

The European Monetary Fund: Internal Planning and External Relations

Proceedings of the Second International Seminar on European Economic and Monetary Union, held at the International Center for Monetary and Banking Studies, Geneva, December 7-8, 1979.

Introduction by Alexander K. Swoboda

"In Bremen we discussed a 'scheme for the creation of closer monetary cooperation leading to a zone of monetary stability in Europe.'... We remain firmly resolved to consolidate, not later than two years after the start of the scheme, into a final system the provisions and procedures thus created. This system will entail the creation of the European Monetary Fund as announced in the conclusion of the European Council meeting at Bremen on 6 and 7 July 1978, as well as the full utilization of the ECU as a reserve asset and a means of settlement. It will be based on adequate legislation at the Community as well as the national level."

Resolution of the European Council of 5 December 1978 on the establishment of the European Monetary System and related matters.

The European Monetary System came formally into being on March 13, 1979. According to the timetable set by the European Council's resolution, the European Monetary Fund should thus be established by March 1981. The provisions governing the transitional two-year period of the EMS are on the whole clearly spelled out in various Community documents. These specify principally the exchange-rate and intervention mechanisms, the accounting and settlement procedures, and the credit mechanisms as well as the role therein of the ECU and its definition. In contrast, the role, function, and structure of the Fund are left undefined beyond stating that "the existing arrangements and institutions will be consolidated in a European Monetary Fund."¹

Quite naturally, public discussion has focussed mainly on the known and operational features of the EMS, in particular on the

¹ Annex to the conclusions of the Presidency of the European Council of 6 and 7 July 1978 in Bremen.

exchange-rate stabilization procedures and on the requirements — and likelihood — of their successful implementation. The design of the European Monetary Fund (EMF), both of its internal structure and of its external relations, has attracted much less attention, partly because of the greater immediacy of stabilization problems and partly because the design of the EMF is thought to be a matter for technicians. The contrast with the preparatory work that led to Bretton Woods and the passions that the design of the postwar world trading and monetary systems aroused is striking — and worrisome. If the EMF is to be an on-going, successful and vital institution destined to play an important role both for Europe and in the international monetary system at large, its structure and role deserve careful study and scrutiny lest a hastily conceived institutional framework should relegate it to the dustbin of half-baked and pro forma organizations.

It is precisely in order to open the discussion on the EMF that the seminar on "The European Monetary Fund: Internal Planning and External Relations" was organized. It took place in Geneva on December 7 and 8, 1979 and was the second of a series of international seminars on European Economic and Monetary Union organized by Robert Triffin under a grant from the Ford Foundation and with the help of an advisory committee composed of Rudiger Dornbusch, Alexandre Lamfalussy, Alexander Swoboda, Niels Thygesen and Jacques van Ypersele de Strihou. This second seminar was co-sponsored by Geneva's International Center for Monetary and Banking Studies. The first seminar had been held in Louvain-la-Neuve on March 24 and 25, 1979, less than two weeks after the launching of the EMS. It dealt with the background and rationale of the EMS as well as with the first steps of the transitional period and the emerging policy options, especially in the exchange-rate and monetary policy fields.² It was only natural that the second and third seminar should peer at the more distant future, dealing, respectively, with the EMF and the private uses of the ECU.³

² The record of the first seminar was published as R. Triffin (ed.), *EMS: The Emerging European Monetary System* (Brussels: The National Bank of Belgium, 1979).

³ Proceedings of the third seminar will appear shortly as A.L. Swings and R. Triffin (eds.), *The Private Use of the ECU* (Brussels: Kredietbank, 1979).

This issue of the *Banca Nazionale del Lavoro Quarterly Review* contains the papers and comments presented at the Geneva seminar. Quite obviously, the design of the Fund raises, on the one hand, questions of internal planning of the relations among member states and, on the other hand, questions concerning the relations between the Fund, other institutions, and the world monetary and financial system at large. Tommaso Padoa-Schioppa's paper deals more specifically with the first of these two themes, Jacques Polak's with the second; though, as both the papers and comments indicate, the separation is somewhat artificial.

