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Mediterranean countries and compensation for diminution of their sales of agricultural products in the Community,

□ Greater awareness on the part of the Community of its — further increased — economic responsibility to the developing countries (e.g. in the Mediterranean and ACP-regions) and industrialized states with an interest in agricultural exports (incl. still North America, Australia).

The inclusion of Greece, Portugal and Spain in the EC raises a variety of issues (e.g. social, industrial, financial, foreign trade and agricultural questions) as evidenced by the negotiations with Greece. These issues bear in different ways on each of the acceding countries and also on the old members of the EC but are regarded and judged by the new members and the old Community alike as a "package". This is the case because of the general economic ramifications of the individual areas and also because of the

bargaining tactics of combining substantially different questions in a "negotiating package".

The southward extension of the EC will not make its agricultural policy any easier. If anything, it will become more difficult. The common agricultural policy will have to live with the new agricultural problems; it will have to come to grips with them even though it may be impossible to solve them all or solve them quickly. This basically positive and also optimistic view must not however induce us to turn the agricultural policy of the EC into a "beast of burden" for the policy of enlarging the EC. It is only logical that agricultural conflicts which have political causes and are induced by the accession should be tackled and solved by political and general economic measures. It is a prerequisite of these general economic solutions that they should be tenable on grounds of order and finance policy and unobjectionable from the point of view of the people in the agricultural sector who are affected by them.

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## EUROPEAN MONETARY SYSTEM

# The Taming of the Shrew(ish Snake)?

by Manfred Borchert and Helmut Ross, Munster \*

**An article in the last issue of INTERECONOMICS discussed problems of the monetary integration in Europe as they may arise under the new European Monetary System<sup>1</sup>. It dealt more particularly with the exchange rate problems whereas the following contribution is concerned with the intervention and credit mechanism.**

**T**he new European Monetary System (EMS) goes back in a certain currency area — which is almost identical with the EC — to the old "fixed" (though adjustable) exchange rates, the "adjustable peg". This kind of exchange rate system existed after World War II, albeit in a different institutional form, in the Bretton Woods system and later also in the — at times swelling and subsequently contracting — currency "snake".

This snake regularly contracted whenever a member country faced a fundamental balance of payments deficit — and this means, whenever it should have become bigger and more comprehensive on grounds of stability policy. The institution of the ECU as a new European Currency

Unit<sup>2</sup>, in combination with an intervention mechanism with similar effects as the European joint currency float<sup>3</sup> and extended credit facilities<sup>4</sup>, is deemed to provide a more serviceable instrument for charming the snake — both to prevent a contraction and to create a stable currency zone in Europe.

<sup>2</sup> The ECU however is no parallel currency (yet). To make it that, the institutional details would have to be developed much further. Concerning the problems of parallel currencies cf. Roland Vaubel, Die Pläne für eine europäische Parallelwährung (The plans for a European parallel currency), in: Weltwirtschaftliches Archiv, Vol. 108 (1972), p. 136 ff.

<sup>3</sup> A comprehensive survey of possible intervention and balancing arrangements and their effects is given in Rolf Caesar, Monetäre Wirkungen eines Multiwährungs-Interventionssystems mit Saldenausgleich (Monetary effects of a multi-currency intervention system with balances settlement), in: Kredit und Kapital, Vol. 1 (1975), p. 91 ff.

<sup>4</sup> ECU 14 bn as short-term currency standby credits and ECU 11 bn as medium-term financial assistance. Cf. the European Council resolution of December 5, 1978 on the setting-up of a European monetary system and connected questions, Bulletin of the Federal Government's Press and Information Office, Bonn.

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<sup>1</sup> Cf. Hans-Eckart Scharreier, Problems of Monetary Integration in Europe, in: INTERECONOMICS, 1978, No. 11/12, p. 267 ff.

The fixed-rate system in the EMS consists of a parity-grid for the individual members — a parity in relation to the ECU is fixed for each of the previously “floating” partners. If the exchange rate between two currencies touches one of the intervention points determined by the fluctuation margins<sup>5</sup>, the directly affected central banks are obligated to intervene to an unlimited extent in EMS partners’ currencies; if, for instance, the lira-deutschmark rate rises or falls to the extremes of the permitted fluctuation band (maximum: 12%), the two central banks concerned are under the bilateral obligation of intervening by offering the “strong” currency in both countries and at the same time bidding for the “weak” currency. Concurrently one of the two central banks acquires a claim in ECU on the other at the Fund for European Monetary Cooperation (FECOM).

