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## Issues of European monetary integration

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## EUROPEAN COMMUNITY

# Issues of European Monetary Integration

by Heinrich Matthes, Brussels\*

**In recent years significant progress has been made towards European monetary integration. Widespread agreement as to the role of monetary policy has been established and there were no realignments of exchange rates within the European Monetary System between March 1983 and July 1985. This was the longest period without realignment in the EMS and contrasted sharply with the six realignments observed in the four years previously. What are the prospects for the further strengthening of the EMS? How can the present system be developed further?**

Over the past few years, and especially since the realignment of March 1983, the coherence of monetary policies within the Community and within the EMS has greatly improved. This improvement began with the reaction of monetary policies to the second oil shock, an orderly reaction on the whole, geared to preventing secondary inflationary effects and a further reshifting of income distribution to the detriment of profits and investment; it was greatly helped by the workings of the EMS and by discussions at Community level; and it was based on an improved consensus among the member countries on the role of monetary policy in the context of national macro-economic policies.

Indeed, there is now general recognition that the task of monetary policy is essentially to secure internal and external currency stability within the member countries. This is a necessary, but not sufficient, condition for more growth and more employment. However, performance of this task depends to a large extent on whether the remaining policy mix is a reasonable one; what is needed in particular is an appropriate fiscal policy and a satisfactory trend of the functional distribution of income. The upshot is that fiscal policy and incomes policy should fit into the stability-promoting framework set by monetary policy, and not the other way round.

A key element in the monetary strategy has been the adoption of quantitative monetary targets which have been gradually reduced over the years – most strikingly in France, which reduced its target for monetary expansion from 11 % in 1980 to 4-6 % in 1985, i.e. to only one point above the Bundesbank target (3-5 %) (Table 1). In the larger countries monetary targets are explicit, while the adoption of the EMS exchange-rate

rules tends to transmit to smaller countries the discipline implicit in the orientation adopted by the major countries. Nevertheless, even in the smaller countries a steady supervision of the money creation process, and particularly of domestic credit expansion, is as important as ever.

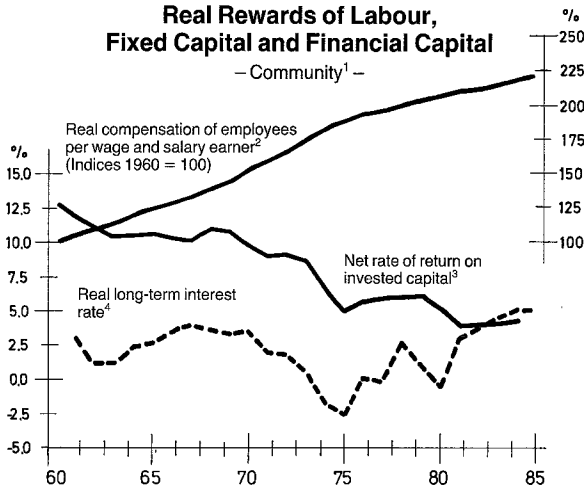
In the pursuit of these policies, the Community inflation rate as measured by the rate of increase of consumer prices has declined from 12.8 % in 1980 to an expected 5½ % this year. A further fall is expected for 1986. Moreover, inflation differentials – measured in terms of the country with the lowest rate of price increases – have narrowed appreciably in the Community.

As European monetary authorities have been moving further away from systems of administrative control, the pursuit of the policies outlined above has had increased consequences for interest rates. Given the unwillingness to accommodate excessive money creation, long-term interest rates would assume a clearer role in reconciling ex-ante saving and borrowing behaviour in our economies and, in view of the demands of public sectors as well as investment needs in European economies and given external constraints, it is not surprising that real long-term interest rates rose quite sharply in the Community (from -0.4 % in 1980 to just over 5 % in 1985) (Figure 1).

Last year long-term interest rates in several member countries and in the area as a whole were higher than they had ever been in the 1960s or 1970s. Today we have clearly recognised that the general interest rate level of the 1970s was distorted: the frequent and widespread occurrence of negative real interest rates in that period represented the exploitation of a money illusion which probably no longer exists. Indeed, there is strong reason to suspect that declining or low real

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**Figure 1**  
**Real Rewards of Labour,  
 Fixed Capital and Financial Capital**  
 – Community<sup>1</sup> –



<sup>1</sup> Community average weighted with GDP of 1975 and 1975 purchasing power parities. <sup>2</sup> Deflated with GDP-prices. <sup>3</sup> Net operating surplus of enterprises (excluding housing) as % of corresponding net capital stock. Because of the definitions adopted here, the level of this curve has to be interpreted with caution and it is its evolution which is of greater relevance. Source: Deutsches Institut für Wirtschaftsforschung (Berlin) on behalf of the Bundesministerium für Wirtschaft (Bonn). Last years and Community average calculated by Commission services. <sup>4</sup> Interest rate on government bond yields. Deflated by consumer price index.

interest rates, together with sharply rising or accelerating real wages over a long period, both deterred saving and misallocated relatively scarce available resources. In the past, the relatively low return on financial and fixed capital in the presence of the very high and rising level of labour costs has certainly had something to do with the secular rise in unemployment which has plagued our economies for more than a decade now.

