# THE EUROPEAN MONETARY SYSTEM

The goal of economic and monetary union has always been implicit in the Treaty of Rome. Article 2 states

> *"The Community shall have as its task by setting up a common market and progressively approximating the economic policies of Member States, to promote throughout the Community a harmonious development of economic activities, a continuous and balanced expansion, an increase in stability, an accelerated raising of the standard of living and closer relations between Member States belonging to it."*

Whilst substantial progress was made in the early years with regard to the removal of tariff barriers and the setting up of a Common Agricultural Policy, little attention was paid to the development of monetary integration. This was changed with the presentation of the Barre Plan in 1969 and the publication of the Werner Report in 1970 which recommended the attainment of monetary integration by 1980 and set out the steps by which this was to be achieved. The requirements for monetary integration were clearly spelled out including; a system of irrevocably fixed exchange rates, or preferably a single Community currency; unified monetary policy conducted by a single monetary authority; a single exchange rate against other countries with Community control over the exchange rate and international reserves; a unified capital market; a Community regional policy and major fiscal policies to be decided at Community level. In the economic sphere the expectation was that this would lead to a simplification of the profit maximising calculations of producers resulting in a more efficient allocation of resources through the integrated markets for goods and factors, both capital and labour.

These proposals were overtaken by the dollar crisis of 1971 and the Smithsonian settlement in December of that year which recommended an international system with wider exchange margins.

The Community countries did, however, regain the initiative with a scheme in April 1972,known as the Snake, which was intended to reduce exchange rate fluctuations between Community currencies to half the level permitted under the Smithsonian Agreement. Initially all members of the Community joined as well as the potential members at that time, the United Kingdom, Ireland, Denmark and Norway. The original membership was rapidly reduced with the UK and Ireland giving up the unequal struggle in June 1972. Italy left in 1973, France in 1974 to return in 1975, only to leave again in 1976. Sweden joined in 1973 but left in mid-1977. Norway has now also withdrawn from the system. Essentially, the members who remained could be regarded as part of a Deutschmark (DM) Area with West Germany dominating the system, and other members prepared to acquiesce in whatever policy measures were necessary to retain links with the DM, especially with regard to interest rate changes. Members of the Snake accepted that interest rate variability was less costly in terms of the efficiency of resource allocation than exchange rate variability. Both represent changes in relative prices. In a very open economy the costs of adjustment associated with an exchange rate change may be greater than the adjustment costs associated with an interest rate change. There have, however, been a fairly large number of exchange rate changes within the Snake system. This appeared to be a very small return for the hoped-for development towards monetary union. Three of the four major economies in the Community were not members and some members of the Snake were not members of the EEC. The Snake itself was not without its difficulties associated with the continuing upward pressure on the DM but as between members it provided a haven of exchange rate stability compared to the exchange rate gyrations elsewhere.

## Proposal for A European Monetary System

It was against this background that the President of the Commission submitted to the European Council in October, 1977, a five year plan aimed at securing monetary union. The Council re-affirmed its support for eventual monetary union but no concrete measures were forthcoming. However, increasing dissatisfaction with the instability of the exchange rate system under floating rates, and in particular, dissatisfaction with the unsettling influence of the dollar which was becoming increasingly unacceptable to both private and official holders, led France and Germany to put forward proposals with a shorter time scale which they hoped would lead to a zone of monetary stability in Europe.

After intensive negotiations and last minute alarms and excursions, it would appear that the European Monetary System is in existence *de facto*, if not *de jure*, with all the members of the EEC fully participating, except the UK which at this stage can only be regarded as an honorary members not participating in the central elements of the system.

## Elements of the Scheme

There will be introduced a European Currency Unit (ECU) which is a weighted basket of EEC currencies initially identical in value to the already existing European Unit of Account (EUA), the weights being determined by the distribution of trade within the EEC. The ECU will perform four functions:

- as numeraire for the exchange rate mechanism;
- as the basis for a divergence indicator which will show which currency is exerting most pressure on other EMS exchange rates and require appropriate action to be taken by that currency;
- as the denominator for operations arising from intervention in support of exchange rates and for the credit mechanism which has been established;
- as a means of settlement between monetary authorities of the European Community.

There will ultimately be a European Monetary Fund in two years, but in the meantime the existing European Monetary Co-operation Fund (FECOM) will undertake the functions associated with credit and the clearing of intervention balances. It will also issue ECU against the deposit by member countries of 20% of their gold and 20% of their dollar reserves.

