The EMF: Topics for Discussion *

> *" All too often I have come up against the limits of mere coordination: it makes for discussion, but not decision. In circumstances where union is necessary, it fails to change relations between men and between countries."*
>
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I. Introduction

Just a year ago the European Council in Brussels approved the Resolution that gave birth to the European Monetary System. It was stated in that Resolution that a " final " system would have been established within two years. " The Group considers that economic and monetary union is an objective realizable in the course of the present decade." These words were written in the Werner Report in October 1970. It was added that " a monetary union implies inside its boundaries... the irrevocable fixing of parity rates."

With only twenty-four days left or, under a more favourable hypothesis, just more than a year, the temptation may be to serve a seminar on the European Monetary Fund with precooked dishes. This paper will resist such a temptation and will present little more than what used to be called " an annotated agenda." It will do so because many problems need more discussion and clarification and because its purpose is only to introduce a debate.

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* The ideas expressed in this paper involve the sole responsibility of the author and do not commit any other person or institution.

The main concern of the following pages is thus not so much to offer solutions as to provide the framework for finding them. This, in turn, requires both certainty that the proper headings for a discussion on the Fund have been correctly identified and that the focus is placed at the appropriate level of generality: for instance, a certain number of specific questions that are currently discussed in this area, such as intervention rules, criteria for realignments, etc. do not necessarily need to be finally decided in their content in order to establish the Fund as an institution.

Three main subjects are identified here as constituting the pillars of the next stage of the European Monetary System: credit mechanisms, exchange rate arrangements, and the ECU. The first and the latter are respectively the asset and the liability side of the Fund's balance sheet. The first and the second represent the alternative means by which tensions among member currencies may be relieved within the system. Each of these three pillars has to be built on solid foundations and in such a way as to allow progress from a " looser " to a " tighter " system. But the secret of a successful new institution, such as the Fund, will lie perhaps more in the appropriate balance between them than in the perfection of each individually. Discussion should therefore centre first on whether the constituting elements have been identified correctly in the three headings mentioned above, and secondly on the question of the balance among these elements.

A few ideas that may be worthy of discussion are suggested in the paper. To offer the reader a quick summary, they are listed here:

— the conditionality attached to the various credit facilities should be reconsidered and increased;

— the relative rôles of the credit facilities and of central rate realignments in the exchange rate mechanism should be re-examined, mainly because it is thought that there is a tendency for the former to be underutilized and the latter abused;

— the rôle of the ECU in both the exchange rate and credit mechanisms has to be defined in such a way that the EMF becomes the instrument for a coordinated approach to adjustment;

— the system should allow some flexibility in exchange rates even in the next stages. The most important point is not variability per se but how changes are made. The Fund should be given the responsibility of managing such a flexibility. Greater stability in exchange rates should be sought initially in an indirect way;

— the Fund should be endowed with procedures rather than with specific rules concerning exchange rate arrangements, conditionality, etc.

It is a premise of the paper that the whole system should be organized in such a way as to be an instrument to fight inflation in the Community, and the first meaning to give to the establishment of a " zone of monetary stability in Europe " should be in the sense of price stability even more than exchange rate stability. No claim for symmetry among high inflation and low inflation countries should be made in this respect. Relatively bold suggestions such as increased conditionality or a more exclusive rôle of the ECU are to be discussed in the light of this anti-inflationary goal.

The paper deals with the system very much as a closed economy. For lack of time the section on the " open system " has not been included but it could be written without too much difficulty, and the second session of this seminar will specifically deal with this question.

The reader may wonder why such favourite chapters in the literature on monetary union, such as intervention rules, convergence to fixed rates, etc., are given little room in this paper. Reasons other than product diversification can be given. The main concern here is with the establishment of a new institution, meaning by that something more steady and stable than case by case coordination. This implies, among other things, that those subjects will be on the agenda of the new institution once it comes into being, rather than on today's agenda. Moreover, too much emphasis has perhaps been given to exchange rate arrangements as the core problem of a monetary union. The Community will have to find its original way in the monetary field as it has done in others, and it is not obvious that the way can be found by immediately focusing on the " irrevocable fixing of parity rates "; rather, an effort has to be made in an area that could be called the economics of institutions, to which the pages that follow aim to address the reader's thoughts.

II. The Credit Mechanism

II.1. *The existing arrangements*

Before discussing how the existing credit facilities could be consolidated into the Fund, it is useful to summarize briefly the mechanisms involved and their current use. Basically there are three mechanisms:

— the very-short-term financing facility;

— the short-term monetary support;

— the medium-term financial assistance.

Apart from the increase in duration and size, these mechanisms were taken over with unchanged operating procedures by the EMS from the previous regime. As we shall see, this poses a problem of integration into the system and one of utilization.

The Very-Short-Term Financing follows largely from a snake-type intervention mechanism. Compulsory interventions in the currencies of the system make it necessary that the relevant currencies are available to the intervening central bank in theoretically unlimited amounts. The very short-term financing facility allows that the claims and obligations resulting from these interventions are not settled spot, and at the start of the EMS the duration of this *unlimited* financing was increased from 30 to 45 days after the end of the month during which the intervention took place. This period may be *automatically* extended for three months subject to the financing not exceeding the debtor quota of the central bank concerned in the short-term monetary support facility; obligations in excess of this limit may be renewed only with the consent of the creditor central banks.