In the framework of this policy, within the Community as a whole the growth of the broadly defined money stock per unit of real GDP has been halved (from 12.1 % in 1981 to 6.0 % in 1985). This progress went together with a fundamental reorientation of policy in many countries, examples being the way Belgium came to grips with some of its problems after the realignment of February 1982, the reorientation of French policy in the wake of the realignments of June 1982 and March 1983 and, perhaps of special interest, the adjustment undertaken by the Danish authorities in the autumn of 1982 without waiting for pressures in the foreign exchange market.

The nucleus formed by the large member states has become more homogeneous, and this has made an enormous contribution to the increase in exchange-rate stability within the EMS. March 1983 to July 1985 was the longest period without realignment in the EMS and contrasted sharply with the six realignments observed between the start of the EMS in March 1979 and the realignment in March 1983. For extended periods since

then five of the currencies participating in the exchange-rate arrangements stuck close together and over most of that period no currency other than the Belgian franc passed either of its divergence thresholds.

The more stringent exchange rates were not only the result of, but also the reason for, increased stability within the EMS. They helped promote stability in two ways:

- if the exchange rate in a country with comparatively high inflation does not fall, the inflationary effects of higher import prices are averted;
- the accompanying rise in the real exchange rate exerts a dampening effect on domestic and export prices and buttresses efforts being made within the country to bring down inflation.

Thus, although in Italy cumulated inflation over 1984 and 1985 will be substantially higher than in its EMS partner countries (Table 2), the EMS exchange mechanism prevented a corresponding fall in Italy's effective exchange rate until July 1985, thus limiting the effect of higher import prices on domestic prices. Therefore, Italy's real relative GDP price (i.e. the real exchange rate) has been rising, which has put competitive pressure on Italian domestic and export prices, setting a limit to the rise which can be accepted without losing too much price competitiveness. In France and Ireland this process worked in the same way although at a lower level. In Germany and in the Netherlands, on the other hand, the fall in the relative GDP price was not accompanied by a corresponding increase in their effective exchange rates. As a consequence, the relatively stable German and Dutch economies gained in international price competitiveness.

How these developments affect profitability depends largely on the reaction of wage policy and that shows up in the development of the real relative unit labour cost relative to the development of real relative GDP prices (Table 2). According to this measure, profitability developments seem to have been relatively favourable in the Netherlands, Denmark and France and relatively unfavourable in Belgium and Italy.

The stabilising effects of the EMS exchange-rate mechanism also helped in coping with developments outside the EMS. Because inflationary pressures were controlled, participating countries were able to endure a rise in the exchange rate of the US dollar, which in other circumstances would have brought inflationary effects. The European countries were also helped by the weakness of the prices of oil and other raw materials in US dollar terms – but it is of particular interest to note

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**Table 1**  
**Monetary and Credit Expansion Targets**  
(in percent)

		1979		1980		1981		1982		1983		1984		1985	
		Target	Outturn	Target	Outturn	Target	Outturn	Target	Outturn	Target	Outturn	Target	Outturn	Target	Outturn
F. R. Germany	MZ <sup>1</sup>	6-9	6.4	5-8	4.8	4-7	3.5	4-7	6.0	4-7	7.0	4-6	4.6	3-5	
France	M2 <sup>2</sup>	11.0	14.4	11.0	9.8	10.0	11.4	12.5-13.5	11.5	9.0	10.2	5.5-6.5	7.6 <sup>a</sup>	4-6	
Italy	TDCE <sup>3</sup>	18.5	18.6	17.5	18.4	16.0	18.2	15.5	20.8	18.2	20.6	17.4	19.3	16.8	
UK <sup>4</sup>	£M3	7-11	12.7	7-11	18.6	6-10	13.8	8-12	10.8	7-11	9.4	6-10	9.3 <sup>b</sup>	5-9	
	MO											4-8	6.1 <sup>b</sup>	3-7	
USA <sup>5</sup>	M1	1.5-4.5	5.5	4.5-6	7.3	3.5-6	2.3	2.5-5.5	8.5	4-8	9.6	4-8	6.0	4-7	
	M2	5-8	7.9	6-9	8.4	6-9	9.2	6-9	9.9	7-10 <sup>c</sup>	7.8 <sup>c</sup>	6-9	8.0	6-9	
	TDCE <sup>3</sup>									8.5-11.5	10.6	8-11	13.6	9-12	

<sup>1</sup> Central bank money. <sup>2</sup> For 1984 and 1985: M2R (residents M2). <sup>3</sup> Total domestic credit expansion. <sup>4</sup> Targets were also fixed for M1 and PSL2 (broadly defined liquidity) in 1982 and 1983. <sup>5</sup> The USA also sets a target for M3. <sup>a</sup> Outturn to December. <sup>b</sup> 8 months to October, in annual terms. <sup>c</sup> February/March 1983 to the fourth quarter of 1983, in annual terms.

