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only be greater disequilibrium in other markets. Intervention to prevent overshooting of a depreciating currency could slow the necessary adjustment in markets for real goods and services and in the current account of the balance of payments, resulting *inter alia* in a higher unemployment rate than would otherwise occur.

This is not a defect peculiar to the OPTICA proposal: any rule that *requires* governments to intervene in specified circumstances is likely, at times, to be counter-productive. But that does not mean that we should have no rules at all: that would simply condemn us to continued anarchy in exchange markets, which I have already argued is undesirable. Rather, it means that we must develop a *different kind* of rule — one that promotes a degree of certainty that policy instruments will be employed, and targets established, in ways that are mutually consistent, and yet which is not itself likely to become a source of market instability.

Rules for Governmental Behavior

Rules for governmental behavior may take two basic forms:

☐ those that specify circumstances in which certain policy actions are required (what may be called, using Biblical language, "thou-shalt" rules); and

☐ those that specify circumstances in which certain policy actions are prohibited ("thou-shalt-not" rules).

The Bretton Woods system and the OPTICA intervention rule are both examples of a "thou-shalt" type of rule. An example of an alternative "thou-shalt-not" type, which I would strongly advocate, is one that simply prohibits governments from selling (buying) their own currency at a price below (above) the lower (upper) margin around its reference rate. Such a rule gives a point of reference away from which an exchange rate cannot be forced by central-bank intervention (rather than a target which must be defended). It offers the advantage, therefore, of restricting the scope for "dirty floating", minimizing the risk of inconsistency among national policies or competitive exchange-rate manipulations, while nevertheless leaving governments free to play as active a stabilization role as they like when market conditions warrant. Assuming reference rates are set and revised by an appropriate procedure such as I have suggested above, this alternative would surely act to reduce uncertainty in exchange markets and to promote stabilizing expectations. It would also have the suppleness to bend like a willow before the force of winds in the exchange markets, which the OPTICA proposal does not. That is why I prefer it as the basis for managing exchange rates.

Uses and Limits of Monetary Mechanisms in the EC

by François-Xavier Ortoli, Brussels *

The efforts to establish a European Economic and Monetary Union have a rational basis. Our nations cannot achieve individual and social welfare if they do not command markets of the capacity demanded by present-day production technologies. This technological phenomenon has implications which manifest themselves in the progressive integration of the national economies. The task devolving on those bearing political responsibility in this context is clear: they must support the undeniable spontaneous tendency towards economic integration by pursuing appropriate policies.

* Vice President of the EC Commission.

Since 1970 the gradually coalescing European area has been exposed to various shocks from outside which pose highly diverse restructuring and readjustment tasks for the individual national economies. The responsible policy-makers have therefore to cope with another task as well: they must take concrete measures related to the contemporary scene in order to minimize the most adverse repercussions of these adjustment processes — high and divergent rates of inflation, a general weakening of the investment propensity, employment problems, and lack of stability in the foreign exchange markets.

While the purely monetary proposals of OPTICA I were intended to contribute to the long-term involvement of a general policy of monetary integration, the proposals of OPTICA II are designed to assist in the solution of immediate difficulties in the sphere of exchange rate policy.

Some salient points of the discussion about the establishment of a European monetary union may with advantage be called to mind before an appraisal of the OPTICA II proposals is undertaken.

Some Key Ideas

The question how exchange rate alterations affect the adjustment process on the one hand and the integration process on the other cannot be evaded. This question is of crucial importance insofar as a monetary union may, in a first approximation to a definition, be characterized as the elimination of exchange rate alterations within the area which is to be integrated. Countless studies have been devoted to this subject; from the point of view of the policy-maker they may be summed up as follows.

While exchange rate alterations are certainly not devoid of repercussions on the "real" economy, there is much evidence to suggest that flexible exchange rates as an instrument are becoming increasingly illusive. Recourse to exchange rate alterations inside the Community will nevertheless remain a useful instrument of economic policy during a transitional period because social and political circumstances may arise, or have already arisen, in which this instrument is for political reasons to be preferred to other instrument combinations because the retention or introduction of fixed exchange rates would in such cases involve politically unacceptable economic and social costs in the short term.

To concede a position of preference to the exchange rate instrument would however undoubtedly be inappropriate, especially if the immediate difficulties referred to above are to be removed, because it would involve the great danger that the essential and largely real economic character of the adjustment process would not be brought sufficiently to the fore. The recent developments should serve as a warning in this respect. The authors of the Werner Report had put the emphasis on the parallelity of economic and monetary development. We must do justice to them at last and resort to the monetary mechanisms only after due consideration and as part of a comprehensive policy.

All this has to be borne in mind when the proposals of OPTICA II (cf. OPTICA 1976, Chapter II)

are subjected to an appraisal. These proposals may be reduced to two basic recommendations.

□ In view of the acute instability of the markets — as the outcome of sudden swings in expectations which result in capital movements and have brought about inordinate exchange rate falls — the report comes to a first series of recommendations couched in very general terms. They provide for a wide range of economic and monetary measures which include in particular intervention in the foreign exchange markets in order to even out short-term rate fluctuations and to prevent an escalation of the inflation. Such an escalation would in fact be triggered by the "mechanical" rise of import prices consequent on an excessive fall of the exchange rate. It is evidently in order to provide the authorities concerned with a somewhat more precise criterion for interventions than the IMF guidelines that OPTICA II recommends a formula which is based on the concept of purchasing power parity (PPP).

