"THE EUROPEAN COMMUNITY LOOKS AT MONETARY INTEGRATION"

(Speech by Vice-President ORTOLI at the FINANCIAL TIMES colloquium in Frankfurt on February 14, 1979)

I. The European Monetary System did not enter into force on 1 January, and I find this regrettable. But, however great my disappointment, I remain convinced that this merely means a delay. The economic considerations and the political will that led to the decisions taken last December still remain valid. If there is a crisis, it is a crisis of growth: only rarely has major progress in the construction of Europe been achieved free from obstacles and without friction, and even though I am disappointed I prefer the difficulties produced by movement to the difficulties created by an eclipse of political inspiration.

The reasons for the delay that has occurred need to be examined from the viewpoint of the future management of the system, which will be demanding. The logic behind it is not purely monetary and it is not merely an intervention agreement between central banks; to be successful it must be the pivot of joint measures to bring our economies more closely into line with regard to their objectives, behaviour and achievements.

II. In this respect, the task which lies before us is immense. The Treaty of Rome has very little to say on monetary policy. With a view to promoting the coordination of Member States' policies in this field, it mainly provides for the establishment of a Monetary Committee with advisory status. It also stipulates that each Member State is to treat its exchange rate policy as a matter of common concern. In the event of balance of payments difficulties, it provides for safeguard clauses and mutual assistance. Altogether, this takes up only a few lines, very general in nature, in a chapter entitled "Balance of Payments".

The developments which have taken place since then and which resulted in the decisions taken at the Hague Summit on Economic and Monetary, the Werner Plan, the Barre Plan, the partial establishment of the "snake" and then the initiatives launched in 1977-78 were prompted by two major considerations.

The first consideration is a political one and reflects the conviction that our countries have a common destiny. The idea of European Union, with all its imprecision, is the expression of this aspiration, and Economic and Monetary Union the key instrument.

The second consideration is much more practical and of much more immediate significance. It stems from two premices : that monetary instability constitutes a major threat to our economies, and that to put an end to such instability, we must begin by establishing in Europe, between highly interdependent and institutionally linked economies, a zone of monetary stability.

A more detailed analysis of this argument reveals that it has a whole series of components:

Firstly, there is considerable disappointment with the negative impact of the system of floating exchange rates on international competition, market and profit expectations, the growth in investment and, lastly, growth and employment. The absence of monetary rules has very serious practical implications and also a psychological impact since it affects the ability of companies and of economic agents generally to plan ahead, and since it undermines confidence.

Secondly, there is fear about the future of the European Common Market, which is faced with a monetary and economic crisis that might jeopardize its achievements to date (l'acquis communautaire) and, more generally, a fear that the principle of freedom in international trade may not be upheld.

Thirdly, at a time when our interdependence is self-evident (we transact between ourselves half of our aggregate foreign trade), there is an awareness of the limits to economic policy coordination that is based on good will alone; hence the need to secure a sound and sufficiently stringent basis for the restoration of economic order and a revival of growth by relying on the key role played by the monetary constraint, which acts both directly and as a catalyst for other policies. The construction of Europe, which has been made too exclusively dependent on the good will shown by Member States, needs firmer anchoring points.

Lastly, there is the force of our common interests in determining the new pattern of international economic and monetary relationships.

In short, the world is thirsting for stability; Europe needs it more than any other area, and it must make a start on creating such stability by accepting the constraints and common disciplines that go with it.

III. From these considerations, or rather facts, has begun to develop, helped by the Commission of the European Communities, a political conviction that has found practical expression in the policy guidelines adopted at the meetings of the European Council in Copenhagen and Bremen and subsequently in the decisions taken at the meeting of the European Council in Brussels.

What has the work that has been going on for almost nine months achieved? I shall attempt to answer this although I am perfectly aware that, as it stands at present, the European Monetary System:

(i) brings together both concrete mechanisms and potential measures, so that a full appraisal can be made only on the basis of experience and in the light of how we will fit in the details and meet some of the conditions it imposes;

(ii) is merely the forerunner of a genuine monetary system and does not feature, even in their nascent form, all the necessary elements;

(iii) will not be judged solely on its own merits but also on its contribution towards strengthening the international monetary system, a monetary system that it can help to improve but that will also affect its own chances of success.