**Table 2**  
**Changes in Relative Positions in the EMS**  
Index values for 1985 (1983 = 100)

Country	GDP price of country	GDP price of EMS partners	Relative GDP price	Effective exchange rate	Real relative GDP price <sup>1</sup>	Real relative unit labour cost <sup>2</sup>	Relative corrected wage share <sup>3</sup>
	1	2	3 = 1:2	4	5 = 3×4	6	7 = 6:5
Belgium	110.87	108.99	101.72	101.55	103.30	105.93	102.55
Denmark	109.88	108.94	100.86	100.06	100.93	100.31	97.11
F. R. Germany	104.04	113.11	91.99	102.62	94.39	94.78	100.40
France	113.68	109.07	104.23	98.62	102.79	102.42	99.64
Ireland	112.10	109.27	102.59	98.71	101.27	101.67	100.40
Italy	120.60	107.81	111.86	95.95	107.35	109.09	101.61
Netherlands	104.89	109.37	95.92	100.56	96.46	92.11	95.49

<sup>1</sup> Or: Real effective exchange rate (on the basis of GDP prices). <sup>2</sup> Or: Real effective exchange rate (on the basis of unit labour costs). <sup>3</sup> Or: Divergence of evolution between real wages per wage and salary earner and labour productivity.  
Source: Estimates by Commission Services.

that it was the existence of the EMS which really made it possible for the participating countries to accept more readily the rise of the US dollar. Each participating country knew that the rise of the dollar would not entail a rise of the other participating currencies against its own currency. Because they are a large and integrated trading bloc, the countries knew that the direct inflationary effect of the US dollar rise would be limited. This also was an important effect of the EMS exchange-rate mechanism.

The establishment of widespread agreement about the new role of monetary policy is an important achievement of recent years. This means that in countries where the objectives of stability have already largely been met, the instruments of monetary policy will have to be used in such a way so as not to rekindle inflation. In the countries still contending with high inflation, monetary policy will have to be directed at making further progress towards internal and external stability.

Decisions affecting nominal and real incomes are of great importance not only for stability but also for investment, growth and employment. In countries with persistently high inflation, the growth of nominal incomes has to be adjusted to the intended deceleration of price increases. At the macroeconomic level, the development of real labour costs should be such as to ensure that it will be profitable to increase the number of jobs; such a development will promote employment. For this reason, real compensation of wage and salary earners will have to lag for a while behind productivity gains.

Budgetary policy has lost much of its former anti-cyclical effectiveness during the last decade. There are many reasons for this change, but an important one has been the structural fall of the return on fixed capital, aggravated by the higher tax burden. In the member states where public indebtedness is high and budget deficits are large (Table 3), budgetary consolidation will have to continue in order to eliminate existing domestic

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**Table 3**  
**Net Lending (+) or Net Borrowing (–) of General Government**  
(% of GDP at market prices)

Years	Belgium	Denmark	Fed. Rep. of Germany	Greece	France	Ireland	Italy	Luxem- bourg	Nether- lands	United Kingdom	EC 8 <sup>a</sup>
1960-69	– 1.7	1.5	0.7	2.7	0.4	– 3.5	– 2.0	1.9	–0.7	–1.0	–0.4
1970-73	– 3.1	4.3	0.2	:	0.8	:	– 5.8	2.5	0.7	0.1	–0.8
1974-75	– 3.5	0.9	–3.5	:	–0.8	–10.4	– 9.4	2.9	–0.7	–4.2	–3.9
1976-79	– 6.0	–0.7	–2.8	:	–1.0	– 9.4	– 9.1	2.5	–3.1	–4.0	–3.9
1979	– 7.1	–1.7	–2.7	:	–0.7	–11.6	– 9.5	–0.6	–4.5	–3.3	–3.9
1980	– 9.0	–3.3	–3.1	:	0.2	–12.9	– 8.4	–1.6	–4.2	–3.7	–3.8
1981	–12.8	–6.9	–3.9	–11.9	–1.8	–13.8	–11.9	–2.3	–5.3	–3.1	–5.3
1982	–11.1	–9.3	–3.4	– 9.7	–2.6	–14.3	–12.6	–1.4	–7.0	–2.3	–5.4
1983	–12.2	–7.4	–2.7	– 8.8	–3.3	–12.3	–12.4	0.0	–6.1	–3.4	–5.4
1984	–10.8	–4.6	–2.3	– 9.7	–2.8	–10.3	–13.5	1.5	–5.6	–3.7	–5.4
1985	– 9.6	–3.1	–1.7	–10.6	–3.3	–11.6	–13.6	1.9	–5.3	–3.3	–5.2
1986	– 8.1	–1.8	–1.6	– 9.5	–3.3	–10.4	–13.3	2.2	–5.1	–2.1	–4.7

<sup>a</sup> Excluding Greece and Ireland.

