

The ERM-1: Key Features

- ERM: optional feature of EMS
- A parity grid:
 - (bilateral) parities against central unit (ECU)
 - margins of fluctuations (+/- 2.25%).
- A strange money: the E.C.U.:
 - as unit of account only
 - but you could bank in ECU (deposits/loans)
 - It did not exist as a note
 - Made by a basket of currencies (DM, FFR, lit...)



The ERM-1: Key Features

- Mutual unlimited support (?):
 - exchange market interventions
 - short-term loans.
- with realignments (currencies over/undervalued):
 - frequent (before 1986): due to inflation differentials
 - require unanimity agreement.



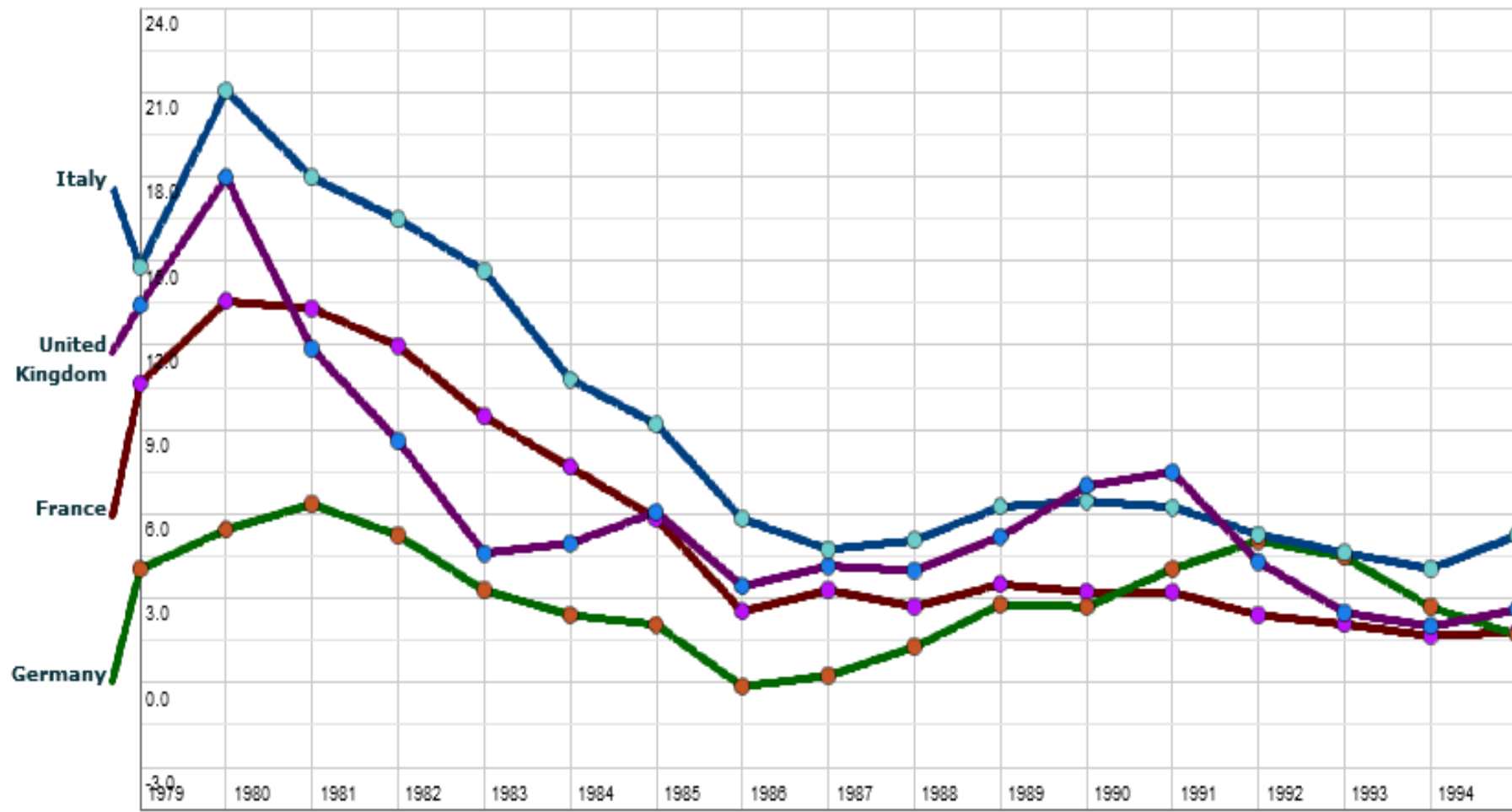
Evolution: from symmetry to DM Zone

- Initially a flexible arrangement:
 - different inflation rates (monetary policy independence!)
 - frequent realignments
 - usually too little to restore external balance
 - opened the door to speculative attacks
 - erosion of credibility of some countries
- Bundesbank emerged as the example to follow



feasible?

Consumer prices - all items, Percentage change on the same period of the previo...



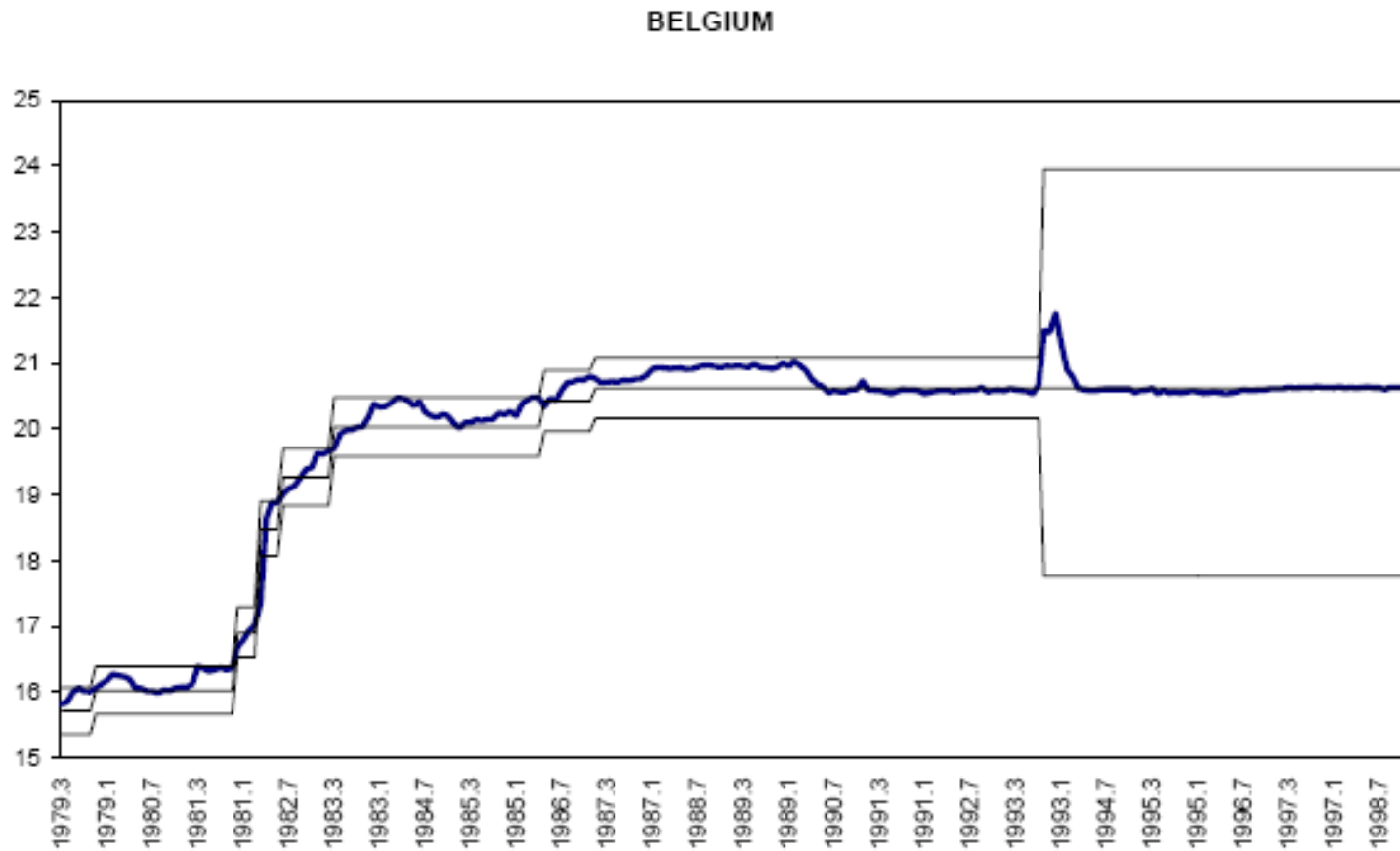
fixed exchange rates?

