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# The European Monetary System Five Years On: Achievements and Prospects

by Norbert Kleinheyer, Diethard B. Simmert, Bonn\*

**The record of the European Monetary System at the five-year mark is rather a disappointment for the System's advocates. Has the "EMS experiment" failed? Or is there potential for developing the System further to the advantage of all member countries?**

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Five years' experience with the European Monetary System (EMS) has had two effects; on the one hand, euphoria has given way to disillusionment, but on the other rejection has been replaced by realistic objectivity. In sober retrospect, it has to be conceded that some of the important objectives set by the founding fathers of the system have not been achieved. In 1984 the European Community as a whole is in a grave crisis affecting practically every aspect of the policy of integration. Nevertheless, the EMS has proved fully viable so far, in spite of forecasts to the contrary. It is precisely because the Community is confronted with acute problems that it is important to reflect on an intensification of monetary cooperation and on further development of the EMS in order to consolidate achievements so far, to promote economic convergence and also to give an urgently needed additional impetus to European integration.

## The Record of the EMS

Experiences with the EMS so far are not as bad as many had predicted (the proposition that it was bound to fail), and yet not good enough to come even part way towards attainment of the Community's permanent objectives (the proposition that it would be the locomotive of integration). On the positive side, exchange rates were relatively stable for five years. Several of the seven realignments were small; compared with exchange rate changes within the "snake" between 1973 and 1978 and fluctuations vis-à-vis freely floating currencies, in particular the US dollar, exchange rates within the EMS held remarkably stable. This relative exchange rate stability was not ascribable

solely to the EMS, however; the over-valuation of the US dollar was also an important factor, for it was accompanied by a weakness in the Deutsche Mark which could not be explained by non-monetary developments and which had an overall stabilising effect on the exchange rate structure within the EMS.

On the negative side, the sometimes excessively high expectations in the ability of the EMS to stabilise the value of money in member countries were not fulfilled. Inflation rates have been falling in EMS countries of late, but there has been only a very modest reduction in inflation differentials. Monetary policies in the various countries continue to follow very different paths and the economists' belief that pioneering action in the monetary field would be followed swiftly by convergence in economic policy has proved unrealistic. The hopes that the EMS would be the motor of European integration have therefore not been fulfilled.

Despite all the scepticism, the EMS has however reached its fifth anniversary, even though from the outset its critics gave it a very slim chance of survival. On the other hand, it must be said that the timetable laid down within the EMS for the further development of the system (transition to the second stage after two years' experience with the EMS) has not been kept, nor has it been possible to persuade all member states of the European Community to join.

## EMS: quo vadis?

In the eyes of its critics, the record of the EMS is therefore astonishingly good, but for its advocates it is largely a disappointment. Be that as it may, it is a fact that the further development of the EMS has made no

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headway so far. This is due mainly to the lack of agreement among member countries – and also within certain states themselves – on the direction in which it should evolve. As a result, the European Council has set no binding target for the expansion of the system, which in turn explains why the Monetary Committee has not so far made adequate preparations for its further development.

If there is dissatisfaction with the experience to date, with the status the system has achieved and with the only partial attainment of its objectives, there are essentially only three possible courses of action:

- ☐ to declare the “EMS experiment” a failure, dissolve the currency bloc and revert to fully floating exchange rates;
- ☐ to leave the EMS in its present state and rest satisfied with its modest achievements;
- ☐ to attempt to raise the efficiency of the EMS and to extend the system step by step.

The first path would mean that exchange rates among the EC currencies would again be free to fluctuate, as is at present the case of the Deutsche Mark against the US dollar, the pound sterling, the Swiss franc, the Japanese yen and other currencies. Events of recent years have provided sufficient evidence however to show that exchange rate fluctuations in relation to these currencies could not always be justified on rational grounds, so that trade and payments with these countries suffered as a result of increased uncertainty. Therefore economic integration in Europe would not be encouraged by a return to flexible exchange rates. Moreover, the collapse of the EMS would have damaging repercussions on the European Community as a whole. For that reason, a return to floating exchange rates cannot be seriously considered. History has also taught us that merely deciding to allow currencies to float falls far short of guaranteeing a successful monetary policy; even under flexible exchange rates domestic policy must ultimately bow before the process of economic adjustment.

