

DELEGATION OF THE COMMISSION OF THE EUROPEAN COMMUNITIES

EUROPEAN MONETARY COOPERATION: FIVE YEARS EXPERIENCE
OF THE EMS

by

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EUROPEAN MONETARY COOPERATION: FIVE YEARS EXPERIENCE OF THE EMS.

1. Introduction

The European Monetary System (EMS) celebrated its fifth anniversary just over a month ago and has thus now been in existence for long enough for a reasonably balanced assessment of its performance to be made and maybe even for certain lessons to be drawn from that performance.

I wish first to look at the internal and external context in which the EMS was set up. Internally it is part of the overall process of monetary integration which has always been and will remain one of the key elements within the European Community. The EMS has, therefore, "a political dimension which makes adherence to the system not just a question of economic expediency". Externally it is part of the international monetary system and must co-exist with it. Understanding is not advanced either by seeing the EMS as a device aimed primarily at sheltering the Community from the rest of the world, or as an attempt to recreate something which no longer exists in the rest of the world. I shall also try to assess how the system has performed during its first five years and the degree to which its original goals have been fulfilled. I will conclude by outlining some of our immediate hopes possibilities for further development.

2. The EMS in Context

2.1 Internal

Although the setting up of the EMS was an important and historic development, it did not represent the beginning of monetary cooperation within the European Community. An appreciation of its implications and achievements is easier if the EMS is seen as part of the overall process of forming the Community. A developed monetary organisation is one of the essential ingredients in the creation of a unified internal market. One is unlikely to succeed without the other. Conversely, if the political commitment to economic integration in Europe falters, there will be serious consequences also for the EMS.

In the early years of the Community, the Bretton Woods regime was working smoothly and efficiently, with the U.S. providing a solid "anchor" for other countries' performance.

Capital mobility between national economies was still limited, and inflation differentials among members of the Community, as indeed among industrial countries generally, were of the order of only 1-2 percentage points a year. There was therefore a monetary organisation and monetary stability. The maintainance of exchange rate stability as well was hence not difficult; there were only two parity changes within the Community during the first ten years of its existence.

As a full participant in the international monetary system then prevailing, Europe had a monetary organisation, if not a monetary identity. The most pressing task was to get on with the job of removing tariffs and other obstacles to a common internal market.

The Treaty of Rome does not neglect the need for monetary organisation nor for its institutional infrastructure. Article 105 sets up the Monetary Committee "in order to promote coordination of the policies of Member States in the monetary field to the full extent needed for the functioning of the common market". It was also recognised that exchange rate changes need special considerations, and Article 107 states that "Each Member State shall treat its policy with regard to rates of exchange as a matter of common concern".

As soon as the monetary organisation provided by the Bretton Woods system started to break down, various schemes for putting flesh on these bones provided by the Treaty were devised. The first major and most ambitious attempt was the Werner Report of 1970. As well as calling for increased fiscal and monetary cooperation, the report proposed total convertibility and the elimination of fluctuations in exchange rates between Community currencies. It added that they should preferably be replaced by a single currency. The first stage in this process was to be a gradual narrowing of the margins of permissible fluctuation to plus or minus 0.75 percent. This initial step was, however, quickly overtaken by the events.

After President Nixon closed the gold window in August 1971, both the Community and the rest of the world answered by trying to replace the most obvious aspect of the previous system, the exchange rate arrangements. The Smithsonian agreement of December 1971 provided for a return to pegged exchange rates, but with wider margins of permissible fluctuation. Whatever the arguments for greater exchange rate flexibility in the world as a whole, it was already considered at that time that there was no need to allow Community currencies to fluctuate against each other by

the new wider margins. As a result, early in 1972 the Community established its own exchange rate regime, the so-called "snake", under which member countries' exchange rates were held within a narrower band of plus or minus 2.25%.

The "snake" was a partial system. It could work for a group of countries clearly in the deutschmark zone, but it did not have the overall policy making apparatus nor the political commitment necessary to make it work for a broader and less cohesive group of countries. One after the other the United Kingdom (and with it Ireland), Italy and France dropped out. Of course, it was a difficult period, and the impact of the first oil crisis would have placed a heavy strain on any regime of fixed but adjustable exchange rates. The inability of the 1972 arrangements to survive must, however, be ascribed more to the political and policy differences in the response to the oil shock, than to its direct impact. There was a marked divergence of views on how to react to the disequilibria provoked by the oil price increase; some countries giving priority to the control of inflation and prompt external adjustment, while others, initially at least, were more concerned with maintaining employment in the short run. In any case the "snake" arrangements provided a useful experience on which a more ambitious system could be built upon.

