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Monetary Integration in the EEC

by Dieter Gehrman, Hamburg*

Last weeks' dollar crisis which ended with the devaluation of the dollar emphasised once more the need for a reform of the international monetary system. It also brought to the open the necessity to reorganise the EEC monetary relations. The floating of pound and lira seems to support this case.

On April 24, 1972, the European Community resolved to reduce the margins between the EEC currencies from 4.5 to 2.25 p.c. In order to defend this narrowing of margins, the Central Banks of the Community are to harmonise their interventions on the domestic exchange markets. That is to say, they will intervene in EEC currencies whenever these currencies' exchange rates on the relevant exchange markets have reached the highest permissible fluctuation limit of the EEC band. The balances resulting therefrom are to be settled within a month's time, the form of such settlements to be governed by the structure of the reserves. The Central Banks of the Community will intervene in US dollar only if the exchange rate of the dollar on its foreign exchange markets reaches the utmost fluctuation limit permissible according to the IMF agreement.

The reason why the EEC, for its internal sphere, has cancelled the generally welcomed widening of the margins according to the Smithsonian Agreement of December 1971 can hardly be substantiated on economic grounds. Thereby the EEC has thrown away the advantage of greater flexibility and two months later already met with the first failure of this predominantly political way of acting. In the relatively harmless sterling crisis of June 1972 the EEC did not succeed in defending "the snake in the tunnel". Great Britain allowed the exchange rate of its currency to float, Denmark and Ireland departed from the common currency band, and Italy could at that time be prevented from floating its currency's exchange rate only by granting it special conditions. The Italian Central Bank could intervene in dollar instead of EEC currencies in order to maintain its exchange rate within the reduced currency band.

In view of this development the EEC countries should have realised that their fixed exchange rates were not rates of equilibrium, but that the

next monetary crises — at least internally — were already programmed by the reduction of margins. Despite of that — or for this very reason — the government heads of the member states resolved at their summit meeting in Paris in October 1972 that a monetary fund be established by April 1, 1973, although the necessary prerequisites were not yet given. The resolution of the Community's Council of Ministers dated March 22, 1971, provides for the establishment of this fund only after it is justified by the experience made with the reduction of margins and the increasing harmonisation of economic policy. Even the greatest EEC optimists can hardly maintain that these conditions are met. It is true, however, that the creation of the Monetary Fund, which is designed to be the forerunner of a European Central Bank, belongs to the "systematic manner of integration" of the Community. In order to defend the premature and thus unsuccessful reduction of margins, a new instrument is provided which, at least in its initial phase, can hardly meet the requirements.

The Fund is to work on the following principles:

- ☐ Concerted action among the Central Banks for the purpose of reducing the margins between their currencies.
- ☐ Multilateralisation of claims and debts resulting from interventions in EEC currencies, and multilateral settlement of inter-community balances.
- ☐ Use of the European currency accounting unit for these purposes.
- ☐ Management of short-term monetary arrangements between Central Banks.¹

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¹ Cf. declaration of the conference of government heads of the member states of the enlarged European Community in Paris on October 19 and 20, 1972, reprinted in: Europa Archiv, Folge 21, (1972), p. D 504.

Therewith the Fund is nothing but another organ of coordination without any competences in the sphere of monetary and credit policy. But it is especially in this field that it should have autonomous competences so that it can successfully defend the EEC parities. This, however, would call for harmonisation of the internal monetary policy which exceeds the scope of formal technicalities. Without such coordination even small differences of interest rates between the member countries will induce capital movements which will soon require interventions of the Central Banks due to the reduced band between the EEC currencies.