IV. The exchange rate system adopted in December, while no less strict than the "snake", is different from it. Rather than describing it in detail, the simplest thing for me to do would be to highlight its main features by outlining its objectives and the machinery to be used to tackle any strains which might affect it.

The first objective is to maintain real stability in the relationships between the currencies participating in the system

(a) In order to do this, any two Community currencies will each have a maximum permissible fluctuation margin of 2.25% against one another, with the exception of the lira, for which the margin will be 6%. Once the limit is reached, intervention will be automatic, but here we see the first difference with the "snake". This lies in the scale and time-span of the resources deployed to help ensure that the maximum divergence limit is not exceeded and also in their form since the EMCF will henceforth issue ECU against the deposit by the central banks of 20% of their gold and dollar reserves.

In order to deal with any speculation, the unlimited very short-term credit which central banks make available to one another is extended from 30 to 45 days and will be renewable for three months within certain limits. Short-term credit may be granted for nine months instead of six months as in the present monetary arrangement and the amount of 14 000 million ECU actually available is more than double the previous figure. Both in real terms and as a means of dissuasion, this will considerably strengthen the lines of defence for maintaining the quasi-stable parities which will be established.

Community medium-term credit machinery will be strengthened and will have a ceiling of 11 000 million ECU as against 5 450 million ECU today. This is an improvement along the same lines, though its purpose will obviously be different. Short-term credit is essentially a means of containing erratic movements on the market. It ceases to apply as soon as the situation returns to normal. Medium-term credit can either take over from short-term support - thus avoiding any immediate drain on the currency reserves of a debtor country - or, as will more frequently be the case, it can fulfil quite a different role, that is to say it can enable a Member State which pursues an economic policy in line with the common interest but which is in temporary balance of payments difficulties, to avoid the unnecessary constraints involved in the need to restore its external accounts too rapidly.

(b) A second line of defence in maintaining parities is the establishment of a preventive system based on the use of a divergence indicator, defined in relation to the ECU, i.e. the currency-basket unit of account.

When a currency diverges, that is to say when it moves away from the ECU by more than a certain percentage, there will be a presumption that the relevant country will take action. Notice that I use the word action, which is a broad term, and not the word intervention. This arrangement was included in the system so as to deal with the problem of the involuntary debtor or creditor, i.e. to impose on a country whose currency was regarded as pulling the other currencies upwards or downwards a more specific responsibility in easing tensions.

However, I feel that the new mechanism will help to change, in a very desirable way, the nature of the European monetary system by means which have little to do with the problem of the involuntary debtor.

First of all, as I have said, it introduces the very desirable notion of prevention into the system - a new notion and one which may make our machinery more flexible and more effective at less overall cost. This preventive action will be accompanied, where necessary, by diversification of the intervention currencies, Community currencies or non-member currencies, thereby ensuring that the measures taken are better adapted to the market situation.

Secondly, the divergence indicator concept gives the system a further characteristic: its use makes it necessary to investigate the causes of the strains which appear on the foreign exchange market at a given time. It induces the authorities to act in the light of these causes and not simply - and automatically - by purchasing or selling foreign exchange with a view to maintaining the spread between two currencies within certain limits.

These strains may stem from very different sources, necessitating very different corrective action. They may stem from the system itself:

from the short-term weakness of a currency or from a reaction to a policy - perhaps a monetary policy - which the market judges to be incompatible with the maintenance of the parity chosen, or may even be a judgment on what is now seen to be an unsuitable parity. They may have an external origin: the weakening or, alternatively, the strengthening of a major non-member currency (such as the dollar) acting on the whole of the European monetary system through the pressure of available liquidity on one of our currencies.

