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# Controversial Issues about the "Right" Monetary Order

by Hermann Burgard, Brussels\*

**The European Monetary System (EMS) has now been in operation for about one year. Dr. Burgard explains the main elements of the system and the problems still awaiting solution.**

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There are some people who do not acknowledge the systemic character of the "European Monetary System" (EMS). Nevertheless, even if a number of issues remain unsettled as will be shown in the following analysis, it should be possible to find common ground as to how the EMS should be classified. Idealising a little, it could be baptised as a dual currency exchange rate union of the harmonisation type with an adjustment trigger and the use by EEC central banks of a genuine common reserve asset. As we shall see, this definition is not complete and overstates some issues.

Effective first steps toward monetary unification may clearly be detected since beginnings of

- ☐ a central authority in the monetary field
- ☐ a common instrument of settlement
- ☐ an adjustment trigger and a set of harmonisation rules

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\* Head of the Division for Monetary Relations, EC-Commission. — Together with Professor André Fourçans, the author of this article has conducted the "Alpbach Banking Seminar on the EMS" organised by the "Austrian College" from 19 to 26 August 1979. The text is an amended version of the oral report Dr. Burgard gave on 27 August to the "Europäisches Forum Alpbach". Opinions expressed are personal and the European Commission's views are not involved, nor those of Professor Fourçans or the participants of the Seminar. Given the review-character of this text, more than 50 footnotes would be necessary to indicate sources. As printing space is limited and in order not to discriminate, no references are presented.

- ☐ an organisation of resource transfers and
  - ☐ a better harmonisation of monetary policy vis-à-vis the outside
- are evident.

## Central Monetary Authority

The "European Monetary Cooperation Fund" (EMCF), has got a new unit of account. This unit is of the "fixed amount basket type". It creates a network of financial solidarity between "member central banks". Under the former unit of account, creditor central banks, in the end, benefitted for all credits granted in the Fund context from an exchange guarantee in their own currency. The debtor central banks had to shoulder the whole exchange risk. Now the creditor central banks get a guarantee in ECU terms. On historical experience, this is a better guarantee than the usual dollar risk they run on the bulk of their national monetary reserves.

By Council Regulation (EEC) No. 3180/78, this Fund has seen a widening of its banking rules and got a certain issuing right concerning ECUs. Part of the banking rules are common valuing prescriptions for gold and dollars, applicable to a fraction of "member central banks' " official reserves. Inversely, there exist

minimum reserve requirements scheduled upon certain kinds of "member banks' " assets.

The EMCF is to be transformed into a European Monetary Fund (EMF). As far as the issuing right might be enlarged in the EMF, via reformulated credit facilities, a controversy arose in the economic literature about the "moral hazard" of an interest policy not based on market-related decisions by the EMF but on an averaging rule as is presently applied to the interest being paid on ECU debts. The problems arising from the question of what the interest rate on SDRs should be, seem to some people to be a good (or bad) experience. Furthermore, there are arguments for and against a role of the EMF as financial intermediary (comparable to the International Monetary Fund) versus enhancing the central monetary authorities' qualities. If there were to be credit tranches as a certain interpretation of the Bremen Annex (para. 2) suggests, the question arises as to which institution will fix the terms of economic and monetary conditionality. The possibility was mentioned that higher credit tranches could bear higher interest rates.

One of the most important issues concerning the future EMF is its institutional position vis-à-vis the "member central banks" and the Council. At present, the Board of Governors of the Fund – following Art. 3 of its Statutes – is bound to "act in accordance with the general economic policy guidelines drawn up under the Treaty by the Council and in accordance with such directives as the Council may adopt acting unanimously on a proposal from the Commission".

### **Beginnings of a Common Currency**

Without any doubt, the ECU is for "member central banks" not only a unit of account and a store of value, but also a means of payments and of settlement. However, for some of these functions, the use of the ECU is still rather precarious, being based on a roll-over of three-month swaps, or conditioned by an acceptance limit. Nevertheless, following the Brussels Resolution, the ECU "will be at the centre of the EMS" (para. 2.1). Does this mean that the aforementioned precariousness is to be eliminated? Will the ECU be a fully-fledged money reserved for the use of "member central banks"?