Sources: 1960-70: OECD; 1970-85: Member countries' national accounts and Commission departments.

**Table 4**  
**Total Expenditure of General Government**  
(% of GDP at market prices)

Years	Belgium	Denmark	Fed. Rep. of Germany	Greece	France	Ireland	Italy	Luxem- bourg	Nether- lands	United Kingdom	EC 8 <sup>a</sup>
1960	30.3	24.8	32.5	:	34.6	28.0	30.1	30.5	33.7	32.4	32.3
1969	36.1	36.3	38.8	:	39.6	36.6	34.2	34.1	44.4	41.3	38.8
1973	41.5	42.1	41.7	:	38.5	:	37.8	36.3	47.5	38.2	39.8
1975	46.7	48.2	49.0	:	43.5	46.3	43.2	48.9	54.1	44.2	45.9
1979	51.9	53.2	47.7	:	45.5	47.1	45.5	52.1	56.9	41.4	46.3
1980	53.7	56.2	48.4	:	46.4	51.4	46.1	54.4	57.7	43.2	47.4
1981	58.0	59.8	49.3	40.9	49.1	53.1	51.4	56.6	59.2	44.4	49.8
1982	58.1	60.9	49.5	40.9	50.8	55.8	54.8	57.0	61.2	44.8	51.1
1983	58.2	61.5	48.7	42.1	51.5	54.9	57.5	58.1	62.8	45.1	51.7
1984	57.4	60.5	48.5	42.9	52.6	54.0	58.7	55.6	60.9	45.7	52.1
1985	57.3	59.1	47.9	45.9	52.5	54.9	59.1	55.4	60.0	44.9	51.7
1986	56.5	57.6	47.2	45.9	52.2	53.4	59.8	55.4	58.5	43.3	51.1

<sup>a</sup> Excluding Greece and Ireland.

Sources: 1960-70: OECD; 1970-85: Member countries' national accounts and Commission departments.

imbalances. In the countries which are well on the way towards consolidation and in which the debt service burden is declining in real terms, there may be some room to utilize fiscal policy in order to support employment more directly.

The developments described above have created much more favourable conditions for further progress towards convergence, stability, growth and a reduction in unemployment. The erstwhile disputes between "Monetarists" and "Economists" have been largely overtaken by these developments. Nevertheless, important unresolved problems remain. These include:

□ the fact that the State's share of GDP is now over 50 % (Table 4) – coinciding with the highest level of State indebtedness – and its adverse repercussions for domestic stability;

□ the still very low rate of return on physical capital and the continuing failure to pay sufficient attention to the bench-mark function of interest rates;

□ the inadequate liberalization of capital movements within the Community;

□ last but not least, the unresolved problems of growth, employment and flexibility within the Community's internal market.

The still unsatisfactory progress made on these fronts has made genuine convergence (i.e. approximation of living standards in the Community countries) once again a more distant prospect.

These unresolved problems are to a certain extent reflected in the structure of financial flows (Table 5). In most of the member countries the money creation process in 1985 still shows important imbalances which

need to be corrected. Thus, in Belgium, Ireland and Greece bank lending to the public sector still predominates heavily over bank lending to the private sector. This is particularly pronounced in Belgium where the central bank is effectively obliged to finance a substantial part of the Treasury deficit. The United Kingdom and Denmark, on the other hand, show evidence of a major consolidation effort within the public sector, with the United Kingdom even reducing its net indebtedness vis-à-vis the banking system.

In the Netherlands, domestic money creation is very low. This goes together with the current account surplus exerting an important expansionary monetary influence. In the Netherlands and Germany the increase in monetary capital formation with the banks offsets more than two-thirds of domestic credit expansion. This illustrates the progress achieved in these countries in reducing inflation. In Denmark, as well as in the United Kingdom, Ireland and Greece monetary capital formation with the banks tends to play a much less significant role.

### Prospects for Strengthening the EMS

For some time now, there have been many arguments to support the United Kingdom's joining the EMS. It is evident that the value of the EMS currency bloc in protecting participant countries from external inflationary shocks would be greatly enhanced if sterling were fully incorporated in the system. There is a fundamental anomaly in having at the centre of our monetary policy in the Community a monetary system which does not properly include one of the larger member countries. Probably the United Kingdom initially stayed out of the exchange-rate mechanism because it wished to be free to pursue monetary policies radically different from those adopted in the rest of the Community. It can be questioned, however, whether that fundamental reservation still applies today. The

growing consensus in the Community that monetary policy must be assigned essentially to the task of protecting domestic stability is not very far removed from the fundamental objectives of the British Government.

