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Gerhard Maier, Bonn\*

## Monetary Co-operation in Europe

*The decisions of the EC conference in Nyborg last autumn were designed to consolidate and expand monetary integration in Europe. What degree of integration have the many years of effort achieved? What are the prospects for the future of the European Monetary System?*

At their meeting in Nyborg, Denmark, on 12th September 1987, the Ministers of Finance of the European Community countries extended the existing credit facilities for financing exchange market intervention within the EMS and re-affirmed their willingness to co-ordinate their economic policies. Both of these actions have become somewhat traditional: politicians who realised the need for European integration began to develop appropriate institutional arrangements long before the establishment of the EMS, and at the same time they proclaimed their readiness to co-operate in the fields of monetary and fiscal policy.

These compromises, which have characterised the history of monetary co-operation in Europe, are an attempt to accommodate two different points of view:<sup>1</sup>

□ the so-called economists point out that European monetary integration can be achieved only if developments in the real economies of member countries are harmonised (co-operation);

□ the so-called monetarists (who are not identical with the school that advocates the use of money supply targets) believe that in the first place institutional arrangements, and above all fixed exchange rates, are needed in order to force an adjustment of economic policies in member states.

The first steps in the field of co-operation were made as early as the fifties.<sup>2</sup> The initial aim was to liberalise payments within the old world and to create a system of multilateral settlement among the central banks, the germ of the presentday credit mechanisms within the EMS. The First Agreement for the Intra-European Payments and Compensations was signed in 1948, the European Payments Union (EPU) was established in 1950 and the European Monetary Agreement was formulated in 1955.

The Treaties of Rome of 1958-59 (EEC Treaty), which laid the foundation for a common market, ushered in the second phase of European monetary integration. These efforts were given fresh impetus chiefly by the Council decision of 2nd February 1971 to achieve economic and monetary union in stages within ten years.

The close trade links within Western Europe are an argument for establishing a currency area. As Mundell concluded in his seminal essay written about three decades ago, a monetary union achieved either by agreeing on completely fixed exchange rates among member countries or, more logically, by introducing a common currency brings savings in terms of the information and transaction costs that cross-border trade would otherwise entail in a system of flexible exchange rates.

However, a monetary union presupposes not only uniform economic development in member countries but also a high degree of conformity of economic policies. Since this aspect has been lacking hitherto, European monetary union is not in prospect. Nevertheless, in the seventies an edifice that would aid the monetary integration of Europe began to be constructed. The institutional arrangements established then – more or less fixed exchange rates among the European partners and financing mechanisms among

<sup>1</sup> Cf. Claudia Albrecht et al.: Das EWS als Modell währungspolitischer Integration, in: Sparkasse, Vol. 104, No. 9, September 1987, pp. 398 ff. On the problems of international co-operation in general, see Beate Reszat: Wirtschaftliche Interdependenz und internationale Kooperation, in: Hamburger Jahrbuch für Wirtschafts- und Gesellschaftspolitik, Vol. 31 (1986), pp. 267-291.

<sup>2</sup> On the history of European monetary integration and the remarks below, see for example Rolf Caesar, Dietrich Dickertmann: Einige kritische Anmerkungen zum Europäischen Währungssystem, in: Kredit und Kapital, Vol. 12, 1979, No. 3, pp. 280 ff.; Wolfgang Cezanne: Begriffe und Optionen der wirtschaftspolitischen Koordination in der EG, in: Hans-Eckart Scharrer, Wolfgang Wessels (eds.): Stabilität durch das EWS? Koordination und Konvergenz im Europäischen Währungssystem, Bonn 1987, pp. 13 ff.

\* Deutscher Sparkassen- und Giroverband.

the central banks – have been developed further in some respects, but they continue to determine the shape of monetary co-operation today.

### Abortive First Attempt

So-called “short-term monetary support”, which provided for loans for two periods of three months, came into being as early as 1970.<sup>3</sup> “Very short-term financing”, providing credit for periods of between 30 and 60 days, and “medium-term financial assistance” were instituted in 1972. The European Monetary Co-operation Fund (EMCF) was founded in 1973 to settle balances between debtor and creditor central banks. Many see it also as the nucleus of an eventual European central bank, but even today it still does not have its own organisation; from the outset its operations have been carried out by the Bank for International Settlements (BIS).

Essentially, the financing mechanisms all come down to the Deutsche Bundesbank providing the central banks of weak currency countries with Deutsche Mark for a set period so that they can stabilise their currencies by means of intervention purchases and thus meet the obligations deriving from fixed exchange rates. These loans are limited not only as to duration but also in some cases in terms of volume, but the history of European monetary integration is one of repeated increases in the limits, the most recent having been agreed in Nyborg.