Consequently, the remedies will themselves change: it will not simply be a question of intervention - however diversified - on the exchange market. It may be necessary to take measures of domestic monetary policy or to rethink overall economic policy or to change the central rate.

This diversification of action, combined with more effective coordination of policies and with a greater measure of solidarity, and this systematic organization of an effective dialogue, are the best way in which to allay the fears associated with the rigidity of the system and also the fear that it may have an inflationary or deflationary impact.

The new indicator has, of course, aroused much discussion. It has been argued, for example, that we should have opted for a more automatic system. I do not share this view. Only an analysis of the facts makes it possible to assess the cause of the strains, their extent and the best way of correcting them. What to me seems essential is the strength of the presumption, the importance attached to basic solutions as opposed to a simple reflex response to events on the market and, finally, the decision to review the working of the indicator after six months so as to assess whether it is fulfilling its complex role effectively.

As you will have noted, I have attempted to show what guarantees of orderly functioning the monetary system itself offers.

These guarantees are, first of all, technical ones, namely mobilization of sufficient funds to combat speculation, provision for preventive measures, establishment of machinery to remedy the causes of strains. Finally the arrangement goes further than a mere agreement on exchange rates concluded between central banks in providing for the use of domestic monetary and economic policy instruments, including, where necessary, those within the sphere of competence of the governments themselves.

A further guarantee is afforded by the flexibility of the system, which readily permits changes in central rates as a safety valve and not a mere convenience.

This analysis, however, calls for three concluding remarks:

- firstly, this system, which is more comprehensive, more complex and more refined, combining automatic mechanisms and potential means of action, must be "got off the ground". It has still to undergo its baptism of fire and difficulties - some of them unexpected - are bound to arise. I trust only - and believe - that we have not failed to see where the real issues will lie.

- secondly, the system will, as I mentioned earlier, have to operate within a disturbed international monetary environment and, in managing it, we will have to take into account the prospective developments in this field;

- finally, exchange rate stability must correspond to economic reality. This remark leads me to our second objective: to ensure that the basic conditions for the success of the European monetary system are in fact met: the technical condition that it will reflect sufficiently homogeneous economic policies and performance, and the political condition that it will help to solve the main problems confronting Europe's economy.

(a) In this field, the first priority is to coordinate economic policies. There is a danger under the system that the relationship between European currencies will not be stable enough. Despite the flexibility which I have just referred to, the EMS will be meaningful only if parity changes are reasonably rare and reflect only objective trends. If this is not the case, there will be no area of monetary stability in Europe, but simply a system of periodically recording variations. In the long run, stable exchange rate relationships can be safeguarded only through the convergence of economic performances,that is to say by bringing down inflation rates and by achieving satisfactory balance of payments positions.

However, although convergence is expressed in terms of figures and performance, it depends on the joint definition and monitoring of objectives and policies, that is to say on coordination. How would it be possible for countries to take part in the same exchange rate system while at the same time continuing to pursue different monetary, budgetary and other policies? The EMS must therefore be complemented by a convergence of economic policy extending to the main fields of macroeconomic policy and to the main instrumental policies.

This means that coordination will have to be much more systematic than at present and will have to take place before major national decisions likely to influence exchange rate relationships are actually taken. It means that the definition of domestic monetary policies, while continuing to be the responsibility of governments or central banks, will become a matter of common concern and will have to be treated as such.

We have three assets at our disposal for implementing this programme: the awareness, which was expressed during the preparatory work, of the logical connection between monetary system and economic policies;

recent experience of concerted economic action, which has led us to strengthen our procedures and to breath new life into the various bodies which work out the beginnings of a Community economic policy; and finally, in the light of these facts, and relying on this improved capacity for managing our affairs, the natural concern to make the major political initiative a lasting success. I do not overestimate these factors. However, bearing in mind the events of 1978 as I saw them, I believe they are very strong.

I would like to make a few additional points. The first is that integration is already well developed between certain Member States. It is therefore not something entirely new nor a leap into the unknown. The question is whether the process will just keep going imperfectly, covering only part of the field and comprising only some of the Member States, or whether it must include all nine Member States and be taken a stage further along the road towards joint formulation of policies.