There are, however, a number of rather more technical arguments. Sometimes these are fairly pragmatic. From its low point of October 1976 sterling rose by 21 % against the Deutsche mark up to the end of 1980, but then fell back by roughly the same amount between end-1980 and the beginning of 1985. How, it is asked, can such a currency be part of a zone of exchange-rate stability? More theoretically, it is argued that sterling's status as an international currency makes it unstable. It is used as a store of value by traders across the world, and shifts in their enthusiasm leads, it is said, to vast flows into and out of the currency. Furthermore, both the current account and confidence in the currency are heavily influenced by the oil factor. The initial exploitation of the North Sea fields greatly strengthened the current account, but the currency is now vulnerable to shifts in oil prices.

It might be helpful to make a distinction between the very substantial structural changes impinging on sterling between 1978 and 1982 and the present situation. The transition to oil self-sufficiency did indeed require changes in other parts of the UK balance of payments, and while these changes were occurring a certain instability of the exchange rate may have been inevitable. But adjustments to the new situation have now been made and the current account is in surplus, with Britain a modest net exporter of oil. What may now intervene are changes in the price of oil, but these must be kept in perspective. A 10 % fall in the value of total North Sea oil production would be equal to only 2.1 % of total UK exports of goods and services, and to 0.5 % of GDP. We now expect market economies to adapt fairly

**Table 5**  
**The Money Creation Process in EC Member Countries**  
Counterparts of monetary expansion expected for 1985

Counterparts <sup>1</sup>	Belgium	Denmark	Fed. Rep. of Germany	Greece	France	Ireland	Italy	Netherlands	United Kingdom
1. Bank lending to the private sector	2.4	10.9	11.0	11.6	7.3	5.3	9.4	7.3	13.5
2. Bank lending to the public sector	12.1	0.0	1.8	15.9	2.0	8.9	8.9	2.8	-1.8
3. Non-monetary liabilities	4.2	1.7	8.6	0.0	4.1	3.5	6.8	8.0	2.7
4. Domestic money creation (= 1 + 2 - 3)	10.3	9.2	4.2	27.5	5.2	10.7	11.5	2.1	9.0
5. External money creation (net)	13.2	0.0	0.3	-2.9	0.1	0.0	0.0	7.6	0.0
6. Others	-1.2	1.8	0.2	0.0	0.5	0.0	-0.2	-1.7	-0.9
7. Money creation (= 4 + 5 + 6)	5.9	11.0	4.7	24.6	5.8	10.7	11.3	8.0	8.1

<sup>1</sup> Absolute change as percentage of money stock at the end of 1984.  
Source: Estimates by the Commission staff.

smoothly to changes of that order. Furthermore, it should not be forgotten that the period of exceptional strength in sterling and the UK current account resulted not only from oil, but also from the UK cyclical position. The country entered the recession before the rest of the EC, with a real GDP decline of 2.2 % in 1980 while Germany, for example, enjoyed real GDP growth of nearly 2.0 %.

International capital flows have been strongly influenced both by the fundamental shifts in UK fiscal and monetary policy, which followed the 1979 elections, and by the abolition of exchange control. These events were bound to lead, with varying lags, to substantial rearrangements of portfolios. It seems, however, that the major part of these readjustments has now occurred.

Another sign of the appropriateness of the present time for bringing sterling into the exchange-rate mechanism is given by real exchange rates. On the basis of GDP prices, we calculate that for the UK this indicator rose very high in 1981 but is now back to its level of 1970 and below its average level of the 1960s. There is no argument based on price competitiveness which suggests that sterling is due for a fundamental shift in its value. It seems that even over the last five years membership of sterling in the EMS exchange-rate arrangements would have reduced the volatility of sterling. With clear guidance to the markets from the stance of policy, backed up by some intervention, the extremes of the over-shooting might have been avoided. The incorporation of the pound sterling in the EMS exchange-rate mechanism is now a practical proposition. The advantages to the UK would not be inconsiderable. These include the benefit which membership of a zone of monetary stability can bring through dampening the impact of exchange-rate

instability in the rest of the world. Perhaps even more important is the prospect that a stable exchange-rate link to the other EC countries would enable UK producers to see more clearly and more quickly where the chances of profit lie. They will be able to base their investment plans on a commercial appraisal of demand throughout the Community, without their judgement being clouded by important exchange rate uncertainties.

### Problems of Capital Liberalization

Consolidation of the EMS mechanism and closer convergence should also bring greater liberalization of capital movements. Free capital movements in the Community are of prime importance from several points of view. First, capital should be able to flow freely to locations offering the highest reward for its use. This would favour a rational allocation of the scarce factor, which is financial capital. Second, movements of capital imply sanctions which oblige countries, regions or sectors to adapt. Restricting the free movement of capital, therefore, impedes the operation of the market forces leading back to equilibrium. From this point of view, free capital movements tend to preclude measures of economic policy which do not take adequate account of harmful long-run consequences. For these reasons, greater freedom of capital movements will certainly help to reinforce the EMS.