An independent European system of fixed exchange rates made little sense while the Bretton Woods System was still intact. Under Bretton Woods, currencies were tied to the US dollar and their exchange rates could only fluctuate within a very narrow band ( $\pm 0.75\%$  against the dollar,  $3\%$  against one another). It was only the gradual collapse of this worldwide system of fixed rates – in 1971 the margin against the dollar was extended to  $\pm 2.25\%$  and that against the other currencies to  $9\%$  – that made room for a separate European system of fixed exchange rates. The first chance for specifically European monetary co-operation therefore came in April 1972, when the then members of the EC agreed to allow their currencies to fluctuate by no more than  $2.25\%$  against one another and to limit fluctuations against the US dollar to  $2.25\%$  (the snake in the tunnel). The participating central banks therefore undertook to intervene if the exchange rate reached the agreed upper or lower limits (the intervention points). Sales and purchases within the intervention points, so-called intra-marginal interventions, were permitted in addition to these compulsory interventions, but only with the express approval of the central banks whose currencies

were to be used. When the Bretton Woods System was finally abandoned in 1973, the countries participating in “group floating” severed the link with the US dollar (the snake without the tunnel).

With hindsight, the history of the European currency snake can be described as an abortive first attempt. It lived through a turbulent period and the circle of participants was constantly changing. For example, France left the snake in 1974, rejoined in 1975 but left again for good in March 1976. Thereafter, the snake comprised only the currencies of the Benelux countries, Denmark and Germany. European monetary integration was not much in evidence.

### Claims and Reality

Disillusioned, the then heads of state and government of France and Germany, Valérie Giscard d'Estaing and Helmut Schmidt, took the initiative. The EMS, which was brought into being on 13th March 1979 as a result of their action, had an ambitious objective: after a “transitional phase” lasting a maximum of two years, it was to advance to its definitive form – a monetary union on the basis of a uniform monetary constitution. For that purpose, the final stage of the system was to include a European Monetary Fund. The ECU, which had been born at the same time as the EMS and was identical with the European Monetary Unit of Account already used for accounting purposes, was supposed to develop gradually into a European reserve currency as a counterweight to the US dollar. Those who were particularly ambitious even dreamt of a pan-European medium of payment.

In the beginning, however, a pragmatic approach was adopted, and the EMS was constructed from the elements of the European currency snake, in other words the margins of fluctuation ( $2.25\%$ , exception Italy  $\pm 6\%$ ), the reciprocal intervention obligations and the financing arrangements,<sup>4</sup> although the latter were augmented considerably. Very short-term financing was extended to between 45 and 75 days and the limit for short-term monetary support was increased to three periods of three months each. Intra-marginal interventions were no longer subject to express prior agreement between the central banks concerned.

The system's achievements have been rather modest by comparison with the ambitious objectives it was set. It has not been possible to turn the overambitious

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<sup>3</sup> On the role of the financing mechanisms, see for example Rolf Hasse: *Das Europäische Währungssystem: Gebändigte Regeln*, in: WISU, No. 4, 1985, p. 205.

<sup>4</sup> Cf. Rolf Caesar, Dietrich Dickertmann, op. cit., pp. 285 ff.

dreams into reality; the EMS is still in its initial phase and a European central bank remains as remote as ever. The widely held hope that the pressure of the DM as an international reserve currency would be eased has been dashed, despite the ECU. The ECU has gone into hibernation as far as its official function as a reserve currency is concerned, although it has had a respectable success in private markets.

The EMS appears in a better light if viewed pragmatically, however. Inflation rates have come down markedly in all member states, as have inflation differentials. Moreover, the number of changes of central rates has been small; the EMS has been an oasis of stability compared with the pronounced fluctuations in the dollar.

To what extent are these successes attributable to the EMS? The first point to note is that inflation has also slowed down sharply outside the EMS, as in the USA, Japan and numerous other countries that let their currencies float more or less freely. Like the world economy as a whole, the EMS benefited from the decline in commodity prices, especially the sharp fall in oil prices. In addition, the marked depreciation of the dollar since the spring of 1985 has given most non-dollar countries a strong injection of price stability. The stabilization of prices in EMS countries is therefore due in no small measure to special factors, so that the relative exchange rate stability within the system can also be attributed partly to special factors, since the narrowing of inflation differentials reduced the need to adjust exchange rates.

### Volatile Capital Flows

During the early years, the EMS also benefited from the strength of the dollar vis-à-vis the Deutsche Mark, which competes directly with the dollar as an international investment and reserve currency.<sup>5</sup> The upward pressure on the DM exchange rate that there must have been within the EMS owing to Germany's very much lower inflation rate at that time was therefore offset for a fairly long period, though not entirely. If the dollar had already been weak during the first five years of the EMS, considerably more realignments would have been necessary than the twelve that did take place. It is questionable whether the EMS could have survived.

