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Problems of Monetary Integration in Europe

by Hans-Eckart Scharrer, Hamburg *

On December 4/5, 1978 the heads of states and governments of the EC-member states are meeting in order to take decisions on the new European Monetary System agreed on at their Bremen summit. The problems of monetary integration in Europe are discussed in this article.

All of a sudden, monetary integration has again become a political topic for the European Community. Only a year ago, in October 1977, Roy Jenkins, the President of the EC Commission, had been derided for his ambitious initiative¹ to relaunch debate – and action – on economic and monetary union (EMU). Later still, the EC Commission's five-year action programme² prepared for the Brussels Summit meeting on December 5/6, 1977, though being far less explicit, had received a harsh refusal by the Schmidt administration³ (and other governments). But then the rapid fall of the dollar in early 1978, provoked by US "malign neglect", brought about a major – though not complete – swing in the thinking of European policymakers. Stimulated by a German/French initiative, the heads of governments at their Copenhagen Summit on April 7/8, 1978, debated at some length the consequences of the monetary developments. At their Bremen meeting, the European Council discussed a "scheme for the creation of a closer monetary co-operation (European Monetary System) leading to a zone of monetary stability in Europe . . . The European Council regards such a zone as a highly desirable objective. The Council envisages a durable and effective scheme"⁴. Decisions are to be taken at the next Council meeting on December 4/5, 1978.

The communiqué and its annex are rather vague in their description of the scheme's relevant features. Information on the results reached so far in the negotiations of the various EC bodies concerned is scarce, too. From what has become known the following main characteristics emerge:

□ There will be fixed but adjustable central rates for the currencies of participants. Central rates will formally be expressed in terms of the European Currency Unit (ECU), a basket-type of "currency" of the same definition as the European Unit of Account (EUA) presently in use. "Changes

in central rates will be subject to mutual consent"⁵.

□ Market rates will be allowed to fluctuate within margins similar to those ruling in the present "snake". "For a limited period of time countries currently not participating in the 'snake' may opt for somewhat wider margins . . ."⁶ ("boa"). Intervention points are in practice to be set bilaterally ("parity grid" as in the "snake") rather than in terms of ECU. Technically, the need to continuously readjust bilateral margins to fluctuations in the value of the basket itself is thereby avoided. More fundamentally, the responsibility for intervening in the exchange markets is always shared by at least two countries (a weak and a strong currency country) rather than resting with one country alone as might at times happen in the other case⁷. However, it appears that the parity-grid mechanism will be supplemented by policy rules linked to the ECU: fluctuations in a currency's ECU value will trigger automatic interventions (UK and Italian option) or at least consultations on a possible need for interventions (German/Dutch/Danish option) if a currency is deviating from its central rate (expressed in ECU) by 75 % of the agreed maximum margin of fluctuations (also expressed in ECU). In principle, inter-

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¹ Roy Jenkins, Europe's Present Challenge and Future Opportunity, Jean Monnet Lecture, Florence, October 27, 1977.

² Kommission der Europäischen Gemeinschaften: Mitteilung über die Aussichten der Wirtschafts- und Währungsunion, KOM (77) 620 endg., Brussels, November 17, 1977.

³ Finance Minister Apel: "I cannot help feeling that what these plans are about is not so much the political contents of European integration but rather payments obligations." (Orig. German, own translation) BMF Finanznachrichten, No. 67/77, December 2, 1977, p. 3.

⁴ Bremen summit communiqué on monetary policy, reprinted in: BIS Press Review, No. 134, Basle, July 14, 1978 (in the following quoted as: Bremen communiqué).

⁵ Ibid., Annex.

⁶ Ibid., Annex.

⁷ Unilateral intervention puts a premium on the convergence of inflation rates at the Community average.

ventions will be in the currencies of participating countries⁸ rather than in US dollar.

☐ Accounts will be settled in ECUs.