The facility has been used fairly extensively since the start of the EMS. In the first months of the system there was some intervention at the margins for the Belgian franc and the Danish crown, but the amounts were settled immediately and no use was therefore made of the very-short-term financing. In June, however, after the rapid rise of the DM and the failure of the Belgian franc to recover, despite internal monetary measures taken

when the divergence threshold was reached, there was considerable intervention at the margin and the Belgian authorities did not settle spot and drew on the financing facility. This pattern was repeated in July when the interventions were on a smaller but still quite substantial scale. In both July and August the Belgian authorities made some advance repayments which brought their net position to within their debtor quota of 580 million ECUs. In September, before the realignment, there was again very heavy intervention at the margin to maintain the limits of both the Belgian franc and the Danish crown against the DM. As none of these interventions were settled immediately, the very-short-term financing facility was again activated.

The Short-Term Support and Medium-Term Assistance were expanded as the table below shows at the start of the EMS. The effect of this expansion was to increase the total credit availability to about 25 billion ECUs. The duration of short-term credits was increased from a maximum of six to nine months, by allowing the possibility of two three-month extensions instead of only one. But neither mechanism has been activated within the EMS and their previous use was very limited.

INCREASE IN THE SHORT-TERM MONETARY SUPPORT AND MEDIUM-TERM FINANCIAL ASSISTANCE
(million ECUs)

I. *Short-Term Monetary Support*

	QUOTAS			
	Debtor		Creditor	
	Old	New	Old	New
Banque Nationale de Belgique	200	580	400	1,160
Danmarks Nationalbank	90	260	180	520
Deutsche Bundesbank	600	1,740	1,200	3,480
Banque de France	600	1,740	1,200	3,480
Central Bank of Ireland	35	100	70	200
Banca d'Italia	400	1,160	800	2,320
Nederlandsche Bank	200	580	400	1,160
Bank of England	600	1,740 [1]	1,200	3,480 [1]
Total quotas	2,725	7,900	5,450	15,800
Rallonges	3,000	8,800	3,000	8,800

[1] There is an agreement that the UK will not use the addition to its quotas until it has become a full participant in the exchange rate mechanism of the EMS.

II. *Medium-Term Financial Assistance*

	COMMITMENT CEILINGS	
	Old	New
Belgium/Luxembourg	400	1,035
Denmark	180	465
France	1,200	3,105
Germany	1,200	3,105
Ireland	70	180
Italy	800	2,070
Netherlands	400	1,035
United Kingdom	1,200	3,105
Total	5,450	14,100

The Short-Term Monetary Support was set up by an agreement between central banks in February 1970 and was extended with the accession of the three new Member States in 1973, but it has only been activated once in 1973 when the Banca d'Italia was granted a dollar credit for the equivalent of 1.6 billion units of account. This amount was drawn in March 1974. Under the terms of the STMS the amount would have been available for three months renewable once automatically, giving a total period of six months, but in the event it was renewed both in June and September 1974, and in December was partially converted into Medium Term Financial Assistance. In 1976 Italy was also granted a stand-by facility on the STMS but this was not activated, and in June 1977 the Banca d'Italia renounced its right to do so when Italy received a Community Loan.

The Medium-Term Financial Assistance has also been used only once, and again by Italy, whose short-term facility was converted into a medium-term one at the end of 1974, as explained above. The dollar equivalent of about 1.2 billion units of account was lent at an interest rate of 7 9/16 per cent for an average duration of 3 1/2 years, but the repayments were made ahead of schedule and the final tranche was paid off in September 1978. The economic policy conditions attached to the loan were monitored regularly by examinations in the Monetary Committee.

II.2 *Development of the credit mechanisms within the EMS*

a) Consolidation of the credit mechanisms

The Resolution of the European Council in Brussels states that the credit mechanisms " will be consolidated into a single fund in the final phase of the EMS." To that purpose it is easy to conceive the following alternative formulae:

i) consolidate the very-short- and short-term mechanisms;
ii) consolidate the short- and medium-term mechanisms;
iii) consolidate all three mechanisms.

In current discussions the choice between these formulae is thought to bear an important relationship to the question of the nature of the Fund. More specifically, it is claimed that the shorter the duration of the mechanism the stronger the " central bank character " of the institution responsible for it. The rationale of this contention seems to be twofold. First, money, the produce of central banks, is itself of a short-term nature. Second, the existing medium-term mechanism is at present not the responsibility of central banks. However, neither of these points provides, in my view, a strong support to the claim. I will return to that when dealing with the ECU and the institutional aspects of the Fund.

On the relative merits of these three formulae, it is not necessary to summarize here the considerable amount of discussion which has already developed. Rather, it is worth noting that the three mechanisms risk being incorporated in the " final system " in their existing form in much the same way as they were carried without any qualitative change from the previous regime into the EMS. Before that happens it may be useful to ask whether their present characteristics correspond to the needs of a new system.

b) Development of the credit mechanisms

At the start of the EMS the most significant change in the credit mechanisms was the change in the amounts available, and it is worth asking whether the amounts available are now appropriate or whether they are too large or too small. The fact that the short- and medium-term facilities have remained virtually unused would suggest that the amount available for these is at the moment a relatively insignificant question and that developments in other directions should be considered first. For the very-short-term facility the initial credit is available for an unlimited amount, but the automatic renewal is limited by the debtor quotas in the short-term monetary support arrangement. Although the amount of intervention that may be necessary when the system is under pressure can be very large, there is no clear evidence that increasing the amount of financing available or its duration would be helpful. The main aim of this facility is that of a weapon against speculation, and it is doubtful whether any larger movements over the already extended time span can be considered as being only erratic and likely to be reversed. Rather than just expanding them in their existing form more fundamental developments of the mechanisms must therefore be considered.