A crucial lesson from this period was the symbiotic nature of economic coordination and exchange rate stability. Some disillusionment with the promised gains from increased policy independence and the experiences with exchange rate instability, led the Community to re-attach greater weight to policy coordination. The period between the Smithsonian agreement and the setting up of the EMS witnessed very large exchange rate movements, both nominal and real, both inside and outside the Community. To single European economies, which are considerably more open than the US and Japan, these exchange rate movements had certain highly undesirable consequences. In the strong currency countries real exchange rate appreciation, while undoubtedly helpful as a means of exerting downward pressure on costs and prices, seriously eroded the profitability of exporting industries and tended to depress investment; while in the weak currency countries, especially those with a high degree of wage indexation, rising import prices gave an additional boost to the inflationary spiral. Moreover, exchange rate misalignment was encouraging demands for protection from industries that felt themselves threatened, so that the Community's major economic achievement and the symbol of European unity, the common market itself, was in jeopardy. In these conditions there was a strongly held belief, voiced most cogently by the leaders of Germany and France at that time, but shared with

varying degrees of enthusiasm by the other member countries, that something needed to be done to restore a measure of stability.

2.2 The External Context

External reasons were one of the proximate factors behind the setting up of the EMS. The German authorities were worried that the weakness of the dollar at that time was having a disproportionate effect on the deutschmark. Footloose capital, flowing out of dollars, tended to flow into deutschmark rather than into the other European currencies, thus forcing the deutschmark up not only against the dollar but also against the currencies of its close European trading partners. The Germans hoped that a fixed exchange rate link with other EC currencies would mitigate this tendency. However, as important as this short-term phenomenon was in acting as a catalyst to bring about the political reaction necessary to create the EMS, it is longer term considerations which were more important.

The external context mirrored the internal one, and suggested to the Community that not only did it require more monetary organisation for its own internal purposes, but also that the external world demanded that it progressively develop its own monetary identity. The breakdown of the Bretton Woods system was not only the abandonment of an exchange rate regime, it was also the loss of the anchor of the system. As the 70's progressed it became increasingly obvious that in a highly interdependent world, composed of a small number of large, but nearly equally economically powerful, blocks, a hegemonic system was no longer optimal or indeed possible. The world has thus been hesitantly moving towards a multiple currency reserve system since then.

In a paper recently published by the Institute, Ron McKinnon has set out some proposals for a better organisation of this type of system. There is plenty of room for disagreement over the exact nature of a reformed international monetary system, but two things seem to be reasonably clear. First that it will need more rather than less organisation at the international level. In fact it will demand active cooperation. Second that each of the major currency blocks will have to be relatively well organised within itself so as to be able to adequately play its part in the whole. Japan is making moves, supported and cajoled by the US, to internationalize the yen and to open up its domestic capital markets. Europe also is making its moves, and the EMS is the cornerstone of these.

Having reviewed the background, both internal and external, against which the EMS was created, it is possible to lay down the criteria by which it should be assessed. It should be fairly obvious that success or failure cannot be judged solely in terms of its ability to stabilize exchange rates within the Community. The first criteria must be its success in achieving monetary stability, defined primarily in terms of price stability but, also including exchange rate stability. However, importance must also be attached to the following:

- the degree and development of economic policy coordination;
- the role of the EMS within the international monetary system;
- the creation of a monetary identity and the role of the ECU.

3 Monetary Stability

3.1 Price Stability

Monetary stability means first and foremost price stability, both in terms of a low overall rate of inflation and in terms of a small differential between the inflation rates in the Member States. It was not expected that the establishment of the EMS would create price stability instantaneously. Progress has however been disappointing, partly because of difficult external circumstances and partly because the constraints imposed by the exchange rate mechanism and other tools for policy convergence have taken time to develop their potential, and were especially soft in the first years of the system.

The five year period since the EMS was established can be divided into two distinct sub-periods. In the first half of the quinquennium the Community's average rate of inflation under the influence of the second oil shock, accelerated sharply and inflation differentials between member countries widened, due partly to differences in the degree of their vulnerability to higher oil prices, but also and more importantly, to differences in the types of economic and monetary policies which they pursued. France, Italy and Ireland had joined the EMS at exchange rates at which their costs and prices were highly competitive vis-a-vis those of Germany and the smaller "snake" countries. In the early years of the system's existence, therefore, inflation differentials could persist for some time before the exchange rate constraint began to be felt. However, as realignments only partially offset these differentials the system gradually came to exercise an increasingly disciplinary

pressure. During the last two years that discipline has become more deliberate and has resulted in a marked convergence of monetary policy stances and profound readjustment of fiscal and economic policies in certain member states.

The resulting developments on inflation rates can be seen from the data presented in table 1.

Table 1
Inflation Differentials

	1979	1980	1981	1982	1983	1984
					(1)	(2)
Highest	15.0(I)	20.3(I)	19.5(IRL)	17.1(IRL)	14.7(I)	10.6(I)
Lowest	4.0(NL)	5.4(D)	5.6(D)	5.3(D)	2.7(NL)	3.1(NL)
Diff.	11.0	14.9	13.9	11.8	12.0	7.5

EC						
Average	8.9	11.2	10.1	8.8	6.2	5.2

(1) Estimate

(2) Forecast

In the early part of the period both because the constraints of the system were new and weak and because of exterior shocks, the inflation differential widened from an already high level. From 1982 onwards the average inflation rate in the Community started steadily to decline, but the difference between the lowest and the highest inflation rates remained above the 1979 level. Our forecasts show that the situation will change dramatically this year. The Community average will drop to close to 5% and the differential to around 8 percent. When compared with the experience after the first oil price increase, the decline in the average inflation rate and in the differential is considerably larger since the existence of the EMS.