Table A2. Realignment dates and central DM parities in the ERM

Realignment dates	BF/DM	DK/DM	FF/DM	IP/DM	IL/DM	NG/DM
13/03/79	15.7164	2.82237	2.30950	0.263932	457.314	1.08370
24/09/79	16.0307	2.96348	2.35568	0.26921	466.460	1.10537
30/11/79	...	3.11165	...	...	...	...
23/03/81	...	...	...	...	496.232	...
05/10/81	16.9125	3.28279	2.56212	0.284018	539.722	...
22/02/82	18.4837	3.38433	...	...	...	...
14/06/82	19.2693	3.52817	2.83396	0.296090	578.574	...
21/03/83	20.0285	3.63141	3.06648	0.323703	626.043	1.12673
22/07/85	...	...	...	...	679.325	...
07/04/86	20.4252	3.70332	3.25617	0.333416	699.706	...
04/08/86	...	...	...	0.362405	...	...
12/01/87	20.6255	3.81443	3.35386	0.373281	720.699	...
08/01/90	...	...	...	...	748.217	...
15/09/92	...	...	...	...	802.488	...
02/02/93	...	...	...	0.414757	...	...
25/11/96	...	...	...	...	990.004	...
16/03/98	...	...	...	0.402676	...	...

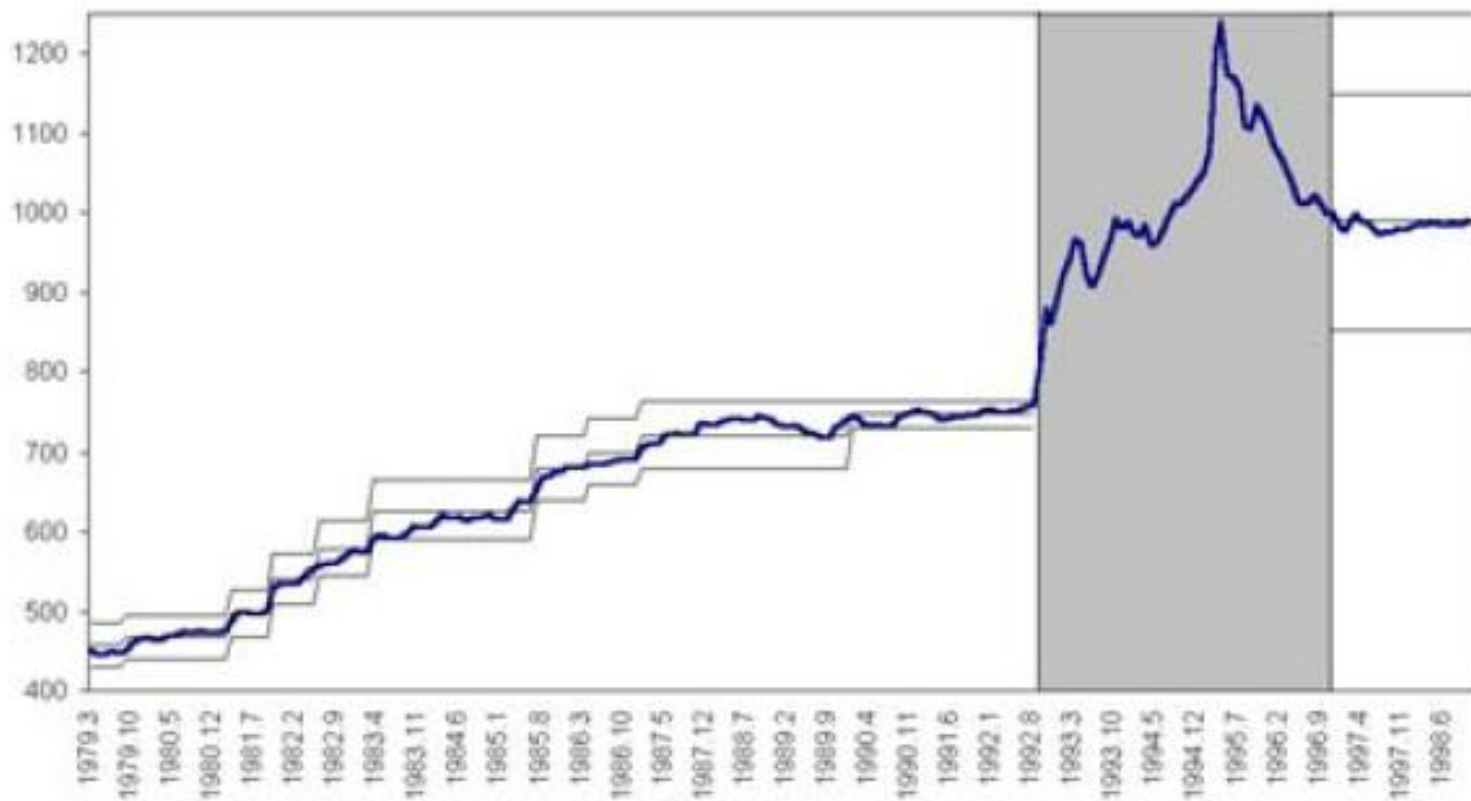


fixed exchange rates? BFR/DM



fixed exchange rates? lit/DM

ITALY



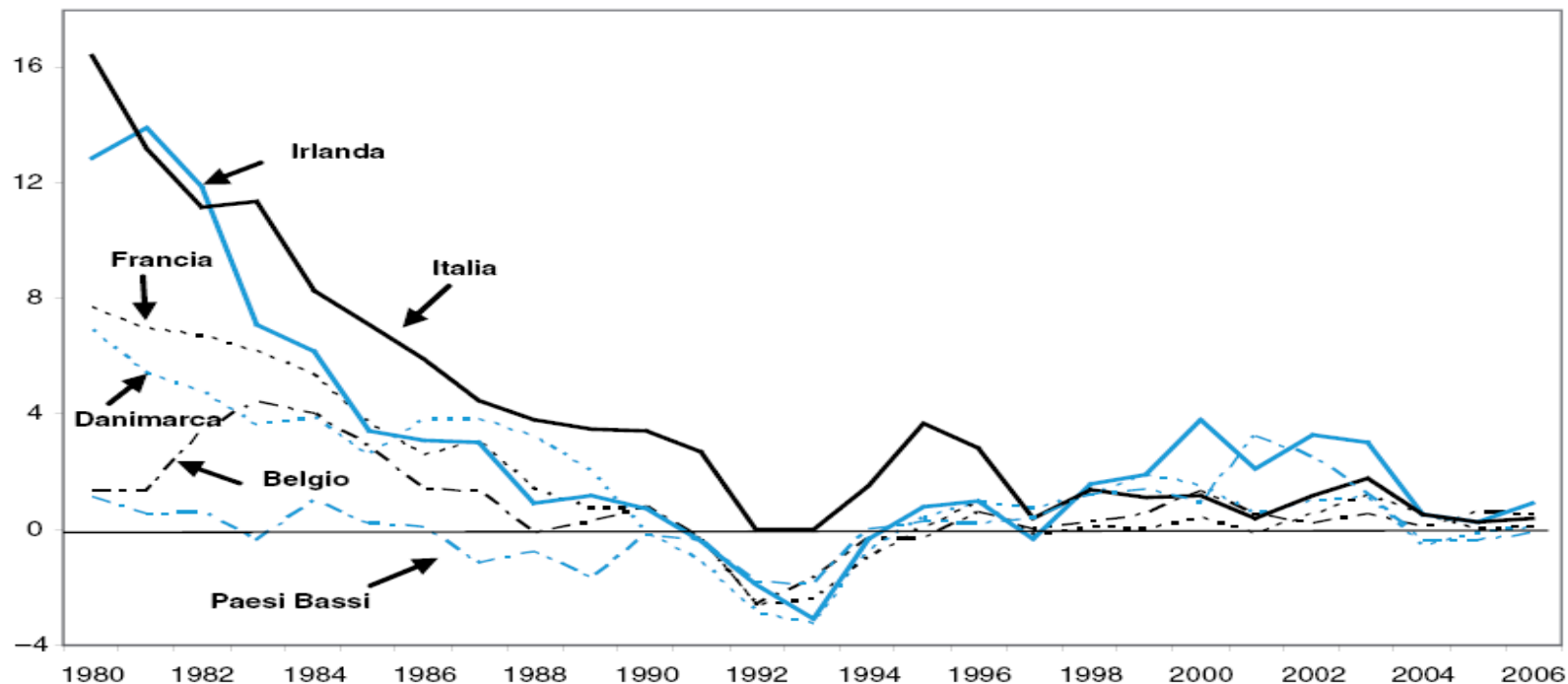
Convergenza dei tassi di inflazione tra i