The second option would clearly be no more than a second-best solution. To leave the EMS in its present state would certainly be an easier course to take; it would save laborious discussions within the Community and far-reaching decisions on the right path to monetary and economic integration. However, if the Community contented itself with the modest achievements of the EMS, it would forego the possible advantages of better monetary cooperation. Above all, however, it would signify acceptance of the fact that the EMS could break

down at any time, for until the system operates better the need for adjustment necessarily builds up time and again: exchange rates have to be adjusted at varying intervals, depending on the circumstances, and past experience has demonstrated that each realignment carries with it the latent danger that the EMS will break apart. In all probability the final collapse of the EMS would have adverse consequences for the European Community as a whole.

The third option, namely to consolidate and expand the EMS, is certainly no easy path. However, the tough negotiations that could then be expected to take place at Community and national level could, and would have to, lead to further progress towards integration that would be of decisive importance for the economic development of Europe. There is therefore no realistic alternative to this difficult undertaking.

### **The Long-term Prospects**

The EMS represents the European Community's attempt to create a monetary area in Europe enjoying stability in the domestic value of money and external exchange rates. In political terms, however, the creation of the EMS should be seen as an element in the more comprehensive plan to combine the European states into an economic and monetary union. An economic and monetary community that aims to hold exchange rates among member countries' currencies as stable as possible must progress step by step towards a common economic policy with identical priorities. Along the way, exchange rate realignments naturally serve to offset the existing but steadily narrowing divergences in economic and monetary developments. However, a country that wished to conceal its internal structural problems and lack of growth beneath a cloak of inflation would quickly set up severe strains within a monetary union of this kind.

The essential political requirement for a workable EMS is therefore revealed: the will to integrate subject to the constraint of stability in the value of money. It is doubtful whether all the advocates of the EMS fully realise the implications of such conditions for the autonomy of their national economic policies. A workable and stable monetary union requires a corresponding economic union! Those who wish to enhance the EMS cannot avoid this long-term implication.

The free movement of capital across the borders of the European Community is another objective that has still not been achieved. Indeed, in France and Belgium, for example, further restrictions on capital flows have

been imposed since the establishment of the EMS. The free movement of capital, however, is one of the fundamental requirements for integration of the European economy, so that member governments cannot content themselves with non-binding declarations of intent promising the removal of controls on capital movements some time in the future. What is needed is a timetable for the gradual dismantling of restrictions at clearly defined intervals culminating in complete liberalisation within the Community. In particular, steps must be taken to ensure that individual member states can no longer slip below the Community standard by unilaterally introducing open or covert controls on capital flows.

### **European Monetary Fund**

The basic proposals constantly revolve around the question as to the role that a future European Monetary Fund should play and how stable exchange rates can be reconciled with effective monetary policies geared towards stability in individual member countries. The two questions are obviously closely related.

To us Europeans it should really be a foregone conclusion that the ultimate aim of the EMS should be a single, common currency. Those who bemoan Europe's present impotence and lack of political influence should promote political integration. Those who desire this must demand an improvement in economic cooperation and sweep away the remaining impediments to trade. However, those who desire that course of action can only wish for Europe to have a common currency over the long term. Hence, in any further development of the EMS especial care must be taken to ensure that the possible paths towards this ultimate goal are not obstructed.

The central bank, which issues the currency and watches over the stability of money, occupies a position of prime importance in every country. If Europe is to have a single currency in the future, the foundations for a European central bank with full powers must be laid now. Such projects cannot be implemented from one day to the next, but if the European Monetary Fund is established it will be a success in terms of our ultimate goal only if it constitutes the "nucleus" of a European central bank. This means that the Fund should be given responsibility solely for monetary and exchange rate functions, but not for regional, structural, agricultural and other undoubtedly important financing and regulatory problems, which fall within the ambit of national governments or the EC Commission. The European Monetary Fund should concentrate on the dual problem of stabilising exchange rates within the

EMS and safeguarding the value of money in the individual member states.

### **A Consistent Monetary Policy**

This brings us to the second problem. Exchange rate stability within a monetary system can be achieved over the longer term only if the countries involved have reached a comparable standard in stabilising the value of money. Faster than average inflation in one or several countries belonging to an exchange rate system is incompatible with stable exchange rates if capital can move freely. If exchange rates are linked together through monetary cooperation despite differences in the degree of price stability, the pent-up pressure for adjustment must be released periodically by realigning exchange rates if the system is not to break apart. However, the more frequent and larger the realignments, the less can the central rates be regarded as stable.