3.2 Exchange Rate Stability

As discussed in John Williamson's recent paper, there are various ways of measuring exchange rate variability. It can be measured through bilateral or effective rates in nominal or real terms; and it can be measured over short periods such as from week to week or month to month, or over longer periods, such as a year or more

Let me take short term variability first. It is doubtful whether over periods of a week or a month the concept of "real", or inflation adjusted, exchange rate changes has much significance, so I shall confine myself here to nominal changes.

Table 2
Short-term Variability of Nominal Exchange Rates
 (average month to month absolute percent change)

	Bilateral against the DM		Effective	
	1974-78	1979-83	1974-78	1979-83
DM	-	-	1.8	1.5
FF	1.7	0.8	1.8	1.5
Lit	2.2	0.8	2.0	1.5
Hf1	0.6	0.5	1.5	1.2
FB/Lux	0.5	0.7	1.3	1.2
\$	2.4	2.4	1.9	2.3
Yen	2.1	2.7	2.1	2.8
Pound	2.1	2.4	2.1	2.5

Table 2 shows average month to month changes of the main EMS and non EMS currencies against the deutschmark during the five years before the EMS went into operation and the five years since. It is clear that for the French franc and the lira, the two currencies which were floating freely against the deutschmark during the pre-EMS period but which have had fixed but adjustable rates since 1979, short-term variability has been sharply reduced. For the Benelux currencies, which had fixed but adjustable rates against the deutschmark during both periods, variability has been low during both periods. In the case of sterling and major non-Community currencies such as the dollar and the yen, which have all been floating freely against the deutschmark, short-term variability has been high during both periods.

Effective rate variability gives the same pattern as that of bilateral rates. The weighted average month to month variability of EMS currencies against all major currencies, both inside and outside the EMS, has also been significantly less than the weighted average month to month variability of the dollar, yen and sterling against all currencies - largely of course, because for each EMS currency the combined weight of other EMS currencies in the basket used to calculate the weighted average change is fairly heavy. Thus the EMS has been pretty successful in reducing short-run instability in

the exchange rates of the participant countries. On this point the evidence appears to be clear and unambiguous.

In the view of a majority of economists, the real disadvantage of floating rates, as they have operated over the last 11 years, is that they have led to exaggerated movements over the medium term unrelated to the underlying changes in countries' external payments positions, to "over-shooting" and "misalignment" of exchange rates - i.e. to exchange rates which have been incompatible with a structure of external payments for the country concerned that is sustainable in the medium term or which, to use John Williamson's definition, have shown a persistent departure from their long run equilibrium levels.

In this context it is more instructive to look at real exchange rate variability (since large movements in nominal exchange rates over a period of several years may simply offset large differentials in inflation rates).

Table 3
Real Exchange Rate Variability Between EMS Currencies
(Average and maximum deviations from trend)

	Average		Maximum	
	1974-78	1979-83	1974-78	1979-83
DM	2.6	2.4	16.8	8.5
FF	4.0	2.5	15.1	8.8
Lit	2.3	1.4	16.9	7.0
HFl	1.4	1.5	6.7	6.5
FB/Lux	1.7	1.8	6.0	8.1
DKr	1.7	1.8	7.5	10.2
Irl	2.0	1.7	14.3	8.4

Table 3 shows that there has been a very substantial fall in medium term real exchange rate variability between the seven currencies which make up the EMS in the five years since the system was established compared with the preceding five years. For France and Italy both the average and the maximum deviation from trend has decreased dramatically. It is interesting to note that for Italy, which participates in the exchange mechanism with 6 percent margins rather than the usual 2 1/4 percent, the improvement has, if anything, been greater. For Ireland, which previously was part of a currency union with the UK, the average has declined a little and the maximum has been nearly halved. For the Netherlands there is virtually no difference in either measure between the two periods. Belgium-Luxembourg and Denmark have experienced virtually no change in the average but the

maximum was somewhat greater since the EMS was established because both countries were already suffering from large structural balance of payments deficits in the closing years of the last decade and in both cases a substantial downward adjustment of real exchange rates has been an indispensable element in the strategy of the authorities for restoring external balance.

Because the EMS countries conduct a high proportion of their trade with each other the stability of intra-EMS real exchange rates is reflected in the behaviour of the EMS countries' real exchange rates vis-a-vis industrial countries as a whole. Since 1979 real exchange rate variability, measured against a basket of all industrial countries' currencies (both those inside and those outside the EMS) has been substantially less for EMS currencies than for the major freely floating currencies such as the US dollar, yen, pound sterling and Swiss franc (see table 4). In short the system has functioned in such a way as to attenuate the misalignment induced by the exaggerated movement of the major outside currencies.

