The EMF: External Relations *

1. Introduction

The contribution that I shall try to make to this seminar is, intentionally, limited in two respects. First, I shall concentrate on the technical aspects of the EMS as it exists now and of the EMF as it may take shape in the future. I am fully aware of the broader light in which these Community institutions can be seen and which account in part for their creation: the contributions which, it is hoped, they will make toward political integration and the stimuli which they may exert toward greater harmonization of policies among members. But these are, I believe, not our topics. Secondly, I shall concentrate on a number of interrelated financial aspects of these institutions, rather than attempt to cover their broad economic impact. Thus I shall not comment on the exchange rate mechanism of the EMS, fascinating as that subject is. This is a restriction I have imposed upon myself to keep my remarks reasonably brief, rather than for good and logical reasons.

The concentration of our program this morning on "external aspects" should carry no implication that these aspects are to be regarded as the concern of non-EC countries only, or of the IMF as an institution in abstraction from its members. That would be an extraordinarily narrow way of looking at these matters. Among other things, it would imply attributing to the EC members an insularity and an inward-looking character that one would believe to be equally alien to the larger countries in Europe with their worldwide responsibilities and to the smaller countries that have always prided themselves on their international outlook. Sure-

* The views expressed in this paper are those of the author and not necessarily those of the International Monetary Fund.

ly, the effectiveness of the international monetary system as a whole, and of the IMF as the guardian of that system, is a matter of prime political and foreign policy interest to the members of the Community. With 28 per cent of quotas in the IMF — nearly half of the total for the industrial countries — (as against less than 22 per cent for the United States) and six seats on the Executive Board, the members of the EC clearly have a major responsibility for the future of that institution. Thus the "external aspects" of the EMS are part and parcel of the considerations that should motivate Europeans in defining their position on various aspects of the future EMF.

2. A Comparison of the Liquidity Aspects of the EMS/EMF and the IMF

The liquidity aspects of the EMS as it functions at present and of the EMF as it may function in the future raise important policy issues. Before these issues can be approached it is necessary to reach an understanding of what impact these institutions have or may have on liquidity, which is by no means easy to do. Perhaps it might facilitate understanding of this question if we approached it against the background of the operation of the IMF. Admittedly, the financial aspects of the IMF are not simple either, but at least they have been studied in some detail and some consensus on their implications has been reached.[1]

The IMF is more complicated than the EMS in that it has created at least two reserve assets for its members (reserve positions in the Fund and SDRs) and is planning to create a third — SDR-denominated claims on the substitution account, while within the EMS only ECUs have been issued.

The IMF has created, or may create in the future, liquid reserve assets in four ways:

[1] See, e.g., J.J. Polak: "*Thoughts on International Monetary Fund Based Fully on the SDR*," IMF Pamphlet Series No. 28, Washington, D.C., 1979.

a) It has created "reserve positions in the Fund" as members contributed outside money to the IMF when it began, and when its scale was enlarged by quota increases. This refers in particular to the gold contributions made to the IMF in the past, which was at the time judged necessary for the IMF's liquidity. These transactions, which were normally equal to 25 per cent of quotas, did not involve net reserve creation as countries gave up gold to receive positions in the Fund. Indeed, in the early years of the IMF, these positions could not be regarded as reserves so that the gold contributions amounted to reserve destruction.

b) Secondly, the IMF creates reserve positions in the Fund when it extends credit to members. The net result of these transactions is the creation of additional reserves but this is not their purpose; the reserve creation is a by-product of the credit extension.

c) The IMF allocates SDRs, without receiving any counterpart asset, for the purpose of creating reserves as and when this is needed to meet the global need for reserve increases. While the legal basis for the creation of SDRs is to increase reserves, the observation has been made that in a world in which the great majority of countries can readily increase their reserves by borrowing them from the international banking system, the effect of SDR allocations may primarily be to change the composition of reserves rather than to increase the total amount: to the extent that countries find their need for reserve increases met by SDR allocations they have to rely less on the international banking system for such increases.

d) It can be expected that, in the future, the IMF will create SDR-denominated claims in substitution for dollars which members will deliver to a Substitution Account. The purpose of the operation of this Account will be to contribute to the stability of the international monetary system and to enhance the role of the SDR; the operation does not involve net reserve creation.