Stabilising exchange rates over the longer term – which implies more than simply fixing them – therefore requires the countries involved to pursue a comparably strict or ambitious policy with regard to the value of money. Hence, in future one country must not rest content with a 10 % annual rate of inflation whereas another is still dissatisfied with one of 5 % and is further heightening its stabilisation efforts.

Just as one cannot expect, say, the Dutch, the Belgians and the Germans to sacrifice their conception of desirable monetary stability for the sake of dubious harmony at a high level of inflation, so one cannot demand that the Italians and French reduce their inflation rate overnight to a level they cannot attain.

Monetary stability can only be achieved through a painstaking process of adjustment. Any attempt to rush the process generates social tensions and strains the political, economic and social fabric. For that reason the "stability" countries must have more patience, but as a corollary the "inflation" countries must step up their efforts.

The time is not yet right to found the monetary fund tomorrow or to take the necessary decision today, but it is high time that consultations on the further development of the EMS are carried forward energetically at the highest level and brought to a conclusion within a reasonable timeframe.

### **Ground to be Made up**

After more than five years' experience with the exchange rate system, debate about the further development of the EMS has progressed beyond

square one. Consultations in official bodies such as the Monetary Committee have not reached any concrete conclusion so far owing to the European Council's failure to set clear objectives but the economic and political debate has thrown up a series of proposals on expansion of the system.

The heart of the EMS is the intervention mechanism whereby the exchange rates are kept within the margins of fluctuation. Those proposals that aim to modify the intervention mechanism are therefore particularly important. Before turning to possible further developments, however, we must note that there is ground to be made up first. During the introductory phase of the EMS the new member countries that had not previously belonged to the currency snake were permitted wider margins of fluctuation in the EMS and in the intervention system. Italy, which has made use of this possibility, has a margin of  $\pm 6\%$  for the lira exchange rates instead of the normal  $\pm 2.25\%$ . This privilege affords an opportunity to spread the process of adjustment to the EMS over several years. However, it should now have served its purpose, after five years' membership of the EMS. It is now time to reduce the wider margin of fluctuation in one or two stages, for example to  $\pm 4.5\%$  at the beginning of 1985 and finally

to the margin of  $\pm 2.25\%$  applied to all members at the beginning of 1986.

In addition, the intervention system must be oriented more strongly towards its true objective. Interventions are intended as a means of limiting exchange rate fluctuations. If the currencies drift apart – owing to disparities in monetary policy, for example – market exchange rates quickly reach the intervention points. Member central banks are then obliged to intervene without limit, in other words they must buy the weak currency in exchange for the strong currency as long as foreign exchange is offered to them at the intervention rate. This leads to changes in the volume of money in circulation in the countries affected. As these changes should occur without delay, intervention financing is limited to a short period and any extension is subject to certain conditions.

### **Strengthening Discipline**

It has become common practice in the EMS to circumvent these consequences and hence to lighten the burden of adjustment. For example, the pressure of adjustment can be postponed and concealed for a while by means of intra-marginal interventions in third currencies, such as the US dollar. Furthermore, a

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**V E R L A G   W E L T A R C H I V   G M B H   –   H A M B U R G**

central bank can finance its interventions over a longer period by borrowing in the private capital markets and hence completely avoid any drain on its foreign exchange reserves. It is generally held that creditworthiness is actually enhanced if the credit lines within the financial support systems of the EMS are not utilised. In the final analysis, however, such conduct is a violation of the common operating procedures for the EMS, as the process of adjustment, which should be completed as quickly as possible to the benefit of all member states, is stretched out, not least to the detriment of the more stable countries. Ways of strengthening discipline within the intervention system must therefore be examined. Possible measures include:

- the general prohibition of interventions in currencies other than the member currencies then at the intervention limits;
- the prohibition or at least severe restriction of intra-marginal interventions within the EMS and vis-à-vis third currencies;
- the obligation to use the EMS support systems for financing interventions; and finally
- a high degree of transparency in intervention activities so that banks, enterprises and the general public in member states are not left in the dark as to the central banks' true operations and intentions.

An intervention system modified in this way would ensure swifter adjustment within the exchange rate pattern of the EMS. It might force central banks and economic and financial policy-makers to build the possibility of rapid adjustment into their calculations and might therefore provide an incentive for closer policy coordination among EMS member countries.

