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International Perspectives of the European Monetary System

by Hartmut Picht, Speyer*

The none too firmly established position of the IMF with regard to the realization of the objectives of its Articles of Agreement has been additionally impaired by the establishment of the European Monetary System. From an international point of view a revision of the present EMS concept would seem to be called for in order to prevent the credibility of the IMF and the objectives of its Agreement being called in question.

The Articles of Agreement concerning the International Monetary Fund (IMF) were amended for the second time with effect from 1 April 1978. The Amendment represented the provisional conclusion of negotiations, initiated in 1971, on a more up-to-date structuring of the International Monetary System.¹ At the centre of the Second Amendment was a revision of Article IV. Member states are to be free to choose their exchange arrangement, although linking of a currency to gold (gold parity) is ruled out. The possibility of stable but adjustable rates of exchange is specifically emphasized. At the same time manipulation of the rate of exchange with a view to preventing an effective balance-of-payments adjustment or gaining an unfair competitive advantage is banned. The Fund undertakes the task of ensuring the functioning of the International Monetary System by supervising, in particular, exchange rate policies. Principles governing exchange rate policies have been laid down for member states to observe.

The decisive difference from the earlier version of the Agreement lies in the way in which exchange rate stability is to be achieved. Article IV emphasizes that a greater degree of exchange rate stability can be achieved only by the restoration of greater stability in economic and financial circumstances in the member states. Prior to the Second Amendment, by way of contrast, exchange rate stability was enforced by the fixing of parities and obligations to intervene, as well as by an accommodating economic and monetary policy.

The Amendment to the Agreement also entailed a reorganization of the reserve system. This concerned mainly the applicability of Special Drawing Rights (SDRs) and the position of gold. The use of SDRs was

made easier; the range of participants can, if necessary, be extended. The SDRs were to become the principal reserve asset and, above all, to reduce the function of gold in reserve holdings and in squaring the balance of payments. The obligation to make in-payments in gold within the framework of the gold tranche – now called reserve tranche – was rescinded and the official gold price abolished. Earlier ideas concerning a restriction of the role of reserve currency accounts were not adopted into the Agreement.

It should be added that, as a result of the establishment of the Trust Fund and the possibility of shortening the periods between quota increases, the Fund's credit potential was directly increased. Added to this were further credit facilities outside the Amendment proper.²

Compatibility of the Present EMS Concept

All countries participating in the European Monetary System are also parties to the International Monetary Fund Articles of Agreement, whose regulations apply in full. The first aspect to be examined here is whether, and to what extent, the organizational provisions of the EMS are beneficial, or detrimental, to questions of concern on the international plane.³

The countries fully participating in the EMS undertake reciprocally to keep within bilateral margins of

¹ Cf. F. E. A s c h i n g e r : Das neue Währungssystem – Von Bretton Woods bis zur Dollarkrise 1977 (The New Monetary System – From Bretton Woods to the Dollar Crisis 1977), Frankfurt 1978, for a detailed explanation of the new IMF Agreement.

² Mention should be made, for example, of the liberalization of the "compensatory financing facility" and the extension of the "General Arrangements to Borrow" within the framework of the Group of Ten. Cf. also H.-H. T a a k e : Die währungspolitischen Auseinandersetzungen zwischen Entwicklungs- und Industrieländern – eine Zwischenbilanz (The Monetary Policy Conflict between Developing and Industrialised Countries – An Interim Balance), in: Außenwirtschaft, Vol. 34, Zurich 1979, p. 143 ff.

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fluctuation on either side of the implicitly agreed national central rates. Changes in the central rates through the interposition of ECU central rates are possible only by agreement; a change in one central rate necessarily results in variations in the central rates of the other member states also. We are dealing – in line with the IMF Articles – with a system of stable but adjustable rates of exchange. In accordance with the changed concept of the Fund's exchange rate policy such variations of the central rate would have to occur whenever there is a danger of delay in balance-of-payments adjustments. The requirement of mutual agreement on central rate adjustments is formally compatible with the IMF Articles. In practice, however, the Fund has only limited powers to enforce the objectives of the Agreement. Its supervisory activity, at best, comes into operation in cases of drawings on higher credit tranches. Its intervention with regard to possible EMS debtor countries could be made even more difficult, since under the Agreement all other participating countries (otherwise under no obligation) must approve of the economic requirements imposed on such debtors – in so far as these concern the rates of exchange.