☐ Initially, the central banks' mutual monetary support facilities are likely to be expanded to ECU 25 bn (\$ 32 bn) from the present EUA 8.5–15.7 bn short and medium-term facilities⁹. "The EEC's monetary committee has suggested that credit should be available for up to five years, with conditionality linked to the maturity of the credit. Loans of a year or less would have no strings. All loans will be denominated in ecus"¹⁰.

After a transitional period of two years the European Monetary Fund (EMF) is to replace the existing Fund for European Monetary Cooperation (FECOM). At its start the EMF is envisaged to dispose of 20% of the EC countries' gold and dollar reserves (about ECU 25 bn) and an equivalent amount of the countries' national currencies. In the course of its operation the Fund is to sell and acquire dollars to and from participating countries against ECUs; these transactions will be linked to the exchange market interventions of the national central banks.

☐ Member countries will aim at a common dollar policy.

☐ The scheme is to be supported by an increased transfer of resources from high-income to low-income countries. However, up till now little progress has been made partly because the poor have different demands and there is still some argument about definition of a poor country"¹¹.

In short, the intention is to expand the "snake" to include the currencies floating individually, by

⁸ Bremen communiqué, loc. cit., Annex.

⁹ There are still major differences of opinion on how the EUA 25 bn are to be defined. If interpreted as effectively available credits (the wide, English version) the proposed sum compares with only EUA 8.5 bn now, i.e. credit lines would have to be roughly tripled. If interpreted as the sum of creditor quotas and rallonges (the narrow, German version) the present amount is EUA 15.7 bn so that the expansion required would be "only" 60%. Between these extremes lies the sum of debtor quotas and rallonges (now EUA 12.4 bn).

¹⁰ Snakes in the Basket, in: The Economist, 23-29 September 1978, p. 65.

¹¹ Ibid.

liberalising the present mechanism with respect to the width of the band (for newcomers) and the amount and conditions of credit facilities available. The objective is thus an exchange rate union rather than an economic and monetary union of the type envisaged in the early seventies and favoured by Jenkins. Indeed, judged by its rather narrow functions the European Monetary Fund is no more likely to become the forerunner of a European central bank system than the present FECOM.

Lack of Economic Coherence

The approach is "monetarist" in nature (in the sense attributed to this word in the earlier EMU debate): it is solely confined to the technical — and financial — aspects of exchange rate stability. The economic coherence required to guarantee this stability is believed to be brought about by some invisible hand. In this the new initiative is strikingly similar to the ill-founded 1972 attempt of linking the nine currencies together in an all-EC "snake". The scheme which had started to operate on April 24, 1972, had soon began to crack: after only two months, on June 23, 1972, the United Kingdom and Ireland withdrew under the pressure of heavy speculation; Italy left the "snake" on February 13, 1973; and effective January 19, 1974, France took the decision to have the Franc float individually, too.

Are the economic preconditions for a success of exchange-rate unification better today than they were then? There is general agreement that a close conformity of the participating countries' inflation rates is an indispensable prerequisite for the smooth functioning of any mechanism of fixed exchange rates.

Consequently, in defending their initiative, policy-makers would point to the improvements in inflation performance achieved in most European countries over the last two years and especially in the more recent past¹². This observation while

¹² As an example see: Wilhelm Haferkamp, Fünf Argumente für das Europäische Währungssystem (Five Arguments for the European Monetary System), in: EG Magazin, No. 11/1978, p. 3.

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being correct does not describe the situation adequately. It needs to be added that despite the laudable success the range between the highest and the lowest inflation rates currently recorded in the European Community continues to be higher than it was in 1972 or 1973 when the first attempt failed (see Table 1).