The call for free movement of capital within an economic community is admittedly based on the belief that all countries benefit equally if the factor of production capital is able to flow to the location at which it can be put to best use. But this belief is not entirely borne out by history. For example, following the establishment of the Italian unitary state, capital flowed from the south of the country to the north, and this did much to aggravate the problems of the Mezzogiorno.

**Table 6**  
**Development of the ECU by Market Centres**  
(in billions of US dollars at current dollar exchange rates)

	end-Dec. 1982		end-June 1983		end-Dec. 1983		end-June 1984		end-Sept. 1984	
	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets
Banks in										
Belgium	1.9	1.9	2.5	2.6	1.9	2.5	2.5	3.7	2.8	4.5
Luxembourg					1.1	1.2	1.7	1.7	1.8	2.0
France	0.9 <sup>a</sup>	1.9 <sup>a</sup>	1.6 <sup>a</sup>	2.2 <sup>a</sup>	2.4	3.2	4.4	5.9	4.8	6.2
Italy	1.7	1.8	1.9	1.9	2.8	2.9	4.9	4.8	5.0	4.9
United Kingdom	1.0 <sup>a</sup>	0.9 <sup>a</sup>	0.9	1.0	1.3	1.7	2.3	3.9	3.5	5.3
Others			0.3 <sup>a</sup>	0.3 <sup>a</sup>	0.4	0.4	0.7	0.8	0.7	0.8
Total <sup>a</sup>	5.5 <sup>a</sup>	6.5 <sup>a</sup>	7.2 <sup>a</sup>	8.0 <sup>a</sup>	10.0	11.9	16.5	20.9	18.7	23.6

<sup>a</sup> Owing to rounding, figures may not add to totals. <sup>a</sup> Estimated.  
Source: Bank for International Settlements.

Quite soon after the creation of the EEC, two directives, based on Article 67 of the Treaty, introduced a liberalization of certain transactions such as the acquisition of shares quoted on a stock exchange, direct investments and commercial credits. In the course of the collapse of the Bretton Woods System several member states were forced to reverse, to a certain extent, their liberalization process. This was done with reference to Article 108(3) of the Treaty.

In April 1983 the Commission sent the Council a communication on financial integration in which it attempted to spell out the conditions and procedures for giving a new impetus to the process. The Commission took the view that progress must be made on three fronts simultaneously: strengthening of the EMS mechanisms, convergence of economic policies and greater liberalization of capital movements. These three approaches, it argued, were interrelated and mutually supportive. Greater exchange-rate stability and closer economic policy convergence would facilitate gradual removal of the obstacles to free movement of capital. Conversely, greater financial liberalization would be a calculated risk intended to contribute to greater discipline in economic policy.

In December 1984, the Commission made it clear to the countries still utilizing safeguard clauses that recourse to such clauses was limited in time and that the arrangements were subject to constant monitoring and had to be discontinued once the grounds for their introduction no longer existed. Subsequently, the restrictions were relaxed to some extent. All in all, capital movements in the Community are freer today than at the end of the 1970s.

### The ECU and the System's Further Development

The main surprise in the EMS has been provided by the private ECU, which is proving to be a genuine

financial innovation. Many firms clearly regard it as a useful instrument because of the special combination of remuneration and exchange-rate expectations it offers. It is also gaining in importance as an instrument for exchange-rate hedging. Lastly, European multinationals (e.g. St. Gobain) are finding that it can also be used as an accounting unit. As the private ECU market becomes more liquid and deepens, the problem of wider monetary policy controls on the private ECU will also increase and become relevant. At the end of September 1984, ECU transactions carried out by banks already totalled US \$ 24,000 million (Table 6) and loans to non-banks just under US \$ 7,000 million (Table 7). At the time liabilities towards non-banks stood, it is true, at only US \$ 1,400 million, an order of magnitude that still does not give any cause for concern from a monetary policy angle. To the extent, however, that the ECU starts to circulate independently of national monetary circuits, this market will become more important.

Furthermore, the private ECU is also a particularly apt instrument for borrowing by the authorities in countries with an inflation rate above the EC average. Indeed, the market in ECU-denominated bonds has grown remarkably, particularly in recent months (Table 8). According to figures just released, the ECU was the second most important currency of denomination in April 1985 (borrowings amounting to US \$ 740 million), although there was still an enormous gap separating it from the US dollar (US \$ 7,200 million).

