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No. 142, June 1981

THE EUROPEAN MONETARY SYSTEM:
AN OUTSIDER'S VIEW

BENJAMIN J. COHEN



INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS

PRINCETON UNIVERSITY

Princeton, New Jersey

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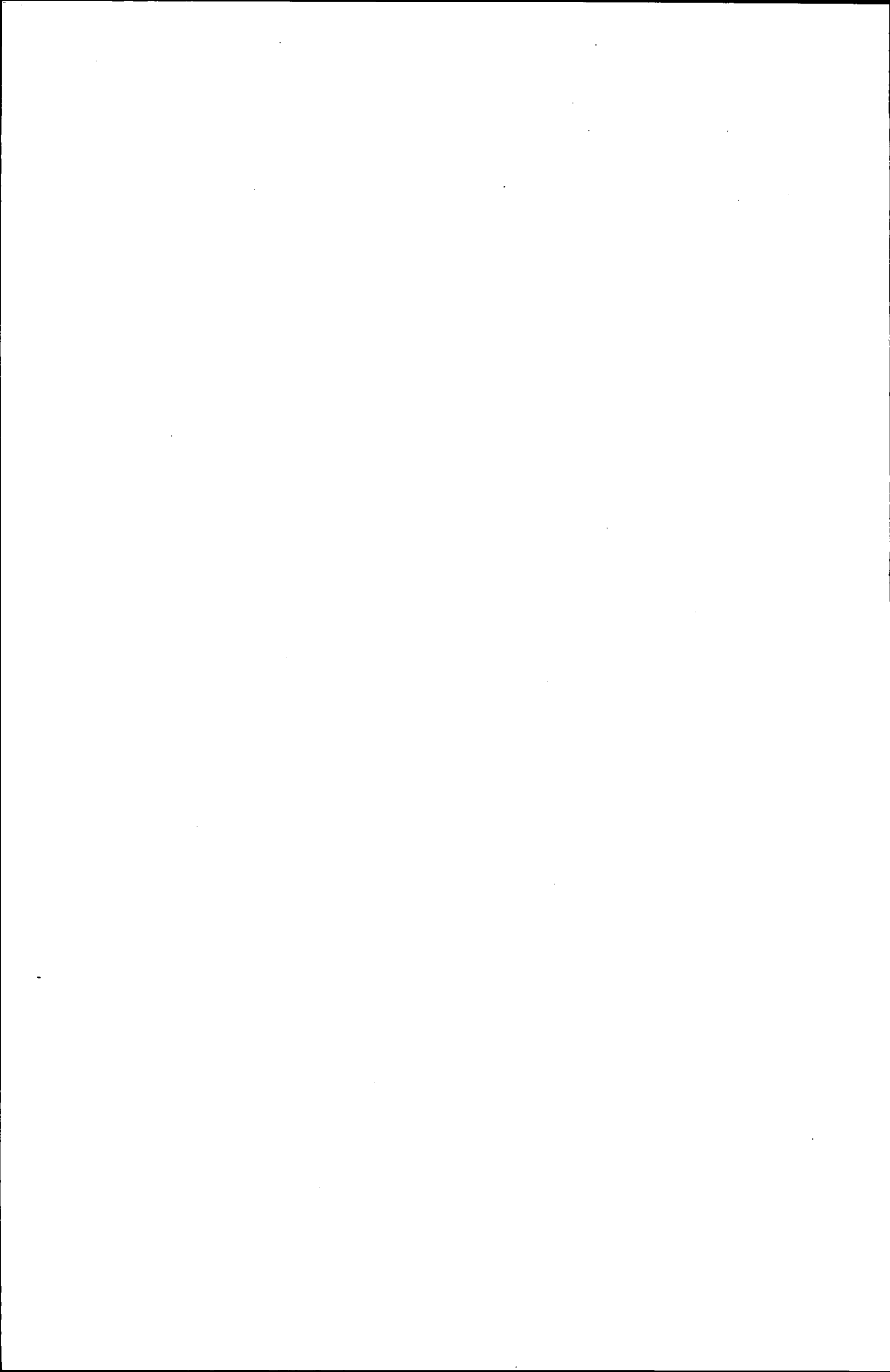
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The European Monetary System: An Outsider's View

On March 13, 1979, the European Community launched a new initiative in monetary organization—the European Monetary System (EMS). Although strictly regional in nature, EMS cannot help but have an impact on nonmember countries as well as on members, given the size of the states involved and the importance of their currencies in international finance. In a recent Essay in this series, Tom de Vries (1980) discussed the meaning and future of EMS from the perspective of a Community national. In this Essay I present an alternative perspective of an outsider. Three possible risks posed by EMS for outsiders are considered: (1) the danger of increased worldwide exchange-rate instability; (2) the potential for either a deflationary or an inflationary bias in EMS; and (3) the possible erosion of the status of the Special Drawing Right (SDR) and the International Monetary Fund and weakening of any impetus toward global monetary reform. The Essay begins with an outline of the principal features of EMS, reviews its performance to date, examines prospects for the future, and ends with a brief summary of the main conclusions of the analysis.

Principal Features, Performance, and Prospects

The first direct impetus for EMS came from Roy Jenkins (1977), former president of the European Commission. In his Jean Monnet Lecture in October 1977 (as well as in subsequent private lobbying efforts with member governments), he attempted to kindle interest in a new Community monetary initiative.¹ Six months later, these efforts appeared to bear fruit when Germany's Chancellor Helmut Schmidt unexpectedly put forth a radical new plan of his own for creation of a "zone of monetary stability" in Europe. First unveiled at a meeting of the European Council, the Community summit, in Copenhagen in April 1978, the idea of EMS was formally endorsed at a second Council meeting in Bremen in July and, after protracted

¹ For a discussion of initial reactions to Jenkins's efforts, see Hogg, 1978.

negotiations, adopted in detail at a third summit in Brussels in December.² Launching was initially set for the new year but was then delayed for two and a half months until a Franco-German dispute over the Community's common farm policy could be satisfactorily resolved.

Principal Features

EMS consists of three interrelated elements, each building on already existing Community structures: (1) an arrangement for linking exchange rates, (2) a projected European Monetary Fund, and (3) a system of credit facilities for mutual payments support.