Very short-term and short-term stand-by credit facilities have been considerably extended both in term and amount. The probability of being compelled to have recourse to conditional IMF facilities has been decisively diminished. The position of the Fund, weak as it was, has been additionally impaired; necessary exchange rate corrections are more easily avoided or delayed.⁴

Creditor countries of the EMS as a rule either have to provide for additional sterilization facilities or else expect an impairment of their own monetary control. This, too, runs counter to the changed concept in the new IMF Agreement, since control over the money supply is an indispensable prerequisite for ensuring orderly economic and financial conditions in the member states. EMS participants are, moreover, in a

position to deny exchange rate adjustment even to creditor countries of the System. Even if the Fund and the creditor countries themselves regarded such adjustment as necessary this could be "blocked".

If a debtor country of the EMS intends to take up medium-term credits outside the Community, the remaining Community countries and the EC Commission must first be consulted. These examine whether such assistance can be provided within the Community; this facility was also massively increased for countries fully participating in the system. This arrangement, therefore, also potentially impairs the IMF's supervisory function and hence the realization of its concerns.⁵

The construction of the ECU divergence indicator raises additional problems only to the extent that not the attainment of bilateral intervention points but the exceeding of the divergence threshold triggers off compulsory adjustment. The one does not necessarily presuppose the other. It is possible for intervention pressure or at least justification pressure to arise even though there is no need for central rate adjustments or other measures such as intervention in the foreign exchange markets or any other economic or monetary policy measures. Conversely, there may be a need for economic and monetary policy decisions even without a reaction of the divergence indicator. Altogether, the dualism of obligatory intervention and presumption of required action renders realization of its tasks more difficult to the IMF. Only by chance could the otherwise feeble intervention by the Fund be supported.

Within the framework of the very short-term stand-by, the settlement of balances is made possible within certain limits – or even beyond, given agreement with the creditor bank concerned – in ECU, which were created specially for this purpose. This undoubtedly runs counter to the objective of the IMF Agreement of making the Special Drawing Rights (SDRs) the principal medium for reserve holdings and for the settlement of balances. Moreover, the ECU reserves are established by the depositing of dollar and gold stocks. This represents a confirmation of the role of gold as a balance-settlement and reserve medium. However, owing to the time stipulation, whereby the created ECUs are in the form of revolving three-month swaps, no real mobilization of gold takes place. The direct use of gold for balance settlements within the framework of the very short-term stand-by was in fact explicitly ruled out. Strictly speaking, this limitation even exceeds the IMF

³ On the European Monetary System see: Europäische Gemeinschaften – Währungsausschuß, *Kompodium von Gemeinschaftstexten im Bereich der Währungspolitik* (European Community – Monetary Committee, *Compendium of Community Texts in the Sphere of Monetary Policy*), Brussels-Luxembourg 1979; also, for an overall view, Deutsche Bundesbank: *Das Europäische Währungssystem, Aufbau und Arbeitsweise* (The European Monetary System, Structure and Functioning), Monatsbericht März, Frankfurt 1979. For a "traditional" interpretation cf. H. Picht: *Die Ziele des Europäischen Währungssystems aus der Sicht der EG-Staaten* (The Aims of the European Monetary System from the Viewpoint of the EC-Countries), Speyerer Forschungsberichte 8, Speyer 1979.

⁴ In the event of extensions within the framework of the very short-term stand-by, creditors have a certain, unspecified possibility of action (Art. 11, section 1). In the short-term stand-by the coordination aspect is in the foreground (Art. III, section 1, and Art. VII). See footnote 3.

