

CONFERENCE ORGANIZED BY THE FINANCIAL TIMES

London, 27-28 February 1984

---

"The City and Europe - A ten-year appraisal"

---

Address by Mr F.-X. Ortoli

Vice-President

of the Commission of the European Communities

---

"The European Monetary System - Achievements and prospects"

---

1 I am to speak to you on the achievements and prospects of the EMS at the end of its first five years. I will concentrate on three main questions:

- first, to what extent has the EMS achieved the objectives initially set for it?

- second, what degree of flexibility has it been able to demonstrate?

- third, what developments may, in the normal course of events, be expected at this stage?

\*

\* \*

1. The EMS was set up in March 1979 in a well thought-out political move:

(a) Although a mini-snake still existed, it was becoming increasingly clear that the floating of currencies threatened all that had been achieved so far in the Community. There was a need to establish a more stable monetary framework for the Community and to restore coherence and predictability to the Community economy.

(b) In strictly monetary terms, the objective was more far-reaching: the European zone of stability was to contribute to a satisfactory international trend and to help create the conditions for a dialogue between major monetary areas.

(c) Lastly, over and above the achievement of integration through the market, a first step was to be taken towards a more fundamental union involving the political decision-making centres. The approach was more pragmatic than is the tradition in European affairs. The Member States and their central banks concluded mainly gentleman's agreements, taking good care to lay the basis for success by building economic requirements into the monetary arrangements and by basing action on:

- first, a rigorous but flexible exchange rate mechanism protected by powerful credit facilities;

- second, a more resolute attempt than was the case with the snake to achieve convergence, which was clearly recognized as a necessary condition of success. Parity changes were to be used only as a last resort, and would therefore

either have to be avoided through prior adjustment of economic policies or would have to be accompanied by a package of economic measures designed to ensure that the parity changes had their desired effect;

- and, third, further development of the system through instruments (the ECU) or institutions (the Monetary Fund) that would fully establish Europe's monetary identity.

At the end of its first five years, the general purpose of the European monetary system remains valid; the Community now enjoys relative monetary stability, and a contribution can be made at the appropriate time to gradually creating the basic conditions for an international monetary system marked by greater stability and more balanced exchange rate relationships.

Experience with the operation of the system must be assessed in the light of the results achieved in pursuing its three fundamental objectives - stabilizing exchange rates, improving economic policy convergence and agreeing on an exchange rate policy vis-à-vis the rest of the world.

- The system has made a remarkable contribution to ensuring exchange rate stability. During the last five years, the volatility of exchange rates within the Community has been contained within limits which are in sharp contrast with the scale of fluctuations of the dollar, the yen and even, to some extent, sterling. The relationships between the exchange rates of the currencies participating in the exchange rate mechanism have essentially remained satisfactory in economic terms.

A few figures will illustrate this: taking the short-term volatility of nominal exchange rates, the monthly variability of the French franc, the Italian lira, the Dutch guilder and the Belgian franc against the German mark ranged between 0.5% and 0.8% in the period from 1979 to 1983, whereas during the same period their monthly variability against the dollar, the yen and even sterling was between 2.4% and 2.7%. The results are just as conclusive if one looks at the variability of real exchange rates.

What is more, the adjustments made during the period broadly offset the differences in inflation, and the relationships between real exchange rates remained much more balanced within the EMS than between the other major currencies.

The results point to fairly satisfactory progress on monetary stability; moreover, businessmen and consumers have had greater certainty about what to expect in the future and have been able to rely on exchange rates that are sufficiently in line with economic fundamentals. Without doubt, this sort of situation holds protectionist forces at bay and consolidates the continental-sized market which is Europe's present and potential strength.

- The EMS has also considerably strengthened convergence within the Community.

The most usual way of demonstrating this is by looking at the convergence of economic trends, particularly well illustrated by the performance on inflation: the average rate of price increases in the EMS countries was 9.3% in the period from 1979 to 1981, with the standard deviation being 5.4%; by 1983, the rate had been reduced to 7.6%, with the standard deviation down to 2.7%. The operation of EMS has thus been accompanied by a narrowing in the dispersion of inflation rates and at the same time by a significant slowdown in inflation.

The fact that the Member States have to assess jointly the consequences of their major economic decisions has led to considerable strengthening of consultation procedures, i.e. more effective coordination, and has enhanced the roles of the Monetary Committee and the Committee of Governors. This has made for growing convergence in economic analyses and economic thinking within the Community.

