

ESSAYS IN INTERNATIONAL FINANCE

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

*This is the one hundred and forty-second number in the series* ESSAYS IN INTERNATIONAL FINANCE, *published from time to time by the International Finance Section of the Department of Economics of Princeton University.*

*The author, Benjamin J. Cohen, is William L. Clayton Professor of International Economic Affairs at the Fletcher School of Law and Diplomacy, Tufts University. A frequent contributor to the literature on international monetary problems, his most recent books include ORGANIZING THE WORLD'S MONEY (1977) and BANKS AND THE BALANCE OF PAYMENTS (1981). This is his second contribution to this series, the first being THE REFORM OF STERLING (No. 77, 1969).*

*The Section sponsors the Essays in this series but takes no further responsibility for the opinions expressed in them. The writers are free to develop their topics as they wish.*

PETER B. KENEN, *Director*  
*International Finance Section*

ESSAYS IN INTERNATIONAL FINANCE

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

INTERNATIONAL FINANCE SECTION  
EDITORIAL STAFF

Peter B. Kenen, *Director*  
Ellen Seiler, *Editor*  
Linda Wells, *Editorial Aide*  
Kaeti Isaila, *Subscriptions and Orders*

*Library of Congress Cataloging in Publication Data*

Cohen, Benjamin J.  
The European monetary system.

(Essays in international finance, ISSN 0071-142X; no. 142)  
Includes bibliographical references.

1. Money—European Economic Community countries.  
2. Foreign exchange problem—European Economic Community countries.

I. Title.	II. Series.			
HG136.P7	no. 142	[HG930.5]	332'.042s	81-4167
			[332.4'5'094]	AACR2

*Copyright © 1981 by International Finance Section, Department of Economics, Princeton University.*

All rights reserved. Except for brief quotations embodied in critical articles and reviews, no part of this publication may be reproduced in any form or by any means, including photocopy, without written permission from the publisher.

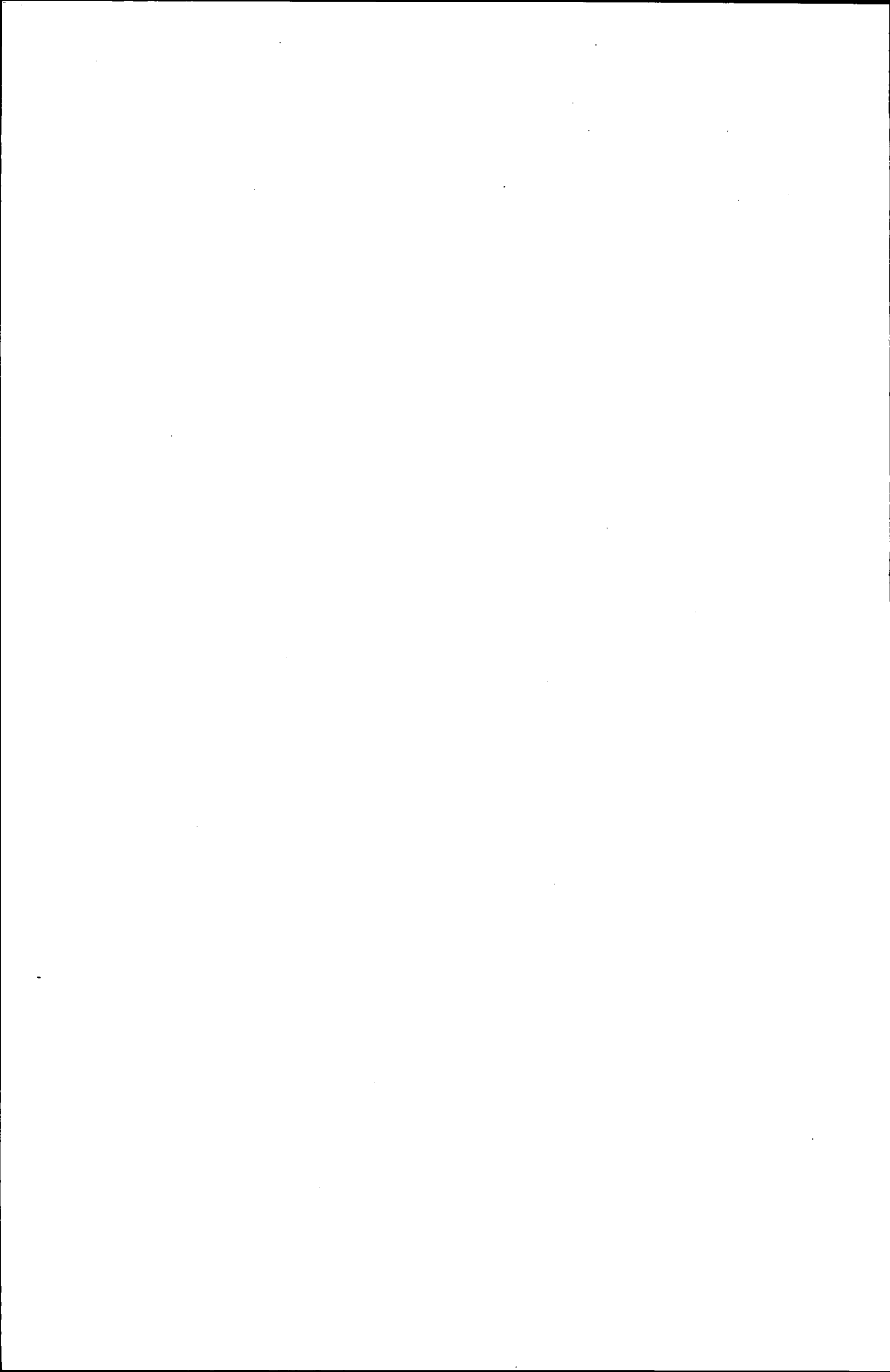
Printed in the United States of America by Princeton University Press at Princeton, New Jersey.

International Standard Serial number: 0071-142X

Library of Congress Catalog Card Number: 81-4167

## CONTENTS

PRINCIPAL FEATURES, PERFORMANCE, AND PROSPECTS	1
Principal Features	2
Performance	5
Prospects	7
Next Steps	12
A ZONE OF MONETARY STABILITY?	14
DEFLATIONARY OR INFLATIONARY BIAS?	19
THE SDR, THE IMF, AND MONETARY REFORM	21
CONCLUSIONS	25
REFERENCES	26



# 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.<sup>1</sup> 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

<sup>1</sup> 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.<sup>2</sup> 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-

<sup>2</sup> 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.<sup>3</sup> 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.<sup>4</sup>

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-

<sup>3</sup> 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).

<sup>4</sup> 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).<sup>5</sup> 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

<sup>5</sup> 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.<sup>6</sup> 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.

<sup>6</sup> 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<sup>a</sup> 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 <sup>b</sup>
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

<sup>a</sup> Percentage changes of consumer-price indices over corresponding period of previous year.

<sup>b</sup> 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;