## Exchange Rate and Intervention Mechanism

Each currency will have an ECU related central rate. These central rates will be used to establish a grid of bilateral exchange rates - the parity grid, i.e each currency will have a central rate against all other currencies in the system, twenty eight rates with eight currencies participating. Margins of ± 2.25% are permitted around these bilateral exchange rates. Countries floating before the introduction of the system can opt for ± 6% margins around the agreed bilateral rates as Italy has chosen to do. The expectation is that these permitted margins will be reduced over some extended period. On the face of it variations of up to 4½% and 12% are possible. These extreme variations are unlikely because the permitted variation in a downward direction is calculated from the strongest currency and the variation in an upward direction is calculated from the weakest currency. The permissible range will be 2¼% - 4½% and 6% - 12%, depending on the constellation of exchange rates at any time. If the UK decided to join at a later date the option of a ± 6% variation round the central rates would be available.

Intervention using participating currencies is compulsory when the bilateral intervention points set by the margins are reached. This is an obligation on both the currency at the top intervention point and at the bottom intervention point. Should, for example, the DM be at the top of the range and the French Franc (FF) be at the bottom of the permitted range both countries will intervene by selling DM - Germany to keep the DM from appreciating further and France to prevent the franc from depreciating. This is one element in the system to which the UK objected because it was felt that this might not be an equitable distribution of the adjustment burden. If, for example, the intervention was necessary largely due to upward pressure because of an inflow of dollars into DM it was felt that the DM should bear the brunt of the intervention and take the necessary adjustment measures. Further, since the currency at the top of the intervention range is intervening with its own currency, whilst the currency at the bottom is intervening in the same currency which, however, it has to borrow,then this would give the system a deflationary bias since the borrowing currency cannot avoid adjustment for long.

In the example used above, when both France and W Germany were intervening in DM there would tend to be a greater immediate pressure on the borrowing country, France, using foreign currency reserves than on the country acquiring foreign currency reserves, W Germany, to take adjustment measures.

## Divergence Indicator

It was to avoid such pressures on "innocent" currencies that a "threshold of divergence" has been established using the ECU formular with a reduced margin of fluctuation. When this threshold is reached there is a presumption that the authorities will correct this situation by:

- diversified intervention on their own;
- measures of domestic monetary policy;
- changes in central rates;
- other measures of economic policy.

If such measures are not taken this has to be justified to other Central Banks. Although such unilateral action is thought of largely in terms of the DM being the currency pushed over the threshold, the system would apply with equal force to currencies subject to pressure in a downward direction.

## Change of Central Rates

The central rates established are not irrevocable. Provision exists for these rates to be changed subject to mutual agreement by a common procedure involving all countries participating in the exchange rate mechanism and the Commission. Provision is also made for reciprocal consultation within the Community framework about important decisions concerning exchange rate policies between countries participating,and any country not participating in the system, i.e. the UK.

It is clear that it is not the intention of the EMS to have permanently fixed exchange rates. The crucial question which can only be answered when the system is in operation is, how often, or how easy will it be, for exchange rates to be changed, or how effective will be pressure on one country to change its exchange rate in the interest of the system. If exchange rates are easily changed then the desire for greater stability will not be achieved, and UK fears of having an exchange rate policy dictated by some outside authority, would not be well founded. If, on the other hand, changes are difficult and long-delayed, the crisis potential of a fixed exchange rate system, amply demonstrated by the Bretton Woods system, will be brought to bear on the EMS. In such circumstances drop outs from membership are inevitable and the reversion of EMS to some rump elite similar to the Snake arrangement is likely. It is clearly a scenario similar to the latter which influenced the UK decision not to enter the system at the beginning.

## Credit Facilities

In order to encourage exchange rate stability there will be a number of credit facilities available to member countries. In the very short run there will be unlimited access to funds for the support of an exchange rate. Settlement will be 45 days after the end of the month, with an extension for another 3 months more under the Short Term Monetary Assistance Scheme for amounts limited to the debtor quotes in the Short Term Monetary Facility. Short Term Monetary Assistance up to a total of 14 bn ECU (£9.5 bn) is to be made available. There is also a medium term policy extending from 2-5 years to the value of 11 bn ECU (£7.5 bn). The total credit available of 25 bn ECU (£17 bn) compares favourably with the IMF total of some 39 bn Special Drawing rights (SDR) for a much larger organisation with greater external responsibilities. Additionally, the IMF is made up of currencies which are often not useable in international transactions.

The question at issue, however, is whether the credit available under EMS will be used to stop adjustment taking place to meet real influences in the market or whether it will be used simply to cope with market speculation having no basis in the underlying economic situation of a country. Past experience with the Snake arrangement suggests that any persistent large scale intervention to cope with speculation tends to be ineffective, with a currency either leaving the Snake or being forced to acquiesce to an exchange rate adjustment involving a considerable transfer of resources from the country concerned to speculators. That substantial flows of foreign exchange may be involved is made clear by the statement in the Monthly Report of the Bundesbank for November 1978 that intervention in the Snake between 1 October and 18 October brought in DM 6.5 bn of foreign exchange.