Given the fact that the currency basket of the ECU is the "numeraire" for the national monies of the adhering "member banks", the ECU is not the embryo of a flexible rate parallel currency; rather "member banks" could, in accordance with theory, be regarded as parts

of a kind of dual currency two-tier central bank system. In contrast to what theory has imagined, the second stage of this system is not an emanation of the first stage, but rather the inverse.

Even if formally we are faced with a dual currency system, sceptics will question whether there will not be for most "member banks" in reality a triangular system comprising the ECU, the respective national currency and the strongest EMS currency. The characteristics and the strength or weakness of the ECU are a product of its components and of the rules established for its use. As a weighted average of its components, the ECU can only compete with the strongest EMS currency insofar as the rules applied to its use give it a competitive capacity. So, what future the ECU will have in comparison with EMS currencies and, particularly, the strongest one depends not only on comparative national stabilisation policies but also on Community legislation.

From a technical point of view, there exists a remedy. We may remember that the "snake" had two kinds of experiences as to necessary central rate changes. There were cases when a currency adjusted its bilateral central rates equiproportionally vis-à-vis all other participating currencies. In other cases, there was some differentiation. In all cases of central rate adjustments practised in the "snake", however, no common denominator had to be concomitantly adopted. Now, due to the complexities of the ECU as "numeraire" a variety of options are theoretically open. One policy stance is to look only at the adjustment of bilateral central rates, simply accepting the arithmetic consequences on the ECU rates of all participating currencies. This was the case when central rates were adopted in the EMS on September 24 and November 30, 1979. Another policy stance could be to introduce a supplementary arithmetic rule guaranteeing after each adjustment both the expected bilateral central rate changes and stability in value with the strongest EMS currency. To resume this point: the system – technically seen – has the capacity with the same adjustment of bilateral central rates, to hold the ECU at least as strong as the strongest EMS currency.

If it were decided to hold the ECU in central rate terms steady vis-à-vis the strongest EMS currency, then there would no longer be a risk of a triangular currency system. Besides, the market would get, by a Council Regulation, a strong incentive to deal in market-created ECU-denominated assets.

The monetary rule for the issuing of ECUs has been, until now, a mechanical one. ECUs are to be created or

destroyed in a fixed minimum proportion to the acquisition or loss of certain kinds of assets by "member banks". As long as the existing monetary rule is not extended following ECU money creation via Fund credit or by increasing the above mentioned fixed proportion (exchange market interventions in ECU seem too far away to speak about), the ECU supply will depend on six factors:

- ☐ depositing of "acceptable" assets by a "member central bank" beyond the fixed minimum proportion;
- ☐ market-related valuation changes for dollars or gold at the given valuation rule;
- ☐ valuation changes for dollars or gold due to a change in valuation rules;
- ☐ changes in gross national reserve volume substantiated by increases or decreases in the number of dollar or gold units; external monetary loans or credits are not excluded;
- ☐ asset shifts operated with third countries or institutions by a "member bank" between assets, "acceptable" or not, to the Fund for the purposes of ECU creation;
- ☐ changing the list of "acceptable" assets by including, for example, net SDR holdings or reserve positions in the IMF.

So far there is no intention to inject "base money" in ECUs into the commercial banking system. But the markets are free (as far as xeno-markets are concerned and at least in Belgium/Luxembourg) to create ECU-denominated assets and liabilities. As there is no quantitative money supply policy in ECU terms, commercial banks would have to assure their micro-economic liquidity by holding national currencies, covering themselves at the same time on a private base against the exchange risks. The use of the ECU as *denominator* by economic agents would be strongly enhanced if there were a forward market in ECU-denominated assets. The organisation of this venture is open to private banks. But monetary authorities might give a starting push if this idea seemed worthwhile. The use of this unit of account would be decisively influenced if, by simple decision and in the way indicated above, the ECU were held steady in terms of the strongest EMS currency.