How can the operations that may be foreseen for the EMF be classified in terms of the financial operations of the IMF as here described?

a. The creation of the initial amount of ECUs, when the financial operations under the EMS started last spring, bears a considerable similarity to the first operation described for the IMF:

like that, it constituted a mandatory and proportional (to reserves rather than quotas) contribution at the start of the scheme. On further consideration, however, one may wonder whether this is the right comparison. While it is true that the IMF in the past required its members to subscribe gold as a basis for its operations, such is no longer the case and the IMF has indeed begun to phase out its gold holding since before the second amendment. Moreover, the credit mechanisms of the European Community had been in operation for a number of years before March 1979 and are continuing, although on a larger scale, on very much the same lines as before. If these mechanisms did not require capital subscriptions before, why should they be needed now, and in such large amounts (the initial contribution was about ECU 25 billion)? Taking these considerations into account, it would appear that the main function of the contribution of gold and dollars to the FECOM was a different one, viz. to establish the ECU as a major means of settlement among its members. In other words, a more appropriate comparison might be with a Substitution Account of the IMF, among the objectives of which is to enhance the role of the SDR as a reserve asset.

However, if the ultimate aim of the contribution of gold and dollars is to substitute ECUs for these assets in members' reserves, a number of major issues will still have to be resolved. The transfer of the assets will have to be made definitive; at present they revert back to members through 3-months swap operations. And the future EMF will have to decide what to do about the two crucial questions of any substitution account: where to lodge any exchange risk, and how to generate enough income to pay an adequate interest rate on the ECUs — a particularly difficult assignment for the ECUs issued against gold. For the time being, there is no true substitution as members continue to bear the exchange risk on the assets and to earn such interest as their present investment yields. The agreed ECU interest rate (a composite of discount rates in member countries) applies only to those ECU positions, positive or negative, that result from the transfer of ECUs among members. That self-balancing provision is similar to the one determining interest receipts and payments on SDR positions. Indeed, with none of the provisions of a substitution account in place, the most accurate way of describing the distribution of ECUs so far

may be that of an allocation of ECUs, accompanied by the immobilization by each member of an equivalent amount of its reserves in gold and dollars.

b. If it is difficult to interpret, in IMF terms, the issuance of ECUs that has taken place, it is even harder to envisage how EMF credits will be extended. It seems clear that the contributed assets can not be used for this purpose. Will credit be extended in additional ECUs? Like the credit operations of the IMF this would, as a by-product, produce an increase in international liquidity, viz. an increase in the amount of ECUs outstanding without a reduction in any other reserve assets. Is this the interpretation to be put on the reference in the Bremen Communique to a further creation of ECUs "against member currencies"? If so, would that mean that the EMF would follow the — unnecessarily complicated — practice of the IMF that borrowers "purchase" the resources they obtain against an equivalent amount in their own currency?

3. The Supply of Liquidity in General

It is a not particularly surprising fact of life that the supply of international liquidity and the access to international credit in this world is not distributed according to the needs of various classes of countries. The industrial countries enjoy the privilege of access to large swap credits, they are considered the best risks by commercial banks, and they happen also, as the main gold holders, to be the beneficiaries of the steep rise in gold prices. Among the non-industrial countries, the more advanced ones have also had access to large bank credits, while the poorer and poorest countries have been predominantly dependent for the financing of any current account deficits on a shrinking flow of aid money.. Given these differences, it is only natural that the interest that countries show in measures to provide additional liquidity bears an inverse relation to the supplies of liquidity at their disposal. The industrial countries have typically taken cautious stands on such matters as increases in IMF quotas, the liberalization of IMF credit policies and the allocation of SDRs, while developing countries have been more