Table 1
Changes in Consumer Prices of EC Countries
(in % over corresponding period of previous year)

| Country | 1972 | 1973 | 1975 | 1977 | 1978Q2 |
|----------------|-------|-------|------|------|--------|
| Belgium | 5.4 | 6.9 | 12.7 | 7.1 | 4.4 |
| Denmark | 6.6 | 9.4 | 9.6 | 11.1 | 10.9 |
| France | 6.2 | 7.4 | 11.7 | 9.5 | 8.9 |
| Germany | 5.5 | 6.9 | 5.9 | 3.9 | 2.7 |
| Ireland | 8.7 | 11.3 | 20.9 | 13.6 | 6.1 |
| Italy | 5.7 | 10.8 | 17.0 | 17.0 | 12.1 |
| Netherlands | 7.7 | 8.1 | 10.5 | 6.4 | 3.5 |
| United Kingdom | 7.3 | 9.1 | 24.2 | 15.8 | 7.7 |
| Max. range | 2.3 * | 3.9 * | 18.3 | 13.1 | 9.4 |

* Excluding Ireland whose currency is linked to the Pound Sterling.

Source: IFS.

How, then, are the perspectives for a further narrowing of the inflation differentials? From the statements of government officials it becomes evident that they expect the (enlarged) "snake" to somehow bring about the convergence of national economic policies which in reality is the basis of the mechanism's proper functioning. Their allegation that experience with the present (Mini-) "snake" had demonstrated the soundness of that reasoning turns out to be based on wishful thinking rather than on a careful analysis of facts. In reality, inflation rates in Scandinavia, but also in the Benelux countries have been consistently higher than in Germany (at least until 1977); they were usually more in line with the rates of the retired "snake" member France. Also, monetary expansion proceeded at higher rates in the smaller "snake" economies than in Germany. Contrary to all solemn declarations to the opposite, economic coordination in the "snake" is working no better than in the European Community at large. This is all the more astonishing since Germany and the Netherlands, the two most ardent advocates of the "economist" principle¹³ in the earlier negotiations on EMU, are members of the group where they appear to have completely discarded their previous convictions. Prime Minister Tindemans, without any doubt an authority in this field, sum-

¹³ According to this principle, economic coordination had to precede any moves on the exchange-rate front. The antagonism between "monetarists" and "economists" was at that time bridged over by a compromise which provided for a *pari-passu* approach. In the end, the "monetarists" seem to have won, however.

¹⁴ Ministerium für Auswärtige Angelegenheiten, für Außenhandel und Entwicklungszusammenarbeit (ed.), *Die Europäische Union, Bericht von Leo Tindemans an den Europäischen Rat* (The European Union, Leo Tindemans' Report to the European Council), Brussels, 1976, p. 31 (own translation from the German version).

marized the present state of economic coordination in the "snake" with the words: "At the moment the obligations in the 'snake' are confined to external monetary policy only"¹⁴.

Also, the material pressure ("Sachzwang") which fixed exchange rates are said to exert with regard to a better harmonisation of the participating countries' domestic policies is often overcompensated by stronger countervailing pressures. The exchange restrictions practiced in the present "snake" – as in the envisaged European Monetary System (EMS) – are moreover demonstrating that most countries are not prepared to fully accept market-induced policy harmonisation.

In the more inflation-prone "snake" countries economic policy has hitherto mainly relied on the international price transmission mechanism to provide for price stability (via imports mainly from Germany). The outcome has only partially come up to expectations. While the pace of price inflation was indeed slowed down the retardation was sometimes less than expected and was achieved at high economic costs: With the appreciation of the "real" exchange rate – at a constant nominal exchange rate – international competitiveness worsened and unemployment increased. Benefits in terms of (imported) price stability were repeatedly outweighed by the costs in terms of (imported) unemployment, i. e. a loss of social stability. Therefore, even disregarding the massive losses of exchange reserves, this policy could have seldom been carried through for long. It is indeed no wonder that especially the Scandinavian countries were repeatedly forced to devalue their currencies vis-à-vis the other "snake" members (Sweden even chose to leave the "snake" on August 29, 1977).