Table 4
Real Exchange Rate Variability Against All Currencies
1979-1983

	Average	Maximum
EMS Currencies		
DM	3.3	13.1
FF	1.8	8.2
Lit	2.4	10.1
HF1	2.1	11.2
FB/Lux	1.8	11.6
DKr	3.1	12.2
Irl	2.2	12.3
Average	2.4	11.2
Other Currencies		
\$	3.0	16.6
Yen	5.0	29.1
Pound	7.1	41.5
Sfr	4.0	18.4
NKr	2.0	9.7
OS	2.1	8.7
Average	3.9	16.1

Exchange rate variability within the system is composed partially of the day to day fluctuations within the permitted margins and partially of changes in central rates, normally known as realignments. Since the EMS went into operation there have been seven exchange rate realignments between the participants. The increased frequency and size of these realignments are cited as evidence of the inability of the system to achieve its objectives. This seems to me altogether too naive and simplistic a way of looking at the matter. Clearly, the more perfectly the mechanisms of policy coordination between the member states are working and the greater the convergence of economic performance that is achieved, the less frequently exchange rates will have to be adjusted. But nobody expected perfect convergence from the start. It was always accepted that this would be a slow process and that during the transitional period exchange rates would have to be changed from time to time; although it was hoped that the frequency of such adjustments would gradually decrease. Over a year has now passed without a realignment.

Of course the need to carry out fairly frequent adjustments does reflect shortcomings in policy coordination and a failure to achieve substantial convergence of economic performance. But I believe that there are also positive conclusions to be drawn from the way in which exchange rate changes have been managed in the system. Adjustments have for the most part been carried out before exchange rates have had time to get really badly out of line, and for this reason, they have usually been quite small (although, for certain currencies, the cumulative changes over the whole five year period have been considerable in nominal terms). These factors may help to explain why, with one or two exceptions, realignment operations have not been preceded by speculation on a truly disruptive scale. Moreover, the adjustments have, in all cases, been in the direction indicated by fundamental economic factors - i.e. by relative trends in costs and prices and/or the behaviour of current balances. In most cases they have, cumulatively, produced a discernible shift of the real exchange rate in the appropriate direction, and in most cases these real exchange rate changes have been followed by changes in current account performance, relatively to the other countries in the group, in the direction that was intended.

Thus I think it is fair to claim that, as an instrument for managing the exchange rates of a group of countries whose economies are closely integrated, but whose economic performance is still divergent in important respects, the EMS has proved rather successful. Exchange rate changes have been carried out smoothly and early enough to ensure that

serious misalignments between participant currencies did not occur. At the same time overshooting has been avoided and so far there has been no case of a member state adjusting its exchange rate in one direction and subsequently having to propose a corrective adjustment in the opposite direction. The avoidance of serious misalignments is probably one of the main reasons why commercial frictions and protectionist pressures have been less in evidence in the EMS countries than in certain other major industrial economies.

Expectations about exchange rate changes dominate capital flows prior to realignments, while nominal interest rate differentials become predominant after the realignment has been decided. This has caused some departure of monetary aggregates and/or interest rates from the desired path or level, but it is the cost of avoiding overshooting of the exchange rate. This cost will be minimized when the size of realignments can be contained to an amount not much larger than the allowed margin.

In summary therefore considerable progress has been made in achieving exchange rate stability, but the experience with the underlying goal of monetary and price stability is so far less encouraging, although there has been some progress. Previous experience has shown that monetary stability will not be achieved through the use of one instrument alone. Of greater importance to the longer term development of the system is how the exchange rate constraint is being used in conjunction with other policy instruments to develop increased policy coordination.

4. Monetary Coordination

The process of monetary coordination has been developed further in the Community than in other international organizations. This is partly because of the close political ties and the limited regional nature of the group, but it is also because of a developing institutional infrastructure and because the exchange rate commitments of the EMS tend to make the Community's surveillance process more concrete. In contrast to procedures elsewhere, coordination through conditional credit has not developed as much in the Community.

4.1 Institutional Infrastructure

The Council

Economic decision making within the Community is coordinated through the Council of Ministers in which the finance ministers meet approximately every month, and through the summit meetings of Heads of State which are held three times a year. Also the Commission presents an annual assessment on the basis of which the finance ministers are required to adopt an annual report on the economic situation in the Community and to set economic policy guidelines to be followed by each Member State.

The Monetary Committee and the Committee of Governors

The Monetary Committee, composed of high level officials from the national treasuries and central banks as well as a representative from the Commission, has an important role. The Committee meets regularly to discuss a wide variety of issues. Every year there is a detailed discussion of the appropriate targets for monetary aggregates in each of the member states, the implications which a given rate of monetary growth may have for interest rates, inflation, real growth and the balance of payments and, of course, exchange rate relationships between the member countries. We try to arrive at some sort of consensus on what kind of monetary policy is appropriate for each country and this is expressed, to the extent possible, but in quantitative terms. Naturally there is no absolutely binding commitment by member states to adhere to the monetary guidelines which are suggested in the policy papers prepared for these discussions by the Commission staff. But these discussions do force members to face up to the probable external consequences of their domestic policies and they have proved to be an effective means of exerting pressure on countries to modify internal policies when this appears to be necessary to avoid serious strains on their exchange rates.