⁵ The granting of credits under the medium-term stand-by is nevertheless linked to stability-policy requirements (Art. 3, section 1).

regulations which do not prohibit the transfer of gold at market terms.

It should be remembered that the EMS arrangements do not formally clash with the IMF's Articles of Agreement. But they impede the realization of the objectives laid down in them: the Fund's influence has been directly weakened and the (long-term) goal of reorganizing the reserve system has been obstructed. The stipulations remain ambivalent as far as the role of gold is concerned.

The reflections on organizational theory below show that, from the point of view of the EMS participants, this direct impairment of the Fund's function – there are also, as should be pointed out, indirect impairments – is partially offset by an advantage in the sphere of monetary policy.

Basic Principles

Monetary policy, as is well known, has two dimensions: that of regulative policy and that of procedural policy. The establishment of the European Monetary System on 13 March 1979 falls under the heading of regulative policy. Regulation or organization is a formative activity. It must be in line with the goal of the system. In the present case, therefore, we must first formulate the real monetary organizational task.

Money in modern exchange economies is not a good but a claim.⁶ The holding of money typically involves a liquidity advantage. If one considers that this advantage from the holding of money depends on its value in exchange, trends in the latter and the recompense which is to be paid for the holding of this title, it becomes immediately evident that the productive activity of a money issuer must relate to the preservation of its exchange property, i. e. control over the evolution of its value in exchange. If, *ceteris paribus*, the real interest rate represents the recompense for a temporary waiving of consumption, then what we call the deflationary or inflationary value trend of money is governed by the recompense fixed for the productive activity of "guaranteeing". In the case of technically non-interest-bearing cash holding, the value trend of money over time therefore represents a kind of "exchange money", or an implicitly paid price component for taking advantage of monetary services.

The monetary services so far described belong to the category of private goods. The exclusion principle is applicable; at the same time there is rivalry in use. However, weaknesses or impairments in the functioning

of competition due to exogenous disturbances may be offset, or at least mitigated, by influencing the money supply. Insofar as this aspect is concerned, it may also be said that the overall volume of real money holdings, or the supply of monetary services, is a collective good. Typically there is non-rivalry in use. At the same time, the exclusion principle cannot be applied.

Monetary services have, in a sense, a dual character. They are marked by a private and a collective component. The collective component clears the way for the application of a line of research known as "public choice". This is an independent discipline to the extent that by its combination of subject and method it is differentiated from other lines of research. In terms of subject it is concerned with collective institutions, while in terms of method it belongs to microeconomics.⁷

The primary concern of an economy is of course concentrated upon taking the greatest possible account of the citizens' preferences while allowing for the general situation of scarcity. In the present instance the purpose of the system consists in providing the best possible supply of monetary services on the basis of their dual character. The organization of monetary systems must orient itself towards this requirement. Monetary organization generally includes all measures concerned with the articulation and aggregation of (citizens') interests in monetary services, the production and supply of such services, as well as the relationship of supply and demand.

The partial characterization as "collective" must be changed to "public" to the extent that the self-organization of the individual citizens is not sufficient to avoid the well-known free-rider problem.

The weaknesses or disturbances in the functioning of competition referred to above can as a rule be regionally localized. They therefore call for regionally differentiated control of the money supply. The present customary differentiation by countries is one way of making allowance for the local-public character of monetary services.

The international division of labour entails a more or less close interlinking of such monetary areas. Supranational regulations therefore represent an acknowledgement of territorial spillover effects of the money supply.

Both the EMS participants and the member states of the IMF may now be described as buyers and sellers: as buyers they represent the interests of their own citizens

⁶ Cf. A. Stobbe: *Volkswirtschaftslehre I, Volkswirtschaftliches Rechnungswesen (Economics I, National Accounts)*, 5th revised and extended edition, Berlin-Heidelberg-New York 1980, p. 12.

