Mr. Doyle discusses the achievements of the European Monetary System in the last decade and its prospects for the future Speech delivered by the Governor of the Central Bank of Ireland, Mr. Maurice F. Doyle, at the Irish Economic Association Conference at Trinity College in Dublin on 20/3/89 as reproduced in the Bank's ANNUAL REPORT for 1988.

This is a timely moment to consider the evolution of the EMS and I commend the Irish Economic Association for organising a conference on this topic. The moment is opportune, not only because we have the benefit of a decade's experience, but also because of the likely impact of some important recent initiatives, such as the Basle/Nyborg agreement, the growing liberalisation of capital movements and the establishment of a unified European market for goods and services, as well as the study by the Delors Committee of concrete steps towards the realisation of economic and monetary union in Europe. In the few minutes at my disposal this morning, I should like to suggest some principles that should govern the future evolution of the EMS. But first, a quick look at the experience and insights acquired over the past decade are in order.

The EMS came into operation on 13 March 1979 with the objective of "closer monetary cooperation leading to a zone of monetary stability in Europe". Expressed more practically, participation in the exchange-rate mechanism (ERM) of the EMS was viewed as giving greater exchange-rate stability and through this a reduction in inflation, lower interest rates and improved economic growth. While the EMS has not been equally successful in achieving all its objectives, it has generally exceeded the expectations held out for it in 1979.

The lessons of the first ten years of the EMS are probably best seen in the key areas of exchange-rate and price stability and in the evolution of policy coordination over the period.

As regards *exchange-rate stability*, there seems to be little doubt that compared with non-ERM currencies, the variability of both nominal and real exchange rates has declined significantly since 1979. Moreover, this reduction in variability has become more pronounced according as the system has developed. There have been eleven realignments within the ERM, but seven of these occurred in the first four years of the system's existence, after which there was a growing realisation that the use of realignments as a tool to restore competitiveness was misguided. Moreover, four of the eleven realignments were "unilateral", that is, involving a change in the bilateral central rate of only one currency in terms of all the other currencies, while the immediate change in *market* exchange rates after many realignments was relatively small.

The record on inflation has also been impressive. The oil price increases in 1978-79 had initially adverse effects, but since the early 1980s there has been a significant reduction in inflation rates and a narrowing of inflation differentials, with the average rate of inflation in the ERM declining more rapidly and to a lower level than that recorded in countries outside the mechanism.

To a large extent, the success of the ERM has been due to an increasing degree of *monetary coordination*. This has enabled the system to tackle many of the internally-generated pressures while also allowing it to cope with tensions arising from external sources. The system has, for instance, been resilient enough to withstand the enormous volatility in the value of the dollar over the past decade.

The most recent step in monetary coordination was the Basle/Nyborg agreement of September 1987. This comprised a combination of technical improvements and moves towards greater policy coordination. There was agreement to exploit the scope for a more active, flexible and concerted use of the instruments available, that is, foreign-exchange market interventions, exchange-rate movements within the fluctuation band and interest-rate changes. In addition, the agreement permits the financing of intramarginal interventions in certain circumstances, which is both an important technical and practical step forward, and it was agreed to strengthen the joint monitoring of economic and monetary developments and policies by the Committee of Governors of Central Banks. These measures proved their worth in the months of October and November 1987, when the ERM successfully coped with pressures arising from the turmoil in international financial markets and the decline in the dollar at that time.

While the Basle/Nyborg agreement demonstrates the degree to which monetary coordination has been improved within the ERM, coordination or convergence has not been as great in other important areas, notably in fiscal policy and external imbalances, while the relatively sluggish growth performance of ERM countries generally has also given rise to some concern. Differences in fiscal policies, particularly during the initial years of the ERM, have overburdened monetary policy in a number of countries.

The Irish experience of the ERM mirrors many of the considerations I have mentioned. Our hopes in 1979 were to reduce the rate of inflation by moving from the high-inflation sterling area to the lower-inflation ERM area. With hindsight, it is possible to argue that we parted from the inflationary influence of sterling just before the UK took stern measures to bring it under control, but I have no doubt that our decision to join the ERM was the correct one. While the Irish economy now had to cope with exchange-rate uncertainty against our major trading and financial partner for the first time since 1826 and was not helped by the domestic economic policies that were followed, more recent experience suggests that we have now largely overcome these difficulties. The Irish inflation rate and the level of Irish interest rates are considerably below those prevailing in the UK and we are now enjoying the benefits of the commitment to the ERM.