Although the ECU is still far from becoming a common currency for economic agents, it may nevertheless be stressed, that the exchange rate union has consequences which prepare the ground for a common currency to circulate in private markets. The

exchange rate union differentiates all member currencies vis-à-vis non-member currencies given that

- ☐ transaction costs between member currencies are less
- ☐ exchange rate stability is greater
- ☐ exchange market transparency increases.

Member currencies, the ECU and "associated" currencies become closer substitutes as they were before. As central rates will stabilise, hopefully, with time, this phenomenon may prove to be a very important factor for the financial integration of the Community.

Inside the exchange rate union, the flow of capital is impeded by complex national tax regimes, different stock exchange regulations and exchange control devices designed to protect – in a different way certainly – both strong and weak currencies from market pressures. Some would make a strong case for the view that removing such barriers is more important than progressing in the direction of definitively rigid exchange rates or even a common currency. But a controversy could develop on the question if greater freedom "erga omnes" is the priority choice or if, on the contrary, the prospects of European integration call for a differentiation of capital movement regimes in favour of member states.

### Adjustment Trigger and Harmonisation Rules

When the divergence indicator is flashing, it does not necessarily signal a fundamental need to act and, if bilateral margins are reached and must be defended, it may not flash at all. It cannot, for technical reasons, fulfil all the tasks asked for. Therefore a choice could become necessary later on between a device to effectively reduce the margins, a premargin warning bell, or a trigger for presumptive adjustment action.

If the choice is made in favour of the last mentioned option, the crucial question arises, if neutrality in terms of third currency interventions (i. e. absence of dollar interventions *within* bilateral margins) is needed for the proper operation of the trigger. To make quite clear what is meant, it must be recalled that intra-marginal interventions are one of the options open to a central bank when the divergence indicator is signalling that there exists a presumption to act. But central banks are not forbidden to deal, on their own initiatives, within margins, and they may use third currencies or system currencies. In both cases, there is an obligation for prior consultation via the special telephone network linking the central banks' foreign exchange dealers.

As regards the harmonisation rules, the EMS does not provide for the establishment of compatible national monetary supply targets nor does it advocate domestic credit expansion rates ("DCE" method) combined with symmetrical interventions and automatic money base creation or destruction. So, using the well-known classification of harmonisation approaches, it cannot be pretended that the EMS corresponds to a quantity-cartel approach. Neither do we have a price-cartel approach as prices (i. e. exchange rates) are not definitively fixed. Nor is it adequate to speak of a binding price quantity-cartel approach because prices are not fixed, but only declared for an unknown time period, and as to quantities there is only a declaration of intention.

So, if harmonisation does not work along these lines, is there another harmonisation method which could be labelled, by economic historians, as the "presumptions approach"?

There is a "presumption to act" whenever the divergence indicator bell is ringing. Some are holding then that there exists a second presumption to act via *internal* adjustment, whilst others are pretending that there is a presumption that the "mutual agreement" asked for on behalf of an *external* adjustment exists if the new bilateral middle rates were not to fall outside the old margins. Does there exist a *binding* other presumption giving priority either to internal or to external adjustment whichever tends to sustain greater price stability in the Community?

In the scientific literature, there is a proposition to change fundamentally the divergence indicator: in a step (backwards or forwards?) to Mr. Duisenberg's proposals, the divergence indicator could be constructed around effective exchange rate changes. This argument may be controversial on two grounds. First, given that in "effective" or "real" rate calculations, there are fixed dollar coefficients, it should be clear that such an indicator would, on behalf of the EMS, revert to a unilateral option for some kind of automatic dollar stabilisation. Secondly, assuming for a while that such a unilateral binding would be politically acceptable, why refer to effective rates rather than to inflation-corrected effective rates (the so-called "real" ones)?

Quite naturally, the discussion thus arrives at the controversy concerning the debate "adjustable nominal peg" versus "real exchange rate band". In a nutshell, the question is, which criteria should be used

when there seems to be a need for nominal exchange rate adjustment. Bilateral inflation differences with the less inflation-prone member currency? Weighted inflation differentials vis-à-vis all other EMS members? Inflation-corrected international effective exchange rates? Corrected by what kind of index (consumer prices, GDP-deflators, unit export values, unit costs)? How to phase out cyclical elements and changes in resource endowments?