The connection between credit mechanisms and the definition of the means available to the EMF is at present neither clear nor quite logical. Indeed the credit mechanisms developed historically into a structure that has little to do with the decision to endow the Fund with 20 per cent of member countries' gold and dollar reserves. The existing credit mechanisms have the advantage of making available to each country an amount of reserves greater than its contribution. On the other hand, the endowment of the Fund with deposits of gold, dollars and national currencies has the advantage of clearly defining the asset side of the balance sheet. But the liability side, the ECU, does not correspond at the moment; the amount of resources available to the Fund once the deposits both of reserve assets and, possibly, of national currencies are made does not correspond in quantity or in availability to the amount that countries could receive through the different support mechanisms.

There is also a problem of consistency within the set of the three mechanisms. If there are differences in duration and conditionality, and if the debt contracted under one mechanism can be transformed at maturity into the next-in-length facility (subject to a limit of amount), then one can spell out the implicit story of an economy which uses the three mechanisms. Very-short-term

credit, one can say, is designed to deal with erratic and accidental pressures on the exchange rates, those that are not based on any real disequilibrium in the economy. Inability to repay at maturity, the story goes, may indicate that pressures are perhaps not so accidental and that some kind of disequilibrium is there after all, possibly of a seasonal or even of a cyclical nature. Credit has then to be granted for a longer duration. Similarly, medium-term credit may be interpreted as being granted to deal with even more serious disequilibria, of a cyclical or of a structural character, which can be eliminated only over a longer period of time. This is no doubt only one of the possible stories and it is only meant to show the kind of questions that immediately arise when one tries to rationalize the system of credit facilities. Is the duration of the three mechanisms consistent with the types of sources that may cause tensions in the system (the short-term mechanism may be too short, etc.)? More fundamentally: what kind of actions are going to be taken when tensions prove not to be purely erratic and while a currency is supported by one of the facilities? What happens to the central rate? These questions pose the three further points of conditionality, cost and the balance between credit and realignments as alternative means of relieving tensions, to which we now turn.

There is no element of conditionality in the very-short-term facility but it is only automatically available for intervention at the margins. An important difference between the EMS and the snake arrangement is the use of the divergence indicator, which is in general expected to sound an alarm before bilateral margins are reached. Since, in the EMS, intervention should in principle be made in participating currencies, these should perhaps be automatically available for intra-marginal interventions as well, and not only for intervention at the margins. This could be made subject to the understanding, or even the formal condition that a national currency would only be used by another participant when that currency is on the opposite side of its central rate as compared to the currency of the intervening central bank, so that the action would have the effect of bringing it closer to its central rate. The practice under the present arrangements is that a central bank requiring another currency in the system for intramarginal intervention has to ask permission and there may be instances where this is not granted, in which case the only alternative would be to intervene in dollars. The short-term facility, like the very-short-term, has no elements of conditionality initially, but there can be some conditionality in granting an extension. The medium-term financing in contrast has a strong element of conditionality, involving non-monetary aspects of policy, such as budgetary policy, etc. The introduction of new elements of conditionality is conceivable and perhaps desirable at least for the short-term mechanism. It should aim at variables such as interest rates, growth in monetary aggregates, exchange rates, etc., i.e. variables that are within the strictly monetary horizon and the responsibility of central banks.

As to the cost of credits to a debtor, in the short-term and medium-term mechanisms this is decided at the time the credit is granted. In the very-short-term facility, the interest rate is calculated as the weighted average of the official discount rates of all EEC central banks, with the weights corresponding to those in the ECU; and whereas this has an element of generosity in that the discount rates are frequently lower than other rates, it could be questioned whether there is not a case for the interest cost being borne more widely than only by the country whose currency has arrived at its lower intervention limit, especially if its currency is not divergent while others are. It may be that it is at that position because of the general characteristics of the whole system vis-à-vis the outside world and not only because of its own internal policies. If it has already made efforts to adapt those policies, there are grounds for suggesting that the cost of supplying some credit should be borne more widely. However, it should also le remembered that the general acceptability of an asset can be adversely affected if it bears an artificially low interest rate.

The third point is the appropriate balance between the use of credit and parity adjustments in the exchange rate mechanism. Although it is clear that, given the potential size of international capital movements, no volume of credit is sufficient to hold an exchange rate at a non-equilibrium level for long, it seems that adjustment of central rates has been resorted to more and more frequently and that credit facilities have been used very little. Indeed, it must be asked whether the realignment option is not being abused. I shall return to this later.

These brief remarks suggest a paradox and two conclusions. The paradox is that although it is suggested here that there should be a greater use of the credit facilities, it is also suggested that there should be increased conditionality, which in itself may be thought to discourage such use. This will be returned to below. The two conclusions, which are going to emerge again in the following discussion of the other aspects, are, first, that the key of the system is not so much the perfection of each of its building blocks as the balance between them; second, that the essence of the Fund is not so much in the specific rules that may be chosen at the outset as in the procedures that will be established to adopt the rules.

III. The Exchange Rate Arrangements

Exchange rate arrangements, i.e., both intervention rules and realignment procedures, and the credit mechanisms are the two instruments by which tensions among currencies can be relieved. Within one country, where exchange rates are irreversibly fixed, only credit (or transfer) mechanisms are at work. Within the EMS as it is now exchange rate adjustments are limited by (a) exchange rate agreements (intervention rules, etc.) and (b) realignment procedures. These are also the two subjects on which we have to express ourselves, after briefly reviewing the existing arrangements.