How should the system evolve to meet the challenges ahead? Any examination of the future of the EMS is now inextricably bound up with the consideration of economic and monetary union (EMU). EMU involves

- freedom of movement of goods and services, capital and labour

- a high degree of policy coordination

- the reduction of regional disparities.

These together constitute *economic* union; *monetary* union, which we regard as the final stage of the process, would require, in addition,

- the irreversible fixing of exchange rates.

These objectives will require commitments which far exceed those made in joining the EMS and in ratifying the Single European Act.

Economic and monetary union has long been considered as the desirable, if sometimes remote, objective of European integration. As far back as 1972, the heads of Government approved a Council resolution on EMU which remained a dead letter. Nor, indeed, did EMU feature as a significant factor at the time of the establishment of the EMS. However, with the passing of the Single European Act (SEA), the member States confirmed the objective of EMU and the Hanover European Council meeting in June of last year appointed the Delors Committee to study and propose concrete steps leading towards EMU.

What has caused this recent re-emergence of sentiment in favour of EMU? A number of different, but related, factors have operated. Apart from the success of the EMS to date, perhaps the most important is the substantial progress made towards liberalising capital movements and towards the establishment of a unified European market for goods and services, due for completion in 1992. Free movements of money and capital on the one hand and goods and services on the other are the essential elements of European integration. The unification of financial and goods markets will, however, itself create tensions which can be resolved only by extending the integration process. In an environment of free capital movements and exchange-rate constraints, the scope for autonomous monetary policy is severely limited. If there is not a corresponding convergence of budgetary and other economic policies, the increased scope for speculation could exert great strains on exchange-rate stability. Moreover, in the markets for goods and services, the new freedom of trade could result in a tendency for activity to converge on the economic centres of the Community while peripheral regions deteriorate.

In order to avoid such difficulties, active policies will be needed to ensure that all Community members can reach a broadly similar stage of economic development and are committed to broadly similar economic policies. Looked at in this way, economic integration aims to provide the necessary framework for coordinating monetary and economic policies and reducing regional imbalances, both of which are essential conditions for a monetary union with permanently fixed exchange rates. In this sense, EMU can be regarded as the logical outcome of the integration process and, indeed, as a safeguard that the process will be sustainable and beneficial to all member States.

A final consideration in our support for EMU is the conviction that a policy of fixed exchange rates provides the best environment for controlling inflation and promoting economic growth. Experience shows that for small open economies, competitive devaluations are not a solution to economic problems. Any benefits of exchange-rate adjustment are merely temporary, being quickly reflected in higher inflation and a loss of credibility. Moreover, this is no longer a conviction of small open economies only. The need to avoid realignments to improve credibility and to achieve price stability is increasingly seen as essential for the larger ERM participants too.

What principles should govern the evolution of EMU if it is to be both sustainable and of benefit to all member States?

As the EMS experience has shown, coordination of policies is essential. The objectives of EMU go significantly beyond those of the ERM and require a correspondingly greater degree of policy coordination. We have already seen in the past ten years how monetary policy has become overburdened, having borne most of the adjustment in the ERM. It is vital, if we are to move towards EMU, that there should be convincing mechanisms for the coordination of other economic policies. In particular, budgetary policy coordination, which has lagged far behind what has been achieved in the monetary area, must be reinforced.

A second principle is that there be parallel advances in interrelated areas. So far, most progress has been made in the monetary field; there is a clear need to ensure that evolution towards monetary union and permanently fixed exchange rates be matched by a parallel evolution towards economic union. All member States will, before the final stage of EMU is achieved, need to have reached a broadly similar level of economic development and a high degree of convergence in fiscal, monetary and other economic policies. If this is not the case, disparities within the Community would cause persistent capital and labour outflows from the less prosperous to the richer regions, creating both economic and political tensions that would put the whole process of realising EMU in jeopardy.

Respecting this principle will require a concerted Community effort to minimise the problem of regional imbalances. While the recent decision to double the Structural Funds is welcome, this will not of itself be sufficient to cope with the problems of regional disparities as we approach EMU. As integration proceeds, policy autonomy will progressively diminish, so that Community regional policy must increasingly take over if EMU is to be sustainable. It is, therefore, crucial that adequate policy measures be in place from an early stage to deal with the problem of regional imbalances.