strongly in favor of such measures. These differences in circumstances had made it relatively difficult in any event to reach international agreement on liquidity creating measures, with the results usually reflecting some kind of compromise. These difficulties could become considerably more serious if the liquidity needs of a number of major industrial countries — the members of the Community — were to be met to a large extent by arrangements outside of the IMF system. In considering the facilities offered by the EMS these comments would seem to apply in particular to the provision of intermediate credit; there is no ready counterpart in the IMF to the mobilization of gold that has been made possible by the depositing of gold in EMS context, nor to the unconditional short-term credits. No useful quota comparison is possible between the resources provided by the EMS and the IMF, but it may be noted that the maximum credit available to any EMS member under the medium-term financial assistance, about seven billion ECUs, is a multiple of the quotas in the IMF of even the largest EC members (these quotas are as follows: United Kingdom SDR 2.9 billion, Germany SDR 2.2 billion, France SDR 1.9 billion, and Italy SDR 1.2 billion). Moreover, the ready enlargement of both the short-term monetary support facility and the medium-term financial assistance facility in a ratio of approximately 2.5 at the inception of the EMS strike the outside observer as generous in comparison with the agreement, laboriously arrived at just previously, to increase IMF quotas by 50 per cent.

These observations are not intended to suggest that the EC members have a closed mind to the needs of other members of the Fund, both with respect to the provision of liquidity and the provision of aid. But something is lost if these two issues are not kept apart — if decisions in the IMF with respect to quotas or the allocation of SDRs do not reflect a felt need on the part of all (or nearly all) members, but the needs of some and the generosity of others.

4. Conditional Credit

The medium-term financial assistance of the EMS—which is intended to be merged into the EMF—is a close parallel to medium-term credit extended by the Fund. A question to be considered is how, if both institutions can extend this type of credit to EC members, the activities of the two institutions should be related to each other.

It is an oversimplification of this problem to see it merely as a question of coordination among two institutions. The first point to bear in mind is that any extension of conditional credit by an international organization is an extremely difficult activity. The intensive criticism to which the Fund conditionality is often subjected bears testimony to this fact. The granting of conditional credit must, on the one hand, be firmly based on principles of adjustment and on guidelines for their application if it is not to be castigated as arbitrary. It must also, on the other hand, take into account and respect the social and political characteristics of the borrowing country if it is not to be castigated as imposing a rigid doctrine on countries without regard to the particulars of the case. Clearly it is not simple for an international organization to navigate between these two rocks. I would not want to say that we know all the conditions that have to be met to make this possible — but I can mention a few. The organization needs a staff with experience, knowledge of countries, a sound theoretical approach, and the courage of its convictions. The staff needs to deal with a wide variety of cases from which it can draw a balanced judgement on the differences and the similarities of the situations in particular countries. It also needs the backing of a strong management, and sufficient independence from political influence so as to be able to implement the principles in individual cases without detailed political supervision. To bring together a staff with these qualifications and operating under these conditions, has, at least in the case of the IMF, taken considerable time; it also requires conditions of employment that are conducive to the creation of a strong *esprit de corps*.

In listing these requirements for the administration of conditional credit by international organizations I am basing myself to considerable extent on the experience of the IMF, but I do not want to imply that the Fund's administration of its credit program is in any sense perfect. Nor is the Fund's experience unique; it had a very interesting precursor in the 1920s in stabilization loans administered by the League of Nations in a number of Euro-

pean countries. What can be said is that the IMF has made strong endeavors to establish a staff that is able to administer a policy of conditional credit with a fair measure of success, and that it has learned from experience how difficult it is to do this. This experience cannot simply be duplicated by any organization that is willing to assemble an *écurie* of economists for this task.