⁷ Cf. D. C. Mueller: *Public Choice*, London-New York-Melbourne 1979, p. 1 ff.

in monetary policy decisions in other countries. Conversely, every country is, at least potentially, interesting to others as a seller of consideration in monetary policy decision-making.

Reinterpretation of the IMF and the EMS

The IMF Articles of Agreement, just as the EMS arrangements, may be interpreted as multiple supply-and-demand arrangements. On the demand side the well-known free-rider problem arises. The large number of currency areas makes "bilaterally" conceived arrangements between a single or several buyers on the one side and a single seller on the other practicable only in rare cases. Multiple supply-and-demand arrangements in principle constitute more manageable, though undoubtedly cruder, forms of interest representation.

The establishment of stable economic and financial conditions within the individual IMF member states may be interpreted as a reflection of supra-national, external influences on the supply of monetary services. It represents an attempt to call a halt, indirectly, to potential mistakes in the political reflection of domestic citizens' interests and in the organization of monetary production.⁸ The "price" to be paid as a collateral consists in voluntary adherence to the stability mandate, together – if circumstances render this necessary – with the granting of concessional terms in the granting of credits within the framework of the Fund's facilities, though in the case of higher credit tranches only in conjunction with the imposition of additional requirements regarding stabilization policy.

The feebly established supervisory function of the IMF at the same time reflects the endeavours of member states to keep open for themselves the option of a free-rider position.

Organizational solutions with a limited circle of participants – "lesser groups" within the meaning of M. Olson⁹ – provide an opportunity of additionally consolidating the stability mandate, or of directly opposing potential organizational weaknesses at home.

⁸ A first survey of the potential organizational weaknesses is provided by D. C. Mueller, loc. cit., though this needs amplification, especially regarding the production sector. Cf. also V. Ostrom, E. Ostrom: Public Choice: A Different Approach to the Study of Public Administration, in: Public Administration Review, Vol. 31, Washington 1971, p. 203 ff., as well as W. A. Niskanen: Bureaucrats and Politicians, in: Journal of Law and Economics, Vol. 18, Chicago 1975, p. 617 ff.

⁹ Cf. M. Olson: Die Logik des kollektiven Handelns. Kollektivgüter und die Theorie der Gruppen (The Logic of Collective Action. Collective Goods and the Theory of Groups), in: W. W. Pömmerehne, B. S. Frey (eds.): Ökonomische Theorie der Politik, Berlin-Heidelberg-New York 1979, p. 295 ff.

Moreover, the interests of the participants can be taken particularly well into account. This includes the possibility of concluding further, mutually advantageous, internalization arrangements in a common external relationship towards third countries. Partial solutions with a limited circle of participants therefore enable interest to be taken account of in a more differentiated manner while at the same time ensuring a greater measure of influence.

The EMS arrangements may be seen, in this respect, as a partial solution of a supra-national internalization problem. The following assessment emerges in detail:

If one disregards the application of policy instruments which, in the long run, are suitable only to a limited extent for influencing exchange rates, then the exchange relationships of currencies are affected in the medium run mainly by real factors not assessable in advance. If nominal exchange rate agreements are to be kept permanently then this means absolute subordination of the influence of monetary policy and the abandonment of all scope for monetary policy decision-making. This monetary policy dilemma can be checked only by exchange rate corrections, but these can only be decided upon in mutual agreement.

It could also be said that the EMS participants are, in the medium term, being given the opportunity of exerting the greatest possible influence upon the money supply in the other participant countries. Simultaneously they surrender their own autonomy in monetary policy. Agreed exchange rate decisions are no more than the outward reflection of this exchange. In fact, one might speak of an indirect kind of "communalization" of monetary policy.

Creditor countries additionally grant concessional terms in intervention financing. Only in the short term do the participants enjoy scope for autonomous decision-making in monetary policy matters.

The built-in reciprocal dependence of the participants is so great in the medium term that any non-cooperative free-rider strategies would, in subsequent decision situations, inevitably rebound on the non-cooperative participant or participants.