<sup>5</sup> On the international role of the Deutsche Mark, see Gerhard Maier: Die inlandswirksame Geldmenge in einer interdependenten Welt, Duncker & Humblot, Berlin 1987, especially pp. 109 ff.

<sup>6</sup> Cf. Rolf Caesar: Internationaler Zinszusammenhang und deutsche Zinspolitik im Europäischen Währungssystem, in: Konjunkturpolitik, Vol. 33, No. 1, 1987, pp. 47 ff.

The situation has changed fundamentally since the spring of 1985, however; international investors are now switching assets out of the dollar into the Deutsche Mark, causing repeated bouts of strong upward pressure on the German currency. These capital flows are reinforcing the latent tendency of the DM to appreciate within the EMS owing to the inflation differential and are necessarily causing serious tension between member currencies.

These tensions do not yet herald the demise of the EMS, however. There are several strategies to which member countries can resort if they wish to prevent a realignment despite the persistent appreciation of particular currencies. Besides increased exchange market intervention, mostly within the margins, they have created or tolerated an interest rate differential that makes financial investment in the weak currency countries attractive.<sup>6</sup> Short-term French franc investments are now yielding 9% and lira funds 11%, whereas the return on investments in Mark is only 4%.

Both strategies, which are generally used in tandem, curtail the monetary sovereignty of Germany as well as its partner countries. In retrospect, the adjustment burden in Germany was in fact slight. The Deutsche Bundesbank was not forced to abandon its price stability objective, although the exceeding of the money supply targets in 1986 and 1987 can be attributed partly to the consideration paid to the EMS. Since the Bundesbank

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held fast to its point of view, the EMS was able to survive only because the other member countries were broadly prepared to bring their monetary policy more closely into line with Germany's by accepting higher interest rates.

What induced them to do so? On closer examination, it can be seen that it was not the discipline imposed by fixed exchange rates – that had proved of little avail in the snake – but the recognition that inflation provides no guarantee of economic growth but rather impedes it. Hence in many countries the EMS served to give the stabilization policy added force and credibility.<sup>7</sup> This behaviour turned the EMS largely into a DM currency area, a convoy led by the Deutsche Bundesbank.

## Frictions

The convoy did not operate smoothly, however. Italy and France attempted to insulate their financial markets by severely restricting capital movements in order to preserve at least part of their monetary sovereignty. Some of the necessary interest rate adjustments in their currencies occurred in the unregulated Eurocurrency markets. The purpose of restricting capital mobility was to save these countries having to choose between high interest rates and politically undesirable devaluation of the currency making it easier for them to belong to the EMS. Paradoxically, an arrangement that ultimately runs counter to the objective of the common internal market contributed to the survival of the EMS.

The realignments that were nevertheless carried out generally served to offset the inflation differentials that repeatedly built up in the intervening period. Hence they more or less eliminated the cost advantage the strong currency countries derived from the inflation differential within the EMS and which had diverted trade flows in their favour. In real terms, however, no substantial exchange rate corrections were made; the realignments served essentially to keep the EMS operational.

This is not entirely true of the realignment of January 1987,<sup>8</sup> however, which had been preceded by a wave of strikes in France that had depressed the franc and by a persistent depreciation of the dollar. Although only about

nine months had passed since the previous realignment, the German government could no longer resist the increasing political pressure to revalue, since the financial markets react very sensitively to pronouncements by officials in this regard. The political pressure for an exchange rate adjustment therefore contributed to the instability and revealed a lack of solidarity.

## Nyborg – a Compromise

Exchange controls in France and Italy were greatly relaxed in 1987, although in the case of Italy some have already been restored. This easing of restrictions and the growing disillusionment caused by the lack of progress towards the ambitious ideals envisaged by the initiators of the EMS were the main reasons why in the spring and summer of 1987 the slowly crystallizing desire for further development of the EMS at the institutional level gained impetus in some member countries, and in particular in France and Italy. Far-reaching plans, such as the idea of establishing a common central bank, did not gain acceptance among the hard currency countries, which were not prepared to relinquish control over the domestic money supply. A compromise was therefore reached in Nyborg, on the basis of the proposals drafted at a meeting of EC central bank governors in Basle on 8th September.<sup>9</sup>

The compromise comprises on the one hand a willingness to engage in closer monetary co-operation, backed up by reference to a series of macro-economic indicators designed to show the progress towards convergence, and on the other an extension of the financing mechanisms; the duration of very short-term financing was extended by a month to a maximum of three and a half months, the ceiling for automatic

<sup>7</sup> Cf. Heinrich Matthes: Die Geldpolitik der Bundesrepublik Deutschland im Zeichen der europäischen Integration, paper delivered at the symposium on "Economic policy – new directions in monetary policy", Gustav-Heinemann-Akademie, Freudenberg, 9th May 1987, reproduced in: WIRTSCHAFTSDIENST, Vol. 67, No. 10, 1987, pp. 506-511.