1. *The exchange-rate arrangement.* The arrangement for linking exchange rates was built on the old "snake"—the scheme for narrowing margins of fluctuations between member currencies that had first taken life seven years earlier, in April 1972. Originally, the snake had been meant to encompass all nine Community currencies. Within two years of its birth, however, five of the Community's members—Britain, Denmark, France, Ireland, and Italy—had been forced to withdraw because of a variety of problems. (Denmark later rejoined, while France tried to rejoin and failed.) By 1976, the joint float had been reduced to just five Community members (the three Benelux countries, Denmark, and Germany) plus two outsiders (Norway and Sweden) and two informal "associates" (Austria and Switzerland). By 1978, when the negotiations for EMS were begun, one of the outsiders (Sweden) had left, and in December 1978 the last outsider (Norway) dropped out. At the Brussels summit, the French Government committed itself to immediate re-entry into the snake. After some hesitation, Ireland and Italy did so too, although in Italy's case initially only within a broader band of movement of up to 6 per cent in either direction. Britain refused to commit itself at all, arguing that its payments position was still too precarious. For the time being, the pound sterling continues to float independently, as it has since 1972.

In designing this new "supersnake," the biggest question was what operational rules should govern central-bank intervention required to maintain the joint float. Two alternative mechanisms were considered. One mechanism—the "parity grid" solution—would have con-

² The Council resolution establishing EMS is reproduced in de Vries (1980), Annex I. For some discussion of the negotiations leading to EMS, see Ludlow (1979) and de Vries (1980, pp. 8-14).

tinued to tie each currency to each other currency in a matrix of bilateral cross-rates, as in the old snake. The other—the “basket” solution—would have tied each currency to a European unit of account, renamed the European Currency Unit (ECU), equal to some weighted average of all the currencies. (It is no accident that the acronym ECU also happens to be the name of an ancient French silver coin.)

Much heat was generated in choosing between the two mechanisms, because they implied very different intervention obligations under varying circumstances. For example, had one country's currency—say, the Deutsche mark—begun to move sharply out of line, the basket solution would have required only that country's central bank to intervene, whereas the parity-grid solution would have required all central banks to intervene. Given the anticipated strength of the Deutsche mark, it is not surprising that weaker countries like Italy and Britain argued for the basket approach alone. But, owing to German opposition, that solution was ultimately rejected in favor of the parity grid as the primary guide to intervention. As a concession to the weaker countries, however, it was agreed that the ECU would nevertheless be retained (a) to define the central rates of the parity grid—in effect, to function as denominator, or numeraire, for the exchange arrangement—and (b) to be used as a “divergence indicator,” that is, as a sort of alarm bell or early warning signal to indicate that a country's currency has begun to diverge too far from the weighted average. A signal by the divergence indicator would create a “presumption” of the need for that country to act, either in the exchange market or by adjusting domestic monetary and fiscal policies.³ At the outset, the value and composition of the ECU were set equal to those of the European Unit of Account, which had been introduced in April 1975 for transactions under the Lomé Convention.⁴

2. *The European Monetary Fund.* The projected European Monetary Fund (EMF) was intended to build on the so-called European Monetary Cooperation Fund (known as FECOM, by its French in-

³ For more detail on the EMS exchange-rate mechanism, see Bank of England (1979); IMF (1979, pp. 97-98); and U.S. Congress (1979, Chap. 2).

⁴ Thus the ECU consists of 0.828 Deutsche marks (equal to 33.02% of the total on the basis of market rates on March 1, 1979), 1.15 French francs (19.89%), 0.0885 pounds sterling (13.25%), 0.286 Dutch guilders (10.56%), 109 Italian lire (9.58%), 3.66 Belgian francs (9.23%), 0.217 Danish krone (3.10%), 0.00759 Irish pounds (1.11%), and 0.14 Luxembourg francs (0.35%).

itals), first established in April 1973 as part of the Community's earlier snake arrangement. Originally intended as an embryonic European central bank, FECOM was supposed to supervise all Community credit facilities related to exchange rates and balance-of-payments financing. In fact, however, it has existed only in name, having neither a headquarters nor a staff. The settling of debts among the snake's central banks has always been handled by the Bank for International Settlements in Basel, and all decisions have been made by the Community's committee of central-bank governors, wearing their hats as the board of FECOM.

EMS aims to breathe life into FECOM, renamed the EMF, by pooling under its authority a portion of the gold and dollar reserves of all Community members, in exchange for which members receive deposits in the EMF, denominated in ECU, to be used in settlement of all intra-Community debts. In effect, the ECU is thus intended to become not just the numeraire and divergence indicator of the exchange-rate arrangement but also a full-fledged means of settlement similar to the IMF's SDR. For the present, however, it is for use only within the European Community. Significantly, ECUs are available to all members of the Community—even Britain—since access to the Fund is not limited to snake participants alone. Pending formal establishment of the EMF, reserve pooling has been carried out initially in the form of revolving three-month "swaps" among the separate monetary authorities, to avoid any question of transfer of ownership in the absence of the requisite national legislation. Twenty per cent of all gold and dollar reserves have been pooled in this manner. At the Brussels summit, the European Council declared its intention in principle to bring the EMF into full formal existence in a second stage "not later than two years after the start of the scheme," i.e., not later than March 1981. But in practice no steps have as yet been taken to realize that objective.

3. *Credit facilities.* Although all Community credit facilities are supposed to be consolidated eventually under the aegis of the EMF, the issue of credit is kept quite separate for the time being. At present, the EMF is simply a mechanism for swapping existing reserves for ECUs. As in the past, credit continues to take the form of loans made directly by one member country to another. These include (1) very-short-term loans that must be repaid within forty-five days and are available only to snake participants, (2) short-term loans that must be

repaid within nine months, and (3) medium-term loans that need not be repaid for up to five years. Very-short-term loans have always been available in unlimited amount. The EMS agreement called for increasing "effectively available credit" under the short-term facility from the equivalent of 5.5 billion to 14 billion ECUs (approximately \$18 billion) and under the medium-term facility from the equivalent of 4.5 billion to 11 billion ECUs (approximately \$14 billion). These increases amounted, in effect, to a substantial concession by Germany, potentially the largest creditor in the Community, to weaker members such as Britain, Ireland, and Italy.

Additional financial concessions. Germany backed additional financial concessions to weaker members in the form of supplementary subsidized loans from the European Investment Bank and other Community institutions. The weak countries regarded such "transfers of resources" as essential if they were to withstand the potentially harsh disciplines of a joint float. Indeed, Ireland and Italy had made clear all along that increased transfers were an absolute condition for their agreement to re-enter the snake, and their hesitations were not overcome until the additional financial concessions were promised. As already indicated, British hesitations have not yet been overcome.