III.1. *The existing arrangements*

To classify an exchange rate mechanism with words like " fixed," " floating " or " crawling " is more difficult in practice than in theory. However, for any construction that, like the EMS, carries the ambitious name of a " system " in the area of exchange rate relationships, some place has to be found in the fixed-floating spectrum.

It is perhaps too early to say in which direction the EMS is developing. As far as the currencies *outside* the system are concerned, it seems as a whole to be towards the floating end of the spectrum, although there is agreement that the unlimited fluctuations of currencies like the dollar may cause problems within the system. As far as the currencies *within* the system are concerned, the experience of the September 1979 realignment would suggest that we are moving towards the direction, taken by the snake since 1976, of a crawling peg without formal decision rules about the size or speed of the crawl.

During its history, the snake moved substantially towards increased flexibility: so much so that it adopted for at least some of its realignments one of the main characteristics of a crawling peg system,[1] i.e. that changes in central rates were accomplished within the margins and so did not cause a discontinuity in market rates. Over the period 1973-1978 two distinct phases may be identified. In the first phase, between September 1973 and October 1976, there were no changes in central rates in the snake amongst those members which remained in the system to the end; in the second phase starting with the adjustment of October 1976 and ending with the final snake realignment two years later, there were four changes in central rates. In contrast, the following table, which shows the balance of payments positions and inflation rates of the countries concerned, shows no marked changes between the two time periods.

TABLE 1

BALANCE OF PAYMENTS[1] AND INFLATION RATES[2] IN SNAKE COUNTRIES 1973-1979

	Germany (1)	Germany (2)	Netherlands (1)	Netherlands (2)	Belgium (1)	Belgium (2)	Denmark (1)	Denmark (2)
1973	1.3	7.6	4.0	8.9	3.3	5.8	−1.7	10.1
1974	2.6	7.1	3.2	9.6	2.1	12.2	−3.0	12.4
1975	1.0	6.1	2.5	9.8	1.2	12.2	−1.5	9.7
1976	0.8	4.5	3.2	8.8	0.9	7.7	−4.8	10.1
1977	0.9	3.8	0.9	6.1	−1.5	6.8	−3.7	10.9
1978	1.5	2.6	−0.7	4.4	−1.5	4.5	−2.6	9.4
1979*	−0.2	4.3	−0.3	4.8	−1.8	4.5	−3.7	9.7

1 Balance of payments: current balance in GDP, percentage shares.
2 Consumer prices, percentage changes
* Forecast.
(*Source*: *European Economy*, Nov. 1979, n. 4).

1 See N. THYGESEN: "The European Monetary System - An Approximal Implementation of the Crawling Peg?", Rio de Janeiro Conference, October 1979.

As far as the balance of payments is concerned, it can be seen that there was a substantial worsening in the position of all countries but an improvement in the relative position of Denmark. On the inflation side the position of Denmark remained very unfavourable relative to that of Germany throughout the period, whereas those of Belgium and the Netherlands relative to Germany were nearly at Danish levels over the period 1974 to 1977 but have since improved. Table 2 shows that, despite the fact that there was substantial evidence at the beginning of the period that some shift in real exchange rates between Germany and the other members was needed, there was no realignment between September 1973 and October 1976.

TABLE 2

CHANGES IN CENTRAL RATES IN THE SNAKE
(against the EMUA)

		DM	HFl	FB/FLux	DKr
March	1973	+3	—	—	—
June	1973	+5 1/2	—	—	—
September	1973	—	+5	—	—
October	1976	+2	—	—	−4
April	1977	—	—	—	−3
August	1977	—	—	—	−5
October	1978	+4	+2	+2	—
September	1979		Changes within the EMS		

The above tables therefore show that initially exchange rate changes were resisted, but that a policy was later followed of trying to adjust through nominal rate changes.

The Danish crown moved down by a cumulative amount of 18 per cent against the DM whereas the Belgian and Luxembourg francs moved by just under 9 per cent and the florin by only a total of 4 per cent. In the latter group of countries, tight domestic monetary policies achieved a substantial reduction in the rate of inflation, but in Denmark the inflation rate was allowed at least to match that of its trading partners with matching shifts in the exchange rate. The realignment mechanism shifted from being used only in response to fundamental disequilibrium to accommodating differing inflation rates and monetary policies.

The initial period of the EMS shows that the new system could be moving in the same direction, with rather frequent use being made of the realignment mechanism. There are good reasons for claiming that the September 1979 realignment of the EMS was a success. It was not made under the pressure of speculation. Confidentiality was preserved. The sign of the parity adjustments was on the whole right. However, one may now wonder what rôle the credit mechanisms play if circumstances such as those that had been prevailing in the June-September period result in a realignment rather than in at least a consideration of the appropriateness of recourse to credit facilities, to support domestic adjustment measures that were taken or could have been taken. While it may be said that the realignment was made in such a way as to precede a speculative attack, it may also be said that it was dictated by fear of such an attack, rather than by any " fundamental disequilibrium ". Indeed, if fundamentals were out of line so as to justify the expectation of a change in parity, this was not necessarily the case for all the currencies that lost ground vis-à-vis the DM.