As the EMF is destined to consolidate "the provisions and procedures" created for the European Monetary System's transitional period, it is not surprising that Padoa-Schioppa's paper should discuss the role of the Fund with respect to the three features of the EMS which received most attention when that system was created: credit facilities, exchange-rate arrangements, and the role of the ECU. The originality of the paper lies not so much in what it has to say on the role of the Fund in each of these individual respects — though there is much that is valuable there — as in its emphasis on the price stability component of the "zone of monetary stability" concept, on the role of procedures versus specific rules, and, most forcefully, on the importance of striking an adequate balance between the aforementioned three functional tasks of the Fund rather than trying to achieve perfection on each front separately.

Most participants in the seminar very much welcomed Padoa-Schioppa's focus and emphasis, though they did not agree with each and every one of his arguments. This is indicated both by the comments of T. Peeters, W. Rieke, and A. Shonfield and by the general discussion at the seminar. I will not attempt to summarize individual comments here but will confine myself to a few remarks suggested by the discussion, without trying to identify the points made with the positions of individual participants.

The relationship between conditionality, credit use, degree of exchange-rate flexibility, and the non-inflationary goal set for the EMS gave rise to a good deal of discussion. The main points are familiar from the liquidity-adjustment nexus used to characterize problems of the international monetary system at large. Too much liquidity is inflationary and enables countries to postpone adjust-

ment, too little is deflationary and may force upon countries unnecessary transitional costs of adjustment. And, of course, reserves are required to maintain fixed exchange rates. How then, in the European context, does one insure that adequate credit is available so as not to encourage exaggerated recourse to exchange-rate realignments, and yet prevent excessive recourse to payments deficit financing that could prove inflationary for the area as a whole? Conditionality may seem to be our answer since it should encourage member countries to adopt adjustment measures in addition to financing on-going deficits (or surpluses). Unfortunately, the answer is not quite so easy. Too strict a conditionality may discourage member countries from having recourse to EMF credit, especially in a world where they own abundant reserves and where credit to rich countries is available from other sources: from the IMF, but also and perhaps more importantly, from flush private capital markets. A number of suggestions to help solve the problem were made in the discussion. First, a good case can be made for consolidating very-short-term, short-term, and medium-term credit facilities in the EMF, if only to rationalize the terms of conditionality. Second, it was suggested that "surveillance" was becoming more important than conditionality as a means of encouraging proper adjustment in a world where there is substantial availability and use of unconditional credit. This is the International Monetary Fund's experience and the EMF may well borrow a leaf from it. It was also suggested that surveillance and conditionality could be combined, for instance, by relating conditionality to a criterion such as net reserve accumulation or depletion.

There are of course many further problems with both conditionality and surveillance. One of them is jurisdictional and highly political: are these tasks to be discharged by the EMF or by the European Council? Moreover, what is the proper degree of exchange-rate flexibility acceptable in the surveillance process? This brings us to Padoa Schioppa's contention that excessive reliance has been placed in the EMS on the exchange-rate mechanism to the detriment of the credit mechanism. With this contention, several participants disagreed. They argued that exchange-rate alignments had been few (and that those that took place were indeed needed), that there was the opposite danger of overly rigid exchange rates, and that the purpose of intervention supported by the credit mechanisms was

to avoid erratic movements in exchange rates and not to buck fundamental trends. In fact, intra-marginal intervention has been increasing recently and, in Germany at least, there have been complaints that defense of existing exchange rates has forced an unwanted and large amount of reserve accumulation on the Bundesbank (even if the Bank was able to unwind some of its dollar acquisitions more recently). But one could answer, first, that the record does not enable us to decide *ex post* whether reliance on exchange rate changes (versus financing or internal adjustment) had been excessive: *ex post* the devaluation of the Danish Kroner was perhaps warranted, given the internal policies of that country; *ex ante*, it might have been preferable to have avoided the need for an exchange-rate change by more credit, conditionality, or surveillance of the domestic policies of Denmark. Second, Padoa-Schioppa argued that the point is not so much whether there had been excessive reliance on the exchange-rate mechanism in the past, as whether current practices fail to integrate credit and exchange-rate arrangements to achieve a better balance between the two.