The second point I would like to make is this. Coordination implies constraints. However, refusal to accept constraints, and these constraints in particular, always results in more inflation and more unemployment in the long term. With or without a monetary system, each country must comply with these constraints.

My third point is that coordination does not mean a transfer of powers. There is no question whatsoever of encroaching on anyone's powers of action. What is needed, during the initial phase, is to develop consultations, to achieve a degree of policy integration and also of mutual frankness, so that each country can take its own decisions in full knowledge of the intentions, objectives and policies of the others.

Having said this, let me be quite clear about one thing: neither the procedures that we develop, nor the certainty that there is a community of interest, nor the force of monetary constraints can act as a substitute for clearly defined national policies or the consensus on which they must be based. However, the Community can help to foster awareness, it can help to develop a common assessment of problems (recognition of the need to be competitive, of the requirements of competition, of the need for moderation of incomes growth and the crucial role of combating inflation), and it can take positive, and indeed, I believe, essential measures to supplement national action.

(b) This need for coordination which is inevitably implied by the EMS goes hand in hand with a political condition, which is its logical counterpart. The EMS is a basic element in overall economic policy; not only must it not have the effect of unduly curbing growth in Member States whose currencies are under pressure, it must also prove its ability to help solve the problems of growth and employment. Hence the importance of ensuring that concerted action becomes a permanent feature; this will make it possible, through the multiplier effects of symetrically balanced measures, to provide some countries with an additional boost to growth, without affecting the stability of the others. Concerted action is the means of using our interdependence to obtain more growth and less inflation in the Community. It is therefore an essential element in the game.

At the same time, it is an aspect of the general principle of solidarity which is also a necessary complement to the EMS. The principle of solidarity takes two main forms: in its conventional sense, it applies directly to the sharing of the burdens created by the system. The aim must be to ensure that no Member State is forced to leave the system because it is unable to bear constraints which have temporarily become too great; it is only natural that the members of a team should make an effort to rally round a partner who is in difficulties: this effort is reflected in the Community's machinery for providing aid, such as medium-term financial assistance and balance of payments loans, the role of which is to enable a Member State in difficulties to overcome its problems while remaining in the system.

Solidarity must also take on a new aspect that is linked to the nature of the system. The EMS cannot develop successfully in the long run unless it is accompanied by harmonization of production and trading conditions, that is to say harmonization of structures, between the Member States participating in it. Where the economic weakness of a Member State is due to inadequate development of technology and infrastructures, or where there is not sufficient capital available to finance the necessary investment, the Community must help to overcome such problems. It can do so, firstly by providing the necessary capital; the Community's structural instruments are developing rapidly and can play a growing role. Secondly, the Community can help the Member States concerned to fit their selective projects into properly integrated programmes which will provide a general and political framework for specific schemes and will ensure that the measures taken are along the right lines, i.e. contribute to the modernization of structures and convergence. Solving these problems would enrich the Community as a whole and would represent an investment in the future; it is an essential aspect of the EMS.

At the same time, I am opposed to indiscriminate transfers designed to finance consumption or to mask economic divergences temporarily without tackling their roots. Such transfers, based on the feeling that the rich countries will pay, would mean a net impoverishment for the Community which would sooner or later become intolerable.

I apologize for having spoken at such length on questions with which everyone is familiar and for having apparently wandered away from the subject on which I was supposed to talk. However, if I did so, it was to illustrate the subject better. The EMS and its necessary associated aspects, namely policy coordination, economic convergence and solidarity, carry a momentum which goes well beyond the strictly monetary framework. If the EMS is to remain stable and lasting, the whole range of instrumental, macroeconomic and medium-term policies must gradually be integrated. This is what is meant by the march towards economic and monetary union.