Furthermore, and this is a point I would like to emphasize, during periods of crisis the existence of the EMS has played an important and perhaps crucial role in the devising of strict adjustment policies. The EMS has perhaps enabled Europe to avoid the danger of breaking up as a result of recourse to competitive de facto devaluations or to protectionist measures, or quite simply because of the clash of conflicting policies.

- The results achieved in coordinating exchange rate policies vis-à-vis non-Community currencies have been more disappointing, which is not surprising, since the main thing here is the form and extent of the dialogue with the major monetary areas.

Floating is very far from having brought the degree of stability and alignment with economic fundamentals that was expected of it. The real effective exchange rate of the dollar has varied considerably in both directions since 1970. If we take 1970 as a base, the average real effective exchange rate of the dollar had fallen by 33% in 1975; in 1980, it was 40% below its 1970 level, while in 1983 it was only 13% below that level. Whatever the reasons for such movements, they inevitably have a very marked effect on the allocation of resources in the world economy, make for financial instability and increase protectionist pressures.

Such variations can create severe strains within the EMS because of the reserve currency status of the German mark, which is in the front line against the dollar. Strengthening the internal coordination of exchange rate policies, participating actively in the current discussions on international monetary questions and speaking with a single voice in such discussions, and improving the dialogue with the United States and Japan - these are the main lines along which action should be taken. I will come back to this in a moment. But let me first remind you that in December 1980, at a conference organized by the Financial Times in Amsterdam, I emphasized the dangers of an international exchange rate system in which there was an undue tendency for exchange rates to get out of line with basic trends. As a remedy, I proposed that relationships between the dollar, the yen and the ECU should, without excessive rigidity, be maintained within "zones of plausibility" 1) that corresponded to economic, commercial and monetary realities in the United States, Japan and the Community, which meant recognizing a risk and organizing ourselves flexibly to deal with it together.

---

(1) The French expression is 'zones de vraisemblance'

2. These reasonably satisfactory conclusions regarding the internal objectives are all the more encouraging when it is remembered that the general context was not conducive to the success of such a bold venture. After all, Europe was alone in seeking to restore relative exchange-rate stability.

(i) Although the 1978-79 increases in the crude oil price again called for major real adjustments in relation to the outside world - under conditions which varied widely from one country to another - since the Community's net oil bill increased from 2.5% of GDP in 1978 to 4.1% in 1981, none of the member countries participating in the exchange-rate mechanism resorted to competitive devaluations.

(ii) What is even more remarkable is that the scheme has also withstood the dollar shock which I referred to earlier. In March 1979, the launching of the scheme was helped by the decision taken in November 1978 by the United States authorities, in agreement with a number of central banks, notably those in Europe to pursue a policy of intervention on foreign exchange markets. Despite the strains resulting from the radical change in American monetary policy since then, European cooperation has held, demonstrating the system's technical capacity and its underlying political vigour.

(iii) Finally, the EMS has survived the 1980-82 recession. Initial situations and adjustment needs were different. Policies have converged only gradually. Through adjustments which are still admittedly too frequent, the EMS has grown stronger (I am thinking of the discipline it imposes) and its objectives have been respected.

(iv) I will conclude this brief assessment by pointing to a relatively unexpected development arising from the setting up of the EMS: whereas the public use of the ECU has remained fairly strictly circumscribed by the provisions initially laid down, the private ECU has spread very quickly on public markets and has demonstrated great adaptive capacity. A number of United Kingdom banks have taken an active part in this rapid development. The ECU market developed first (1979-81) in the form of roll-over credits renewable every three months and granted by private banks. International loan issues<sup>1</sup> denominated in ECU then steadily increased, beginning in April 1981:

---

<sup>1</sup> Excluding Italian Government issues on the Italian market.

these issues exceeded 300 million ECU in 1981, reached 1 980 million ECU in 1982 and topped 2 000 million ECU in 1983. Within three years, the ECU has therefore established itself in third place, after the dollar and the German mark, in the league table of international bond issues, and international ECU bonds totalling 4 000 million ECU are now in circulation on the markets. This growth in the use of the ECU on international financial markets - even if helped by the fact that the Community institutions' issues accounted for some 30% of the total at the end of 1983 - is very largely a spontaneous phenomenon.

While much has therefore been achieved to date, further progress can and must still be made. Monetary stability has improved but is still imperfect, convergence is insufficient and international monetary stability has yet to be achieved.