Of course, for those countries which target on the money supply (in one form or other) as distinct from domestic credit or the exchange rate, the need to maintain the exchange rate within predetermined limits can pose problems if the central bank is forced to intervene on a large scale in the foreign exchange markets. In fact the only EMS country for which money supply (in this case central bank money) is the main target variable is Germany. Generally speaking I think it is fair to say that the need to intervene has not seriously impeded the Bundesbank in the pursuit of its monetary target. The growth of central bank money has been successfully kept within the target range in each of the five years since the EMS was established. What has happened in practice is the realignments have usually been carried out before speculative capital movements have had time to build up to a level at which intervention would have caused the Bundesbank's money stock target to overshoot too seriously.

The Committee of Governors meets monthly in Basel and its discussions are focussed on exchange rate and monetary policy issues, with the Commission playing a lesser role than in the Monetary Committee.

The Commission

The Commission has the right to address Recommendations to member countries whose policies appear to be inconsistent with the goals of the Community. The Commission has used this right on a selected number of occasions, the most recent one being during the summer of 1981. In the course of 1981 it became clear that there were serious disequilibria in some EMS member states and that the goal of convergence on a low rate of inflation was threatened. The Commission reacted by addressing Recommendations to the governments of Belgium and Italy. These Recommendations called for certain budgetary restrictions and emphasized the need to reduce wage and salary indexation.

4.2 Surveillance and Exchange Rate Realignments

The interaction between the exchange rate mechanism (ERM) and the overall process of monetary cooperation in the Community is a complex process. The experience so far has shown that having a rule has given focus to the process of cooperation and has reduced the tendency for members of the system to delay or fudge decisions. From time to time concrete decisions have to be made not only about exchange rates but also about all the policy variables which enter into their determination. Of course there are costs. Our theoretic understanding of the world would suggest that some types of shock are better absorbed by allowing the exchange

rate to float freely, but in the real world it is not always possible to switch costlessly between policy instruments choosing the optimum one for each given disturbance without loss of credibility.

Formulating the rule in terms of exchange rates can be justified on a number of grounds. First, it is now well accepted that exchange markets are asset markets and so exchange rates tend to behave like asset prices. This has some awkward consequences for small open economies where the exchange rate is a very important variable in the whole price determination process. Excessive fluctuations can lead to inflationary spirals and misallocations of resources. Second, in a world of highly mobile capital the exchange rate is very responsive not only to actual but also to expected policy changes. Focusing on the exchange rate can often, therefore, lead to ex-ante policy coordination. Third, the exchange rate is the most obviously shared variable. Between n countries there are only $n-1$ exchange rates. Finally the exchange rate poses no data collection or compilation problems. The information is immediate and continuous.

The exchange rate constraint of the EMS is not intended to achieve the aims of the system by itself. Rather than being a firm rule for the conduct of policy or a part of policy, it is a flexible constraint. There are no rules about the frequency or size of changes in central rates, apart from the rule that these have to be made by common decision. It is through realignments that the vital interaction between the exchange rate rules and discretionary policy coordination can be seen.

Exchange rate realignments within the system have gradually come to provide the most effective occasions for reappraisal and redirection of national economic policies, even though this result derives more from actual practice than from the texts which form the legal basis of the EMS. Essentially what has happened is that the constraints imposed by fixed exchange rates have forced the participant countries to pay greater attention to external factors in framing their policies. Although a fairly elaborate institutional machinery for the coordination of economic policy already existed before the EMS was established, it had not in practice produced any noticeable results. There were for example provisions for coordinating budgetary policy and budgetary guidelines were fixed every year by the Council of Ministers. Guidelines for monetary aggregates were also laid down and there were frequent discussions of monetary and exchange rate policy within high level committees such as the Monetary Committee and the Committee of Central Bank Governors. The fact is, however, that neither "guidelines"

nor an obligation to consult are really effective as constraints on policy makers. If a budgetary or monetary target is exceeded, the authorities of the country concerned may or may not do something about it and if they do decide to do something about it they may proceed with a greater or lesser sense of urgency, depending upon how seriously corrective action will interfere with other objectives where, to put it crudely, the return, in terms of political popularity may seem to be greater.

An exchange rate constraint, by contrast forces the authorities to take a decision. A deficit country whose currency falls to its lower intervention limit in the EMS band cannot finance official intervention indefinitely. It cannot even borrow indefinitely - although it is certainly true that some deficit countries have managed to spin out the borrowing process for long time, thereby storing up problems for themselves at a later date. The need to defend a particular exchange rate forces a deficit country to face up to the inevitable necessity of external adjustment and to make a conscious decision, shared with the other Member States, as to how that adjustment will be carried out: by acting on the level of incomes (deflation of internal demand), or by acting on the relative level of prices (devaluation), or by some combination of the two.

The early realignments were not accompanied by any real discussion of the economic policies being pursued, although in some cases member states took note of the intention of the governments of those states whose currencies were being devalued to take certain measures. The devaluation of the Belgian franc on 22 February 1982 represented a turning point in the appreciation of the implications of the EMS for economic policy, in that general agreement to the adjustment was made on the basis of governmental declarations of major policy changes. Following the devaluation, the Monetary Committee decided that it would conduct special examinations of the economic and monetary situation in Belgium, the first of which took place in October 1982.

Subsequent realignments were associated with an equally fundamental reorientation of French economic policy, aimed at reducing the rate of inflation and eliminating the external trade deficit.