Among the several other issues raised by Padoa-Schioppa's paper, two at least deserve mention here. The suggestion that it is preferable to endow the EMF with a set of procedures rather than decide on rules from its inception appears quite reasonable at first sight but the absence of rules may well detract from predictability of the Fund's and member countries' policies. This would be most unfortunate since predictability of policy is of the essence for exchange-rate stability and for a reduction in inflation that avoids untoward variance in output and employment. On the other hand, one may be able to design procedures that result in predictable policy outcomes that are preferable to unrealistic rules, which are bound to be breached in any case.

Second, much remains to be done in defining the role of the ECU. As Thygesen observes in his comment, it is mainly in giving meaning to the ECU as more than a mere accounting device that the EMF has a decisive role to play; the Fund is less essential to the exchange-rate mechanism and even less to the credit mechanisms. To many, the ECU is essential as both means towards European integration, and as a reflection of the will towards such integration. As Mundell puts it in his comment, "... whether the

ECU is necessary or not depends on whether you want a political union within Europe or whether you do not. This is a political question about the creation of an exclusive political entity or group." At an institutional level, creation of a meaningful role for the ECU implies transfer to the Fund of both ownership and management of at least a portion of member countries' reserves. To insure that the ECU come into its own, Padoa-Schioppa insisted on the necessity of creating an exclusive role for the ECU, a role for which no other asset could substitute. At a functional level, one needs to decide whether the ECU is to become an intervention asset, and for whom. It must also be realized that fixing member countries' exchange rates in terms of the ECU (or any other asset) forces convergence of inflation rates within the Community and requires that member countries' monetary policies follow the implied monetary rule; in turn the common trend in inflation rates will be in large measure determined by the ECU-dollar exchange rate, though how, and by whom, that crucial exchange rate should be determined is left unspecified in most public official discussions.

Discussion of the role of the ECU provides a natural bridge to the external relations of the EMF and to Jacques Polak's paper. The latter contrasts the EMF and IMF and explores the relationship between these two institutions and between the ECU and the SDR. It begins by a comparison of the liquidity aspects of the two systems, an important concern in a price-stabilization perspective. Polak also points to possible conflicts arising from the existence of two sets of conditionality for countries that are members of both the IMF and the EMS. He concludes with a fascinating discussion of the respective roles of the ECU and SDR where one could envisage the EMF depositing in the IMF substitution account the dollars it had received from its members in exchange for ECUs. Much of the discussion, however, has to be re-read in light of the recent decision to postpone inception of the IMF substitution account indefinitely.

Only a few remarks, again inspired by the seminar's discussion, will be offered here on the EMF's external relations. As several participants noted, discussion of a distant system in which there are harmonious relations between hypothetical full-bodied ECUs and SDRs is somewhat unreal in a world that has already moved into an unhappy and strained multi-currency system incapable of contain-

ing worldwide inflation on an unprecedented scale — why talk about the distant future while Rome is burning? One answer is that unless one tries to design institutions properly ahead of time, the future will indeed remain disorderly.

There are at least three areas where relations between the EMF and the system at large will need to be worked out. First, as already mentioned, there is harmonization of conditionality. It was argued that the need for expertise in the tailoring of conditionality provides a case for a decentralized IMF where many of the credits could be granted on a regional basis; the better expertise would be more acceptable to the borrowing countries. The reply to this argument is, on one hand, that this type of decentralization may well breed unnecessary familiarity and, on the other hand, that it raises general questions about the legitimacy of regional discriminatory groupings to which, to borrow from the trade field, Gatt-type rules ought to be applied.