What is more, the political rationale of the EMS is still there: to demonstrate both internally and externally that we still have the will and political ability to complete the building of the Community, to use Europe's strength to overcome the crisis and to continue the progress towards a common market truly without frontiers and obstacles.

We cannot yet move to the so-called "institutional" phase (which involves the setting up of a European Monetary Fund having some of the characteristics of a central bank). But the system can be consolidated and developed rationally on a fairly broad front.

o

o o

### 3. The EMS can be developed in four ways

- by consolidating the system internally;
- by reinforcing Europe's monetary identity in the world;
- by strengthening the public and private roles of the ECU; and
- by giving a fresh impetus to the process of financial integration in the Community.

### 3.1 Consolidating the system internally

I have told you about what makes the system fragile. There is scope for improvement. This scope must be used: technically, because difficulties still exist; and politically, because the EMS is the one bold step which the Community has taken in ten years. We would thus demonstrate to business and to financial markets both within and outside Europe that we are prepared to use the European dimension to overcome the crisis and to lend all our weight to help establish more satisfactory economic and monetary relations in the world.

The system should be consolidated in three ways:

#### (i) By reinforcing the system technically

Wider acceptance of the ECU in dealings between central banks - facilitated by better remuneration - is within our reach.

#### (ii) By achieving increased convergence through greater discipline

I have already indicated what progress has been made: it is reflected in the growing convergence of analyses and thinking which I have mentioned; in active and increasingly systematic cooperation within the Monetary Committee and the Committee of Governors of the Central Banks; in the discipline imposed by crises within the system, with the establishment of back-up programmes when adjustments are made; and in the conditionality of the Community's balance of payments assistance. But increasing divergence still cannot be excluded.

The system is constructed in such a way that it is only partially binding. This will remain true until such time as there is a transfer of responsibility to the Community. The immediate prospect before us is therefore one of an imperfect coordinating mechanism, the sole day-to-day binding element of which is the observance of declared parities.



What we might realistically hope to achieve is to improve the present coordinating techniques in order to make them more effective. A number of simple decisions would help in this process. They include:

- a commitment not to use certain economic management mechanisms without the Community's prior agreement. I am thinking, for example, of the import deposit scheme which has been used in Italy;
- a more precise definition of "policy surveillance", which should include, firstly, detailed prior discussion on major macroeconomic decisions; secondly, the examination of policies on external indebtedness (whose growth partly explains why the EMS credit mechanisms are little used); and, thirdly, critical evaluation of the results against the stated objectives, accompanied where necessary by Commission "recommendations";
- the requirement that appropriate back-up measures be taken in the event of currency adjustments.

(iii) By arranging the pound sterling's full participation

Without sterling's participation in the exchange rate mechanism, the EMS cannot be fully effective in establishing internal monetary stability throughout the Community and in exercising its external influence.

The arguments advanced against such participation boil down to its possible impact on monetary policy, on the competitiveness of United Kingdom exports, on sterling's status as a petro-currency and on sterling's role as a reserve currency.

(a) On the first point, the difficulty of pursuing a monetary policy which incorporates an exchange-rate objective, I would first of all point out that the exchange rate is in fact already used as an indicator in the conduct of United Kingdom policy; secondly, this constraint has not prevented a country such as the Federal Republic of Germany from successfully pursuing an anti-inflationary policy; and thirdly, the main lines of economic policy in the United Kingdom and in the EMS countries are currently broadly convergent and are likely to remain so in the foreseeable future.

More generally, the Community experience demonstrates that it is perfectly possible to pursue at the same time exchange-rate objectives, provided that they are realistically determined, and domestic monetary objectives; not to mention the nevertheless important fact that the EMS mechanism permits central rates to be adjusted when necessary.