<sup>8</sup> See Eberhart Ketz el: Währungspolitik braucht Orientierung, in: Sparkasse, Vol. 104, No. 2, 1987, p. 42.

<sup>9</sup> See "Verbesserungen am EMS gutgeheißen", in: Neue Zürcher Zeitung, 15th September 1987.

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renewal was raised from 100 to 200 % of the debtor quota under the short-term monetary support arrangement, liabilities (arising from very short-term financing) were made repayable in ECU and the Bundesbank declared its willingness, albeit subject to certain reservations, to grant the weak currency countries credit for intra-marginal interventions under the very short-term financing arrangements.

### Interventions

The main effect of the Nyborg decisions, at least in the "technical" sphere, is to give the weak currency countries more ammunition for intra-marginal interventions, which are useful if tensions come not from within but from without, in other words from the dollar. This was very clear in October and November, when the Louvre Accord came unravelled.

The resulting waves of speculation involving the Deutsche Mark necessarily put other currencies under pressure, with both the French franc and the lira showing a tendency to weaken. No factors specific to the EMS were at play here, since the cost advantage of Germany and the Netherlands resulting from the inflation differentials had been largely eliminated by the January realignment, so that it made sense to ride out the pressure on the franc and the lira by means of increased intra-marginal interventions. But for this, the currencies involved would have quickly reached their intervention points, thereby reinforcing the already existing expectations of a realignment. In the end, it would have been necessary to make an exchange rate adjustment that would not have fitted the fundamentals. The timely defence of the exchange rate grid maintained the credibility of the EMS and made it easier for the weak currency countries to participate in the system. On the other hand, time was only bought at the cost of considerable inflows of foreign exchange to the Deutsche Bundesbank, which offset their liquidity effects by mopping up funds from the domestic economy.

Intervention is therefore a prop that can only be used in certain types of emergency, namely situations in which neither interest rate adjustments nor changes in central rates would be appropriate. The agreement to be guided by indicators is not without its problems either.<sup>10</sup> Such aggregates – e.g. current account balances, unemployment rates, inflation rates, money supply growth rates, etc. – are always capable of different interpretations, depending on one's economic viewpoint. The degree of convergence cannot be

measured objectively; at best, indicators provide points of reference, but these were already available. The success of Nyborg will therefore depend on the seriousness with which the countries take their commitment to economic policy co-operation.

### Prospects

What are the prospects for the EMS in the wake of Nyborg? There is strong interest in retention of the system. More than ever before, industrial firms are now very aware of the advantages of conducting foreign trade at relatively stable exchange rates. For example, 50 % of German exports go to other EMS countries. The same trade considerations long ago prompted Switzerland and Austria to manage their exchange rates by reference to the EMS. Even the United Kingdom, which was a founder member of the EMS but does not belong to the exchange rate mechanism, now restricts the fluctuations in the sterling/DM exchange rate within a narrow band.

The disadvantage of the EMS, however, is that as long as an inflation differential exists it will tend to prejudice producers in weak currency countries. Whether the EMS will endure, and be able to develop further, therefore depends above all on member countries' continued acceptance of the pre-eminence of Bundesbank policy. However, against the background of relatively low inflation, persistently inadequate real growth and chronically high unemployment, criticism of the predominance of the Bundesbank's policy of price stability is growing.<sup>11</sup> It cannot be ruled out that the willingness to co-operate that is essential to the survival of the EMS will again decline. Indeed, only a day after the Nyborg conference Italy reintroduced capital controls without consulting its partners.

In addition there are the problems stemming from the reserve currency role of the Deutsche Mark as long as the dollar remains weak. On the other hand, the Bundesbank has also shown a willingness to compromise as regards interest rate policy, particularly of late. It remains to be seen how the EMS will fare without capital controls, especially if at the same time the stabilization effect induced by conditions in the world economy fades away. Further problems will arise if the number of members is increased without the newcomers being fully integrated into European trade. It appears that the great trials of the system's endurance have yet to come. Widening the band of fluctuation might help the EMS survive the coming storms more easily.

<sup>10</sup> See Hans-Eckart Scharrer: EG-Fesseln für die Bundesbank?, in: WIRTSCHAFTSDIENST, Vol. 67, No. 9, 1987, pp. 430 f.

<sup>11</sup> See Heinrich Matthes, op. cit.