Euro-money Market

The monetary consequences resulting therefrom depend on the strength of capital flows which are decisively determined by the Euro-money market. This international market for short-term capital was primarily due to restrictions of capital movements,² and in the course of time it became more and more a component of the international monetary system. It is, however, not effectively controlled by any of the Central Banks. It acts as a mediator between markets with a high and markets with a low liquidity, and owing to its high degree of organisation and its flexibility the participants of the Euro-money market can make profit of differences in interest within very short periods. As a result of its great volume (estimated at more than \$ 80 bn) it can paralyse the monetary policy of the Central Banks and act as a multiplier in times of crises. The last monetary crises have made this quite evident. However, the Euro-money market has never been the cause of the crises, as has been, and still is often maintained. This is rather attributable to the weaknesses immanent in the Bretton Woods system which are now, at least for its internal sphere, partly preserved by the EEC. By reducing the margins and establishing the Monetary Fund without adequate coordination of the economic policies, the process of harmonising the balances of payments is not improved and a solution of the short-term liquidity problem in conformity with the market is becoming increasingly difficult.

Danger of Inflation

The functions of the Monetary Fund can lead to a postponement of necessary revaluations or devaluations. Indeed, this appears to be very likely since parity changes within the EEC should actually be only the "last means of correction". By the steps made towards a monetary union it was above all intended to preclude such parity

changes in order not to endanger the stage of integration reached so far, especially in the agricultural sector. But if one adheres to unrealistic exchange rates, their defence within the Community may have an inflationary effect.

An additional danger of inflation results from the multilateralisation of claims and debts. This technique may be applied only when counter-rotating flows of payments have accrued at the time of balancing. However, the period between an intervention in a Community currency and the date of settlement will, as a rule, hardly be sufficient for this, so that an extension of the credit periods is probable.³ Apart from these dangers of inflation the Fund will scarcely be in a position to defend the EEC parities when speculative capital movements are initiated by unrealistic exchange rates so that, after all, there remains nothing but a revaluation or devaluation, or a floating of the exchange rates as the ultimate solution. If these measures are considered to be no longer in conformity with its monetary rules, the Community has to introduce exchange restrictions. This is a field in which the EEC has gathered much experience in the past few years. But in doing so it deviates more and more from its proper objective, i.e. the realisation of free capital movements within the Community in order to create a uniform capital market necessary for the Monetary Union. Since 1962 the EEC has not only made no further progress in liberalising capital movements⁴ but, on top of it, has taken national control measures which affect capital movements within the Common Market as much as those with third countries.

Unitary Capital Market Policy

Owing to the differing state of liberalisation within the EEC it is possible that the creditor and debtor position shown by the European Fund reflects the actual situation of the balance of payments in a distorted way. If there is for instance an international speculation for a revaluation of the DM although there is no balance-of-payments surplus, Germany appears as a creditor of the Fund. For in order to defend its parity, the German exchange authorities or the Fund must take up foreign currency. On the other hand, if on account of a balance-of-payments deficit speculations are made against the French Franc it is possible that the account of France with the Fund is not affected because France need not intervene due to its split foreign exchange market and stringent capital transfer controls. If the countries' creditor or debtor positions with the

² For the reasons of formation cf. Dieter Gehrman, Vom Euro-Dollarmarkt zum EWG-Geldmarkt (From the Eurodollar market to a EEC money market), in: WIRTSCHAFTSDIENST, 51. Jg. (1971), Nr. 5, p. 258 f.

³ Cf. Rudolf Morawitz, Der Europäische Fonds für währungspolitische Zusammenarbeit (The European Fonds for Monetary Policy Cooperation), in: Europa Archiv, Folge 19, 1972, p. 670.

⁴ Cf. Dieter Gehrman, Stand der Kapitalmarktiliberalisierung in der EWG (State of Capital Market Liberalisation in the EEC), in: WIRTSCHAFTSDIENST, 52. Jg. (1972), Nr. 5, p. 263 ff.