### Potential Sources of Inflation

The inflation potential created thereby can be localized at two sources: the interventions by the two central banks, the creditor bank as well as the debtor bank, augment the international supply of the “hard” currency and reduce at the same time that of the “soft” currency; and this takes place by a symmetric adjustment by equal amounts (equal intervention volumes) in both countries. While it is possible for an unintended money supply expansion in the creditor country to have a direct effect on demand and thus to stimulate inflation<sup>6</sup>, the increased international money supply of the “hard” currency in the “soft currency country” will sooner or later make itself felt also in the “hard currency country”. This will happen on the way over

☐ Increased goods exports which are financed in the soft currency country out of the “hard currency” inflow, in which case a (further) worsening of the balance of payments of the soft currency country will however occur as a concomitant of the positive effect on employment in the hard currency country;

☐ Interest- or speculation-induced capital imports into the hard currency country.

The obligatory repayment through the settlement of account balances which according to a European Council decision has to be effected within 45 days after the end of the month of intervention<sup>7</sup>

<sup>5</sup> The bands extend to  $\pm 2.25\%$  from the bilateral exchange rates. A wider band of  $\pm 6\%$ , with provision for step-by-step reductions at a suitable time, had to be conceded to the member countries which operated floating exchange rates until the EMS was set up.

<sup>6</sup> In certain conceivable situations the expansion of national liquidity would, contrary to the monetarist view, be dissipated in the property sector.

<sup>7</sup> This means in 46–75 days; the time may be extended by 3 months for sums up to the extent of the debt quotas under the short-term currency standby assistance.

will eliminate the created inflation potential only if and when it is cumulated in the creditor country or with FECOM.

The modalities for the equipment of FECOM with currency reserves<sup>8</sup> are such that the Fund will be equipped with currency reserves by the very same countries which in the past achieved high balance of payments surpluses through their stability-orientated internal economic policies. Dollars accumulated under the Bretton Woods system, which import inflationary trends from abroad, may possibly be used again, for a second time, to accelerate a change of the price level. It could thus happen that the same dollar raises the price level twice in succession.

This would happen if a country with a balance of payments deficit relating entirely to EMS countries receives a FECOM loan. Whether the loan is short, medium or long-term is irrelevant in this context. As the demand for foreign currencies in the deficitary balance of payments country is satisfied out of loaned foreign currency reserves, the “hard” currency will, as under the intervention mechanism, flow first into the international money circulation and then, on the way over trade and capital accounts, into the national money circulation. In the latter case it will inflate the money supply and, as in the Bretton Woods system, give rise to an international inflation potential.

The countries with a favourable balance of payments — their aggregate surplus must equal the total of the balance of payments deficits of all other EMS countries — will now on the other side have the currency reserves which they remitted to FECOM automatically restored to them; for the central banks must of necessity convert these reserves into domestic money since the balance of payments surpluses represent foreign currency offerings by private economic subjects which have to be exchanged at the existing rate.

### Old Wine in New Casks

Whatever institutional form is given to the EMS, it holds the old Bretton Woods wine in new casks; but the wine has not improved in the meantime<sup>9</sup>. Or has it? Has it perhaps mellowed with age?

The old system with the dollar as the key currency predicated that individual countries would earn their foreign exchange reserves by practising an internal economic policy which was orientated towards stability. The old system had a built-in vicious circle: “hard” currencies were virtually the only ones which could serve as currency re-

<sup>8</sup> Cf. Hans-Eckart Scharrer, *ibid.*, p. 268.

<sup>9</sup> Prophylactic measures can be initiated if the early indicator shows a deterioration but once the quality has deteriorated beyond a certain point nothing can be done to make it palatable.

serves but in order to lay its hands on foreign "hard" currencies a country had to make its own currency stable, and if it did that, it could take only "soft" currencies into its own reserve portfolio. That the Bretton Woods system did nevertheless work for quite a long time was due to the long-maintained faith in the dollar and to the initial free currency reserve allocations by the USA to the Western world as part of the Marshall Plan aid after World War II.