FIGURA 10.2

Convergenza dei tassi di inflazione in sei dei paesi fondatori dello SME, 1980-2006.

Nel grafico si riportano i differenziali di inflazione rispetto alla Germania per sei dei paesi fondatori dello SME: Belgio, Danimarca, Francia, Irlanda, Italia e Paesi Bassi.

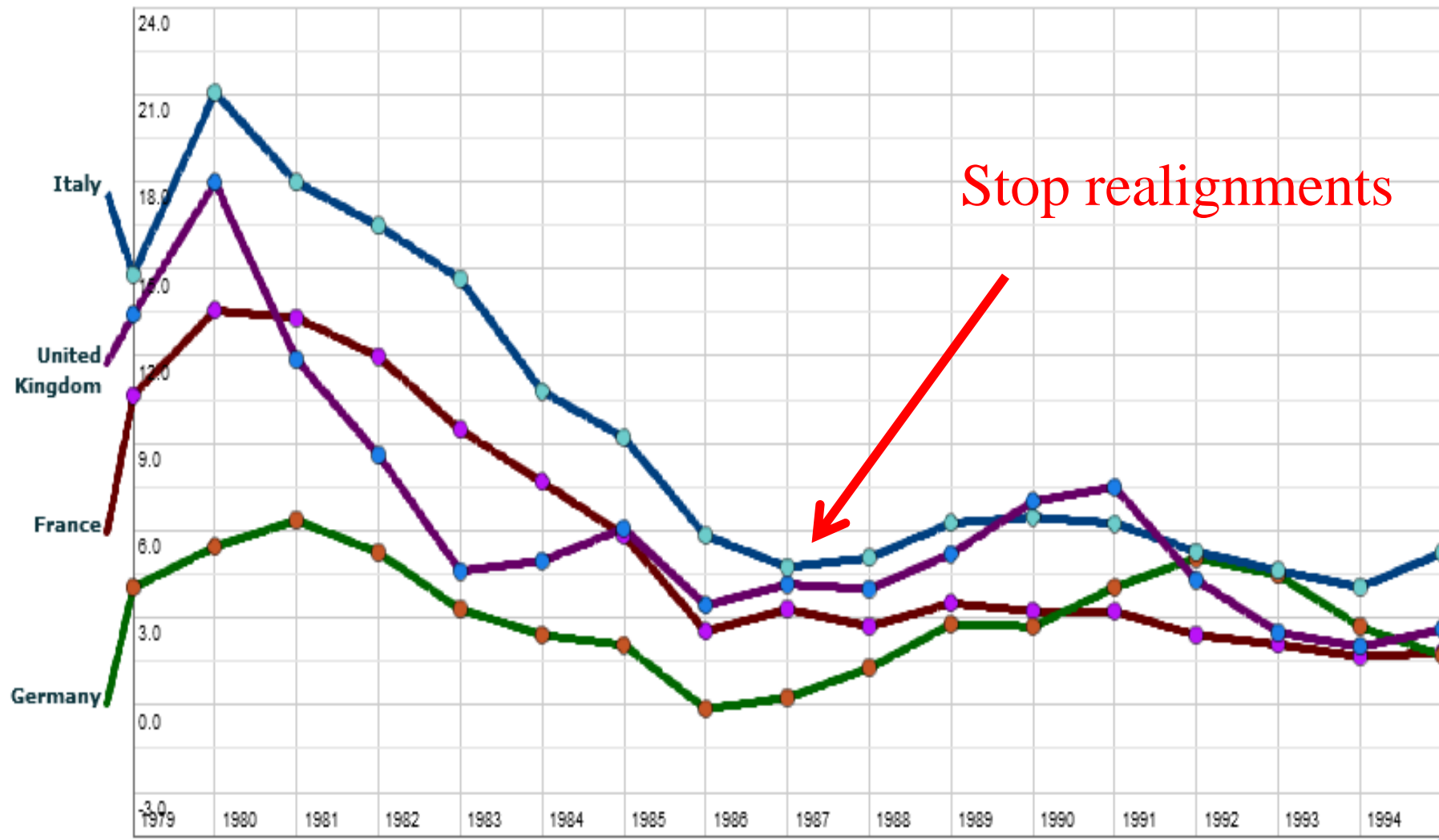
Inflazione annua domestica meno inflazione annua tedesca (%)