IV - I now come to the possible ways in which the system might develop. They are difficult to foresee because they will, in large measure, depend on the way in which the system operates. In the normal course of events, developments might take three main directions:

1. The present arrangements for depositing reserves could be transformed into a Community reserve system managed by the EMCF;

2. ECU could be created against the deposit of national currencies and no longer against the deposit of gold and foreign exchange reserves alone, with implications for the conditionality of such creation;

3. The ECU could gradually take on the role of an instrument for settling private transactions and of a reserve currency, and thus no longer serve only as a means of settlement between central banks.

I will not go ~~into more details~~ elaborate on these three points.

I would, however, point out that these three developments would have the same point of convergence, namely the development of a system broadly based on the multilateralization of bilateral relations - into a system built around strong national poles, and a strong common centre, the EMCF or any other body that became the focal point of the new European monetary organization.

Where credits are concerned, drawing rights on a fund would replace ceilings for swap credits. It is also possible that the ECU will no longer be merely an instrument for carrying out calculations but a reserve instrument, ranking with gold, foreign exchange and SDRs. And I know that there is nothing to prove that the creation of a European reserve currency will be desirable. I am well aware that those seemingly technical developments would, in fact, be a truly revolutionary step.

I am also aware that, if such developments are to take place, the EMS must, during its transitional phase, perform satisfactorily in the eyes of all those taking part. I will be the first to admit that there is no advance guarantee of success. But a failure would be both the consequence and the cause of extreme difficulties in Europe and I am convinced that there is no alternative to success.

V - As I mentioned earlier, success depends in part on the relationship which can be established, in the immediate future and in the long term, between European currencies, and I am thinking here of all European currencies, including sterling. I hope that the United Kingdom, which is a signatory to the system, will be able to take part very soon. The forging of this relationship depends in turn on a sweeping move towards integration in Europe in the different areas to which I referred earlier. But success also depends to a large extent on the relationship which will be established between the system itself and the international monetary system, and in particular the dollar. The emergence in Europe of a zone of monetary stability is in no way an indication that the Community wishes to take a stand against the United States but it does mean that, in order to defend this stability, Europe must enter into a constructive dialogue with its major partners on the future of the international monetary system.

This assumes, first of all, that non-member countries with similar interests which play an important role in world affairs could be associated to that venture.
I will not attempt to list the countries which, as provided for in the Bremen Communiqué, should, if they so wish, be permitted to do so. I am convinced, however, that it is in the Community's interests to cooperate closely with the other countries in Europe; it is by no means my intention to propose the setting up of a bloc but to strengthen the base of the EMS and thereby to increase its chances of success.

Implementation of the EMS is linked to the strengthening of the international monetary system; its durability will largely depend on its capacity to contribute to this objective.

The creation of the EMS has, as such, a positive role to play in the development of the international monetary system; it shows, first of all, that there exists in the world a group of countries - and strong countries at that - which is dissatisfied with the present disorder and which no longer accepts that exchange rates should be allowed to fluctuate arbitrarily. Far from facilitating the international adjustment process, the system of fluctuating exchange rates has in part hampered it; apart from the oil-producing countries and the sub-redistribution which has taken place in Europe, the breakdown of the major groups of countries into creditors and debtors has remained the same as in the early seventies; furthermore, the scale of intervention on foreign exchange markets has been much greater than under the system of stable exchange rates, and this has exacerbated the problem of liquidity, which the system of fluctuating rates was supposed to alleviate. In this respect, the EMS thus represents a fundamental change in attitudes, i.e. the abandonment of the absolute belief in the virtues of fluctuating exchange rates and, conversely, the certainty that stability, a factor conducive to growth, is the result of strictness and discipline.

But the EMS also has a direct practical implication. There is a tendency to attribute sole responsibility for the monetary disorder to the dollar but we should not forget that a number of crises have been triggered by instability in Europe and not by disarray in America. It falls to us to eliminate this occasional cause of world instability.