The credit facilities of FECOM could be compared to such a free gift of currency reserves although the confidence in the ECU would still have to be buttressed first. Like the IMF Special Drawing Rights, the ECU is in its initial stage merely an abstract monetary unit to be transferred solely between central banks. However, this abstract unit has immediate concrete effects if private economic subjects present their foreign currency claims to the central bank. The abstract unit may be shown as a reserve medium in the central bank accounts but its existence will inflate the supply of money in the currency in demand.

#### **Dangers of the Settlement Mechanism**

The triplicity of the settlement mechanism (intervention in the foreign exchange markets, short-term assistance with foreign currencies, medium-term financial aid) can of course prove an impediment to integration if the dangers from this institutionalized potential for inflation cannot be kept under. These intrinsic dangers are the greater

- ☐ The smaller is the debtor countries' ability to comply with their repayment obligations in time or at all;
- ☐ The greater the scope of the credit facilities not only provided but also used;
- ☐ The less successful the depreciation-suspect countries are in regaining the lost trust in the stability of their currencies; and
- ☐ The more crucial it becomes from time to time to carry out exchange rate corrections, which are fraught with an — increasingly foreseeable — risk of pre-programmed bouts of speculation.

Assuming that the debtor positions are not mitigated by exchange rate corrections ("beggar my neighbour" policies with devaluation) as a medium, they have to be alleviated either in the "real economy" or in the monetary sphere.

The debtor countries achieve an improvement of their real economy only by bringing their current account into surplus. But a debtor country is unable to earn a balance of payments surplus if it cannot decisively improve its competitiveness in

the domestic and external markets. Leaving disintegrative segregational measures aside, this could be achieved primarily with a relatively low inflation rate<sup>10</sup>. In actual fact this is rather unrealistic because the potential debtor countries — Italy, France, Ireland (and possibly Great Britain), even though a somewhat more optimistic view is justified at present by their current account positions — are unlikely to achieve improvements in their real economies which would have a decisive effect in the short or medium term. The intervention requirement "worked out" in the real economy should for this reason be reduced, or at least kept within limits, by means of exchange rate variations in accordance with the "real snake model" of the OPTICA group, with special consideration being given to the close correlation between rates of price change and exchange rates<sup>11</sup>.

A monetary improvement of the debtor position through creation of artificial interest rate discrepancies between the internal and foreign markets by means of the swap rate policy (involving in this case a contango in the creditor country and a backwardation in the debtor country) can likewise yield only a short temporary success<sup>12</sup>. The crucial prerequisite of a lasting monetary improvement is success in restoring confidence in the stability of all EMS currencies, for as long as the capital investors trust the stability of the currencies, small interest rate variations may be sufficient to induce the international capital market to finance the deficits of the debtor countries on a market-economy basis. In that case there will be very little need for the EMS intervention mechanism. A sceptical view seems however to be warranted in this respect by the negative experience in the past, by the (also in the medium term insuperable) real-economy discrepancies and by the negative "announcement effects" of the "public opinion" about the inflation potential of the new EMS. The success of the new EMS will depend essentially upon the degree of success in containing the additional inflation potential by limiting the available margin of credit. In this connection it seems advisable at least to fix the interest rates in line with the terms for private credit transactions<sup>13</sup>.

<sup>10</sup> Other criteria could be mentioned, e.g. foreign demand for "monopoly products" which is unaffected by price changes, qualitative advantages due to greater technical advances.

<sup>11</sup> Cf. Hans-Eckart Scharrer, *ibid.*, p. 269.

<sup>12</sup> Market-economy rates of interest for the induced net imports of capital are becoming increasingly unattractive as the expansion of the national money supply results in a general reduction of interest rates.

<sup>13</sup> The Economic Advisory Council in the Federal Ministry for Economic Affairs goes so far as to recommend in this connection that analogous terms should be offered in all respects but this would in our opinion involve great problems and not only legal ones. Cf., e.g., Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung (Board of Experts for Assessment of Overall Economic Trends), Jahresgutachten 1978/79 (Annual Report 1978/79), Stuttgart-Mainz, 1978, Teilziffer 347.