Fonte: FMI, WEO Database. I tassi di inflazione sono relativi agli indici dei prezzi al consumo (IPC).

straight jacket

Consumer prices - all items, Percentage change on the same period of the previo...



Breakdown of the DM zone

- why it didn't last forever

- Bad design:
 - full capital mobility established in 1990 as part of the Single Act: TRINITY REQUIRES....
- Asymmetric shocks:
 - German unification: a big positive shock that called for very tight monetary policy in Germany
 - Italy & UK in recession!
- Political shock
 - the Danish referendum on the Maastricht Treaty worried exchange markets
- A wave of speculative attacks in 1992-3:
 - the Bundesbank sets limits to unlimited support.



Five Incarnations of the ERM 1

- 1979-82: ERM-1 with narrow bands of fluctuation ($\pm 2.25\%$) and symmetric.
- 1982-87: ERM-1 more centered on the DM, several realignments, careful capital controls.
- 1987-92: ERM-1 a DM area, fixed exchange rates and lessen capital controls.
- 1993-99: ERM??? wide bands ($\pm 15\%$) i.e. flexible rates.
- 1999- : ERM-, asymmetric, on the way to euro area.



European Monetary Union: One Market = One Money?

EMU IS NOT A BIRD!



quite a long way: anyway a good idea?

Towards Maastricht		Between Maastricht and the single currency		After Maastricht	
1970	Werner Plan	1994	European Monetary Institute (precursor of ECB)	1999	Monetary union starts
1979	European Monetary System starts	1997	Stability and Growth Pact	2001	Greece joins
1989	Delors Committee	1998	Decision on membership	2002	Euro coins and notes introduced
1991	Maastricht Treaty signed	1998	Conversion rates set	2007	Slovenia joins
1993	Maastricht Treaty ratified	1998	Creation of ECB	2008	Cyprus and Malta join
				2009	Slovakia joins
				2011	Estonia joins

3 Steps to get the Monetary Union

STAGE ONE 1 July 1990

Complete freedom
for capital transactions

Increased cooperation
between central banks

Free use of the ECU
(European Currency Unit,
forerunner of the €)

Improvement of
economic convergence

STAGE TWO 1 January 1994

Establishment of the
European Monetary
Institute (EMI)