Performance

To date, EMS has operated without undue strain, confounding skeptics who had predicted a rather swift collapse (see, e.g., Brittan, 1978; Thornton, 1979). Fluctuations in exchange rates of participating currencies in 1979 were the most moderate recorded in eight years; for all Community currencies taken together, the annual average fluctuation against the ECU was 1.9 per cent, down from 2.7 per cent in 1978, and the lowest since 1972 (1.2 per cent).⁵ And these trends continued into 1980 and early 1981 as well. So far, at least, EMS does not seem to have betrayed its goal of creating a zone of monetary stability in Europe.

Not that the system has been entirely without strain. Tensions involving several members developed fairly quickly in the spring and summer of 1979, following a decision of the German Bundesbank at

⁵ European Commission (1980, pp. 31-32). Even the 1.9% figure is mildly biased upward owing to the inclusion of sterling in the overall Community average. Sterling's fluctuation against the ECU in 1979 was 2.7 per cent, greater than that of all but two of the other Community currencies (the Italian lira at 5.4% and the Danish krone, also 2.7%).

the end of March to tighten monetary policy sharply in an effort to reverse an accelerating domestic inflation rate. Capital began to flow into Germany on a large scale, despite competing increases of interest rates elsewhere in the Community, and by early June both the Belgian franc and the Danish krone had been driven to the floor of the parity grid, well past their ECU divergence limits. Yet Germany continued to tighten monetary policy in June and July, despite some complaints from the weaker members. According to the Germans, primary responsibility for adjustment lay with the Belgians and Danes, whose currencies were below their divergence limits. According to the Belgians and Danes, however, it was the Germans who should have been acting, by relaxing monetary policy. That the Deutsche mark had not exceeded its divergence limit was merely a statistical fluke, owing to a concurrent rise of the pound sterling and Italian lira that was making the mark look artificially weak.⁶ The Germans, they argued, were giving priority to their fight against inflation at the expense of their partners in EMS. In the end, the two sides found ample grounds for compromise and mutual accommodation, and the tensions were removed by a moderate realignment of EMS central rates in September 1979: the Deutsche mark was revalued by 2 per cent, and the Danish krone was devalued by 3 per cent, each against all other participating currencies. Since that date, little stress has been experienced in the arrangement, despite a second devaluation of the Danish krone by 4.86 per cent late in November 1979 and a 6 per cent devaluation of the Italian lira this past March.

Exchange-market interventions by participating central banks were fairly substantial, but only in the first few months after EMS was launched; even these were mainly for the purpose of influencing movements vis-à-vis the U.S. dollar rather than to relieve strains within the joint float. Borrowings under the very-short-term credit facility have remained relatively modest. No calls at all were made on either the short-term or medium-term facilities during the system's first two years.

⁶ Although neither Britain nor Italy is a full member of EMS, their currencies, as already indicated, form part of the ECU basket. While the ECU rates against which divergence limits are calculated are adjusted to compensate for movements of these two currencies beyond what would be permitted if they were full members, adjustment is not perfect. Inclusion of the two at a time when both are rising tends to make other strong participating currencies look relatively weaker. For technical discussions, see Bank of England (1979) and IMF (1979, p. 98).

Prospects

What are the longer-term prospects for EMS? Its relative calm until now might be thought to promise smooth sailing in the future too, and many observers have indeed perceived real grounds for optimism (see, e.g., Thygesen, 1979a; Triffin, 1979a; Van Ypersele, 1979). But others have been more skeptical regarding the long-term viability of EMS (see, e.g., Cohen, 1979a; De Grauwe and Peeters, 1979; Vaubel, 1979). Whether proponents or skeptics, most commentators agree that two problems in particular will be pivotal in determining the system's future: (1) the convergence of economic policy and performance among participating countries and (2) the development of a joint policy vis-à-vis the currencies of nonparticipating countries, especially the dollar.

The convergence issue. Some degree of convergence of economic policy and performance among the participating countries is manifestly essential to the long-term viability of EMS. In the words of one of its principal architects:

To be successful, the EMS, first of all, will have to be accompanied by policies designed to achieve a greater convergence of the economies of member-states. The EMS cannot be durable and effective unless it is backed by complementary policies. . . . Great effort on the part of all countries and in all areas of policy will be needed if the system is to last (Van Ypersele, 1979, p. 8).

The dilemma is clear. Convergence requires a genuine political commitment on the part of all participants to surrender a portion of their traditional policy autonomy. This is not easy to attain. Yet if it is not attained, the system is bound to come under strain sooner or later. Persistent differences in inflation rates and other factors affecting mutual payments positions will inevitably set in motion strong centrifugal forces to pull the joint float apart. Participating governments will then be faced with an unsatisfactory choice between altering their exchange rates frequently in order to avoid speculative buildups or defending their linked rates futilely with prolonged and costly intervention. Either course would make a mockery of their avowed goal of a zone of monetary stability.

Significantly, no real signs of converging performance can be found to date. On the contrary, after EMS was launched, inflation rates

within the Community remained highly divergent—indeed, became even more divergent than before. According to IMF data, in the first quarter of 1979 the maximum inflation differential among participating countries was 9.9 percentage points; a year later, it was 15.4, or 50 per cent greater (Table 1). This trend is confirmed by European Commission data, which show a steady increase in divergence of price performance since 1978 (Table 2). In 1980 the standard deviation among members' inflation rates, as measured by consumer prices, was 5.7 per cent, up from 3.2 per cent two years earlier. The divergences of monetary growth rates also increased in 1979 and 1980.

TABLE 1
PRICE PERFORMANCE^a IN THE EUROPEAN COMMUNITY, 1978-80I

| | 1978 | 1979 | 1979 | | | | 1980 |
|----------------|------|------|------|------|------|------|-------------------|
| | | | I | II | III | IV | |
| Belgium | 4.5 | 4.4 | 3.8 | 4.1 | 4.7 | 5.1 | 6.3 |
| Denmark | 10.1 | 9.6 | 6.9 | 7.9 | 12.0 | 11.6 | 13.3 |
| France | 9.1 | 10.7 | 10.2 | 10.1 | 10.8 | 11.5 | 13.3 |
| Germany | 2.8 | 4.1 | 3.0 | 3.4 | 4.8 | 5.4 | 5.4 |
| Ireland | 7.6 | 13.2 | 10.8 | 12.4 | 13.6 | 16.0 | 15.6 |
| Italy | 12.1 | 14.7 | 12.9 | 13.6 | 14.8 | 17.7 | 20.8 ^b |
| Netherlands | 4.1 | 4.2 | 4.2 | 4.2 | 3.9 | 4.6 | 5.7 |
| United Kingdom | 8.3 | 13.4 | 9.6 | 10.6 | 16.0 | 17.3 | 19.0 |

^a Percentage changes of consumer-price indices over corresponding period of previous year.

^b Based on January-February only.