4.3. Conditional Credit

The ease with which it has been possible for deficit countries to borrow on international capital markets since the mid-seventies has to a large extent freed them from the need to use the Community's official conditional credit

facilities and has thus enabled them to escape the constraints upon their economic policies which these entail. This state of affairs has somewhat blunted the effectiveness of the Community's credit facilities as instruments of economic policy coordination.

The first Community loans to which economic policy conditions were formally attached were those granted to Italy and Ireland in 1976. In the case of Italy, the economic policy conditions, which were reviewed periodically, consisted of two "final" targets for the rate of inflation and the current account balance and a series of "intermediate" targets relating to the growth of public expenditure, to the size of the budget deficit, to its monetary financing and to the expansion of domestic credit. In the case of Ireland, the economic policy conditions, which were subject to similar periodic review, dealt with the central government borrowing requirement, the share to be financed by non-monetary means and the need to avoid any relaxation of monetary policy.

In the case of the Community loan extended to France in the Summer of 1983, a package of restrictive measures had already been introduced by the French government a few weeks earlier, following the exchange rate realignment in March of that year. It was considered that these measures offered sufficient assurance that the necessary internal and external adjustment would be achieved and the decision of the Council which approved the loan referred specifically to them.

5. The EMS and the International Monetary System

In some respects the existing set of arrangements in the international monetary system has performed well over the period since the breakdown of the Bretton Woods system, and it seems certain that the previous arrangements would have been too rigid to cope with the events that were seen during the 1970's. That of course leaves open the question of whether the same events would in fact have occurred if a different and less flexible system had remained in place. Although opinions differ widely on these questions, it is generally agreed that at least some modifications to our current set of arrangements are desirable. The Versailles summit set up the intervention study group and the Williamsburg summit "invited the Ministers of Finance, in consultation with the IMF, to define the conditions for improving the international monetary system."

The EMS must coexist with the international monetary arrangements. It cannot and does not seek to isolate itself from the rest of the world. While the international system is in a rather fluid and evolving state, two questions need

to be answered. First, does the EMS make life easier or more difficult for its members under the prevailing circumstances? Second, is the existence of the EMS likely to assist the development of a more cohesive international system?

5.1 Compatibility with Existing Arrangements

The most outstanding feature of the international monetary system over the 1970's has been the short and long term variability of exchange rates, and the achievements of the EMS in relation to this topic has been discussed above. It might however be argued that the attempt to form a zone of greater monetary stability with an exchange rate rule as one of its primary instruments has made Europe excessively concerned about exchange rate changes.

Europeans frequently complain about the problems which a volatile dollar has caused for the EMS as a whole and for its constituent members. Some of these complaints are disingenuous and exaggerated. But an unstable dollar can complicate Community economic management. In the first place when funds move out of dollars the flows are not distributed evenly among EMS currencies, but go predominantly, in the first instance, into the deutschmark. This can uncover latent tensions within the system, but it has at times also produced tensions even when the competitive position of the other countries vis-a-vis Germany appears to be healthy and their balance of payments in good shape, because the deutschmark is the only EMS currency which is widely used internationally. In these cases EMS currencies other than Germany may find themselves forced to devalue or to deflate or to run down their reserves simply because of what is happening to the dollar. Secondly, large changes in the real exchange rates of major third currencies such as the dollar and the yen can have far-reaching effects on resource allocation in the Community, whose economy is relatively open and whose producers tend to be more strongly influenced by external developments than is perhaps the case in the United States. As discussed above, the EMS has attenuated these effects. It also provides its members with extra resources to ride out temporary fluctuations in exchange rates. The very short-term financial mechanism, which has been extensively used, is a form of reserve pooling.

5.2 The EMS and the International Monetary System

When it was set up a number of fears were expressed that the EMS was swimming against the tide of the international monetary system, that it could undermine the IMF and that the ECU could compete with the SDR. The record shows that the

EMS is innocent on each of these counts and that furthermore it has given some useful cohesion which has allowed Europe to be more constructive in the on-going debate about the international system.

Since it was set up there has been a decrease in the polarisation of the fixed versus floating exchange rate debate. The EMS was initially characterised by some as a naive attempt to re-establish a fixed rate system in the middle of a world which was moving steadily towards floating rates. The five subsequent years have shown this view to be false. First, as discussed above the system does have an exchange rate constraint but a very different one from that of the Bretton Woods system. Second there has been a general movement towards questioning the benefits of unconstrained floating. The IMF's table of exchange rate arrangements shows that only eight currencies are classified as floating independently. It is now recognised that different arrangements may be more suitable for different countries or groups of countries. Also there have been an increasing number of suggestions, including those of Paul Armington and of John Williamson, for schemes which would allow greater management of all the important exchange rates. It seems increasingly clear that the world can live with groups of countries choosing the final details of the particular arrangements which suit them according to criteria like their openness and hence the magnitude of the impact of the exchange rate on their domestic price structure. A greater organisation will not necessarily come from all applying exactly the same rules; it will come from increased discretionary policy coordination.