It seems that, in the end, automatic triggers based on objective criteria and in particular on simple consumer price parity arguments will not be acceptable. What then about starting regular discussions on normative and realised balance of payments structures? How binding would be the above mentioned priority presumption working in favour of price stability and even perhaps ruling out external adjustment?

There is a deeprooted belief, particularly among German academics and journalists, that the EMS as *such* is inflation-biased, whereas European officials normally hold that the EMS has neither an inflationary nor a deflationary bias. A thorough going discussion of both views would produce a chapter of a book, but would not yield many results for policy making in Europe. To put my personal *operational* point in a nutshell: the link between exchange rate interventions and money creation or destruction is not unbreakable. It is, however, doubtful, whether the money sterilisation tools of national central banks are still adequate to the new situation. Scientific observers expressed some time ago the view that central banks' instruments are not yet adapted to the management of floating exchange rates; EMS membership could ask, at least in some respects, for an even more thorough examination of the tool box.

One problem which has not yet been sufficiently discussed in the literature concerns the role of interest rates in the system. Further study of this question is necessary, given that interest rate variability seems to come to the fore as instrument or as consequence of the policy mix. A positive real interest rate seems to be, per se, no reason either for inflationary or for deflationary pressure. Nevertheless, the question may arise whether there is a bias in the EMS for the member countries to produce, on average, nominal interest rates higher than in the past and so sometimes substantial real rates. So, in this context, is it true that in the system there is no built-in bias toward reducing or stimulating activity but only a question of internal policy mix?

Without any doubt, given the relative rapidity of interest rate changes in comparison with policy mix changes, there is some "pace-setting" in the system by the movements of nominal interest rates for assets denominated in the strongest currency. If the responsible authorities apply a rather strict monetary rule and insofar as the markets respond to the interest and exchange mechanisms of the system, quite important asset shifts could be prompted between the system and third countries – evidently conditioned by the policy response of non-system authorities.

### **Monetary Policy vis-à-vis the Outside**

The EMS is not a little island somewhere in the ocean. It cannot be only inward-looking. Given the speed with which the EMS was established, there had to be a first stage during which the elaboration of rules governing internal relationships was given priority. Now, with the preliminary exchange of views on the future European Monetary Fund, this internal exercise will be refined. Beyond this, intellectual and political capital is to be invested to clarify external options and to "realise as far as possible, a concertation" with the monetary authorities of third countries (Resolution of the European Council, 5. 12. 1978, para. 5.1), the European system remaining "fully compatible with the relevant articles of the IMF agreement" (European Council, *ibid.* para. 5.3). Four issues seem most important in this context.

There is the question of an EMS zone. This issue is geographically not confined to those "European countries with particularly close economic and financial ties with the European Communities" as mentioned by para. 5.2 of the European Council Resolution of December 1978. But it is true that these countries, when the time comes, will have a kind of priority in negotiations on agreements between central banks. One question is who should take the initiative, others concern the kind of formal relations to be established. "Participation in the exchange rate and intervention mechanisms" have been mentioned by the Heads of Government. Looking on the "Agreement between central banks of the Member States of the EEC laying down the operating procedures for the EMS" this could theoretically not only mean adherence to common "intervention rules" (Art. 2) but notification of a "central rate in terms of the ECU" (Art. 1) and some kind of indicator of divergence (Art. 3). Are these desirable and necessary features? What kind of very short-term intervention financing is to be provided for? Would there be arrangements concerning the composition of

external reserves? Might there also be central rates declared in terms of an EMS member currency as Art. IV of the IMF Agreement provides for? In reality such central rates already exist in the framework of the French franc zone: its non-European member currencies were related to the EMS with an adjustable peg when France adhered. Given the rules of this zone, part of the ECUs now existing are due to international reserves acquired by France on account of other members. Furthermore the Community cannot prohibit a Mediterranean or Near East country using the ECU as *formal* reference for the purposes of article IV of the IMF Agreement. Even more so, no instruments exist which can prevent a country from adopting

- ☐ a unilateral behaviour without commitment as if participating in the EMS (for example the *de facto* policy adopted by Austria) taking as reference either the currency of a participant or the ECU;
- ☐ a *de facto* policy as adopted by Switzerland in assuring a kind of ceiling for the national exchange rate in relation to the currency of a participant or to the ECU.