If the members of the European Community have access to conditional credit both within the EMS and from the IMF, a major question for consideration is the relation between the two sources of credit. A similar problem was faced not long ago (in 1975) when the member countries of the OECD were in the process of designing the "Safety Net" facility (the Financial Support Fund). The conclusion of these negotiations was twofold—the insertion of a statement of principle in the Agreement and the stipulation of an order of use. The statement of principle, incorporated in the preamble to the Agreement, reads as follows:

> "RECOGNISING the central role played by the International Monetary Fund in providing balance-of-payments financing;
>
> CONSIDERING that, in view of current economic conditions, it is desirable to supplement, in exceptional cases, other sources of credit to which Contracting Parties encountering serious economic difficulties have had recourse;"

The application of this principle was that before requesting a loan from the Financial Support Fund, a country should represent that it had "made the fullest appropriate use of other multilateral facilities." This formulation placed access to the resources of the IMF before access to those of the Safety Net. In this way it ensured that the availability of very large funds under the Safety Net would not undermine the universitality of the IMF or create the risk of wide discrepancies in the terms on which all members of the IMF would receive conditional credit.

The Safety Net never materialized and the considerations that apply in connection with that endeavor cannot in full be transposed to the European Monetary Fund. Thus, the EMF, unlike the FSF, is to be a permanent institution and the close association among the EC countries based on the Treaty of Rome has no counterpart in the OECD. But the recognition of the central role of the IMF

no doubt continues as an important consideration in the thinking of Members of the Community.

It would be more difficult for the IMF to maintain its conditionality if it could no longer show that the same conditionality was practiced in transactions with industrial countries as with developing countries. IMF transactions with the United Kingdom and Italy in recent years constituted an important foundation for the proposition that the Fund dealt in an evenhanded way with all its members. The same transactions also helped to contradict the notion, which would be extremely dangerous to the position of the IMF as an international monetary institution, that its task was to provide resources to developing countries only, or even in particular.

As regards the more technical question of the cooperation of the two international organizations in the granting of conditional credit, there is only one clear example. In 1974 Italy concluded a stand-by arrangement with the IMF and shortly afterwards the Council of Ministers of the EC granted medium-term financial assistance to Italy on terms that were closely related. In this particular case the main negotiations were conducted by the IMF. If the extension of credit to the same country by the EMF and the IMF were to become more than an incidental occurrence, techniques of cooperation would have to be worked out. This may be more or less easy to do, depending on the structure selected for the EMF, including the roles to be played by the staff and by national representatives.

5. **ECU and SDR: Competing Assets?**

As part of the reform of the international monetary system, the recently amended Articles of Agreement of the IMF contain an important new section (Article VIII, Section 7) dealing with members' obligation to collaborate regarding policies on reserve assets. The most quoted part of that section refers to "making the SDR the principal reserve asset in the international monetary system", but the section has a much broader scope and deserves to be cited here in full:

"Article VIII, Section 7. *Obligation to collaborate regarding policies on reserve assets.* Each member undertakes to collaborate with the Fund and with other members in order to ensure that the policies of the member with respect to reserve assets shall be consistent with the objective of promoting better international surveillance of international liquidity and making the special drawing right the principal reserve asset in the international monetary system."

Clearly, there is a close connection between the objective of promoting better international surveillance of international liquidity and that of enlarging the role of the SDR. The idea of a substitution account in the Fund has been presented by the U.S. authorities in the context of a reduced role for the dollar in international reserves and it is along this route that, over time, conditions more conducive to international influence over the growth of international liquidity could be brought about.

It is, therefore, of particular importance to enquire whether there is a risk that the ECU would become an asset competing with the SDR.

In attempting to answer that question one should not simply look at the external similarity of the SDR and the ECU as baskets of currencies. The essential point is that there is a fundamental difference of functions between the SDR and the ECU.