III.2. *Less flexibility?*

It is often claimed that the system should move towards the fixed end of the spectrum. Tensions ought to be resolved to a larger extent through policy changes, backed up if necessary by credit from the Fund. Exchange rate changes would still be necessary if the economic performance of the participating countries remained so divergent, but a major objective should be to achieve conditions which will make exchange rate changes as infrequent as possible and eventually unnecessary. And the relevant policies will be much more likely to be successful if the markets know that the authorities are determined to avoid an exchange rate change.

Prior to generalized floating it was argued that national authorities would be much better able to control prices, interest rates and output in their economy if the external constraint was removed by freeing the exchange rate. Experience has cast serious doubts on this argument.[2] Great and increasing interdependence of the

[2] See S.W. Black: *Floating Exchange Rates and National Economic Policy*, (New Haven: Yale University Press, 1977).

economies, capital mobility, widespread indexation, and the rôle of expectations in exchange-rate determination have led to a weakening of the effectiveness of exchange rate policy to complement domestic stabilization policy.

In a relatively independent reality with low capital mobility, exchange rate flexibility may no doubt enhance the effectiveness of domestic monetary and fiscal policy, as either a monetary expansion or a fiscal stimulus will lower the exchange rate by increasing imports and reducing exports. However, with high capital mobility the direction of the exchange rate movement, following a fiscal stimulus, becomes uncertain. Such a stimulus will, with an unchanged money supply, raise the domestic rate of interest and give rise to capital inflows; if capital is very mobile, the effect on the capital account of the balance of payments could outweigh that on the trade deficit and the exchange rate would appreciate, offsetting the effects of the stimulus. Expectations would speed up this process even if there were some stickiness in capital movements.

While it may be difficult to give a full empirical justification for a move towards more stable exchange rates within the Community, two main propositions seem to be increasingly accepted.

First, the type of exchange rate flexibility that has been prevailing over the past few years has been disappointing in that, despite what was predicted by theory about the stabilizing effects of speculation, exchange rates turned out to display much greater volatility than expected. The volatility in terms of short- and medium-term fluctuations was often such as to serve no useful purpose as regards balance of payments adjustments. Instead it had the undesirable effect of both distorting resource allocation between tradeables and non-tradeables through large swings in their relative prices, and of discouraging investment and trade and hence reducing growth and employment through increasing risks.

Second, it seems to be increasingly accepted, although not empirically proved,[3] that flexible exchange rates may entail inflationary ratchet effects. The case can most clearly be argued for Italy and the UK. The " overshooting " of exchange rates in

[3] See M. Goldstein: " Downward Price Inflexibility, Ratchet Effects and the Inflationary Impact of Import Price Changes: Some Empirical Evidence," *IMF Staff Papers*, November 1977.

Italy in 1976 and in the UK in 1974 seemed to contribute substantially to inflation. The evidence is that causation between exchange and inflation rates works in both directions and that in the short-run the most important direction is from exchange rate movements to prices, rather than the reverse, which seems to be the most important relationship for the long term equilibrium rate of exchange in accordance with purchasing power parity theories.

Current discussions about future developments of the EMS in the area of exchange rates are often based on discomfort with the present " excessive " flexibility. They tend thus to focus on the two following points: a) the appropriate intervention rules (including a common dollar policy, intra-marginal intervention, and the like) that could reduce tension within the system and b) the possible evolution through which the existing margins could gradually narrow to approach a fixed rate system, itself taken as the final stage of monetary union.

The experience of the first months of the EMS has shown that while credit mechanisms have remained largely unused, a tendency may be developing to use, and perhaps to abuse " re-alignments." A paradoxical situation is thus emerging: that of a system which, while created to increase the rôle of domestic policy (monetary and fiscal) relative to exchange rate policy to adjust for external disequilibria, ends up providing the ideal structure for a more frequent recourse to central parity changes. A comparison between intra-EMS and EMS-dollar relationships might perhaps show that the rôle of credit compared to exchange rate adjustment has been relatively more important for the latter than for the former. One of the causes of the breakdown of the Bretton Woods system was the lack of a non-crisis way of adjustment, and the early years of the snake agreement showed the same problem, with adjustments often being accomplished by currencies leaving the system. More recent experience with the snake and the early experience of the EMS suggest the danger of a complete reversal of this situation.

III.3. *Possible developments*

To depart from this path of very frequent realignments is no doubt a necessity. But for various reasons it may be questioned

whether the adoption of new intervention rules and the narrowing of the margins are steps in the right direction and whether these are relevant problems for defining the Fund. For one thing, new intervention rules, though certainly important, can be adopted outside and without the Fund. As an institution, the Fund will only play a rôle if it is enabled to set rules and if it sets them in a new way and with a new perspective. More fundamentally, an evolution towards narrower margins has to be considered with great caution, since it will constitute progress toward a tighter monetary union only if appropriate conditions are met. Without such conditions the system risks either a breakdown (exit of the franc and the lira from the snake) or an even greater abuse of parity adjustments.

We are accustomed to associate progress towards monetary union with a reduction in the variability of exchange rates because of historical experience at national levels, where it may be difficult to imagine a central bank endowed with the power to vary exchange rates between regions. But in this area, as in others, the Community may well find its own original path. And it may be " a quite mistaken form of monetary supranationallism to start by fixing rigidly the exchange rates between national currencies as a first step towards a supranational currency. We are at the very early confederal stage in our affairs." [4]

There is no reason why a change in rates between member currencies should not remain possible, at least for a certain time, even within the union. The crucial point is not variability, but how the relevant decisions are made.