Second, competition between the IMF and the EMF in the granting of credits should be guarded against since such competition would be clearly inflationary.⁴ Third, balance between the SDR and the ECU should be maintained. This requires that both be made desirable assets, carrying appropriate interest and endowed with sufficient liquidity, but somewhat different assets in order that both be held. That can be achieved both by limiting the use of the ECU in terms of holders, and by letting their composition be sufficiently different to endow them with different risk characteristics. In this context, one participant noted, for a well-developed ECU not to be a competing asset with the SDR, the weight of EMF member countries' currencies in the SDR basket should jointly be replaced by the ECU.

But the ECU, if it develops, will compete not only third currencies or outside units, but also with EMF member currencies. If the ECU is to be a success, it should share in at least some of the strength of the Deutsche mark which may make it a strong competitor for some of the weaker European currencies, say, the

⁴ In this respect, there is also the danger that the IMF substitution account may prove inflationary, if U.S. authorities should avail themselves of the opportunity of issuing additional dollars to replace those siphoned off into the account.

Italian lira. This raises several questions as to the long-run transition to a full currency union. It also raises the question of the ECU/DM rate, and through the DM/\$ rate, that of the ECU/\$ rate.

Surprisingly in view of its importance, and not so surprisingly in terms of its difficulty, the question of the ECU/\$ rate or, if you prefer, of the EMS dollar policy, has practically not been mentioned in Community official documents. The issue was brought up at several points during the seminar, in particular at the last session, and this introduction will conclude with a few brief comments on the topic.

The basic problem arises from the fact that the trend ECU/\$ rate plays a fundamental role in determining the roughly common trend of inflation in the countries whose currencies are tied to the ECU. That rate is thus crucial to the cohesion and macroeconomic performance of member countries. Yet there is no explicit mechanism for determining it. In practice, the ECU/\$ rate is largely set by the exchange-rate (intervention) policy of the Federal Republic of Germany. The advantage is that the Federal Republic is also one of the stablest, if not the stablest, member country. As one participant put it: "Under the Bretton Woods System, the U.S. was setting the standard for stability. Why should it be unacceptable that the Deutsche mark should set the standard of stability for the EMS?" The lack of a joint ECU/\$ policy, however, does have some disadvantages. Lack of agreement on the rate can lead to serious tensions within the EMS. For instance, after the November 1979 package of policies in support of the dollar, the strength of that currency provided the Bundesbank with an opportunity to sell some of the dollars it had acquired in the previous period. This, in the end, turned out to be the correct policy for Germany and, probably, for the Community as a whole. In the short run, however, it raised several complaints, notably on the part of the Belgians whose currency was weakened in the process. Some of these tensions (notably as far as the asymmetric impact on cross-rates of capital movements in and out of the dollar are concerned) could presumably be lessened (a) by more explicit, and hence predictable, intervention rules or commitments; (b) by better consultation and information on individual member countries' interventions and some coordination thereof; and (c) by en-

trusting the EMF with some of the jointly decided intervention operations.⁵

In ending this introduction, I should like to record a few of the debts of gratitude we incurred in preparing the Geneva seminar and this publication. I wish to thank warmly Ulrich Camen, Pierre Cosandier, and Georg Junge who helped transcribe the tapes; Sharon Kristjanson and Martine Nguyen-Phuoc who helped edit and prepare the manuscript; this Quarterly, who accepted to publish it. For financial support, thanks are due to the Ford Foundation and to the International Center for Monetary and Banking Studies which also made its facilities available. We are most grateful to authors of papers and comments as well as to all participants for making the seminar a most stimulating one.⁶ Finally, I should like to express our gratitude to Robert Triffin whose customary enthusiasm made it all possible.

⁵ Moreover, as one participant put it, "If an EEC country intervenes in accordance with a joint dollar policy, this country should shift the exchange risk of its interventions to a European Institution."

⁶ In addition to authors of papers and of comments, participants included: P. Baffi, H. Burgard, J. Dixon, M. Emerson, H. Genberg, C. Ghymers, N. Krul, A. Louw, M. Matsukawa, J.J. Rey, P. Ruof, L. Spaventa, R. Vaubel.