Under symmetric intervention rules it cannot be ruled out that the national inflation rates will converge onto an intermediate level. "Asymmetry in favour of greater money value stability" is therefore pointed out as a means of increasing efficiency<sup>14</sup>. Countries with foreign currency inflows will try to neutralize them while countries with balance of payments deficits will restrict their additional borrowing to a less than commensurate (to this neutralization) amount, so that the EMS money supply as a whole will increase less than would otherwise be the case. The central banks could agree incremental rates for the monetary base to serve as indicators.

### Asymmetric Monetary Policies

The additional expansion of the money supply by the central bank of the debtor country would accordingly not be commensurate with the restrictive or neutralizing operation of the domestic (German) central bank<sup>15</sup>. Politically this seems to be practicable as the European governments have jointly agreed on a policy of stabilization; this, however, can only mean that the monetary neutralization policy of one country must not be compensated by an even more expansive money policy for the other national economy. If an asymmetric money policy of this kind fails to function, the existence of the EMS serves no purpose.

There is a difficulty which has to be borne in mind in this context. While the creditor country may be capable of keeping control of its money supply target in spite of liquidity inflows, the debtor country needs an even more expansive monetary policy so as to avoid a falling-off of employment. This excess burden will be reflected by greater difficulty of money supply control on the one hand and capital outflows from the debtor country triggered by interest expectations on the other.

A neutralization policy in the creditor country will now raise the domestic interest rate level in that country and thereby lead immediately to short-term capital imports, with the result of a further increase in the imported inflation potential.

Moreover, a neutralization policy, i.e. an overall more restrictive monetary policy, does not only stimulate intra-European capital movements through higher interest rates but with flexible exchange rates vis-à-vis third countries leads to capital imports from outside into the EMS and in

particular into the countries which are practising a neutralization policy.

These capital imports from outside have no effect on liquidity because of the flexibility of the exchange rates applying to them. With the balance of payments necessarily in equilibrium they will however result in a deficit on trade account, expressed in domestic currency or in ECU. This has the effect of depressing the demand inside the EMS. From the point of view of the hard currency countries forced to operate a neutralization policy this is thoroughly desirable but the other EMS partner countries may consider it a compelling reason to expand. Even if this causal relation applies only in the short or medium term – a mechanism for settlements with the (non-EMS) outside world will come into operation in the long term also if the exchange rates are flexible – it is very dangerous from the point of view of cyclical policy. It could render the asymmetric monetary policy of the EMS impossible.

If the external influences bearing on the EMS can be shut out<sup>16</sup>, asymmetric monetary policies by the European central banks could achieve a harmonization of the money supply expansion nearer to the stability mark of the hard currencies than to that of the soft currencies. In this case, too, the stability-orientated economies will have to pay a price in the form of higher inflation rates – which can be expressed in real-economy terms through a reduced consumption of goods – but this might be acceptable as a political price for European integration. The currency snake would have been tamed.

The asymmetric monetary policy could conceivably also be enforced by bringing additional pressure to bear in the external field, namely by putting the debtor countries in charge of most interventions (asymmetric intervention mechanism). The net effect as compared with the symmetric adjustment process would be in this case that the supply of creditor currency in the debtor country increases whereas in the creditor country it has diminished. A smaller inflation potential, and possibly positive effects on employment, emerge as positive primary effects but there is a danger of compensation or overcompensation if

☐ With full employment in the creditor country the rise of exports results in a demand overhang and thus in an increase of prices (absorption theoretical aspect) or

☐ The additional amount of creditor country currency circulating abroad flows back to the creditor country on the way over the capital transactions account.

<sup>14</sup> The OPTICA proposal on the other hand refers only to asymmetric intervention in the case of exchange rate adjustments. Cf. Hans-Eckart Scharrer, *Der OPTICA-Vorschlag für ein EG-Wechselkurssystem* (The OPTICA proposal for an EC exchange rate system), in: WIRTSCHAFTSDIENST, 57th year (1977), p. 329, and the same author, *Proposal for an EC Exchange Rate Scheme*, in: INTERECONOMICS, 13th year (1978) p. 3 ff.

<sup>15</sup> That is also the view of the Board of Experts which in the Annual Report for 1978/79, numeral 347, expresses the view that the EMS may lead to an asymmetric money policy in Europe.