These considerations suggest that the following criteria are relevant for defining the rôle of the Fund in the exchange rate mechanism:

i) procedures, rather than specific rules, should be defined for the Fund in the area of exchange rate arrangements. It is neither realistic nor necessary to endow the Fund with predetermined rules. These are typically necessary as long as an institution like the Fund does *not* exist. Instead, the Fund should be endowed

[4] J. MEADE: " The Various Forms of Exchange Rate Flexibility," American Enterprise Institute for Public Policy Research, 1966.

with decisional procedures, to be utilized, in circumstances that are inevitably changing and impossible to forecast, to create a " zone of monetary stability." This holds both for interventions and realignments. If central rate adjustments are to take place only in response to fundamental disequilibrium, then it follows that the economic fundamentals within the member states in relation to their exchange rates (amongst themselves) should be continuously monitored by the Fund;

ii) the degree of exchange rate variability should not necessarily be reduced, although some reduction would result from limiting adjustments to those (but not necessarily all) that are based on diverging " fundamentals." More importantly, variability should not be reduced *directly,* i.e. by applying more restrictive intervention and realignment rules. Rather, it should be reduced *indirectly,* i.e. by creating conditions for both the conduct of domestic monetary policies and the use of conditional credit facilities to play a progressively greater rôle relative to parity changes;

iii) an appropriate balance has to be found between the use of credit mechanisms and exchange rate changes, and this in turn requires a clearly established rôle for the ECU. Balanced rôles for these three aspects of the system can only be ensured by managing them together within the same institution.

IV. The ECU

It has been argued above that the three parts of the system in its present form have largely been taken over from the previous arrangements and that they are neither complete nor fit together in a satisfactory way. They are also more characterized by a series of bilateral relationships than by a coherent multilateral system. The goal of a Fund is to both coordinate the workings of the three main parts of the system so as to ensure a correct balance between

them, and to multilateralize each part. To assess the extent of the problem as far as the ECU is concerned, it is necessary to consider the ECU's present position and some of the implications of making it the true centre of the system consistent with the developments discussed above. This can be done by considering two aspects of the ECU: the way it is created and the way it is used.

IV.1. *The existing arrangements*

With the current system of three-month revolving swaps, the vast majority of ECU reserves do not have an existence of their own. They simply represent, under a different name, the *particular* gold and dollars belonging to the central bank concerned. Hence one " Bank of France ECU " does not equal one " Bank of Ireland ECU," as each gives the bank concerned the right to a different proportion of other reserve assets, gold and dollars. This can be expressed in another way by saying that the previous exchange risk position has remained unchanged by the creation of these ECUs. Only the ECUs that are used have an existence which is in any way different from the gold and dollars by which they are backed. But this is true only *within the total period of the swap agreements.* For at the end of that period if the swaps are unwound, so that all the participants reclaim their original amount of gold and dollars, these ECUs also lose their existence.

Parallel to this precarious and largely bilateral way of coming into existence, are the numerous limitations that surround the use of the ECU as numeraire, means of settlement, reserve asset and its position in the credit mechanisms.

In the *exchange rate mechanism* the ECU is used for defining the central rates and so it is formally the numeraire, although the practical consequences of this are very limited as in everyday dealings on the exchange markets the numeraire used is the dollar. Also, the ECU is not used in practice as the numeraire when there is a realignment of central rates. The consequences for the ECU are deduced from the desired bilateral rate changes rather than vice versa, clearly demonstrating the strong bilateral nature of the system. The ECU is also used as a basis for the calculation of the divergence indicator, but this potentially important function is somewhat marred by the complicated, and not altogether satisfactory, adjustments that have to be made because of the non-participation of sterling and the adoption by the lira of wider margins.

As to *settlements,* those for compulsory interventions can be made in ECUs, although even on this very limited class of settlements there are a number of restrictions. The procedure is that when a financing operation falls due, settlement is carried out in the creditor's currency if possible, i.e. if there has been some shift in the market positions; and only if this is not the case, is the settlement carried out in ECUs, and even then the creditor is not obliged to accept settlement in ECUs, for an amount exceeding 50 per cent of the claim being settled.

Looking at the ECU as a *reserve asset,* all the central banks hold 20 per cent of their gold dollar reserves in ECUs, but the system by which this is done means that the practical effects are extremely limited. Each bank has entered into a separate three month swap agreement with the European Fund for Monetary Cooperation (EMCF) for 20 per cent of its gold and dollar reserves. It then manages these reserves on behalf of the EMCF and so, although it formally has ECUs as reserves on its books, there is no real transfer to the EMCF. The exchange risk position remains completely unchanged and the EMCF has no control over the assets. It is agreed that these three month swaps will continue for a period of two years from the beginning of the system.

Finally, *credit* under the very-short-term facility is by nature given in a Community currency but it is accounted for in ECUs and settled in ECUs subject to the conditions given above. There is a provision that short-term credit can be granted in ECUs and medium-term assistance is granted in ECUs, but, as seen above, these facilities have not so far been used.

Thus, while the creation of ECUs is now linked to the specific and temporary swap mechanism, its use is restricted to the official Community circuit and even in that circuit its use is very limited.

IV.2. *Possible developments*

An easy way of dealing with the establishment of the ECU is to analyse how the arrangements could develop beyond today's swap system. It seems clear that if the ECUs are to have a permanent existence of their own, the temporary arrangements have to become permanent, i.e. the swaps made to continue forever with an independent exchange risk. It is less clear, however, that this should require a transfer of *property* of gold and dollar reserves. What has to be conferred to the Fund is not necessarily the property of non-ECU reserves (gold and dollars), but their *management.* And, rather than approaching the problem from that highly controversial and relatively " static " side, it may be perhaps more fruitful to approach it from the functional side of the uses of the ECU.