Even at this side of the institutional hurdle (i.e. before the creation of a single parallel currency in Europe and a common central bank) there is considerable potential for developing the ECU further. At any event, there is clearly no way in which, in its present form (i.e. as a basket currency), the ECU can develop into a parallel

**Table 7**  
**The Role of Individual Market Centres in ECU Operations at end-September 1984**  
(in billions of US dollars at current dollar exchange rates)

	Residents				Non-residents				Total <sup>1</sup>			
	Liabilities banks	non- banks	Assets banks	non- banks	Liabilities banks	non- banks	Assets banks	non- banks	Liabilities banks	non- banks	Assets banks	non- banks
<b>Banks in</b>												
Belgium	0.8	0.2	0.9	—	1.5	0.3	3.0	0.5	2.3	0.5	3.9	0.5
Luxembourg	0.6	0.3	0.5	0.1	0.8	0.2	0.8	0.6	1.3	0.5	1.4	0.6
France	1.6	—	1.6	1.1	3.1	0.1	2.9	0.5	4.8	0.1	4.5	1.7
Italy	0.5	—	0.5	2.8	4.4	0.1	1.6	—	4.9	0.1	2.1	2.8
United Kingdom	1.5	—	1.5	0.1	2.0	0.1	3.0	0.6	3.4	0.1	4.5	0.7
Others	—	0.1	—	—	0.4	0.2	0.5	0.3	0.5	0.1	0.5	0.4
<b>Total<sup>1</sup></b>	<b>5.1</b>	<b>0.6</b>	<b>5.1</b>	<b>4.2</b>	<b>12.2</b>	<b>0.8</b>	<b>11.8</b>	<b>2.5</b>	<b>17.2</b>	<b>1.4</b>	<b>16.9</b>	<b>6.7</b>

<sup>1</sup> Owing to rounding, figures may not add to totals.  
Source: Bank for International Settlements.



**Table 8**  
**International Issues of Bonds**  
 Breakdown by currency of issue  
 (in million US dollars)

Currency	1982	1983	1984	1985 Q.1
Australian dollar	—	214.9	312.1	169.4
Belgian franc	137.0	—	—	—
Canadian dollar	1200.1	1067.0	2147.4	1054.9
Danish krone	—	—	—	107.6
Deutsche mark	3252.7	4042.1	4324.3	1298.1
Dutch guilder	617.8	747.7	986.3	171.5
ECUs	823.4	2191.4	2937.5	1135.3
European unit of account	12.3	—	—	—
French franc	—	—	—	—
Hong-Kong dollar	257.8	147.8	323.8	102.5
Japanese yen	598.0	232.7	1190.1	1207.8
Kuwaiti dinar	173.0	—	—	—
New Zealand dollar	16.3	29.7	41.5	73.5
Norwegian krone	30.9	67.0	156.1	20.9
Pound sterling	845.6	2152.5	3964.5	1361.7
Singapore dollar	35.7	—	—	—
South African rand	—	—	—	—
Swiss franc	99.8	—	—	—
United States dollar	42228.2	39205.4	65333.6	24189.5
Total	50328.6	50098.2	81717.2	30834.1

Source: OECD.

currency. Nevertheless, the progressive transition to convertibility will show that the ECU has now gone beyond the take-off phase and is increasingly becoming a useful instrument for European monetary integration. For the ECU is, after all, more than a simple currency basket. It brings together currencies that are linked through a common exchange agreement aimed at achieving internal and external stability. This is not the case with, say, the SDR. For private firms, therefore, the ECU affords much better predictability as regards interest rate movements and the exchange risk.

Up to now the Deutsche Bundesbank does not authorize residents to contract engagements in ECU. According to the Bank such an authorization would not quite be consistent with its determined attitude against indexation. It will certainly be beyond the scope of this article to discuss these difficult problems. From a pragmatic point of view, this problem will only remain relevant if the value of the other currencies in the ECU basket develops significantly differently from that of the DM. If this is no longer the case – or only to a small and tolerable extent – then these dangers will more or less disappear. The more convergence and stability in the Community improves, the less will be the difference of

“quality” between the DM and the other currencies in the ECU basket. This would be of great help for an increased use of the private ECU.

### The ECU and the Dollar

A banking system that uses the ECU is also better placed to absorb a possible flight out of the US dollar. Such a recycling would not threaten the existence of the EMS. At present the ECU is not a reserve *currency*, but it is manifestly beginning to exploit more and more its potential as an effective reserve *medium*.

There is an obvious interest in understanding what has been happening to the dollar: in this respect I have no quarrel with the many commentators who start their analysis with the Federal Government deficit.<sup>1</sup> Notoriously, this rose in just two years from 2¼ % of GNP to 5½ % in 1983. These figures are particularly high in relation to the flow of domestic savings in the USA. There were even quarters in which the flow of government borrowing has equalled the total flow of savings from the US personal sector. It might have been argued that this deficit was tolerable in the recession year of 1982, when credit demand from the corporate sector was cyclically low, but its persistence into 1985 and the years ahead has come into conflict with expanding credit demands from the private sector. The policy of the Federal Reserve – essentially determined to ensure that money supply grows at a rate corresponding to sustainable growth of the US economy in conditions of low inflation – has not permitted the monetisation of much of the government's borrowing recently, so conflicting credit demands have put pressures on interest rates.