The Community countries have been highly supportive of the IMF, and the EMS arrangements do not create any conflict. The Exchange rate arrangement is compatible with Article IV which expressly recognises the possibility that the member countries of the IMF may adopt "co-operative arrangements by which members maintain the value of their currencies in relation to the value of the currency or currencies of other members." The EMS countries in accordance with the procedures of Article IV of course informed the IMF when the system was established and keep the Fund fully informed when there are exchange rate realignments.

The EMS does not create extra difficulties for the Fund's surveillance procedures. Each Community country is subject to an annual consultation in exactly the same way as any other member. The Fund now intends to put more weight on exchange rate developments in these consultations and in its discussions on the world economic outlook. There may be

occassions in the future when the Fund considers that some country participating in the EMS should change its exchange rate. The country concerned could not implement this advice without triggering a general realignment within the EMS, or without the common agreement of the other EMS countries. As well as the obligation to consult with the others laid down in the rules, the mechanics of the system are such that one central rate cannot change without all the others changing. This is because the central rates are expressed in terms of the ECU, which is a basket of all the currencies. There is however no necessary conflict. The object of the system is not to maintain a given set of exchange relationships for ever.

The EMS does offer its members the possibility of extensive credit facilities, which could entail the danger that it would undermine IMF conditionality. Two points should however be kept in mind. First, as has been discussed above the EMS exercises a broader and earlier form of conditionality on its members through the exchange rate arrangements and especially through the realignment process. Second, there is no reason to assume that the conditionality attached to Community credit need be any weaker than that attached to IMF credit. It therefore seems that any clash between the two is likely to be more apparent than real.

6. Monetary Identity and the ECU

6.1 The Official ECU

The development of the ECU has fallen short of the aspirations that were voiced in the Brussels Resolution - at least so far as official use of the ECU is concerned. ECU are not extensively used by central banks for settlement purposes. As an asset, they are precarious, on the one hand, because they are created by means of a temporary swap system with no indication as to what may happen after the transitional stage, and, on the other, because the volume in existence is unstable, given that it depends on variables which are themselves extremely volatile - the price of gold and the exchange-rate of the dollar. Their attractiveness as an asset is further circumscribed by their limited acceptability (creditors are under no obligation to accept ECU except in settlement of a claim maturing under the very short-term financing facility and only up to 50% of that claim). Accumulated creditor positions in ECU are not convertible, and the yield is low (being an average of official discount rates). For all these reasons, ECU are only used on a small scale even in cases where debtors are

explicitly entitled to use them. A new type of operation has, nevertheless, been introduced, with swaps between ECU and national currencies being utilised in order to mobilise available ECU. As things stand at present, the ECU is considered not so much a reserve asset as a means of credit that will eventually have to be settled using other assets.

From 1979 to 1983, about 80% of very short-term financing operations were unwound without recourse to the ECU through offsetting or advance repayments with creditor currencies. The cumulative amount of settlements in ECU is of the order of 2.000 million ECU over the whole period. This figure compares with a total ECU stock of 53.000 million at end-1983. Voluntary transactions have resulted in net repurchases of ECU, which is also indicative of central banks' efforts to hold down the level of net ECU balances.

6.2 Private Use of the ECU

In sharp contrast with the marked lack of enthusiasm for the ECU in official circles, use of the ECU in the private sector has been highly encouraging. The short-term ECU market (interbank market and short-term transactions) is at present estimated at 10.000 million ECU; the volume of long-term issues totals 3.300 million ECU - making the ECU the currency unit with the third largest share in euro-market borrowing in 1983; outstanding medium-term syndicated bank credits amount to about 2.000 million ECU.

This may be a promising development both for European monetary cohesion and for the resistance of the EMS to external shocks. Freer use of the ECU in commercial and financial operations in Europe would require increased coordination of policies and thus contribute to convergence. More extensive international use of the ECU for invoicing, settlement, borrowing and investment would also help to reduce the impact of external shocks, and spread it over the entire set of Community currencies.

So far the role of the ECU in private credit markets has developed more or less spontaneously, with varying degrees of approval on the part of individual member states. But the ECU market is now so large that a more uniform response to market needs is required from the national authorities of Community countries.

7. Strengthening the EMS

So where do we go from here? It is fairly clear that governments, inside the Community as indeed outside it too, are disinclined at the present time to take any very bold or far reaching initiatives in this field. In particular national governments are most reluctant to take any steps which involve an obvious abandonment of formal autonomy in matters of economic policy making - however illusory the autonomy of small or medium sized economies in today's interdependent world may be - to some supranational or collective institution. Therefore, if we are to make progress it is likely to take the form of small and not unduly ambitious improvements to the present arrangements rather than of grand designs for sweeping reforms.

What improvements can realistically be envisaged?

So far as the exchange rate arrangements are concerned, the improvement which the Commission would most like to see is the full participation of sterling. The arguments against this, based on the incompatibility of a fixed exchange rate with the pursuit of an internal money supply target no longer sound convincing. If Germany can reconcile the pursuits of, both objectives, then the UK should be able to do so as well, although I do think it would be prudent to recognize that this particular balancing act may sometimes prove difficult if we have two large countries in the system trying to perform it, instead of just one as at present, especially when both the currencies concerned are widely used internationally. Nor do I believe that the fact that sterling is a "petrocurrency" any longer constitutes an insurmountable obstacle. No doubt demand for sterling will continue to be influenced by fluctuations in the price of crude oil, but there is no reason why upward or downward pressure on the exchange rate thus induced should not be dealt with by use of the reserves, Community credit mechanisms, the exchange rate, or some combination of these.