European Monetary Fund should at that moment be the presumptive evidence for a disequilibrium of the balances of payments calling for adjustment measures, then Germany would have to revalue in spite of its square balance of payments, while France, with a balance-of-payments deficit, could maintain its old par value. In order to avoid such distortions, the EEC states should harmonise at least their policies in the field of capital movements⁵ so that the positions of the individual countries with the European Monetary Fund may reflect the actual changes of the balances of payments. This requirement must also be met if the settlement of balances according to the reserve structure of the individual countries is to make sense. The purpose of this technique is to achieve long-term an adaptation of the structure of the reserves of the EEC member states so that revaluation profits or devaluation losses of a currency may be distributed more evenly among the members of the Community.

However, it is not very likely that in the near future the EEC will pursue a uniform or at least harmonised policy with respect to capital movements so that the task of reflecting the balance of payments situations of the EEC countries cannot be satisfactorily fulfilled by the Monetary Fund either.

New Problems through Great Britain

The near future will probably show more clearly how little realistic the precipitate resolutions of the EEC in respect of monetary policy are. Although Great Britain became a member of the Community on January 1, 1973, the date cannot yet be foreseen on which the exchange rate of the pound will be fixed again. In Brussels it is already assumed that this will be possible at the end of 1973, at the earliest. Since at that time new problems are expected to crop up for the British balance of payments, mainly resulting from the adoption of the EEC agricultural market system, a fixing of the parity can be very dangerous for Great Britain. For if the balance-of-payments difficulties should lead to a flight out of the pound, Great Britain could defend this parity only if it had sufficiently great reserves. If this is not the case, it can avail itself of the Community's mechanism of financial assistance. However, if interventions are made in EEC currencies, it is not clear how these credits can be repaid in time. Another special arrangement would probably have to be made again.

Even if contrary to expectation the British balance of payments would not be faced with difficulties, the entry of Great Britain into the Community will make it more difficult to solve the problem of

short-term capital movements at reduced margins. For with its membership Great Britain has simultaneously brought into the Community the centre of the Euro-money market, viz. London. Its leading position in the Euro-money market was *inter alia* achieved by London's relatively liberal regulations of domicile for banks.⁶

Great Britain will hardly be interested in losing its leading position in the Euro-money market, for the fact that the City of London was able to increase its foreign profits between 1965 and 1971 from £ 210 to 580 mn was not least due to the existence of the Euro-money market.⁷

Further problems for the monetary-wise integrated EEC arise from Great Britain's relatively high indebtedness vis-à-vis the Euro-money market, which forces Great Britain to offer relatively high rates of interest for short-term finance in order to avoid a drain of capital. Through this high level of interest and the different economic situation of Great Britain in comparison with the other EEC countries there is a danger that capital movements are induced within the Community which, at reduced margins and firm parities, will again lead to crises.

Back to Wider Margins

It should give the Community food for thought that the Confederation of British Industry pleads for considerably wider margins. The flexibility regained thereby can at least neutralise interest-induced capital movements in that way that no interventions of the Central Banks are necessary,⁸ so that the reserves of the EEC countries are not affected. The larger the margins between the currencies are, the larger is the scope for national economic policies to realise the overall economic objectives. The EEC should therefore correct its "slip of monetary policy" and wait with the establishment of the Monetary Fund until harmonisation of the economic policies permits a common steering of market conditions. Steps of monetary integration should be made at the end of the process, for it is becoming more and more unlikely that they can pave the way to integration. If for political reasons the Community cannot take this course it should keep its monetary measures pending at least until such time as the new international monetary system is taking shape and it can be seen what role the gold and the dollar will still play.

⁵ Cf. André Vlerick, *Die europäische Währungsunion* (The European Monetary Union), in: *Europa Archiv*, Folge 22, 1972, p. 763.

⁶ Cf. William M. Clarke, *The City's foreign business: role of the banks*, in: *Euromoney*, Dec. 1972, p. 13.

⁷ Cf. *ib.*, p. 13.

⁸ Cf. Klaus Böck, *Symptomatische Pfundkrise* (Symptomatic Pound Sterling Crisis), in: *WIRTSCHAFTSDIENST*, 52. Jg. (1972), Nr. 7, p. 32.