Ban on the granting
of central bank credit
to the public sector

Increased coordination
of monetary policies

Strengthening of
economic convergence

Process leading to the
independence of the
National Central Banks
to be completed at the
latest by the date of
establishment of the
European System of
Central Banks

Preparatory work
for stage three

STAGE THREE 1 January 1999

Irrevocable fixing
of conversion rates

Introduction of the euro

Conduct of the single
monetary policy by
the European System of
Central Banks

Entry into effect of the
intra-EU Exchange Rate
Mechanism
(ERM II)

Entry into force of the
Stability and Growth Pact

Maastricht Treaty states 5 criteria

The five convergence criteria

What is measured:	Price stability	Sound public finances	Sustainable public finances	Durability of convergence	Exchange rate stability
How it is measured:	Consumer price inflation rate	Government deficit as % of GDP	Government debt as % of GDP	Long-term interest rate	Deviation from a central rate
Convergence criteria:	Not more than 1.5 percentage points above the rate of the three best performing Member States	Reference value: not more than 3%	Reference value: not more than 60%	Not more than 2 percentage points above the rate of the three best performing Member States in terms of price stability	Participation in ERM II for at least 2 years without severe tensions

Six OCA criteria

- Three classic (economic) criteria
 - ◆ Mundell
 - ◆ Kenen
 - ◆ McKinnon
- Three political criteria

3 Economic Criteria

1. **Labour Mobility** (Mundell): In an OCA labour (actually but this applies to Capital too) moves easily across national borders
2. **Production Diversification** (Kenen): Countries whose production and exports are widely diversified and of similar structure form an OCA (in this case asymmetric shocks are unlikely)
3. **Openness** (McKinnon): Countries which are very open to trade and trade heavily with each other form an OCA.

Economic Criteria in EUROLAND

1. **Labour Mobility** (Mundell): NO WAY!!!
How many different languages and cultures???
2. **Production Diversification** (Kenen):
Unlikely: too much diversified production!
Quite obvious as in an single economy i.e. EU it's natural to specialize.
3. **Openness** (McKinnon): OK in EU!

3 political criteria

4. **Fiscal Transfers:** Countries that agree to compensate each other for adverse shock form an OCA:

With a budget that is about 1% of GDP?

Mostly preallocated?

EU does not have transfers can act as an insurance that mitigates the costs of an asymmetric shock

3 political criteria

5. **Homogeneous Preferences:**

Countries that share a wide consensus on the way to deal with shocks form an OCA

We have seen that in ERM 1!!!

Not even within Germany!

6. **Commonality of Destiny**

Countries that view themselves as sharing a common destiny better accept the costs of operating an OCA

As above.....

<http://www.dw.de/german-states-oppose->



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FINANCE

German states oppose 'stupid' wealth transfers

Rich German states helping poor German states by sending them cash is a founding principle of Germany's financial equalization. Yet some of the richer states feel the system has gone too far and outlasted its use.

Date 04.03.2013

Author Wolfgang Dick / cd

Related Subjects [Bayerische Motorenwerke \(BMW\)](#)

Keywords [Federal financial transfer system](#), [budgets](#), [equalization](#), [bavaria](#), [hessen](#), [baden württemberg](#)