SOURCE: IMF, *International Financial Statistics*.

In view of these widening divergences, it is instructive to ask: How has EMS operated until now with so little apparent strain? Four factors, in particular, seem to stand out: (1) When the system was launched, central rates were, in effect, already adjusted to discount for a certain amount of divergence of inflation rates in the near term. (2) Participating governments have been willing to make active use of interest rates to keep exchange rates from moving too far apart. (3) Differences in real economic growth rates and demand-management policies in the participating countries have helped to maintain the balance-of-payments strength of some of the highest-inflation countries (e.g., France and Italy, which ran large current surpluses in 1978-79) while contributing to the deterioration of the external positions of some of the more price-stable members (especially Germany, whose current balance swung from a substantial surplus in 1978 to a sizable deficit in 1980). And (4) the dollar has been relatively

TABLE 2
DIVERGENCE OF PRICE PERFORMANCE IN THE
EUROPEAN COMMUNITY, 1978-79

| | <i>Mini-Max Range between Member States (Consumer Prices)</i> | <i>Standard Deviation</i> | | |
|-------|---|----------------------------|---|--|
| | | <i>Consumer Prices</i> | <i>Consumer Prices, Manufactured Goods Only</i> | <i>Wholesale Prices, Manufactured Goods Only</i> |
| 1978 | 9.4 | 3.17 | 2.54 | 4.05 |
| 1979 | 10.7 | 4.19 | 3.47 | 3.83 |
| 1978: | | | | |
| I | 12.8 | 3.99 | 3.99 | 3.32 |
| II | 8.9 | 2.93 | 2.34 | 2.83 |
| III | 9.7 | 3.40 | 2.80 | 4.07 |
| IV | 10.2 | 3.48 | 2.74 | 4.10 |
| 1979: | | | | |
| I | 9.7 | 3.43 | 2.16 | 3.42 |
| II | 10.9 | 4.08 | 2.46 | 2.61 |
| III | 16.4 | 5.82 | 7.24 | 3.57 |
| IV | 17.0 | 6.34 | 9.28 | 4.87 |

NOTE: Quarterly figures are based upon seasonally adjusted price changes at annual rates.
SOURCE: European Commission.

stable (see below). The essential question must therefore be reformulated: For how long can these factors be expected to prevail over the cumulative impact of persistent price divergences?

Consider the experience of the Community's earlier snake, which operated at a time when inflation rates in Europe were actually less divergent than they are now. It did not succeed—at least not in the sense of holding together all the original participants in their joint float. According to the Marjolin Committee, a special study group appointed by the Community to study the experience, the snake failed for three principal reasons: “unfavourable events, a lack of political will, and insufficient understanding” (Marjolin Committee, 1975, p. 3). The “unfavourable events” included inflation and the energy crisis; the “insufficient understanding” referred to a total lack of prior analysis, at either the national or the Community level, of the conditions necessary for making a common currency operational. But clearly the most critical was the “lack of political will.” At a lower level, national administrative hierarchies resisted all encroachments on their bureaucratic powers and privileges. Central bankers, in particular, were unwilling to become submerged in a kind of European Federal Reserve System. At a higher level, national political leaders resisted all encroachments on their traditional decision-making au-

thority. Governments were unwilling to transfer any significant formal sovereignty to Community institutions. As the late Fred Hirsch wrote in 1972:

In this sense one can conclude that European monetary integration is not a serious issue. It belongs to that category of commitments that are endorsed by national authorities at the highest level, but are in fact ranked low in their priorities when it comes to the test (Hirsch, 1972, p. 57).

Are the participants truly prepared to make EMS a "serious issue" this time around? Do they now truly intend to rank it high among their policy priorities? According to proponents of EMS, the answer is most definitely in the affirmative. They cite the comparative ease with which exchange-rate realignments have been carried out to date. In their view, at the economic level two main differences distinguish EMS from its predecessor: Mutual exchange rates are less rigid, reflecting an increased readiness on the part of all participants to move quickly to make small rate adjustments whenever it seems necessary. And the distribution of adjustment obligations is more symmetrical, in part because the ECU divergence indicator is designed to ensure that adjustment pressures are felt by surplus as well as by deficit countries. Above all, they argue, there is a political difference. Unlike its predecessor, EMS has indeed been backed by the necessary political commitment, particularly in the two major members, France and Germany, and specifically in the persons of French President Giscard d'Estaing and German Chancellor Schmidt, for whom EMS in effect became a test of their joint *de facto* leadership of the Community. (This, of course, was prior to the recent French presidential election, when Giscard d'Estaing was replaced by François Mitterrand.) Interesting evidence of this has been a softening of resistance by Community central bankers, who now apparently feel that, given the strength of the commitment to EMS at the political level, their powers and privileges are more likely to be preserved by supporting and influencing the design of the system than by opposing it.

Such protestations, however, remain less than wholly convincing. At the moment, there are no formal limitations on the policy autonomy of national economic authorities. As one source has commented: "As in the past the great drawback is the absence of *binding* commitments" (De Grauwe and Peeters, 1979, p. 45; italics supplied). Under the ECU divergence indicator, as already indicated, the alarm bell is meant to signal only a "presumption" of action, not a legal obligation;

and no formal definition has ever been given of the precise nature of the action (or order of priority among alternative actions) that might be expected in response to that presumption. As the experience in the spring and summer of 1979 demonstrated, the resulting ambiguity can lead to controversy and acrimony. No one really knows what would happen if worse strains were to develop in the future. The one thing to which all observers can agree is that the system has yet to be seriously tested. In effect, the jury is still out on this issue.

The dollar issue. The other essential for the long-term viability of EMS is development of a joint policy vis-à-vis nonparticipating currencies—in particular, the dollar. “An absolute condition of success” is the way one key Community figure describes it (Van Ypersele, 1979, p. 10). The reason is clear. So long as the dollar remains generally stable, the system need be concerned only with managing its own parity grid. But should the dollar come under pressure, severe strains could be generated in intra-EMS exchange relations as well (in part, precisely because of the continuing lack of convergence of economic performance in the Community). This, in turn, could lead to conflicts of policy among the members. Governments might well disagree on the direction in which to “manage” their joint float against the dollar. Uncoordinated dollar interventions would add to volatility in exchange markets, once again making a mockery of the system’s avowed goal of a zone of monetary stability.