Joint Monetary Management a Precondition

Indeed, the European Council's complete neglect of the problem of policy coordination is quite incomprehensible. This all the more since not only the EC Commission (for many years now) but also Prime Minister Tindemans in his report on European Union delivered to the Council¹⁵ have stressed this basic issue of monetary integration. Given firstly the strong correlation between changes in prices and exchange rates¹⁶ (see Table 2) and secondly the equally strong dependence of the rate of inflation on the rate of money expansion, efforts to harmonise national money supply policies are of paramount importance if

¹⁵ Cf. Ministerium für Auswärtige Angelegenheiten etc., *op. cit.*

¹⁶ See, e.g., the empirical evidence presented by the OPTICA group. Commission of the European Communities: OPTICA Report 1976, Inflation and Exchange Rates – Evidence and Policy Guidelines for the European Community, 11/855/76-E Final, Brussels, February 10, 1977, pp. 11 ff. and 43 ff. (in the following quoted as: OPTICA Report).

exchange rates are effectively to be stabilised in the new system.

In their Annual Report 1976/77 the German Council of Economic Experts have presented a set of proposals for coherent monetary policies with fixed or adjustable exchange rates¹⁷. As to arrangements providing for fixed exchange rates the experts recommend that the central banks' obligation to intervene in the exchange markets in favour of any participating currency be made subject to the condition that the respective country does not deviate greatly and persistently from a jointly agreed path of money expansion¹⁸. According to the experts the demand to agree on a uniform course of money growth appears all the more reasonable since under fixed exchange rates national autonomy in the monetary field is restricted anyway. The sanction – suspension of interventions by the partner countries – would be effective against both, countries whose money expansion is surpassing the jointly agreed target growth path as well as those steering a course more restrictive than agreed.

Looking at the German experience, one may have doubts, though, whether a rather precise management of the monetary base, or of any other suitable aggregate, is technically feasible and economically to be advocated given the interest rate fluctuations likely to result thereof. Anyway, the proposal had deserved a thorough investiga-

tion in the context of the negotiations on the forthcoming EMS¹⁹. The same is true for the Council's variant for adjustable parities. For this alternative the experts propose to jointly agree on a set of coherent – not necessarily identical – national targets and to link the obligation to intervene to the realisation of these targets.

Agreement among EC member countries on coherent, low targets for monetary expansion – as guidelines for the private agents' incomes and price policies and the public sector's fiscal policy – and the authorities' preparedness to enforce these targets against the resistance of private and public pressure groups would be a major step forward from the current practice of unrelated national action in the monetary field. It is only by way of a jointly agreed management of national monetary variables that the European Community has a chance of becoming an area of sustained stability (rather than a mere exchange-rate union, if at all) and eventually a true economic and monetary union. The way in which the negotiations have proceeded so far – with the emphasis on margins, interventions, credit lines, impediments to parity changes and the neglect of the issue of monetary convergence – gives however rise to the suspicion that stabilisation of nominal exchange rates is ranking higher among policy-makers than overall price and economic stability.

¹⁷ Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung: Jahresgutachten 1976/77, Deutscher Bundestag, 7. Wahlperiode, Drucksache 7/5902, Bonn, November 25, 1976, para. 467 ff.

¹⁸ Ibid., para. 497.

¹⁹ Up till now the European Community has only once, in 1972/73, started an attempt to manage the money supply (M₂) according to jointly agreed guidelines (growth rate of real GNP plus normative rate of inflation). This attempt has failed. See Entschließung des Rates der Europäischen Gemeinschaften über die zur Inflationsbekämpfung zu ergreifenden Maßnahmen, Luxemburg, October 31, 1972, reprinted in: Deutsche Bundesbank, Auszüge aus Presseartikeln, No. 83 of November 7, 1972, pp. 2 ff.

Table 2
Statistical Inflation Rates and Changes in DM and Effective Exchange Rates
– Results of Cross-Section Analyses –