<sup>16</sup> This also applies to possible borrowings from the IMF by EMS member countries. The EMS currency reserve stock could in this way be increased even directly with the effect of increasing inflation.

The EMS also provides for exchange rate alterations to be agreed between the EMS partners as occasion arises if there are fundamental balance of payments disequilibria. Such exchange rate variations are of course in principle inconsistent with the system, for the EMS was established for the very purpose of getting away from flexible exchange rates. But if one allows for an adjustable peg, appreciation-suspect currencies will automatically be susceptible to speculative capital imports which will increase the domestic liquidity uncontrollably. Such speculative movements will derive not only from EMS partner countries but as a matter of course also issue from extra-EMS sources.

### **The Monetary Influence of Speculation**

In an adjustable peg system it is impossible to keep such speculative funds away or to forestall them<sup>17</sup>. The only weapon against them would be controls over capital movements such as have of late been successfully employed in Switzerland. In the view of Emil Küng<sup>18</sup> such capital controls do not run counter to the spirit of a fixed-rate system because currency convertibility applies primarily to current transactions. But this is not quite plausible because restrictions on capital movements will always, through their impact on the foreign exchange market, exercise an effect on the current account. If such capital controls are used in an attempt to keep speculative funds away, they will impinge on other capital transactions, too, and thus also influence the basic balance.

Speculation is also stimulated by the agreed differential time limits of FECOM stand-by loans. If a central bank facing a fundamental balance of payments disequilibrium is granted a short-term loan, it can often be foreseen that the parity of the currency in question will be altered when the loan has been paid back. Insofar short-term loans have a signal effect with negative consequences on liquidity even if the parity is not altered. Loans must therefore always be granted for a long term so as to deprive the speculation of a calculating basis.

Dangers of a transmission of inflation inside the EMS arise from a definite attitude of the national monetary authorities to the sparking of monetary activities. Such dangers could be precluded from the outset by implementation in all member coun-

tries alike of the kind of money supply policy practised in the Federal Republic.

In this case all EMS member countries would either let their monetary base potential rise at a rate within a certain acceptance margin. Or else — if the agreed rates for the increase of the monetary base potential are not kept within this margin — acceptable rates of increase have to be fixed beforehand by negotiation. Without this the system could not work or the national monetary policies remain autonomous.

### **A Preliminary Step**

Both these possibilities have been suggested by the Council of Economic Experts but they have not been codified in the EMS agreements. That the danger of transmitted inflation is real is appreciated even if there is no great weight attached to it. From this it can only be concluded that the responsible monetary authorities of the EMS member states wish to pursue a stabilization policy which on cyclical grounds puts the emphasis on influencing the price level at one time and employment at another. The cyclical concepts of the monetary authorities of the EMS member countries thus reflect the Phillips curve conflict which necessitates a more or less Keynesian policy while the idea of general acceptance of agreed increase rates for the money supplies implies rather a monetarist policy. The latter could certainly be operated objectively more simply and efficiently but would in certain circumstances lead to short-term and thus cyclically significant (political and economic) friction losses. Keynesian thinking also shows forth in the wish to revert to fixed exchange rates within a currency area so as to facilitate real and monetary transactions. The monetarist idea need not target on fixed exchange rates because in accordance with its underlying liberal (and sometimes even liberalistic) ideas optimum economic results can only evolve in free markets with variable prices; fixed prices, in contrast, could impair the optimum resource allocation — in certain circumstances differently in different countries.

As it is impossible or not intended to do without a cyclical policy (designed for the short term) and European integration is in the long term economically (according to the comparative costs theorem) and politically beneficial for all member countries, an attempt at a monetary union with fixed exchange rates may well be the only preliminary step towards a unified currency unit; an economic and monetary union with flexible exchange rates is not practicable although theoretically conceivable. Opinions may however differ about the right date for the establishment of the EMS.

<sup>17</sup> The Board of Experts visualizes such a possibility of prophylactic parity changes in its Annual Report for 1978/79 under numeral 357. Prophylactic action however can only be taken by somebody who is aware of danger. Why should speculators be less sensitive than central banks?

<sup>18</sup> Cf. Emil Küng, *Das schmutzige Floating und seine Folgen* (The dirty floating and its consequences), in: *WIRTSCHAFTSDIENST*, 58th year (1978), p. 177.