In fact, it was precisely the instability of the dollar in 1977-78 that set the stage for EMS in the first place. The prolonged depreciation of the dollar wreaked havoc in European financial markets. Dollar holders anxious to diversify or hedge their portfolios were, not surprisingly, attracted to strong currencies like the Deutsche mark and Dutch guilder (and Swiss franc and Japanese yen), rather than to the Italian lira or French franc. Consequently, dollar sales inevitably meant additional upward pressure on the stronger EC currencies relative to the weaker ones, accentuating monetary fragmentation within the Community. For Germany’s Chancellor Schmidt, one of the original motivations of his proposal for a European zone of monetary stability was his desire to slow down the appreciation of the Deutsche mark, which was threatening to hurt German exports (see de Vries, 1980, pp. 9-10). A principal attraction of EMS for other Community members was that it would help shield them from similar instabilities of the dollar in the future.

Happily, the dollar has been relatively stable since the launching of EMS, contributing to the smooth performance of EMS to date. But no one knows for how long this fortuitous circumstance may continue. The possibility of renewed pressures on the dollar cannot be excluded—and neither, therefore, can the need for a common dollar policy. In principle, participating countries are committed by the original EMS agreement to “coordination of exchange rate policies vis-à-vis third countries.” In practice, not even a start toward an explicit dollar policy can so far be detected, and this clearly poses risks for the successful operation of EMS in the future. The issue, as one observer has rightly insisted, “cannot be fudged for very long” (Swoboda, 1979, p. 84). In the words of one dispassionate study:

It is a potentially serious flaw of the EMS that no clear guidelines on such a common policy have yet been established. . . . This flaw need not be fatal. . . . But it raises the specter of a continual conflict of interest among the members (U.S. Congress, 1979, pp. 145-146).

Next Steps

Whatever the longer-term prospects for EMS, in the near term members have seemed determined to keep forging ahead—although not, as indicated, in time for the March 1981 deadline that had originally been set for the project's second stage. Unlike stage one, stage two will almost certainly require formal legislation at the national as well as the Community level. But neither of the system's prime movers, President Giscard d'Estaing or Chancellor Schmidt, was anxious to risk new domestic political controversies prior to their respective national elections (in October 1980 in Germany and this spring in France). And now that President Giscard d'Estaing has been voted out of office, it is not at all clear whether any new steps can soon be expected or what precise shape they might take. Technical studies, continuing both at the European Commission and in national governments, have focused on three specific issues: (1) construction of the EMF, (2) further development of the ECU, and (3) management of the Community's credit facilities.

1. *The EMF.* The deadline for stage two was established originally by the European Council's pledge at the Brussels summit to transform FECOM into a full-fledged European Monetary Fund “not later than two years after the start of the scheme.” This pledge (if not the deadline) presumably remains operational. The problem is to define the

EMF's formal mandate and authority. Should the EMF be designed as an embryonic European central bank, to grow as it were "from within" by gradually taking over functions and responsibilities presently exercised by national central banks? Or should it instead operate "from without," rather as the IMF does, imposing its will on national monetary authorities only in certain specified circumstances (i.e. in the event of external imbalance) but otherwise leaving the functions and responsibilities of national central banks more or less intact? And who would actually manage the EMF? National central-bank governors? An independent board? Finance ministers? These are obviously deeply political questions involving real issues of national monetary and economic sovereignty. They are unlikely to be resolved by purely technical studies.

2. *The ECU*. In the original EMS agreement, stage two was also supposed to witness the beginning of "full utilization of the ECU as a reserve asset and a means of settlement." This, too, involves deeply political questions. Should ECUs be created only through the pooling of gold and dollar reserves, as at present, or should they be formally created against transfers of national currencies as well, thus adding, on a net basis, to the stock of official liquidity? Would intra-EMS settlements in ECUs be obligatory or voluntary? Could ECUs be converted into other reserve assets at will? Would ECUs be available to nonofficial transactors within the Community? Would ECUs be available to non-Community transactors? These, too, are questions unlikely to be resolved by purely technical studies.

3. *The credit facilities*. Finally, consideration is currently being given to the possibility of further expanding or consolidating the Community's three existing credit facilities. At present, both the very-short-term and short-term facilities are the province of central banks. (Indeed, the very-short-term facility is best understood less as a true credit mechanism than as a compulsory financing arrangement that is the logical counterpart of central-bank intervention obligations in the joint float.) The medium-term facility, by contrast, is operated by finance ministers and is less a matter of monetary than of fiscal policy. One possibility for the future might be to consolidate all three facilities under a single authority, perhaps the EMF; another might be to provide for creation of ECUs not only through formal reserve or currency pooling but through activation of the credit facilities as well. Since these possibilities clearly hinge on the decisions to be taken

about the future of the EMF and the ECU, ultimately they too will be resolved only at the political level.

A Zone of Monetary Stability?

Despite the scheme's avowed goal, it is by no means certain that EMS will succeed in creating a true zone of monetary stability in Europe. The *sine qua non* for a successful EMS (and hence for an outcome favorable to outsiders) is that member countries learn to deal adequately with the convergence and dollar-policy issues. If they do not, the dénouement of their initiative could actually be quite different, and exchange-rate instability on a global scale might well be exacerbated.

Scenarios leading to increased exchange-rate instability, as compared with present EMS performance, are not difficult to conceive (see, e.g., Cohen, 1979a; De Grauwe and Peeters, 1979). Whether one starts with renewed pressure on the dollar in exchange markets or with the cumulative impact of persistent inflation differentials on mutual payments positions, the outcome is potentially the same: strains would develop in the joint float, policy conflicts would erupt, and the system would be subjected to periodic speculative crises rather in the manner of the old Bretton Woods pegged-rate system. As compared with a regime of more freely floating exchange rates, such a system—in which central banks might be constantly under pressure to outguess or outgun speculators—would hardly constitute an improvement. In fact, average instability worldwide could turn out to be quite a bit worse. Speculation could increase as a result of the “one-way option” offered by pegging within the joint float, or efforts to maintain the joint float could increase the volatility of fluctuations between participating and nonparticipating currencies.

Are such scenarios realistic? The danger, at least in hypothetical terms, is conceded even by EMS proponents (see, e.g., Thygesen, 1979a; Van Ypersele, 1979). But it is not a danger that, in practical terms, they regard as very serious, mainly for the reasons outlined above. Given the strength of the existing political commitment to EMS, they contend, the absence of binding policy obligations on governments is hardly critical. The “will” is there, and that is what really matters. A genuine change of attitude has occurred, proponents argue, especially in the system's more inflation-prone members. As

one source describes it, "past attitudes to the role of exchange-rate changes as an instrument or as an escape route to reach a more satisfactory combination of balance on current external account and higher levels of employment and investment [have] been increasingly questioned" (Thygesen, 1979a, p. 106). Today, they say, member governments are fully persuaded of the need to make domestic stabilization policies their first line of defense when payments difficulties are encountered.