| Independent Variable | Equation | t_{β} | DW | R ² |
|--|--|-------------|-------|----------------|
| a) Inflation differences and changes in DM exchange rates ^a 1961–1975 | | | | |
| Change in WPI | $\Delta ER_{DM} = .023 + 1.160 \Delta wpi_D$ | 3.468 | 2.211 | .632 |
| Change in CPI | $\Delta ER_{DM} = 1.309 + .498 \Delta cpi_D$ | .975 | .935 | .120 |
| Change in AVX | $\Delta ER_{DM} = -.182 + 1.049 \Delta avx_D$ | 4.253 | 2.205 | .721 |
| b) Inflation differences and changes in effective exchange rates ^b 1963–1975 | | | | |
| Change in WPI | $\Delta ER_{eff} = -.437 + 1.083 \Delta wpi_{eff}$ | 8.049 | 2.297 | .802 |
| Change in CPI | $\Delta ER_{eff} = -.402 + .802 \Delta cpi_{eff}$ | 2.968 | 1.581 | .355 |
| Change in AVX | $\Delta ER_{eff} = -.245 + .858 \Delta avx_{eff}$ | 8.176 | 1.759 | .807 |

^a Nine countries. ^b 18 countries. Effective rates are doubly weighted by export shares.

Notes: ΔER = compound annual rate of change in exchange rate; Δwpi (Δcpi , Δavx) = compound annual rate of change in wholesale prices (consumer prices, average value of exports) relative to Germany (D) and to the rest of the world (eff), respectively; t_{β} = t-value of regression coefficient; DW = Durbin-Watson; R² = coefficient of determination.

Source: OPTICA Report, op. cit., p. 13.

This lopsided approach entails the risk that at the end both internal and exchange-rate stability will be lost: inflation is likely to converge at a medium or high level when stability-oriented economies are exposed to an uncontrolled expansion of their money stock, originated by vast exchange-market interventions; yet the system may still collapse at an early stage. Neither of these results could be rated a political "success". Indeed, not only the credibility of high-level policy-makers but the seriousness of the EC members' commitment to "deepen" the Community are at stake. The risk could materially be reduced, and yet the potential economic benefits of smaller exchange-rate fluctuations be realised, if the concept of exchange-rate rigidity which is implicitly underlying the present approach were replaced by the principle of gradualism. To give substance to this principle policy-makers would have to agree on economically viable rules for continuous exchange rate adjustments. The mere widening of the band of currency fluctuations (for currencies hitherto floating individually) is obviously not sufficient.

Indicators for Parity Adjustment

A great many models of formula flexibility for exchange-rates were devised in the final stage of the Bretton Woods par value system ("Crawling peg", "gliding parity", "movable band" etc.)²⁰. They generally start either from changes in the levels of official reserves or from the spot market rates quoted in the course of the preceding period (usually one year). Proceeding from these variables the required exchange-rate adjustments are calculated by some formula in regular, short time intervals. Against both approaches certain objections may be raised. They mainly level at the limited reliability of the indicator (reserves) and/or the rather mechanistic approach which is lacking deeper economic foundation (exchange-rate averages). Yet, as presumptive indicators these formulae appear still to be useful.

Also, in 1972-74, the IMF's Committee of Twenty in their intensive discussions on "objective indicators"²¹ have invested a great many thoughts into the issue. Whereas they were not able to come to an agreement the experts have certainly clarified the issues so that renewed deliberations could start from solid grounds. Moreover, one may well ask whether it would be too demanding to expect the EC countries to apply at least those rules among themselves which they were then jointly advocating (in opposition to the US).

²⁰ See, e.g., the contributions in: George N. Halm (ed.), *Approaches to Greater Flexibility of Exchange Rates - The Burgenstock Papers*, Princeton, N.J., 1970.

²¹ See: *International Monetary Reform, Documents of the Committee of Twenty*, Washington, D.C., 1974.

More recently, the independent expert group OPTICA (Optimum Currency Area) appointed by the EC Commission²² developed rules for exchange-rate policy conducive to stabilizing expectations of exchange-market participants and supporting the national authorities in their endeavours to contain the upward movement of the price level; rules which should be acceptable to all member countries irrespective of their current level of inflation.

Contrary to earlier approaches to monetary integration the OPTICA scheme is not trying to fix and support nominal exchange rates. Rather it aims at stabilizing real exchange rates within certain specified margins. The approach may therefore be labelled as the model of a "real" snake²³ - as distinguished from the traditional "nominal" snake mechanism. According to the proposal²⁴ the EC members should manage their exchange rates in relation to reference rates which crawl on the basis of countries' relative price performance (measured in terms of their wholesale price indices). Reference rates are defined in terms of effective exchange rates and are expressed in European Units of Account (EUA).