The use of the ECU could conceivably be extended in various directions. Firstly, in the Community official circuit. It seems obvious that a " full utilization " of the ECU should entail the elimination of the existing 50 per cent limit of acceptability in intra-Community settlements. Secondly, the ECU could be used outside the Community official circuit, both on private markets and with third countries.

The question of the use of the ECU outside the Community will be returned to later and that of its use by the private sector is not within the scope of the paper. But it is worth observing that though it may seem to be the most ambitious, this latter development may well be spontaneous. It should be remembered that what is probably the most important monetary and financial development of the last twenty years, the growth of Eurocurrency markets, has largely been a spontaneous phenomenon. In this area, if official institutions have a rôle to play, it will not so much be a functional or operational rôle, as a regulatory and supervisory one, namely the rôle of permitting banks to open ECU-denominated accounts.

Within the general area of responsibility of a monetary authority, we are dealing here with the function of bank supervision, which is twin, but not identical, to the function of central banking. Current discussions about controlling Euromarkets suggest here that the parallel with ECU-deposits can be pursued further.

The establishment of the ECU as the reserve asset and settlement instrument within the Community depends upon its ability to satisfy the two major inter-related criteria of i) leading to stability within the system and ii) being easily controllable in the interest of trade growth.

The international monetary system was stable when gold was the only reserve asset, but there were liquidity problems as the supply of gold was not linked to need, and was physically more restricted than the growth of world trade. For a time the dollar provided a stable system but then it produced problems of both stability and liquidity. At first liquidity growth was too restricted but then with growing American deficits, which had the desired result of expanding liquidity, the stability was affected as Triffin had forecast that it would be.[5] A confidence problem developed and reserve holders tried to substitute one reserve asset for another, thereby creating intolerable strains within the system both for the reserve centre and for the others who were forced to hold a non-optimal portfolio of reserves.

The existing preoccupations and reservations about the possible consequences of fully promoting the ECU can largely be interpreted as doubts about the ability of the new system to satisfy the two criteria mentioned above. This in turn leads to the problem of the "monetary quality" of the ECU and of the inflationary pressures that might arise because of its establishment. A distinction should be made here.

The ECU is the liability of the Fund while the various forms of credit are its assets, in much the same way as the national currency is the liability of the central bank "backed" by credits vis-à-vis the private sector, the Treasury and the rest of the world. It follows that any change in *volume* of total assets, for example due to a change of total credit extended through the various facilities, would result in a change of total supply of ECUs. That would be true *regardless* of the type of asset created or destroyed by the Fund, whether short-term credit, medium-term credit, dollar or other.

A separate and independent question is that of *determining the monetary nature* of the ECU thus created. And here it may be useful to distinguish the ECU as a numeraire from the ECU as a medium of exchange. EMF liabilities should all be denominated in ECUs but do not need to be all sight-liabilities, i.e. money. It would be technically conceivable, and it may indeed be advisable, to enable

[5] See R. Triffin: "Gold and the Dollar Crisis," (New Haven: Yale University Press, 1960).

the Fund to create, against its assets, ECU liabilities with longer maturities, e.g. when the amount of assets held goes beyond the desired amount of Community-currency creation. In this respect the Fund would operate like a substitution account, or like a central bank empowered to sterilize Treasury-created or balance of payment-created liquidity by issuing its own securities.

Concern with price stability is at the origin of a reluctance to promote the establishment of the ECU by conferring full "moneyness" to it. One more currency, it is felt, equals more money, hence more inflation. And the maintenance of limited acceptability of the ECU is seen as the way to avoid the danger.

This preoccupation with the inflationary consequences of the ECU is particularly deep where inflation has been fought more successfully in recent years, and it has to be considered most seriously. Indeed to create "a zone of monetary stability in Europe" must be interpreted primarily in the sense of *price* stability, exchange rate stability being simply an aspect of this.

Trying to think of an ECU strongly oriented in an anti-inflationary sense, leads back to the two aspects that were mentioned at the beginning of this section: the way the ECU is created, and the way it is used. It also leads to a link between the ECU and the credit mechanisms. In this light, three possibilities should be considered:

a) a more *exclusive rôle* of the ECU as a means for intra-Community settlement;

b) a system of *severe conditions* surrounding ECU creation; and

c) the endowment of the Fund with the power to create *ECU-denominated, non-monetary assets.*

The last point was mentioned above and does not need to be expanded further. The significance of the other two can be caught intuitively, but a few words of comment may be useful.

As to exclusivity, it has first to be recalled that at the national level exclusivity is as essential a feature of money as is full acceptability: the production of money is a monopoly. At a world level, it is clear that the stability problem can be solved by having only one reserve asset. A scheme of this sort was proposed by Triffin as early as 1959, when he suggested that dollar and sterling balances should be converted into claims on the IMF. The substitution account and suggestions for an international monetary system based on the SDR have similarities. It must also be asked whether such a system could run on a Community scale and if so whether this would have the desired quality of stability.

In such a system there is of course no place for any acceptance limits on ECU. Also it should be noted that in this case the ECU would not be exchangeable by members of the system into other reserve assets simply because they wanted to change the composition of their reserves, as this would just re-create the confidence problem in another form. Its gold and dollar backing, although still possible and desirable for other reasons, would not be necessary unless all non-ECU reserves were conferred to the Fund, i.e. unless exclusivity were extended to reserve holdings. The main question about such a scheme is how far it would add to total stability when Member States only hold a proportion of their reserves in ECUs. The confidence problem would not exist for the Fund as the reserve centre of the system itself, but member central banks would still feel the effects of the problem in the rest of the international system to the extent that they held the remaining part of their reserves in other reserve assets.