In fact, the joint float is seen as a potentially useful tool in this regard—particularly for the smaller Community members. From their experience in the old snake, they are supposed to have learned the advantages of the option of pegging their rates to an external currency facing less rapid inflationary prospects than prices and costs at home—the so-called "strong-currency option" (see Thygesen, 1979c). This potential for price discipline was also supposed to be one of the system's attractions for former French President Giscard d'Estaing, because it complemented and reinforced his domestic commitment to firm anti-inflation policies (see de Vries, 1980, pp. 10-12).

In any event, according to proponents, the joint float incorporates sufficient elements of flexibility to accommodate any residual exchange-market pressures that may develop. For individual members like Italy, or others in a similar position if they choose, wider margins around central rates are permitted. And, for members generally, changes of the central rates themselves are still a recognized option should a currency's ECU divergence limit be exceeded. Europeans such as de Vries (1980, pp. 16-22) stress that the scheme is by no means a rigid lock-step arrangement. Quite the contrary, the aim appears to be to manage exchange rates in an orderly fashion, not to defend them to the death. Reflecting lessons learned from the experience of the old snake, member governments today are said to be ready to yield quite quickly to exchange-market pressures when it seems necessary (as in the three realignments to date), rather than oppose them with prolonged interventions. In the words of one well-placed observer:

Over the last 2½ years of the snake five small adjustments were made and the system was beginning to look more like joint management of a crawling peg system than like a rigid mini-Bretton Woods system. The practice was continued in the EMS. . . . There is obviously an understanding that exchange-rate changes must be kept small and relatively

frequent for the EMS to avoid the kind of massive speculative capital flows which made the Bretton Woods system unviable (Thygesen, 1979b, p. 4).

Quick and small adjustments of central rates also offer the technical advantage of allowing continuity of market rates, thus canceling any sure gain to speculators from the one-way option when formal realignments are enacted. This, too, presumably helps to reduce the danger of exchange-rate instability.

Indeed, if the arguments of EMS proponents are to be fully believed, the danger of increased exchange-rate instability is not worth worrying about at all. But that is far too sanguine a conclusion. More realistically, even while conceding the force of the observations just outlined, one must recognize that, at bottom, their optimism is based more on faith than hard evidence. In the absence of binding legal obligations (and sometimes even in their presence), governments feel free to change their minds—and their policies. It would be ingenuous to assume otherwise. While the risk of increased overall exchange-rate instability may not be exceedingly high, it is surely greater than zero. Even the most optimistic of EMS proponents warn against undue complacency in this regard (see Van Ypersele, 1980).

Ultimately, as the saying goes, the proof of the pudding is in the eating. In EMS, the proof will be in the extent to which—and the speed with which—participants can make progress in reducing elements of ambiguity in their exchange-rate arrangement. Can they clarify just what obligations are “presumed” when a currency’s ECU divergence limit is exceeded? Can they make a start toward a more formal convergence of domestic monetary and fiscal policies? And can they begin to define a more explicit dollar policy? If they can, then the optimism of EMS proponents may turn out to be warranted. But if they cannot, it would hardly be wise to bank on continued monetary stability in the European zone.

There is also a risk that EMS could amplify destabilizing capital movements and portfolio shifts, which have been a primary cause of the high degree of exchange-rate volatility in recent years. Central to this problem (the so-called “confidence” problem) is the issue of the dollar, whose historical pre-eminence both as reserve asset for central banks and as vehicle currency for private transactions has increasingly been called into question since the move to floating exchange rates back in 1973. Periodically, strong pressures for diver-

sification out of the dollar have manifested themselves. One danger of EMS is that it could exacerbate the confidence problem by broadening the range of attractive alternative assets available to dollar holders anxious to hedge their portfolios. Unless organized properly, the resulting increase of diversification options could only amplify such periodic pressures on the dollar and hence add significantly to overall instability in exchange markets.

Certainly this might be so if the ECU, which at present is intended solely for use by central banks within the European Community, were to be made available to nonmember central banks or private transactors as well. Such an asset, backed by the combined monetary reserves and economic strength of all the EC countries, would constitute a tempting investment medium that could easily amplify periodic selling pressures on the dollar in the absence of appropriate precautions. As one European central banker has admitted:

If the ECU did ultimately become a reserve asset that could be held by non-European official and private holders, no matter how organized the development was there would need to be continuous understandings and arrangements with the United States, and doubtless with Japan. Greater coordination of policies, particularly monetary policies, would be necessary, as well as dialogue and agreement with third countries to limit sudden, massive shifts in reserve preference (McMahon, 1979, p. 90).

Fortunately, for the moment at least, the possibility of enlarging the authorized range of ECU users does not appear to be a matter for practical concern. In fact, it appears that no serious thought at all is being given at present to such a development beyond perhaps the central banks of informal EMS "associates" such as Austria or Switzerland. Community officials are not eager to take on the burdens and responsibilities of an international reserve currency, which they regard as a potentially powerful constraint on the autonomy of EC monetary policy. But there is the danger of an exacerbated confidence problem even without any alteration of the formal rules governing ECU use. Two possibilities suggest themselves.

First, if EMS does succeed in creating a zone of monetary stability, all the participating currencies—not just the stronger EC currencies, as formerly—would become attractive to dollar holders anxious to hedge their portfolios. Already, there is some evidence that advantage is being taken of the broadened investment opportunities provided

by the links of the joint float. Funds now are attracted not only into traditional refuge currencies like the Deutsche mark or the Dutch guilder but even into the historically weaker ones like the French franc and the Italian lira. With the probability of short-term fluctuations among these currencies reduced, investors can focus on the higher interest rates on offer in the more inflation-prone countries. Even if central rates are formally realigned, exchange risks are minimized so long as continuity of market rates is likely to be preserved. This possibility would certainly seem to enhance the susceptibility of the dollar to periodic selling pressures.

The second possibility is that the private market itself will take on the role of promoting use of ECUs by nonmember central banks or private transactors. In principle, there is nothing to prevent the development by private financial institutions of assets denominated in ECUs—or, for that matter, in any other artificial currency unit (see Aschheim and Park, 1976). The problem, in practice, is to back up the artificial currency unit with adequate facilities for deposits, lending, financing, and secondary market operations. To date, private-sector efforts to develop artificial currency units have not been notably successful, although recently there does seem to have been some spread of interest in SDR-denominated instruments.⁷ What distinguishes the ECU, however, from other artificial currency units (including the SDR) is that it is backed by a real political and economic structure. This backing should make the prospect for instruments denominated in ECUs far more favorable. In fact, there has been no lack of proposals for initiatives by the private sector since EMS was first launched (see, e.g., Triffin, 1980b, but cf. Thygesen, 1980). More recently, the European Council has pledged its own support for the development of ECU-denominated assets for use by private institutions (Lewis, 1980). Should such initiatives reach fruition, once again the susceptibility of the dollar to periodic selling pressures would seem to be enhanced.