- (b) The argument about the competitiveness of British exports I do not find convincing. I take for granted of course that as and when pound was fully brought into the EMS the exchange rate parity would then be one corresponding to the objective parameters of the economic situation at that time. And, the figures I quoted earlier show that exchange rates realistically defined are easier to defend within the EMS than if they are allowed to float, even under control. Moreover, with 42 % of British exports now going to the Community, compared to 33 % a decade ago, the relevance of determining the pounds' exchange rate against her EMS partners has increased.
- (c) Certainly, the sterling exchange rate is influenced by the price of crude oil, which directly determines the United Kingdom's current account balance; and, some of the OPEC countries' financial assets are invested on the London financial market, exerting a direct impact on the United Kingdom's capital account. It is equally certain that if sterling were a full participant in the EMS an oil price rise on the scale of the 1979-80 increases could push up the sterling exchange rate while depressing the other currencies. But we must not forget that the situation has eased on the oil markets and that this trend seems likely to continue. And the EMS offers enough scope for stabilizing or adjusting exchange rates that we have good reason to believe that the system could cope with the consequences for sterling of an abrupt change in the price of crude.
- (d) We come to the argument that if sterling joined the exchange rate mechanism the EMS would include two of today's four main international reserve currencies, and this situation would be bound to influence the functioning of the system, since a satisfactory relationship would have to be maintained between the mark and sterling. Such problems do exist. But the main requirement for solving them is very close coordination of monetary policies within the Community and a highly coherent policy - of intervention

in particular - vis-à-vis other countries. There is nothing new in this: on the contrary, these are the system's normal operating conditions from which precisely its full advantages - coherence and stability - are derived.

You must not think that I seek to underrate the problems: I do appreciate them, but all in all, I feel that the advantages of sterling's entry into the exchange rate mechanism outweigh the risks, which can be contained:

- for Europe - and therefore for the United Kingdom - it will have the advantage of setting the seal on a most necessary and most convincing mechanism promoting common discipline, convergence in the battle against inflation and consolidation of the common market in all its forms;
- for Europe - and therefore for the United Kingdom - it will have the advantage of extending the only zone of monetary stability, relative though it may be, in the world today, and increasing its size, its credibility and its negotiating power with the outside world;
- for the United Kingdom, at the present stage in her adjustment process, it will have the advantage of providing the additional asset of a currency tied into a mechanism for stability through which exchange rates can mirror, continuously and as closely as possible, the fundamental economic realities relative to their chief trading partners, while preserving a real measure of flexibility in the system.

### 3.2 Strengthening Europe's monetary identity in the world

Economic interdependence has today gone so far that even the dominant United States economy does not have complete economic sovereignty.

In 1955, the share of exports in United States GDP was under 4.5%; in 1980 it was over 10%. It has also been estimated at 20 % of US manufacturing output. So, what of the Community, which exports 12% of her GDP to non-member countries?

Here we can see the risks inherent in the dislocation of the international monetary system, and the importance of ensuring that the dollar can perform in normal conditions its twin functions - as currency of the United States but also as the principal international reserve and trading currency.

"Organizing interdependence" is therefore a task of the utmost importance: from the moment that national responsibilities no longer have full rein, economic management must in part become collective, even if only on a pragmatic basis.

The immediate relevance of this question needs no demonstration: we only have to consider the influence of the United States' fiscal and monetary policies on the international economy, and the decline of the economic and commercial function of exchange rates (which is based on economic fundamentals) relative to their purely financial function.

Of course, it is far more difficult to organize effective coordination with economic powers outside the Community, one of which is in a dominant position, than among the Ten - and even here we still have a long way to go. The fact remains that we cannot abandon our minimum objective, which is to ensure that no major economic policy decisions likely to influence the international environment are taken until their external implications have been evaluated and taken into account.

The need for dialogue is more and more accepted - witness the summits of the industrialized nations, the Group of Five, the Group of Ten and the new interest being shown in the IMF. Dialogue in all its forms should be systematically consolidated and extended to:

- regular and detailed discussions on the external consequences of national policies;
- the role to be played by the instruments we have to hand and the measures to be taken to ensure that the growth of international indebtedness is kept under control;
- the desired direction for improving the international monetary system.

Progress is hesitant. We in Europe are partly responsible for this state of affairs because of our difficulty in asserting our unity and turning it to account, in proposing solutions and in putting forward our view of what the international scene should be like. Some of the remedies are in our own hands.

I will go even further and say that in our joint deliberations on what the future holds we must at some stage consider how Europe's monetary identity could serve to impart a new equilibrium to the international monetary system and restore to us a greater measure of self-reliance. Our problems stem in part from the fact, in itself a source of conflict, of a dominant reserve currency which at the same time is the currency of the largest country. Can we and should we set out on the long road towards a multi-polar system which would involve an extensive, not to say radical, reshaping of the present monetary set-up? No-one knows the answer; but considering the dangers of the present situation, I feel it is high time we thought about it and opted for an approach that is clear in its principles even if cautious in its practical tactics and choice of path. An analysis of this sort will of course oblige us to look more closely at the role we would like the ECU to play.