However, it seems to me that this analysis is incomplete. Firstly, because the rise of the dollar suggests that the wish of non-residents to acquire dollar-denominated assets has been over-financing the current account deficit; but secondly, because interest-rate differentials are never sufficient of themselves to explain currency movements. They are quickly cancelled out by unfavourable exchange-rate expectations if there is any uncertainty about the currency. The missing element in the explanation may perhaps be glimpsed in an analysis of the way in which the balance of payments deficit has been financed. The financing has been essentially short-term, and two-thirds has been in the form of transactions affecting US banks. Some commentators have concentrated on this phenomenon from the point of view of the banks, but what seems of interest to me is that the US banks can only conduct these operations if, in the last analysis, non-residents are willing to acquire additional short-

<sup>1</sup> See in this context also Heinrich Matthes: Will exchange rate movements impede the economic recovery?, in: Economic Forecasts (North-Holland), Vol. 1, No. 3, September 1984, pp. 16-19.

term claims in US dollars. This, in turn, may stop more or less completely once exchange-rate expectations change drastically.

The facts underline the role of the dollar as the world's money: across the world there are substantial operators who, *ceteris paribus*, prefer to hold their liquidity in the form of dollars. However, this part of the demand for money is not taken into account by the Federal Reserve in fixing its targets for monetary growth. These facts have been persuasively explored by Professor McKinnon. We are a long way from being able to develop the world monetary system in the way that we have developed the EMS. The mutual trust and the system of mutual surveillance which we have built up in the Community just do not exist at world level. But an important step would be to acknowledge that US monetary policy should be responsive to the exchange rate of the dollar as well as to the demand for money arising in the US economy itself. In a system of fixed exchange rates something like this would happen automatically through the intervention mechanism. Perhaps the most important lesson of the last year is that we need to define the analogue for the system of floating rates.

The question which we face in the immediate future may, however, be of a different order. Total demand in the USA is weakening. Thus the depressive effects of the trade deficit and the lagged effects of high real interest rates may cut the US growth rate and with it the private demand for credit quite substantially. In these circumstances market forces have already adjusted the exchange value of the US dollar quite rapidly. What will this mean for the EMS? Before this year, periods of dollar weakness were associated with a flood of money into the Deutsche mark and not into other EMS currencies, putting a strain on EMS exchange rates, but any arguments based on that kind of past experience must be reconsidered.

To project past experience would be to ignore the important achievements of monetary policy in the EMS area which I described earlier. We are converging in low rates of inflation and low rates of monetary growth. Given the significant interest-rate differentials which remain within the EMS, one might expect funds leaving the US dollar to be less centred on the D-mark and more evenly spread among the EMS currencies than was the case in the past. Until further notice even the ECU may be chosen to a growing extent. Substantial funds may also move into the Japanese yen, supported by the liberalization of access to Japanese financial markets now in progress. But it is essentially the success in the

task of progressively stabilizing the purchasing power of EC currencies which inspires confidence as to the cohesion of the EMS for the foreseeable future. Overall, the private ECU could increasingly develop into a medium that makes it into an attractive alternative to existing reserve mediums, and this could in particular relieve the German mark of its function as a reserve currency and a currency for footloose capital, and could ease possible tensions within the EMS.

There is hence the possibility that the ECU will develop as an additional international reserve medium alongside the yen. The present international monetary order, within which the US dollar has a *de facto* monopoly, could then become a system with more checks and balances.

### **Concluding Remarks**

Significant progress has been made in recent years in conquering inflation, restoring external equilibrium and improving the financial position of firms in EMS member countries. The prospects for growth are, therefore, somewhat brighter. The employment outlook is, however, still a source of considerable concern. The average unemployment rate rose in 1984 to 11 % in the Community and looks set to climb further in 1985. There will probably be only a slight increase in job offers, if any. Determined action to tackle unemployment has therefore achieved top priority in the Community. Extra employment will have to be secured primarily through a balanced policy mix that is more conducive to investment and growth. The consensus as to how this policy mix should be designed has been growing considerably in recent years in EC countries.

The main task of monetary policy – and this is increasingly recognized by EC member states – is to guarantee internal and external stability while ensuring the growth of the money stock necessary to achieve adequate growth. The establishment of widespread agreement that monetary policy is to be assigned in this way is an important achievement of recent years, which has led to increased convergence within the system. Indeed, in its present form the EMS emerges as an arrangement that, in the monetary sphere, faithfully reflects the headway made towards European integration. It possesses a high degree of elasticity and leaves national sovereignty in the monetary policy field intact. The transition to a single European currency does, of course, remain quite a distant prospect. Nonetheless, the EMS possesses considerable *de facto* normative strength and has shown that, prior to the institutional phase, further pragmatic impetus can be imparted to monetary integration.