### **Adjustment of Central Rates**

Another possible modification of the intervention system relates to the procedure for adjusting central rates. As a matter of principle, it is incompatible with the underlying concept of the EMS that exchange rate fluctuations between EMS currencies and third currencies work their way through to intra-Community exchange rates and trigger adjustments of EMS central rates. Nonetheless, this effect has been apparent on several occasions in the past and it must be assumed that shifts in investor preferences between the US dollar and the Deutsche Mark on the international markets will continue to lead to exchange rate tensions within the EMS that are ultimately resolved by changes in central rates. It is obvious that such exchange rate changes are

not based on the real appreciation or depreciation of EMS currencies. This means that the new central rates themselves can remain in force for only a limited time before renewed tensions develop in the exchange rate pattern. Hence in future attempts should be made not to react to exchange rate fluctuations vis-à-vis third currencies and their repercussions on the EMS by adjusting EMS central rates. It would be more desirable to absorb such exchange rate changes by means of concerted intervention against the third currency.

Consideration should be given to establishing objective criteria for adjustments in central rates in order to reduce the political sensitivity of realignments. A number of indicators might be used for this purpose. As well as comparing the real purchasing power of the currencies, it would be possible to use nominal and real interest rates or changes in the levels of interest rates over a given period. It would also be conceivable to construct an inflation rate indicator. What is ultimately required to introduce objectivity into central rate adjustments is a yardstick that is largely independent of day-to-day occurrences and special influences and affected as little as possible by politics.

### **Strengthening the System's Ability to Survive**

On no account may the false move made in the EMS in May 1983 become a precedent. When the Ministers of Agriculture failed to agree on a change in farm prices in the early summer of last year, the ECU central rates were promptly amended in order to sweep the political problem under the carpet. This lightning realignment was largely concealed from the public. Over the long run, solving problems in this way cannot lead to a consistent monetary policy. The time would probably soon come when opposite changes in central rates might seem desirable to take account of the different interests of specific industries and regions. Such conflicts of interest would rapidly bring the EMS to its knees.

Besides the proposals relating to the central aspects of the EMS, there are numerous other ways in which the EMS could be developed, each of which would reinforce the system and could therefore strengthen its ability to survive.

The EMS was originally intended to include all EC countries, but at the very beginning the United Kingdom declined to become a full member of the system. The reasons for that decision now no longer apply; nothing prevents UK membership today. The EMS countries should therefore firmly call upon the British Government to join the EMS.

Greece is in a rather different position, having joined the EC long after the establishment of the EMS. Given the tremendous structural adjustments Greece has to make, its entry to the EMS, which is actually scheduled for this year, should be made not in haste but gradually and in several stages, for example by permitting wider margins of fluctuation for the Greek drachma.

### **Credit and Support Mechanisms**

The credit facilities and support systems were to be combined into a single fund when the EMS advanced to the second stage. However, this intention runs partly counter to the long-term aim of monetary cooperation within the EMS, for the credit facilities form part of the Community's financial equalisation arrangements to the extent that they are designed to enable balance-of-payments adjustment or to serve structural and regional policy objectives. They should therefore be classified under fiscal policy in the broadest sense, which should be the responsibility of the European Council, the Commission or the European Parliament.

Concentrating all the facilities in the hands of the Fund would automatically establish direct government influence over the European Monetary Fund, which would conflict with the notion of an autonomous European central bank. Consequently, the consolidation of the credit and support mechanisms should extend only to very short-term financing and short-term monetary support.

These "central bank facilities" have so far not been used on a large scale within the EMS, so that there is no immediate reason to increase the volume of funds available. However, the possibility of tightening the terms for use of the facilities and imposing monetary and other conditions on those central banks that draw on them should be examined. The conditions could relate to the form and time of repayment, to borrowing in the international capital market or to the monetary policy of the debtor country's central bank.

### **Consultations and the Divergence Indicator**

It is often claimed that the regular consultations among central bank governors are very intensive and that little improvement is conceivable in this respect. On the other hand, it might be pointed out that exchange rate concertation is confined mainly to interventions in the foreign exchange markets and that monetary concertation with regard to key interest rate adjustments only operates well between a few central banks. Cohesion within the EMS would be greatly enhanced if consultations were extended to include medium-term monetary policy in order to bring about a convergence of

monetary concepts and objectives. There is still considerable room for adjustment and coordination, particularly between the central banks in Paris, Rome and Frankfurt.

At the inception of the EMS the divergence indicator was expected to play an important role as an "early warning indicator", but these expectations have not been fulfilled. It would be premature to abolish it on those grounds, however. It has occasionally had a positive effect on the economic policy of individual governments, which have redoubled their fiscal efforts and their attempts at restoring current account equilibrium in order to avoid activating the divergence indicator.