### 3.3 Strengthening the private and public roles of the ECU

When the EMS was set up, it was decided that the ECU was to be at its centre. We have not got that far yet. Even so, after five years, the ECU is at the fledgling stage. Experience since 1979 with public use of the ECU is far from negligible but has remained strictly, over-strictly perhaps, within the framework fixed at the outset, even though the ECU is beginning to be used as the counterpart in swaps between central banks.

The fact remains that the ECU is used more as a credit instrument than a reserve instrument: practice shows that the principal aim in the management of the ECU is to restore status quo positions, that is to say zero creditor or debtor positions.

The reasons for the constraints on the development of the public role of the ECU are well known.

The amount of ECU issued is largely determined by the price of gold and the dollar's exchange rate; its acceptability remains limited to 50% of the claim; its convertibility is non-existent in the case of net creditor positions; and, its yield is poor - equal to the average of Member States' discount rates.

I suggested earlier that we should endeavour, without acting precipitately, to remove these obstacles. My philosophy is simple: without rushing things, we should pursue a policy of acclimatizing the ECU. If we can secure the progress that can be reasonably expected in developing its public and private use alike, the ECU will be in a position, provided this is seen to be useful and the necessary conditions and resolve exist, to play a more ambitious role. I often mention the idea of an instrument "held in reserve for Europe" that may never proceed beyond that stage but would be available for future use.

Action is needed on three fronts :

- the role of the ECU in the EMS mechanisms must be consolidated as I described earlier;
- the ECU should be increasingly used, where desired, in relations with central banks in non-member countries;
- the private role of the ECU must be expanded; this means removing the obstacles that still prevent it, despite its remarkable breakthrough, from being used more widely on certain financial markets. I have spoken of foreign-currency status for the ECU. Limited changes in the rules would encourage a gradual expansion in its use, and this is an ambition that forms part of the wider plan to create a large European financial market that would be instrumental in regenerating the productive economy.

#### 3.4 Strengthening the process of financial integration in the Community

The structural adjustment of the European economy, a necessary condition for sustained growth, demands a vast productive investment drive to improve competitiveness and modernize plant and equipment, which in turn requires a comprehensive policy attack in the short and medium term. To underpin the investment demand stemming from economic recovery, create a favourable legal and tax environment, make sufficient room in the allocation of economic resources for ploughing back profits, and expand the Community's loan resources: all these objectives together make up the basic frame for the policy we are advocating at national and European levels.

This is the backcloth to the plan for a European market oriented more towards the growth of companies' capital resources which we have put up to the Council of Ministers. There is not the same market in Europe as in the United States, where savings, although less abundant are much more widely used to acquire capital holdings in companies. This points up the weaknesses in the financial structures of the European economies - apart from the City, of course - and, even more, shows how inadequate is the Community's financial integration.

The genuine opening up of a large European financial market would be a powerful factor in channelling savings into capital investments. Linking up stock exchanges, harmonizing legal mechanisms and removing restrictions on the flow of capital available for investment in the growth of the European economy - these would all buttress the process of commercial integration, attract fresh resources into corporate financing and prompt the financial markets in Europe to offer increasingly sophisticated and well-adapted products and services.

If it were decided to take this step, as the Commission proposed last year, the London market could clearly play a key role, on account of the quality and range of services it is able to offer and extensive adjustment and modernization efforts that have been launched.

My conclusions to round off this appraisal of the first five years of the EMS will be brief.

On balance the experience has been a positive one, even though the Community is evidently not yet ready for a system of fixed exchange rates; the fact that Member States need, to differing degrees, to make successive large adjustments

to their exchange rates is an indication that the basic conditions for the transition to an irreversible phase of monetary integration do not yet exist.

Nevertheless, several factors militate in favour of a consolidation of the system:

- external monetary instability is worse than ever;
- tangible progress has been made in securing the convergence of our economies and must be safeguarded at all costs;
- experience of the system's operation has revealed areas in which improvements could and should be made.

Internally, this consolidation should mean technical reinforcement and stronger convergence, supported by sterling's full participation in the system, and it should serve to enhance Europe's monetary stature in the world. Finally, we must ensure the expansion of both the public and the private role of the ECU and speed up the process of financial integration in the Community.

+  
+       +

Any progress in confirming Europe's monetary identity would therefore not only constitute an essential political step but would also help us to make the most of an asset that we have underestimated - the continental scale of Europe, which can also have a monetary facet.