You will therefore excuse me if I resort to what the French call the "Coué method", but I believe in the virtue of the precept set out in the doctrine of the Order of St Dominic, which states that "teaching is nothing without example"; at the risk of appearing naïve, I believe that demands for the restoration of a sound international order will carry more weight if Europe first sets the example, by encouraging its partners to play their part too.] Lastly, the EMS possesses what I will term a "diplomatic" force: during the transitional phase in the development of the international monetary system on which we are now embarking, the EMS presents Europe with an opportunity gradually to speak with one voice, on at least equal terms, and thus to defend its own interests more effectively.

The directions which the dialogue may take are becoming increasingly apparent, with the collective awareness in industrialized countries of the urgent need for closely coordinated action being one of the most encouraging features of recent years.

(a) The first of these directions concerns moves to combat, through intervention on the markets, exchange rate movements which have no economic justification. It is to be hoped that the decisions taken last November foreshadow a much greater degree of systematic cooperation between major monetary groups aimed at amplifying and diversifying the means available for waging this combat. They are the manifestation of a very welcome common will and, in the case of the United States, of a better appreciation of the dangers of monetary instability. As a monetary entity, the Community can play a major rôle in this connection, as do some of its Member States already.

(b) The second line of action concerns the formulation of national economic policies that are compatible with the objective of international stability. As I pointed out earlier, in the case of Europe, this will possibly be the greatest challenge since it does not involve simple mechanisms or the direct external constraint.

This can be helped by the more systematic organization of the dialogue, the joint consideration of domestic monetary policies, and the effective application of the provisions giving the International Monetary Fund a supervisory responsibility. In this connection, I am convinced that it is in Europe's interests to help to strengthen the IMF. Just as we are trying to organize ourselves, on the basis of accepted disciplines and a stronger common organization, so we must wish for similar characteristics in the international system, and so we would like to see at least part of what we have considered good for ourselves to be practised at international level.

It will take time to develop this closeness of policies, this awareness of the international effects of national decisions. However, since there is no international monetary system that would impose, through its own techniques, an obligation to restore equilibria, this is the road which must be followed.

(c) The major question of the control of international liquidity, and in particular of the Euromarkets, is more controversial. Many arguments have been used to oppose attempts at action in this area. In particular such action has been termed unnecessary (the real source of the liquidity problem is said to be inappropriate national policies), ineffective, and even dangerous, since the Euromarkets have helped prevent, and are continuing to help prevent, serious disruptions connected with lasting balance of payments disequilibria.

I believe however that we should look more closely into ways of drawing benefit from the system while avoiding its excesses. After all, it is not a question of establishing controls in the adverse sense of the word, but, as central banks do at national level throughout the world, of seeking ways of containing money creation within limits which are compatible with overall equilibrium. This opens up a whole field of thought, and, one day, of action, which I believe to be important.

(d) The factors I have outlined, though inevitably not exhaustive, show that in my view any progress in the international monetary field will depend on methodical pursuit of all the possible avenues of approach, which are linked by the need for close international cooperation. I do not think we should underestimate the results that can be obtained if joint action is sufficiently systematic, sufficiently continuous and, of course, on a sufficiently large scale, for all action has its minimum threshold of effectiveness.

As I have said, I am certain that the will to achieve monetary union in Europe, seen as a means of participating more fully in necessary joint action, is a valuable factor contributing to the success of such action. It will strengthen the multi-polar nature of the world economy. What I do not know of course is how, in detail, the world system will evolve and whether the trend towards what is a particular aspect within this multi-polar system - the trend towards the use of a larger number of reserve currencies -

will become stronger, thus in the long term radically changing the features of the international monetary system. Perhaps one day we will see the ECU playing an international role, but that day has not yet come. We need time to firmly establish the new European scheme, to decide on how it should develop and to assess whether the ECU, having performed the role expected of it, can fulfil new functions.

One thing I am sure of is that the present period is first and foremost, whether we like it or not, a period of consolidation and organization that involves much difficult work but is absolutely necessary. Without indulging too much in idealistic daydreams, we must endeavour to develop effectively the links between the major economic areas, and to build a European system which will in itself be a factor of equilibrium, an example of discipline which is both voluntary and organized, a contribution to the world order and the basis for European union.