The SDR was introduced when the conclusion had been reached, in the middle 1960s, that the two traditional means of international reserves and settlement, gold and U.S. dollars, could no longer perform these functions in a fully adequate way. At that time, the considerations that lead to the invention of a supplementary reserve asset were primarily quantitative in nature: based on gold and dollars alone, reserves risked to become too small for a growing world economy. Gold production was about equal to the quantity absorbed in art and industry, leaving little if any for addition to reserves. An increase in the official price of gold, though provided for in the Fund's Articles as a means to stretch the physical supply of gold, was ruled out as a remedy. The quantity of dollars in reserves had crossed the amount of the U.S. gold stock in 1960 and it was feared that any substantial further increase in foreign official dollar balances would undermine the stability of the dollar.

More recently, qualitative considerations supporting a larger role for the SDR in reserves have come more in the foreground. The value of gold in reserves has been multiplied by a factor of close to 10 as the official price of gold, of SDR 35 per oz., has succumbed to market forces. In spite of the conventional wisdom of the 1960s the number of dollars in reserves has increased in a similar proportion — with the untoward consequences that had been feared from such a development. But both of these developments, while reducing the need for a supplementary reserve asset on quantitative grounds, have increased the need for it on qualitative grounds. With a wildly fluctuating price, gold — while immensely valuable as a national treasure — has become unsuitable as an active reserve asset. It has, moreover, been deprived of its previously assured position as a guaranteed means of settlement by the Second Amendment of the Fund's Articles of Agreement. The role of the U.S. dollar as a reserve asset has been impaired by its fluctuations in relation to other major currencies and its tendency on the whole to lose in value compared to an average of them (or, to put the same thought in terms of more basic variables: by the inability of the U.S. Government to prevent or arrest domestic inflationary developments). These qualitative considerations suggest the need for an alternative, rather than a supplementary, reserve asset which could over time take over a large part of the reserve function previously performed by gold and the U.S. dollar. This change in emphasis is reflected in a number of developments in recent years: the objective set for the SDR in the amended Articles as "the principal reserve asset in the international monetary system;" the motivation, "to keep the SDR alive" voiced by many countries for the 1978 decision to resume allocation of SDRs; and the strong and growing interest shown in 1979 by many countries, including the United States, in a substitution account that would replace part of the present stock of dollars in reserves by SDR claims.

These developments over the last 10 to 15 years suggest a clear need for an international reserve asset. One can query whether the present SDR is ideally suited to fill that need — observing its less than elegant name, its rather large currency basket, its low interest rate, or the fact that its circulation is limited to official holders. But it would be difficult to question the long-run need of the system — if there is to be a system — for an international asset that can perform the functions for which the SDR is designed.

The rationale for the ECU lies in an entirely different field. The close association of the EC countries and the desire to avoid unnecessary exchange rate changes among their currencies explain the availability within the EMS of unlimited very short-term credits and large short-term and medium-term credit facilities. These mechanisms tend to delay and — to the extent that swings are reversed — to reduce the need for asset settlement among EC members. In the past, however, the means of intra-EC settlement of positions arising from snake interactions were the same as those used among other countries, and by the EC countries with other countries: gold, dollars, SDRs and positions in the Fund. Indeed, the rule for settlement of the very short-term credits were at one stage that these four assets should be used in the proportions in which the paying country held them in its reserves. As gold lost its position of an active reserve asset, it was eliminated, and the rule was adjusted to the use of dollars, SDRs and IMF positions, in the proportions held. As dollars will be replaced by SDR claims through the operation of a substitution account, these claims could be added to the means of settlement and dollar settlement reduced accordingly.

More generally, the changes in the composition of reserve assets that would take place in the international monetary system as a whole — a system of which the members of the Community constitute a large and leading part — could be expected to be reflected both in the reserves of these countries and in the means used to settle balances among them. Nothing in the experience of the EC up to 1978 suggested an economic or financial need for the addition of a separate asset for these purposes.