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The fundamental question is whether this greater EMS zone will simply grow on pragmatic grounds or actively be constructed and managed. The answer to this fundamental question is not without importance for the three other external issues to be briefly tackled here.

On the one hand, should there only be "coordination of exchange rate policies vis-à-vis third countries" (European Council Resolution, para. 5.1) or a comprehensive policy on third currencies? The internal relationships of the EMS are deliberately shaped to sustain underlying real and financial trends if there were conflict with more short-lived pure financial asset movements. So might there be an intra-European controversy about a dollar policy aiming also at sustaining underlying real and financial trends against the so-called "all assets approach" (comprising short-lived pure financial asset movements)? Such a dollar policy might not only look at the dollar rate, but at international agreements the aim of which is to give *structural* relief to the world's most important international currency, i. e. questions concerning substitution of reserve instruments. And to give still another touch to this too impressionistic picture: should intervention means, needed by the US authorities, be swaps with European central banks thus creating national base money or be denominated in ECU on the understanding that they are to be collected in *designated* European markets (Carter-note type assets) thus altering national currency supplies less?

On the other hand, it seems logical that the external responsibilities of the proposed European Monetary Fund will largely differ if (or if not) a greater EMS zone is actively sought. In any case, in the same manner as the German authorities are now managing a "reluctant reserve currency", the EMF could become a "reluctant ECU-reserve centre", a kind of regional substitution account for certain varieties of reserve assets. As there would be an exchange risk to be covered, should the Fund itself bear it or should there be negotiations with the authorities responsible for deposited assets for *prior* exchange guarantee arrangements?

If ever the pressure of external reserve holders into indirect and partial ECU guarantees via shifts into EMS currencies became unbearable because of its effect on European competitive capacity (real exchange rate overvaluation of the EMS vis-à-vis third countries) the authorities could refer to the German experience. In fact, DM reserves held by third monetary authorities are not so much held with the Bundesbank or German resident banks but in the xeno-DM market. Could there

be, one day, a motivation for ECU authorities to give an incentive to the markets to manage the substitution not into EMF-created ECUs but into market-created ECU-denominated assets? In this case, the advantages of a decision to hold the ECU by definition steady in terms of the strongest EMS currency would become most evident.

Finally, it seems necessary for the EMS to "remain fully compatible with the relative articles of the IMF Agreement" (European Council, *ibid*; para. 5.3), but this is not in itself sufficient for the international economic order. Are, for instance, evolutions in the xeno-markets simply a micro-economic prudential problem or are they a deliberate selling of currencies brand names or, perhaps, even an international struggle for seigniorage? More generally speaking, does the declaration of intention by the European Heads of State and Government mean a behaviour aiming at shielding the EMS in the present world non-system, does it give reason for aggression using the IMF Articles to their extreme limit – or should there be active cooperation? Providing for the last option by giving the EMS an adequate external *operational* structure would be a signal to the world's economic and financial circles.

### Concluding Remarks

The overriding purpose of any exchange rate system is to facilitate trade, movements of capital and people, and to ensure without hindrance the accompanying payments and transfers.

Attention must be paid to the risk that maintenance of EMS central rates could all too easily be invoked for export drives, "buy national" campaigns and restrictions on foreign investments and even trade. Balance of payments problems could be invoked to subsidise "lame duck" industries and prestige projects "because of their exports". Some people think that concurrent Community policies are necessary to elude such developments.

We were told by past integration experiences that a partial approach like the EMS is no guarantee of automatic spill-over effects. The functionalist approach was, from the very beginning, overstating both the spill-over effects and the ease with which existing national interests can be blended together toward common or even supra-national action. A political impetus was the starting point of the EMS; bold action is still needed to shield it against a turn of the tide and to use it to further overall European integration.