The high degree of dependence in the medium term also affects the decision pattern "below" central rate fixing. The additionally induced decision situations on reaching the divergence threshold provide an opportunity for the imposition of reciprocal obligations to

¹⁰ Such occasions were hardly necessary since levels for regular consultation already existed in the form of the Committee of Presidents of the Central Banks and the Monetary Committee.

adopt a cooperative decision behaviour.¹⁰ In terms of games theory these are known as "super games".

In principle this greater measure of mutual consideration, especially in monetary policy decisions, is to be welcomed. The concept of stability has, however, in no sense of the word become established – neither directly nor indirectly.

It ought to be remembered that the two supra-national institutions are basically complementary to each other. Conflicts, however, arise from the fact that the present EMS arrangement makes use of an internalization construction which, as has been shown, undermines the IMF's means of intervention at the expense of third parties without, on the other hand, ensuring an appropriate consolidation of the stability mandate. Since the Fund's weak position anyway means that the option of a free-rider strategy is open, the behaviour of the EMS participants can only be a further encouragement to other signatories to the IMF Agreement likewise to avoid the Fund. Added to a direct impairment we therefore also observe an indirect one. It will be shown below how this problem might be mastered.

Allowance for Community Interests

The indirect interconnection of monetary policy decisions by mutually agreed exchange rate adjustments should be replaced by the direct bringing-in of common monetary interests. Nationally differentiated measures influencing the supply of monetary services remain as before.

A European Monetary Council should be envisaged as a Community institution. This would have the task of formulating and representing the common monetary interests; it should be directly involved in monetary policy decision-making in the member countries. Feasible ideas would be the institutionalization of the right to be heard or of a delaying veto. Also practicable would be the granting of a certain proportion of votes in the responsible monetary control bodies.

In dealings with third countries the Community institution would act only within the framework of its participation in the decision-making bodies of individual countries. This does not rule out direct representation of common monetary interests in international institutions such as the IMF. The national delegations would thus continue to be able to put forward their own interests independently. Their weight, however, would have to be reduced in favour of the Community institution.

To the extent that central banks take on the task of intervention and contribute to the financing of credit

facilities, also within the framework of the IMF Agreement, this should be kept entirely separate from their proper issuing activity, i.e. the monetary guarantee function. Any "leverage" of exchange rate agreements upon monetary policy would thus be eliminated.

Even so, a direct influence upon exchange rate trends cannot be ruled out: for this purpose the central banks would have to re-finance themselves on the customary terms, and separately record and debit their costs. To prevent evasion of IMF intervention the credit potential hitherto envisaged should be reduced or, if necessary, abolished altogether.

There should be no Community embodiment of exchange rate arrangements. This should not be difficult since the main argument in favour of exchange rate agreements has been removed by the direct embodiment of the common monetary interest in the decision processes of the individual countries. Wherever aspects of an intra-Community transfer of resources¹¹, primarily between creditor countries on the one side and debtor countries on the other, run counter to this, other Community institutions should be involved in the form of "issue linkage". This calls for a certain revision, in these areas, of the present distribution of benefits. The benefits of abandoning the present EMS structure would also justify major "concessions" in this connection.

Conclusions

The establishment of the European Monetary System has further impaired the already weak position of the IMF in realizing the objectives of the International Monetary Agreement. At the same time the present EMS concept ensures that the reciprocal interests, mainly concerning monetary policy, of the participants are taken more account of. Impairments on the one hand are matched by advantages on the other. This study has shown that there are possible means of avoiding the disadvantages without jeopardising the advantages of increased reciprocal consideration.

From an international point of view a revision of the present EMS concept seems called for in order to prevent the credibility of the IMF and the objectives of the entire Agreement being called in question in the face of intractable international problems. Limited supra-national solutions can only supplement, but not replace, comprehensive agreements. If the countries of the European Community possess a special importance in terms of the international economy, then this needs to be proved also in the field of monetary policy.

¹¹ As demonstrated earlier, this is not a unilateral transfer of resources but a price component.