It seems reasonable to assume, therefore, that the rationale for the creation of the ECU as a reserve asset within the EMS lies essentially inside that system. From the start, the EC has needed a unit of account and since 1971 neither gold nor the U.S. dollar — which were used until then — could conveniently or suitably be used for this purpose. The kind of conditions which made it acceptable in the 1940s for the IMF and the World Bank to select for this purpose the currency of the member with the largest quota (the U.S. dollar) were never present in the EC. Accordingly, the choice of a package of all member currencies — weighted on the basis of various economic and other criteria — was a natural choice for the European Unit of Account (EUA). The pooling of part of members' reserves envisaged under the EMS scheme then brought about the ECU in its manifestation of a reserve asset. Under the provisions of the EMS, an EC member has the right to use ECUs in settlement of 50 per cent of any very short-term indebtedness, and EC members can make wider use of it among themselves by agreement.

Unlike the SDR, the ECU has no general acceptance obligation extending beyond the settlement provisions just mentioned and no provisions for holdings by other countries. In its present form, it could not, therefore, serve as a reserve asset for non-EC countries. It is also unclear whether any EC interest would be served by introducing the changes that would be necessary to make this possible. None of the individual EC countries encourages the use of its currency as a reserve currency: indeed some go to great lengths to minimize such use. Would these countries want to pursue collectively, at some considerable difficulty, what they are discouraging individually? More specifically, would the EMF want to attract not only part of the dollars of its members but also of non-members?

These considerations suggest that there is no competition between the ECU and the SDR as reserve assets. (Commercial banks can, of course, create ECU-denominated deposits and loans as well as SDR-denominated deposits and loans; this could happen before the ECU existed, in the form of EUA-denominated credits.)

Minister Monory, speaking officially on behalf of all EC countries, informed the March 1979 meeting of the Interim Committee that the purpose of the issuance of the ECU in exchange for gold and dollars is " to progressively institute the ECU as an instrument of settlement and as a reserve asset within the Community but without creating additional international liquidity nor compromising the international role of the SDR. The European Fund for Monetary Cooperation does not have the power, in fact, to use reserve assets deposited with it. Exchange reserves of participating countries will not be increased by the issue of ECUs because they will replace the traditional assets deposited by members. Moreover, the use of the ECUs is limited to settlements between participating countries and, thus, is strictly regional in nature."

The same view was expressed by Henri Basquiast [2] in a paper for a Brookings Seminar, April 18-19, 1979. At that same seminar, however, Christopher McMahon referred to the possibility of a different development in the longer term when the ECU could become "a genuine reserve asset...". He saw it as "an open question whether at a later stage it may be possible for monetary authorities outside the EEC — or even for the private markets — to hold ECUs." [3]

As indicated, the official EEC view is in line with the underlying economics of the possible role of the ECU. It is in line also with the obligation of the EEC members, as members of the IMF, "to collaborate with the Fund and other members [toward the objective of] making the SDR the principal reserve asset in the international monetary system" (Article VIII, Section 7). In this connection one should also note paragraph 5.3 in the Resolution of the European Council of December 5, 1978 on the Establishment of the EMS: "The EMS is and will remain fully compatible with the relevant Articles of the IMF Agreement."

One way to underline the regional/global relationship between the ECU and the SDR would be for the EMF — once it gets lasting possession of the dollars contributed by members — to deposit these in the IMF's Substitution Account when that Account becomes operative. This would substantially reduce the exchange risk to which the EMF would be exposed, on the reasonable assumption that the ECU would fluctuate less against the SDR than against the dollar.

JACQUES J. POLAK

---

[2] H. BASQUIAST: "The European Monetary System and International Monetary Relations," *The European Monetary System: Its Promise and Prospects,* P.A. Trezise, ed., (Washington, D.C.: The Brookings Institution, 1979), pp. 49-56.

[3] C. McMAHON: "The Long-Run Implications of the European Monetary System,", *ibid.,* pp. 81-92.