Consideration should be given, however, to the possibility of improving the divergence indicator. Firstly, it would be more meaningful if it were based on forward exchange rates as well as spot rates and thus acquired a true "early warning" role. Secondly, the proposals of the Belgian Finance Minister Willy de Clercq aim at expanding the divergence indicator into an inflation indicator, a suggestion that shows that Germany is not alone in attaching great importance to the link between exchange rate stability and price stability. Whether such modifications to the divergence indicator are feasible will not be known until member countries have held detailed consultations.

### **The European Currency Unit**

The creation of the ECU sowed the seed for a European currency, although official usage of the unit is currently limited to very specific purposes. No extension of the official utilisation of the ECU can be considered until significant progress has been made with the further development of the EMS as a whole and full responsibility for the issue of ECUs has been vested in a fund or European central bank.

Private usage of the ECU has progressed in almost all EMS countries in recent years, with the approval and even active encouragement of the EC Commission. Only in Germany has private use of the ECU been severely restricted up to now; credit institutions are not permitted to open ECU accounts or savings deposits. The Bundesbank justifies its negative stance mainly on the basis of Section 3 of the Currency Law, which prohibits indexed liabilities, i.e. monetary debts whose value depends on other currencies but which are payable in Deutsche Mark. On fundamental stability grounds the Bundesbank is very sparing with exemptions to this rule and fears that a general dispensation for the ECU would create a precedent.

There are no objections to the private use of the ECU on exchange-rate policy grounds nor are any expressed by the Bundesbank. Moreover, the demand for privately held ECUs in Germany is likely to be very small in any case since the ECU will probably be no more attractive than the DM, so that the problem for Germany is not particularly great. It must therefore be asked whether the obstacles in the way of the private use of the ECU should not be removed.

### Conclusion

This survey of possible further developments of the EMS is far from complete, but it shows that a number of conceivable measures could be taken that would strengthen the EMS, could hold the promise of

economic advantages and would in no way entail incalculable risks. Every sensible opportunity for closer European integration should be exploited, particularly in this, the most serious European crisis since the signature of the Treaties of Rome, and on the eve of European Parliament elections which politicians expect to produce a vote in favour of Europe despite the failure of European policies.

Nevertheless, it is important, especially after the bitter disappointments of the recent past, to avoid arousing excessive hopes that later cannot be fulfilled. The EMS would therefore benefit if an effective and promising concept were translated into action with as little fanfare as possible.

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## MONETARY POLICY

# International Trade in Oil: Effects on the Balance of Payments and Exchange Rates

by Renate Ohr, Bochum\*

**Oil price increases and the persistent OPEC current account surpluses were considered the main problems of economic development in many industrial and developing countries long after the first oil crisis. Since 1983, however, the OPEC surpluses have been completely absorbed and the official base price of petroleum has fallen for the first time in twenty years, although admittedly in terms of a "strong" dollar. Has the serious damage suffered by oil-importing countries in the two oil shocks been completely neutralised, or are the economies of many countries still strongly influenced by the actions and decisions of the OPEC countries?**

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First, let us look briefly at the quantitative importance of the international oil market and developments in the current accounts of the oil-exporting countries.<sup>1</sup>

Table 1 shows that the ninefold increase in oil prices between 1973 and 1982 (from \$ 3.2 to 29.5 per barrel) led to concrete energy savings in the oil-importing countries but that the associated fall in oil exports was small in comparison with the rise in the cost of the commodity. This is attributable partly to the very low price elasticity of demand for oil<sup>2</sup> and partly to the continued economic growth in many oil-importing countries, which, other things being equal, generates an increase in energy demand.

The result was a persistently strong increase in the value of OPEC exports that did not end until 1981.

However, as export earnings increased, so too did the oil-exporting countries' import demand and their deficit on the services and transfers account, so that their initial large current account surpluses had been almost completely absorbed by 1978. After the second price explosion in 1979-80 the increase in the value of imports again initially remained far below the increase in the value of exports and once again there emerged a substantial current account surplus that did not disappear until 1982.

### Extent of Reliance on Oil

This global portrayal of the problem throws no light on the situation of individual oil-importing and oil-exporting

<sup>1</sup> Only the states belonging to OPEC will be examined.

<sup>2</sup> Cf. the estimates in OECD: Economic Outlook, Special Supplement, No 27, 1980, p. 119.

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