Another possibility is that the +/- 6% margins which Italy has operated since the system was launched might be narrowed, all or part of the way towards the +/- 2.25% applied by the other countries. I think it is only fair to say that wider margins were a necessary condition for Italy's participation in the EMS exchange rate arrangements and they have enabled the Italian authorities to manage their exchange rate smoothly, without crises and trauma. On the other hand margins as wide as this do weaken the constraint which the exchange rate exerts on policy makers. Even in the turbulent period of the last 5 years the Italian authorities have not

often had to make full use of their wider margins and I believe that in the more stable environment which may reasonably be foreseen for the next few years they could live with narrower margins.

It has sometimes been suggested that exchange rate realignments within the system should be timed in such a way as to anticipate exchange market pressure, and thus avoid speculation. At first sight this seems eminently desirable - to the extent that it is possible. But in fact, if the need for exchange rate adjustment is not obvious to the markets, then it may not be obvious to the authorities either. This in turn means that such realignments if they can be agreed upon at all, will tend to be small and if realignments become smaller then, unless inflation differentials become smaller too, the need for realignments will arise more frequently. So there is a danger that this approach might transform the EMS into something very close to a "crawling peg" regime. Many people, I know, would see no harm in that. Our own feeling however is that if the process of exchange rate adjustment was dedramatized too much, then the exchange rate would cease to operate as a constraint on economic policy and its effectiveness as a stabilizing influence, which is one of the most positive features of EMS experience, would be greatly weakened. At a time when inflationary forces remains strong this would be most regrettable.

Obviously, greater convergence of economic performance will do more than anything to help the exchange rate arrangements to work smoothly. In these conditions exchange rate changes could be both small and infrequent. What can we do to further the development of such conditions?

One line of action which I should like to see followed would be for all our member states to declare formally that they will in future abstain from unilateral recourse to restrictions on current payments (e.g. limits on tourist expenditure, import deposit schemes). Such measures have been imposed temporarily by certain members from time to time. In my view they are inadequate as a substitute for more fundamental measures and unnecessary as a complement to them. At the very least their use should be conditional upon the prior agreement of the rest of the Community.

But the most important requirement is that we should improve surveillance and coordination of our members economic policies. In particular I believe that we should pay more attention to coordination of budgetary policy and to ensuring that the mix between monetary and budgetary policies contributes to exchange rate stability. Up till now there

has been a tendency for too much of the burden of maintaining exchange rate stability to fall on the shoulders of the monetary authorities. Budgetary policy has all too often been framed without due regard to the consequences for the balance of payments and the exchange rate. Belgium, Italy, Denmark and Ireland are all examples of EMS countries where budgetary policy has seriously weakened the external position.

I believe that we should also make more strenuous efforts to ensure effective surveillance of member countries' external borrowing. As I mentioned earlier, the ease with which countries have been able to borrow on the international capital markets has encouraged some of them to borrow in circumstances where there should have been more emphasis on adjustment. The Community has a number of official and conditional credit facilities available. If these had been used and appropriate conditions had been imposed and observed, I think the external position of some of our member countries today might be considerably healthier than it is. It is important that we should make more active use of these conditional facilities in future.

As regards strengthening the official and private role of the ECU we could envisage:

Firstly, an increase in the acceptability of the ECU as a central bank reserve asset by abolishing or reducing the present limitations on its use and increasing the yield available on it;

Secondly, we should seriously consider allowing central banks outside the Community to hold ECU as reserve assets if they wish to do so. This might, for example, be an attractive proposition for countries which conduct a high proportion of their total foreign trade with the Community and which, under present arrangements, may find that the purchasing power of their reserves, in terms of the currencies which they need to pay for imports, can fluctuate unpredictably and alarmingly;

Thirdly, removal of those legal restrictions on the private use of the ECU which still, regrettably, survive in certain member states and which thus constitute an obstacle to the further integration of Community financial markets.

If the somewhat antiquated structure of Europe's economy today is to be transformed and equipped to meet the challenges of the future, a massive increase in investment, in new technology and new industries, will be required. Much of the finance for such investment will no doubt continue to come, as it has in the past, from the reinvested profits of

industry. But the role of equity investment must not be neglected. At present, equity investment plays a far less significant part in the financing of private business in the Community than is the case in the United States. To a large extent this is because there are still numerous obstacles and restrictions, both legal and administrative, to the free flow of capital and investment income between member states. The abolition of such restrictions and the development of a fully integrated Community capital market is a necessary, although of course not a sufficient, condition for the increase in productive investment than the modernization of our economies requires.

If we can achieve significant progress in these areas:

- consolidation of the EMS exchange rate arrangements
- improved economic policy coordination
- encouraging the official and private use of the ECU
- development of an integrated Community capital market

then I believe that we shall have created a financial environment that will be much more favourable to non-inflationary economic development than that which exists today. I am afraid, however, that the road is still long and bumpy.