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ELECTIONS

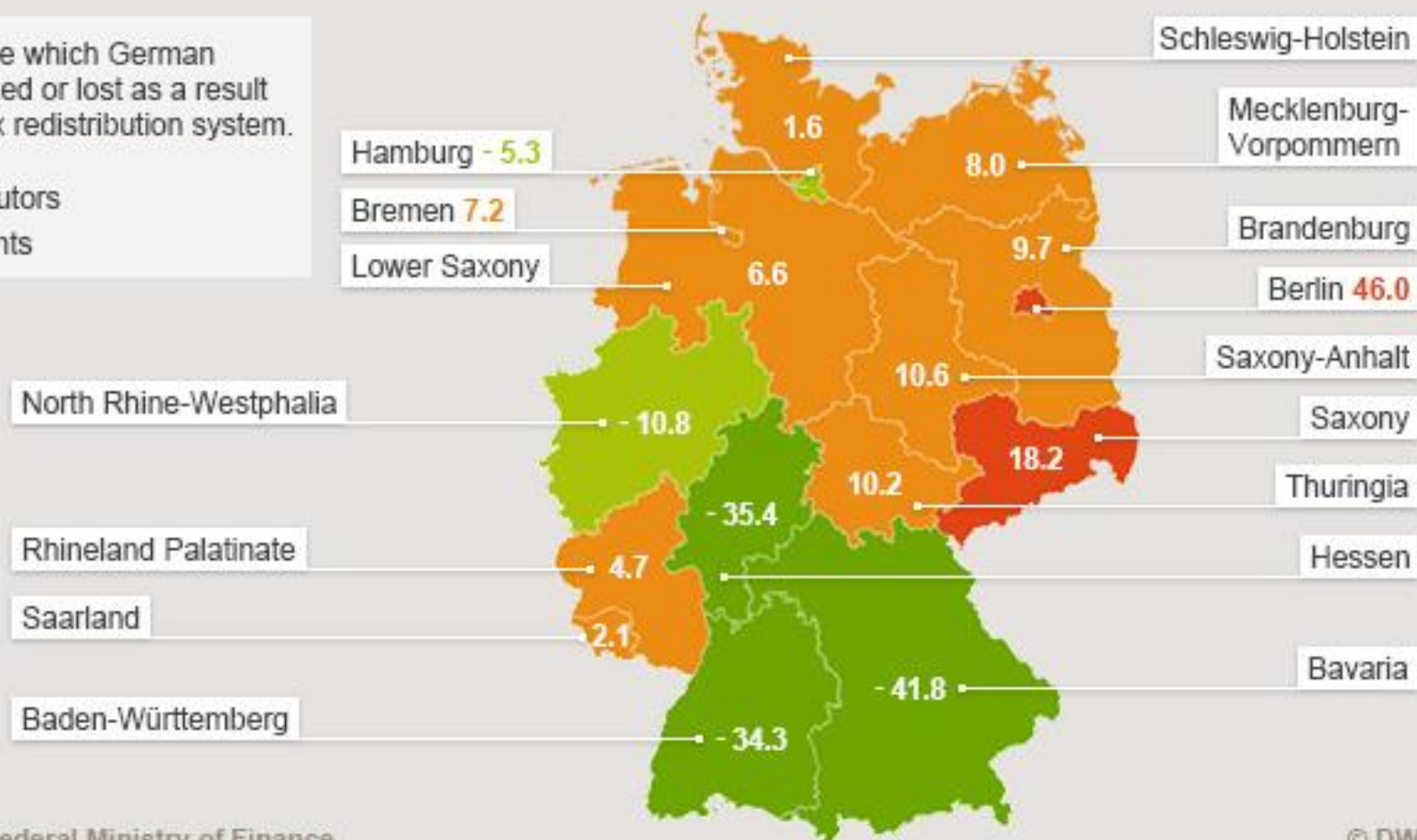


<http://www.dw.de/german-states-oppose-stupid-wealth-transfers/a-16640386>

State tax transfers from 1995-2012 in billions of euros

Numbers indicate which German states have gained or lost as a result of the federal tax redistribution system.

- Net contributors
- Net recipients



<http://www.dw.de/german-states-oppose-stupid-wealth-transfers/a-16640386>

Germany first devised a financial transfer system in the 1950s. The idea was simple: all German citizens should have a minimum standard of living that was independent of their state's financial condition. Problems really began in 1995, however, when Germany was re-unified and five former East German states, impoverished by decades of Soviet control, were incorporated into the system.

Bavarian Premier Horst Seehofer agreed the financial transfers had gone too far.

"It can't be that 10 percent of our budget ends up in other states, which then pay for things we ourselves can't afford," he said. Over the last 17 years, Bavaria's 12.5 million citizens saw 41.2 billion euros in state tax revenues transferred out of Bavaria.

Over the same period, the state of Baden-Württemberg's nearly 11 million residents watched 34.3 billion euros get transferred over state lines. State Premier Winfried Kretschmann called the federal financial transfer system "unfair" and "stupid."