The package of measures to be employed by the authorities (OPTICA II rightly stresses its comprehensive nature) must of course make room for the development of the competitive strength of the national economies. This competitiveness can be measured partially, but only partially, with the aid of PPP. Ambiguities and discussions could, in principle, be obviated through application of a statistical formula. In view of the margins of error typically inherent in such formulae however the recourse to purchasing power parity formulae cannot be more than one aid amongst several for those who have to take the political decisions.

Intervention Criteria

□ Secondly the report contains a very precisely formulated recommendation for a system built on the principle that every country should pursue an exchange rate policy concordant with its monetary policy. This maxim needs examining carefully in order to ascertain whether it is compatible with the European integration and conducive to an improvement of the adjustment process referred to earlier. According to the criterion propounded in OPTICA II intervention in the foreign exchange markets serves the purpose of ensuring the conformity of these markets with changes of PPP which in turn stem primarily from a given national monetary financial policy.

But if one goes on to enquire why one should resort to intervention at all (rather than leave it to the markets to determine the exchange rates) one will find that relaxations of monetary policy have a direct effect on expectations and portfolios (capital account) and a delayed indirect

effect, over the exchange rate, on prices. According to OPTICA II recourse to intervention has thus the purpose of preventing that a fall of the exchange rate fans the inflation unduly (through the concomitant rise of import prices), which would normally happen after a relaxation of monetary policy. Since there must be intervention, reserves or borrowed funds must be applied to this purpose.

OPTICA II wants to involve the European Monetary Cooperation Fund in such interventions. Resources of this European fund are to be placed at the disposal of the central banks which have relaxed their monetary policy so that their countries should not in the end be confronted with a higher rate of inflation than they were actually willing to incur as an outcome of their monetary policy. This is why these central banks are to intervene to hold their exchange rate close to a level determined by the purchasing power parity.

Essentially Illogical

In the face of this proposal one has to go back to the basic question whether a commitment to a criterion turning on the concept of independent national monetary policies should be introduced in the bounds of a strongly integrated area and whether the European Monetary Cooperation Fund should be instructed to finance such national policies so as to enable the central banks of certain countries to vitiate what are after all foreseeable consequences of their policy, namely the consequent shifts in their portfolios and capital movements.

The answer to this question is clear. To confine a European policy to support for the independence of the monetary policies of the individual member states¹ would be the very opposite of such a policy while on the other side their national economies are becoming increasingly interdependent. The aim must, on the contrary, be to set out from this mutual dependence and to work for a convergence of policies and developments — and certainly not for support for independence in monetary policy. This approach will solve the fundamental economic problem — the organizational arrangement for interdependence — and do much more for a stabilization of the expectations than would resort to a mechanism. The markets are nowadays well informed and well aware that fundamental market equilibria can only be restored by harmonious coherent and appropriate policies. To sum up: the complex nature and the technical

perfection of the criterion proposed in OPTICA II cannot compensate for its fundamental weakness and, indeed, essential illogicality.

The mechanism envisaged in OPTICA II, it may be objected, is intended as a prophylactic to be used temporarily against the erection of trade barriers by deficit countries rather than as a guideline for the integration policy. The mechanism proposed in OPTICA II would thus have to be regarded as a kind of compromise solution: loans from the surplus countries would enable the deficit countries to do without competing devaluations.

It may be a tempting idea to try to find through the use of a mechanism an objective criterion by means of which arbitrary decisions can be avoided to everybody's satisfaction. The suggested mechanism however is obviously not particularly suitable for this purpose. The real issue is the adjustment policy to be practised by the deficit countries; the surplus countries wish to expedite it, more especially by the application of monetary discipline.

It is difficult to see how the criterion envisaged in OPTICA II can satisfy the surplus countries, considering that in the final outcome this mechanism would ensure the monetary independence of the deficit countries. Moreover, the deficit countries know from their latest experiences how expensive, expressed in percentage rates of inflation, competing devaluations eventually turn out to be. It thus appears that the proposed mechanism does not adequately reflect the relative strength of the partners and for this reason cannot make it any easier to work out compromise solutions.

Back to the Essentials

To advance on the road to the Economic and Monetary Union we must turn back to the essentials: we must achieve the convergence of the policies so as to absorb the reverberations of the shocks which have hit our differentiated but in great measure interdependent national economies since 1970. Monetary mechanisms of the OPTICA II type are unlikely to be of much help to this end. What is needed instead from all is discipline and solidarity. And this implies

- ☐ that the convergence of economic developments in the member states is facilitated by the transfer of real resources within the framework of a general Community policy for the elimination of structural and regional differentials;
- ☐ and that effective coordination of the national policies can be secured through the strengthening of the decision-making process on the Community level.

¹ A criterion of this kind may be found useful in the framework of the IMF which is to regulate the coexistence of countries which are economically less integrated than we are and are not on the way to achieving monetary union.