## Measures to Assist Less Prosperous Countries

There is an acceptance that certain countries - termed Less Prosperous Countries - would have some difficulty in making the transition to the EMS with at least in principle, a commitment to greater exchange rate stability requiring a convergence of economic policies particularly with regard to inflation. Whilst responsibility for improving economic performance is clearly laid at the door of the individual country, measures of support from the Community are offered to ease the transition. Originally loans of up to 1 bn EUA (£670 m) per year for five years on special credit terms involving an interest subsidy of 3% were agreed. The subsidy element was not to exceed 200 m EUA (£135 m) each year for the five year period.

The funds provided in this way through the European Investment Bank have to be used for selected infrastructure projects and programmes with the understanding that any direct or indirect distortion of the competitive position of specific industries within member states will have to be avoided.

These initial inducements were insufficient to ensure immediate acceptance of the terms of EMS by Ireland, but subsequent adjustment involving an additional £50 m in the first two years to an already agreed total of £225 m of loans,on top of the £1.13 bn already agreed, brought Irish agreement to enter EMS with the smaller ± 2¼% margin around the agreed central rates.

## Will it Work?

The key question is, of course, whether it will work. One basic dilemma here is the standard to use to measure its efficacy. Clearly the intention is not in the short run to reach full monetary union but some intermediate target involving a durable and effective scheme of closer monetary co-operation leading to a zone of monetary stability in Europe for both deficit and surplus countries.

## What Problems are Likely to be Faced?

If exchange rates are to be stabilised, i.e. have a greater degree of fixity than in recent years, one obvious requirement will be for inflation rates between members to converge. In recent years there have been continuing differences in inflation rates between EMS countries. If such a pattern continues, the maintenance of fixed exchange rates will not be possible even in the short run. Governments will be forced to pursue monetary and other policies consistent with the chosen exchange rates and take the consequences, as far as the internal effects on employment and growth are concerned. Balance of payments adjustment between members will have to be achieved through operating on the domestic price level relative to that of the target chosen and financing achieved by borrowing from FECOM.

The standard set is likely to be that of W Germany which has been most successful in maintaining price stability and is unlikely to accept any weakening of its resolve in this area, if only because of the greater independence enjoyed by the Bundesbank in the conduct of monetary policy. If this proves to be the case there will be a substantial deflationary bias introduced into the system. Critics argue that the exchange rate is being elevated to a role as an objective of policy rather than as an instrument of policy used to attain targets of employment and growth. This raises, of course, the role of the exchange rate in the adjustment mechanism. If one accepts the international monetarist argument that changes in exchange rate inevitably give rise to offsetting effects on the price level then the loss of the exchange rate as a policy instrument may not be serious. If, however, it is accepted that whilst a change in exchange rate may well give rise to some change in price level, but that a substantial benefit remains for an extended period, then the loss of this instrument may be regarded as serious. The degree of intra-EEC trade penetration may be a crucial element in any decision regarding joining a fixed exchange rate grouping.

If trade is heavily concentrated with partner countries then the efficacy of exchange adjustment may be greatly reduced as any money illusion effect is likely to be small. Most full members of EMS conduct a high proportion of their trade with other members. The major exception is Ireland which conducts about half its trade with the UK. The UK itself is least heavily committed to trade with its EEC partners and therefore its exchange rate with other members of EMS is of less significance. In these circumstances Ireland will be hoping that the UK can fulfill its declared intention to maintain a stable exchange rate with EMS countries so that Ireland avoids a conflict of interest should the UK depreciate via-a-vis EMS currencies. For this reason it is perhaps surprising that Ireland chose to enter EMS with the narrower 2¼% band of permitted fluctuation around central rates.

## Exchange Rate Intervention and Changes

Another source of conflict arises with the operation of the "threshold of convergence" arrangement. The aim of this measure is to indicate the currency largely responsible for upward or downward pressures on exchange rates and require that country to intervene unilaterally to alleviate the pressure or take other appropriate action including a change in central rates. There is however only a presumption that such action will be taken. Will the presumption be stronger in countries facing a depreciation pressure than in countries facing an appreciation pressure on their rate.

With regard to exchange rate changes,these are to be "*subject to mutual agreement by a common procedure which will comprise all countries participating in the exchange rate mechanism and the Commission*". Community countries not participating, i.e. the UK, will participate on a reciprocal basis on questions of exchange rate policy. Again, will it be easier for surplus countries to avoid adjustment more readily than other countries? Whilst adjustment ultimately took place in the Snake system, usually involving exchange losses, will such changes be as readily acceded to when there are countries of more equal economic power involved?