Finally, severe conditions should be established for the creation of ECUs. One could think of quantitative rules such as the fixation of a maximum growth rate linked to growth of intra-Community trade. But alternatively, and no doubt more rationally, such severity could be linked to the new elements of conditionality that would accompany the consolidation of the credit mechanism.

V. **Concluding Remarks**

V.1. *Institutional and Organizational Aspects*

The considerations above have not attempted to provide a blueprint for the Fund and they have concentrated exclusively on some of its possible characteristics from a *functional* point of view. Nothing has been said about the *organizational* structure of the Fund, or the so-called institutional aspects. It seemed preferable to concentrate on the functional side, which lends itself more

easily to a technical analysis. However, it is often felt that no clear description of the functions of the Fund can be made without spelling out its organizational and institutional aspects. And it is certainly true that functional, institutional and organizational aspects have to be treated consistently. The concept of institution, however, should not be used in too narrow a sense. Indeed it should include all the elements that are susceptible of becoming the permanent, and in part non-reversible, characteristics of the system, such as reinforced conditionality, joint management of reserves, power to set rules for the management of exchange rates, exclusive rôle of the ECU, etc. Thus what is sometimes called the institutional aspect of the EMF is perhaps only a part of what deserves the name of institution: the organizational, legal part of it.

With this clarification, and without aiming at completeness, it may be useful to stress a few points for a discussion of the so-called institutional aspects.

First, a distinction should be made between different aspects of the EMF problem, i.e. i) the definition of the functions of the Fund; ii) the definition of the organic structure of the Fund; and iii) the link between the Fund, national monetary authorities (Treasury and central banks), and Community institutions. The three aspects are related, but different.

Second, it should be borne in mind that today there is no unique formula valid in all member countries for the distribution of rôles between the Treasury and the Central Bank. The same function (setting official rates, changing reserve ratios, fixing monetary targets, etc.) lies in the hands of the Treasury in one country and in those of the central bank in another. This fact by itself suggests that the chosen functional solution has no obvious implication as to the "Central Bank vs. Treasury" nature of the Fund as an institution. Central banks are highly pragmatic inventions and Community pragmatism is most likely to find its new, original pattern.

Third, the choices that have to be made as to the powers and functions of the Fund should not be confused with the choices about the selection of the national institutions from which national representatives in the Fund will be appointed. Similarly, the members of the executive board of the IMF carry specific powers and responsibilities, independently of where they come from.

With these clarifications, four points for the debate can be mentioned:

i) the organic structure of the Fund. The IMF-EIB formula that distinguishes a technical from a political decision level and has some way of weighting votes is particularly interesting in this respect. The example of the Federal Reserve System is of course also interesting;

ii) the need for a "permanent" structure, both with some powers to make technical decisions and with the function of supplying information and leading the decision process;

iii) the problem of voting rules within the Fund;

iv) the scope of responsibilities of the Fund. This is also the problem of placing the Fund in the context of other Community institutions.

V.2. *Why have a Fund?*

The irreverent question has been left for the end. However, to ask whether there is any reason to set up the Fund other than compliance with a Resolution of the European Council is quite legitimate. Only two brief remarks drawn from the preceeding pages will be offered as elements for an answer: they relate to the present state of the EMS, and to the rôle of a new institution.

Some judgement has to be made on the system in its present form. If it is considered that it is not at a stable equilibrium, then some evolution must be envisaged if a move backwards is not to become inevitable. There are good reasons for thinking that the EMS is not at a stable equilibrium. First, there is a tendency for internal tensions to be dealt with by recourse to central rate realignments rather than policy adjustment and/or credit facilities. This polarization is likely to be self-destructive as the system will abuse the realignment option to such an extent that it will no longer provide the external discipline for which it was designed. Second, there is no clear way of dealing with tensions produced from the exterior. This topic has not been discussed in the paper as it is the subject of the discussion in the following session of this seminar, but it forms an integral part of the whole and there must be a well-balanced way of dealing with these tensions if the system is to survive.

If progress towards a "zone of monetary stability in Europe" requires a "tighter" system and a better balance between the various elements, then the problem of creating an appropriate institutional framework arises inevitably. Indeed, only by dealing with credit mechanisms, exchange rate arrangements, and the use of the ECU within *one* single body and *one* set of formal established procedures will it be possible to proceed along an intermediate path between the simple registration of existing divergencies and a too ambitious programme of instantaneous convergence. After all, money is an institutional reality by its very nature and the ECU needs for its establishment to be the liability of a vital institution.

Historical experience suggests that periods of profound change in economic, social and political order often open "institutional breaches" to inflationary processes. It is of the utmost importance to be aware of these dangers in considering the development of a new monetary institution. But dangers do not always come from where they are expected. And one may question whether the best way to avoid more inflation is to limit the role of the EMF and the ECU. Recent experience shows that the "existing order" does not prevent monetary disorder from prevailing in certain countries, and as a result, from threatening the Community as a whole. Thus one is entitled to ask whether the monetary anarchy that some fear may be increased by creating a new system, is not with us already, whether institutional and social breaches are not already wide open and whether the establishment of the Fund, properly conceived, could not be a way to close them.

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