

EMS 10th ANNIVERSARY ISSUE

Editorial Introduction by Michael Moore

The European Community is frequently accused of being short on tangible achievements. Consequently, it seemed obvious to the editors of the *Review* that the 10th anniversary of the EMS was an occasion worthy of note. The first reason for this is that the maintenance of a stable exchange rate zone, for what already amounts to 40 per cent of the life of the Bretton Woods System, should surely be highlighted. There was another reason: Ireland's decision to break the sterling link after more than a century and to join the EMS was a rare textbook example of a "policy regime change" in a way which it was not for the other EMS countries. Despite this fact, most Irish economists have devoted little energy to issues of exchange rate policy and the experience of the European Monetary System. It is worth emphasising that this is particularly surprising in view of the fact that the Irish case has received the attention of a number of major international economists. These include Mussa (1986), Baxter and Stockman (1988) and Dornbusch (1989). This special issue on the European Monetary System is designed both to develop the debate on some of the major conceptual issues which the EMS has given rise to and to stimulate further study of the Irish experience.

Francesco Giavazzi has written extensively on aspects of the European Monetary System. He draws on this experience to write the opening article, which reviews the development of the EMS, and debates the extent to which its lessons are globally applicable. He concludes by examining the future for the EMS in the light of proposed institutional developments within the Community, including the Single European Market in 1992 and beyond.

Though the EMS is inevitably presented at a political level as an institution of co-operation among equals, economic theorists have a strong prior that there has to be a dominant currency within the system. The obvious candidate for this position is the Deutsche Mark. Emil-Maria Claassen explores this concept and finds three distinct meanings to the idea that the EMS is a Deutsche Mark zone. He concludes that, despite the desire of the Community to have the European Currency Unit (ECU) as the monetary anchor of the EMS, it is difficult to avoid the conclusion that the German Mark is the hegemonic currency. This theme is also reflected in the work of Patrick Honohan and Paul McNelis. They argue that it is possible to test the theory that the EMS is a DM zone by comparing the effect of realignments on the Dollar value of the DM, on the one hand, and the Dollar value of the other EMS currencies, on the other hand. They find evidence in favour of the intuition that the time series properties of the DM/Dollar rate are significantly less affected by realignments than the Dollar value of the less important currencies. Though they approach the problem quite differently, they agree with Claassen's conclusion that the EMS does indeed behave like a DM zone.

One of the most important questions for students of the EMS is whether it has attained the objectives for which it was originally intended. Ron Bewley and Colm Kearney apply a little used econometric technique in an innovative way to examine the extent to which the EMS has succeeded in stabilising the bilateral nominal exchange rates of its members' currencies. They conclude that, not only has the EMS been successful in this regard, but it has done so in the face of an even more volatile external environment than that which prevailed in the 1970s. Mike Artis and Mark Taylor also attempt to judge the performance of the EMS by its own pre-set criteria. Using non-parametric econometric and statistical procedures, *inter alia*, they conclude that the EMS has reduced both exchange rate and interest rate volatility. However, they suggest that capital controls has significantly contributed to this success. This indicates that the financial liberalisation which is currently taking place within Europe has the potential to undermine the EMS unless the monetary policies of the member countries are co-ordinated. They also produce striking evidence that, even after a decade, there is long-run real exchange rate misalignment within the EMS.

Rodney Thom takes up this issue using co-integration techniques applied to the Irish pound. He finds no evidence of a tendency towards long-run purchasing power parity in relation to the US Dollar while the evidence in connection with sterling and the Deutsche Mark is mixed. The importance of this finding is that it reopens the question as to whether exchange rate changes are neutral in the long run. Tim Callan and John FitzGerald directly address this issue. Though they are more optimistic than Rodney Thom that purchasing power parity may prevail in the long run, they find evidence that exchange

rate changes affect Irish prices less rapidly than do changes in foreign prices. Interestingly enough, they also find that there is almost no evidence that domestic wage costs have any effect on competitiveness. This result is, of course, consistent with contemporary economic theory but contrasts sharply with journalistic accounts of the causes of changes in competitiveness.

REFERENCES

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