## Pressure from Outside EMS

One important source of pressure on the EMS could come from the international monetary system, particularly as a result of the weakness of the dollar. If this weakness continues large amounts of dollars will seek a safer haven. The DM is the most likely currency to attract these funds. Such an influx of dollars affects not only the DM but, through exchange arbitrage, other EMS currencies. Pressure to appreciate will be dispersed among other EMS currencies reducing their competitive standing against the dollar when they may not be in a strong position to cope with this. The suspicion has been voiced that one of the reasons for German participation in EMS was to secure this protection of their competitiveness and their capacity to generate export led growth.

A weakening dollar will inevitably result in a search for a currency to fulfill the role presently occupied by the dollar as a trading and an asset currency. With no agreement to promote an international alternative, e.g. IMF Special Drawing Rights, the DM will be the prime candidate to receive substantial inflows of foreign exchange, the more so if membership of the EMS stops the DM rate from attaining what the market would regard as its equilibrium level. To become a reserve currency however, requires a currency to accept an overall deficit on its balance of payments. This is the only way by which foreigners can acquire net holdings of DM. The West German authorities seem resolved to avoid the DM acquiring such a role as the continuing surpluses on the W German balance of payments show. Unless the present restricted access to the W German capital market is lifted, such surpluses are likely to continue. There are strong arguments for suggesting that W Germany should now run balance of payments deficits and if the EMS is used to discourage such a development, it is undesirable for both the EMS and the international monetary system.

If there is a similar reluctance to adopt a leadership role in the EMS then problems for EMS in the future can be predicted. History suggests that all fixed exchange rates systems require a dominant currency which plays a special role in the operation of the system. This role was filled by the UK in pre-1914 Gold Standard and by the USA after 1945. Kindelberger claims in his book The World in Depression 1929-1939 that it was the lack of leadership between the wars which caused the depression in the 1930's to be so deep and be sustained for such a long period. The DM is the obvious candidate for the role within the EMS involving a willingness to allow ready access to the German capital market and a preparedness to discount heavily in a crisis through inter-government swap facilities above and beyond any formal arrangement with the EMS. The system will be subject to intolerable pressure if the DM is responsible for setting both exchange rate and monetary policy targets.

## Regional Problems

In all discussions concerning European monetary integration the problem of regional disparities has always been at the forefront. One fear regarding EMS is that membership would make matters worse, particularly if a country involved in the system has to maintain an overvalued exchange rate. The attempt to meet this target without the benefit of an exchange rate policy would impose substantial deflationary pressure on the country concerned. Within such a country, areas of high regional unemployment, e.g Scotland if the UK was a member, would suffer even more. As indicated previously, some measures have been taken to provide relief at least over the first five years through interest subsidies and grants from some member governments in EMS. The greater flexibility of exchange rates permitted to Italy will also provide some relief for the Italian economy as a whole. The subsidies in interest rates can, however, only be used to finance "*selected infrastructure projects and programmes, with the understanding that any direct or indirect distortion of the competitive position of specific industries within member states will have to be avoided*" (Cmmd.7419). Whether subsidies of that nature would provide sufficient benefit to offset the loss of an exchange rate policy is open to question. Such assistance is provided to meet the problems of a country as a whole and is not specifically earmarked for regions of high unemployment.

The Community is, of course, committed outside EMS to achieving a more equitable distribution of income throughout the EEC, through its Regional Policy, so that the EMS provisions are not the only source of assistance to combat regional disparities. Reduction and removal of regional disparities would ultimately require higher growth rates in,e.g. the UK, in order to catch up with countries such as W Germany. It is unlikely that EMS membership will achieve this although EMS provisions are specifically aimed at the special problems that the less prosperous countries in the system will face as a result of membership requiring the "*convergence of economic policies towards greater stability*" (Cmmd.7419). Whether they will be sufficient will be determined by the way the EMS operates with regard to the freedom of movement of exchange rates, the availability and terms of credit for support operations, and the pressures on the system from outside, particularly from the US dollar, that is whether the impact overall is deflationary or not.

If there is a fairly liberal regime in these matters and if the international monetary system presents no major problems,then the UK may regret not accepting membership in the first instance with the special assistance available to ease entry. However, if a tighter regime is operated, the adjustment burdens on the less prosperous countries, and in particular the disadvantaged regions within these countries, may involve a considerable additional burden. A realisation of this fact may account for the last minute reluctance of the French to accept finally full participation.

## Conclusion

The system will be adjudged a success if, after the transitional period when the European Monetary Fund enters into force, the original members are still operating the system, with perhaps the addition of the UK, and the aim of exchange rate stability but not fixity has largely been met. Some improvement in employment throughout the countries in the EMS would be a further confirmation of success. If, however, the system has been reduced to a rump of former Snake currencies, no substantial progress towards eventual monetary union will have been made. The break up of the system will be accompanied by substantial speculative activity, and will undoubtedly involve a transfer of resources to speculators, as well as considerable political recrimination. Such a break up would call into question the entire policy of seeking monetary integration within the EEC.