Unlike the possibility of alterations in the formal rules governing ECU use, these two possibilities do appear to be a matter for practical concern. Neither requires legislation by EMS participants; both al-

⁷ In May 1980 it was reported that at least thirty commercial banks in twelve financial centers were now offering SDR-denominated deposits, as against only about a half dozen two years earlier, although the total volume of these deposits was still probably no more than SDR 3 billion or so (see Helleiner, 1980, p. 12).

ready seem well on the way to reality. Indeed, both may be regarded as virtually inevitable: given the aspirations of the member governments, they are no more than the logical outcome of the system's declared goal of a "zone of monetary stability" based on "full utilization of the ECU." Nonmembers would thus be prudent to worry about the enhanced danger of destabilizing capital movements unless appropriate precautions can be organized.

Deflationary or Inflationary Bias?

Numerous commentaries on EMS have stressed the possibility that it could introduce a deflationary bias into EC policy and performance. In effect, this is the "flip side" of the convergence issue. If inflation differentials are to be narrowed, either the high-inflation countries such as France and Italy must inflate less, or the relatively price-stable members, especially Germany, must inflate more. No one in Europe wants to promote a rise in the Community's average of inflation rates; in any event, no one expects that Germany, with its long history of aversion to rising prices, would consider deliberately accelerating its own national rate. Instead, all evidence suggests that the Germans will continue to give priority to their domestic anti-inflation fight, as they did in the spring and summer of 1979, even if this should add to the external pressures on some of their EMS partners. In practice, therefore, the argument goes, convergence might well mean alignment downward toward Germany's traditionally low inflation rate, as it did in the old snake. This, in turn, would imply the possibility of a deflationary bias in the system that could undermine real growth and employment in the Community.

While conceded by EMS proponents, they regard this danger too as unlikely to be serious in practical terms (see, e.g., Thygesen, 1979a; Van Ypersele, 1979), and in this instance, at least, their optimism seems to be justified. In reality, if there is any bias in the system at all, it is more probably in the opposite direction of an inflationary bias. Experience to date has not revealed a single instance of truly severe deflationary policies in any of the participating countries. (Ironically, the most ruthless deflationary policy in the Community today is to be found in Britain, the one member that has remained outside the joint float, while, in the meantime, Germany's inflation rate—policy intentions to the contrary notwithstanding—has actually

drifted upward since EMS was launched.) Furthermore, if serious exchange-market pressures were to develop, recourse could be had to the several elements of flexibility in the joint float. EMS is by no means a straitjacket on its members.

Quite the contrary, in fact. In the design of EMS there are at least two critical features that are likely to have the effect of making it easier, rather than more difficult, for member governments to avoid truly severe deflationary policies. The first is the sizable expansion of the Community's mutual credit facilities, which could allow participants to pursue somewhat easier monetary policies. The second is the inclusion of gold as well as dollars in the reserve pool backing the ECU, which in effect increases the amount of usable reserves held by member central banks. On the face of it, the reserve pooling would not appear to involve any net increase of international liquidity: existing primary assets are simply transformed into an equivalent amount of ECUs. But monetary gold stocks have been effectively immobilized for most central banks since 1971. In reality, therefore, the arrangement remonetizes 20 per cent of their gold reserves—and does so, moreover, at a market-related price far above that at which most had previously been valued. (The resulting markup of the members' aggregate reserves, when EMS was launched, amounted to some \$14.4 billion.) A plausible implication is that governments might now be tempted to draw on this *embarras de richesse* to finance external deficits, postponing anti-inflation policies that might otherwise be required.

These two concerns, it must be recognized, can be exaggerated. For instance, while it is true that both the Community's short-term and medium-term credit facilities have been expanded, it is also true that no calls have been made on them since EMS was launched. In any event, it may be argued, the expansion represents no more than the logical counterpart of the members' commitment to greater exchange-rate stability, which, other things being equal, implies a greater need for liquidity. Likewise, while it is true that the ECU pool has ostensibly increased the value of central-bank gold stocks by denominating them at a market-related price, it is also true that the market price of gold is so highly volatile that, in practice, members might find it difficult to rely for long on this part of their reserves for deficit financing. Besides, gold stocks had already been partially remonetized by the growing practice of using them, explicitly or im-

plicity, as collateral for official borrowing, as in the case of Italy's loan from Germany in 1975.

Nevertheless, it is difficult to be sanguine about these concerns. The potential for an inflationary bias is there and, unlike the hypothetical reverse danger of a deflationary bias, could well become serious in practical terms. Consider, for example, what could happen if sizable payments imbalances developed within EMS. Any disciplinary effect of the joint float on a deficit member would probably be more than offset by the "safety valve" of access to the credit facilities. It is not difficult to imagine participants being rather more "understanding" of the problems of a partner in trouble than, say, the IMF might be. EMS is based on a Community, after all: sympathetic support would seem to be more probable than a strict insistence on tough policy conditions. And the potential for an inflationary bias can only grow if and when ECUs begin to be created against transfers of national currency or through activation of the credit facilities, further encouraging easier monetary policies than would otherwise be possible. Outsiders may not need to worry about any secular tendency toward deflation in EMS, but they should be concerned about the potential for a systematic bias in the opposite direction.

The SDR, the IMF, and Monetary Reform

The third possible danger of EMS is that it could erode the status of the SDR and IMF and weaken any impetus toward global monetary reform. Certainly, the status of the SDR would be jeopardized if the ECU did become widely available to nonmember central banks or to private transactors. Backed by the close-knit political and economic structure of the Community, such an asset would constitute a potentially powerful rival not only to the dollar but clearly also to the SDR, whose backing in the membership of the IMF is broader but far less cohesive. Community officials deny any intention to set up the ECU as a competitor to the SDR. But, intended or not, it could happen in practice. As one otherwise sympathetic American observer has commented:

It will be confusing indeed to have two deliberately created reserve assets circulating: the SDR and the ECU. . . . If damage . . . is to be minimized, use of the ECU should be confined to settlement among

members of the EMS and it should not circulate more widely either in the private market or among non-members of the EMS (Solomon, 1979, pp. 8-9).