An important lesson of the EMS experience is that non-participation in the exchange-rate mechanism has limited the achievements of the system. Ireland especially has suffered from the absence from the ERM of the UK, our major trading partner, and this has greatly complicated the management of the Irish pound exchange rate. Nor has non-participation enabled the UK to achieve its objective of price stability. Indeed, it is ironical that exchange-rate policy *autonomy* is sometimes justified in the UK by reference to the need to tackle inflationary pressures whereas, for ERM countries, exchange-rate *stability* is relied on as the main defence against inflation. One may also question the consistency of devoting so much effort to completing the internal market - essentially, eliminating distortions to trade - while one of the most significant distortions - the uncertainties created by exchange-rate volatility - is not accorded a higher priority. In this sense, non-participation in the ERM inevitably creates doubts about a member's commitment to European integration and reduces the international role of the EMS.

The principle of participation also applies to EMU. This requires that not only should all member States agree on the final objectives of the

Community, but also that a good deal of progress be made by *all* member States at any intermediate stage along the road to EMU. In this regard, a significant step - and one that would not require a change in the Treaty of Rome - would be if, by the end of 1992, all member States were full participants in the ERM and if margins of fluctuation were progressively reduced. This would represent a touchstone for members' future commitment to EMU.

Another lesson learned from the EMS is that institutional arrangements must be adaptable over time to changed circumstances. In a number of respects, the EMS experience has differed from that expected at the outset; for example, the credit mechanisms, designed to finance interventions at the limits only, were not available for the vast bulk of interventions, which were intramarginal. More generally, with the reduction of exchange controls in recent years, the potential for destabilising capital flows has become much greater than envisaged in 1979. The Basle/Nyborg agreement is a means of coping with this changing environment.

In looking ahead to the institutional arrangements that should accompany EMU and drawing on EMS experience, two considerations suggest themselves. The first is that any new institution should have sufficient powers to carry out its functions independently and should be readily adaptable to changing circumstances. Secondly, as far as possible, decision-taking and policy implementation should be carried out at national level.

With these principles in mind, it seems to me that any future Community monetary institution should be based on an extension of the powers and responsibilities of the existing Committee of Governors. This would ensure that a European central banking system would have the maximum degree of *independence* not alone from national governments but also from Community institutions such as the Council or the Commission. Without such independence, it would not be possible to guarantee that *price stability* would be the primary objective of the new institution. Moreover, a European central banking system should be organised on a *decentralised federal* basis so that only the minimum necessary of functions would be transferred, with national central banks retaining responsibility for as many functions as possible. The federal structure should also permit each constituent central bank to have a voice in policy formulation and decision-taking.

In the early stages of EMU, that is before decisions are taken on a Community basis and before the permanent fixing of exchange rates, it is quite possible that monetary coordination could proceed without any new institution being established, but whether we operate under new or existing institutions, EMU would not endure unless there is effective coordination of monetary and other economic policies and a firm commitment to the reduction in regional disparities.

The exchange-rate mechanism of the EMS has operated more successfully than probably even its enthusiasts could have hoped for in 1979, so much so that it is now a major and permanent feature of the European financial scene. This success, in conjunction with movement towards the completion of the internal market, has considerably heightened expectations for complete economic and monetary union which could lead to a stronger Europe. An EMU embodying the characteristics I have outlined would ensure that the benefits would be shared by all.

Mr. Concha nominated new President of Central Bank of Chile CENTRAL BANK OF CHILE, COMMUNICATION, 6/6/89.

As of 5/4/89 Mr. Manuel Concha Martinez has been nominated President of the Central Bank of Chile. Mr. Concha was formerly Minister of Economy, Development and Reconstruction. On the same date, Mr. Enrique Seguel Morel, former President of the Bank, was nominated Minister of Finance.

Highlights of the Seychelles economy in 1988 and its outlook for 1989 CENTRAL BANK OF SEYCHELLES, ANNUAL REPORT 1988.

Developments in 1988

The economy remained buoyant in 1988. All available monitors of production and growth reveal a higher level of activity in most of the major sectors of the economy. Demand at home was contained within bounds and inflation was kept at bay. Tourism and industrial fishing consolidated their positions as growth sectors, while agriculture, industry, transport, finance and business also revealed a healthy level of activity. The actual GDP estimates for the year are still under preparation, but on the basis of preliminary assessments a healthy growth rate of around 5 to 7 percent is anticipated.

In the real sector tourism and industrial fishing sustained their growth path during the year. Finance and commerce, construction and transport sectors also continued to gain further momentum. Food production is becoming increasingly important particularly in view of the growing import requirements to service the tourism sector. However, owing to the unfavourable weather conditions as well as the uneconomic returns from certain operations, vegetable and root crop production experienced a setback in 1988. Fruit production recorded a significant growth but the Seychelles Marketing Board (SMB) had to import over 2,500 tonnes of fruits and vegetables to meet the market demand. The