and the hypothesis of the vanishing middle regime.

Second, ERM II provides the credibility of a systems' arrangement, built up in a Darwinian evolution, and flexibility through the wide fluctuation bands that may be necessary to achieve nominal convergence. The credibility derived by participating in the ERM II should not, however, be endangered by use of frequent adjustments of the central parity. As the ERM experiences of the 1980s and 1990s vividly demonstrated, frequent adjustments of central parities within a pegged regime are feasible only in the presence of capital controls. In today's world of high capital mobility, exchange-rate changes are not instruments that policy-makers can use flexibly and costlessly. The more often they are used, the less can be the credibility of a pegged exchange-rate system.

Third, the need of a consistent policy mix is crucial and has important implications in terms of how we need to view policy analysis. An implication of both the Mundell-Fleming model and Mundell's famous assignment problem is that monetary policy and fiscal policy constitute two, separate policy instruments. Yet, the simple accounting fact that government expenditure has to be financed by either taxation, borrowing, and/or money creation, implies that any analysis of monetary policy must make consistent assumptions about fiscal policy. Monetary policy and fiscal policy, in other words, are not independent policy instruments. They must work in tandem on the road to EMU, and in EMU.

Fourth, ultimately, a credible exchange-rate regime depends upon the trust evoked by governments. A governance structure that enforces the rule of law and sanctity of contracts and a political system that delivers credible, non-inflationary policies are prerequisites for the existence of a stable exchange-rate regime.

Ladies and Gentlemen, thank you for your attention.

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