The scheme is based on the empirically observed strong correlation between relative inflation rates and exchange rate changes. According to the group's investigations, this correlation is particularly strong when effective (rather than bilateral) exchange rates are used and when relative price changes are measured in terms of the wholesale price index (see Table 2): 80% of the variance of 18 currencies are "explained" by changes in relative wholesale prices. "The relationship is an excessively simple one and it does not give any insight into the causal mechanisms at work. Yet it seems to us too good to be overlooked as a prime objective criterion for exchange-rate adjustments. Over longer periods one would not be upsetting equilibrium relationships by forcing exchange rate movements to conform to PPP (purchasing power parity); such conformity is the long-run pattern in a system of flexible rates."²⁵ In the short run deviations of exchange rates from PPP may be considerable. Empirical studies on

²² OPTICA Report, op. cit. Giorgio Basevi (Bologna), Pascal Salin (Paris), Niels Thygesen (Copenhagen) and this author were members of the group, Paul de Grauwe (Leuven) was an associate member. Michele Fratianni and Horst Schulmann of the EC Commission greatly assisted the work of the group.

²³ The term has been created by S.-C. Kolm, *Pour un "serpent" réel*, in: *Le Monde*, April 3, 1976.

²⁴ For a more detailed description and discussion of the scheme see: OPTICA Report, op. cit., Ch. II; Niels Thygesen, loc. cit.; Hans-Eckart Scharrer, *Proposal for an EC Exchange-Rate Scheme*, in: *INTERECONOMICS*, No. 1/2-1978, pp. 3 ff.

²⁵ Niels Thygesen, *Inflation and Exchange Rates. Evidence and policy guidelines for the European Community*, in: *Journal of International Economics*, Vol. 8 (1978), p. 307.

recent UK and Italian experience²⁶ give however rise to some doubts as to the contribution of such deviations to bringing about real adjustment²⁷. The main argument is that a great deal of the effects of observed currency devaluations is of a purely nominal nature, i.e. confined to speeding up the rate of price inflation ("vicious circle"). Therefore, stabilisation of real exchange rates (within certain margins) is not likely to entail economic losses (in terms of forgone adjustment), while it can be expected to bring about certain benefits (stabilisation of expectations, as a precondition for investment and growth).

The OPTICA approach is not inconsistent with stable nominal exchange rates, provided however that member countries are prepared to agree *ex ante* on harmonised rates of money expansion and inflation. The proposal thus makes evident the political and economic "costs" of fixed nominal exchange rates. It constitutes the strength of the OPTICA scheme that — contrary to the traditional and envisaged "snake" arrangement — it cannot be endangered by a persistent divergence between member countries' monetary and in-

comes policies and the resultant variation of inflation rates.

It may perhaps be too demanding to ask that the OPTICA mechanism or any other objective indicator be incorporated into the EMS as a binding rule. Yet, the stability of the system and the internal stability of member countries would be strengthened if the monetary authorities were prepared to accept certain guidelines for exchange-rate adjustment, perhaps in the form of "presumptive" indicators. The OPTICA proposal for adjustments geared by PPP is a suitable model.

Convergence in monetary policy and — as far as divergencies are persisting — adjustable central rates are indispensable economic prerequisites for a proper functioning of the EMS and indeed for its very survival. Neither an ample European Monetary Fund nor an increase in the transfer of resources are substitutes to these elements. It would be politically irresponsible to have a second attempt at European monetary integration fail for a lack of economic substance.

²⁶ See the literature referred to in: OPTICA report, op. cit., pp. 23 ff.

²⁷ This argument in favour of real exchange-rate changes has been put forward most forcefully by Roland Vaubel, Real Exchange-Rate Changes in the European Community: The Empirical Evidence and its Implications for European Currency Unification, in: Weltwirtschaftliches Archiv, September 1976.

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