Even should the ECU not circulate more widely, there could be damage to the extent that the effective increase of liquidity inherent in EMS satiates the appetite of member countries for future SDR allocations. Many nations, particularly in the Third World, set great store by continued allocations of SDRs, which in effect provide them with a form of external financing considerably cheaper than equivalent amounts of loans from private credit markets. (The interest rate charged by the IMF on net SDR use is equal to a weighted average of short-term rates in five major financial centers. This rate is substantially below what developing countries would have to pay to borrow from the private markets, assuming they would be regarded as sufficiently creditworthy to be able to borrow at all.) This risk, too, is denied by EMS proponents (see, e.g., Baquiast, 1979, p. 55), who insist that EC attitudes on SDR allocations have always been guided by global rather than regional considerations. In reality, however, it is hard to see how the members' perception of global need would not *somehow* be influenced by the extent to which they themselves are experiencing inflationary pressures (see Polak, 1980, pp. 363-364). Insofar as EMS does result in an inflationary bias, therefore, the possibility of a negative influence on members' attitudes toward future SDR allocations cannot entirely be excluded, particularly if, as in the past, developing nations continue to press for a "link" between SDR allocations and development assistance.

As far as the IMF is concerned, EMS proponents readily concede the possibility of adverse consequences. In the words of one: "There is no point in dodging these issues" (McMahon, 1979, p. 91). The Fund's traditionally central role in monetary affairs obviously would be challenged if, for example, EC countries seeking conditional payments financing chose to have recourse first—or perhaps exclusively—to the EMF or their mutual credit facilities. IMF authority would be further undermined if, in addition, the status of the SDR were to be eroded.

Once again, however, the practical importance of these issues is denied by EMS proponents (see, e.g., Baquiast, 1979, pp. 53-56; McMahon, 1979, pp. 90-91). In fact, they stress, the scheme's credit facilities are neither new nor the only alternative source of official

external financing available to members. Members, for example, have long participated in the Federal Reserve's network of swaps. Moreover, members have gone to great lengths to ensure that EMS operating rules and procedures remain fully compatible with those of the IMF. In the one instance, prior to EMS, of activation of the short-term and medium-term credit facilities (on behalf of Italy, in 1974-75), considerable care was taken to coordinate the amount and terms of lending with a parallel Fund standby operation. The launching of their regional initiative, Europeans stress, is in no way intended to signal diminution of support for the IMF. On the contrary, they argue, insofar as EC countries do choose to go first to EMS credit mechanisms, the main result will be to free a larger proportion of Fund resources for lending to other nations—presumably a distinct gain from the point of view of nonparticipants.

Still, one cannot help but wonder how the IMF will be able to retain its central role in international monetary management so long as some of its largest members always have the option of going elsewhere to obtain official external financing (see Polak, 1980, pp. 364-367). In principle, under the amended Articles of Agreement, the Fund is supposed to exercise surveillance over the policies of all its members—debtors and creditors alike—through each country's annual economic consultations and in the course of the Fund's periodic discussions of the world economic outlook. In practice, the only effective influence wielded by the Fund is still on debtors alone, through the power of the purse. The question remains, therefore, to what extent the Fund will now be able to influence the policies of nonborrowing countries as well. The answer will depend on the attitude of the EMS participants. Will they choose to use the enlarged resources of their regional system to bypass (and, in the process, diminish) the authority of the IMF, or rather to cooperate with the Fund and other financial powers to strengthen the fabric of international monetary cooperation? Ultimately, as de Vries (1980, pp. 40-42) has written, it will depend on whether their attitude turns out to be more "outward-looking" or "inward-looking."

Here, plainly, the narrow issue of the IMF merges into the broader issue of monetary reform in general. Indeed, it is on these more general grounds that the prospective impact of EMS on the structure of international monetary relations should be judged. Most international monetary specialists concur on two observations: the monetary

system—or “nonsystem,” as some describe it—has many problems, and universal solutions to these problems are unlikely. Earlier in the post-World War II era, a certain degree of order and stability in global monetary relations was assured by the predominant position of the United States and the dollar, but conditions for unilateral American leadership, or “hegemony,” are no longer propitious. Yet the community of nations still shows no sign of willingness to submit to the rigors of either a self-disciplining regime of automatic and binding rules or a world central bank. In current circumstances, therefore, solutions must be found on a more decentralized basis, in efforts at shared responsibility and decision-making among countries prepared for more intense cooperation than as yet seems feasible on a global scale. If there is one point on which I am in wholehearted agreement with EMS proponents, it is that Europe’s initiative *could* aid in such efforts. In the words of one proponent:

I am convinced that the success of the EMS experiment toward its basic objective, and of the indispensable cooperation between the EMS and U.S. authorities, might at long last break the deadlock which has paralyzed, since Jamaica, the previous determination to restore a workable world monetary order (Triffin, 1980a, p. 45).

Likewise, I have previously written:

The EMS could enable the Europeans to speak with one voice and thus greatly enhance their overall bargaining strength in international monetary discussions. A regime of shared responsibility could then be established that . . . would have a better chance of producing concord instead of conflict. In place of an obsolete hegemony, a new organizing principle of cooperative management would finally be within reach (Cohen, 1979b, pp. 42-43).

But the question remains: Would Europe’s initiative actually produce this happy result? Or might it instead (as even one of the system’s principal enthusiasts fears it could) become “at best a mere inward-looking oasis” dedicated to insulating its members from a world of continuing monetary chaos (Triffin, 1979b, p. 286)? Obviously, this is not a question that can be answered *a priori*. Once again, the proof of the pudding will be in the eating—specifically, in the extent to which, and speed with which, the Europeans move toward genuine dialogue and cooperation with nonmembers on major monetary issues. The task for nonmembers will be to help push Europe in this positive direction.

Conclusions

From the point of view of an outsider, the European Monetary System—for all its evident attractions—is not without risks. Clearly, nonmembers as well as members of EMS will benefit if the Community can in fact attain its objective of a zone of monetary stability in Europe. And everyone's interests will be served if EMS is also able to help regain momentum in the process of global monetary reform. But dangers exist. Unless the issues of convergence and a joint dollar policy can be satisfactorily resolved, EMS could end up increasing rather than decreasing the overall instability of exchange rates. Exchange-rate instability will be further exacerbated if, in addition, destabilizing capital movements and portfolio shifts are amplified as a result of the increase in diversification options inherent in the scheme. Furthermore, EMS risks introducing an inflationary bias into EC policy and performance and could erode the status of the IMF and SDR, as well as jeopardize future SDR allocations. These dangers should not be exaggerated: although possible, they are by no means certain, and much will depend on the attitude and actions of the members themselves, which can hardly be predicted in advance. But they ought not to be ignored. For nonmembers, prudent caution rather than unquestioning confidence would seem to be the most appropriate response.

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