

The European Monetary System: The First Two Years

*Proceedings of the Fourth International Seminar on
European Economic and Monetary Union,
held at Danmarks Nationalbank, Copenhagen, March 13-14, 1981.*

Introduction by Niels Thygesen

The European Monetary System (EMS) was launched on March 13, 1979. According to the Resolution of the European Council of December 4-5, 1978, which outlined the main features of the EMS, an initial or transitional stage of two years was envisaged before moving on to a final stage, involving, in particular, the creation of a European Monetary Fund (EMF) and the full utilisation of the European Currency Unit (ECU) as a reserve asset and a means of settlement.

For a number of reasons, political and economic, the Council of Ministers has been unable to take the decisions required to move to the final stage. Instead, the transitional arrangements have been extended for another two years. Elaborate inventories on the issues involved in moving to the final stage have been prepared by the Monetary Committee and by the Committee of Central Bank Governors, but no early political decisions are expected.

The experiences with the EMS during its first two years seemed the appropriate subject for the fourth and final seminar in a series organised 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 K. Swoboda, Niels Thygesen and Jacques van Ypersele de Strihou. The three earlier seminars had dealt with the emergence of the EMS (Louvain-la-Neuve, March 24-25, 1979), The European Monetary Fund in its internal and external aspects (Genève, December 7-8, 1979) and the prospects for private use of the

ECU (Louvain-la-Neuve, June 14-15, 1980).¹ While the first three seminars had been largely forward-looking, speculating about such issues as the optimal degree of exchange-rate flexibility to be aimed for in the EMS, the structure and functions of a future EMF and the prerequisites for the adoption of the ECU in private financial contracts, the main purpose of the final seminar was to evaluate how the EMS had actually worked.

This issue of *Banca Nazionale del Lavoro Quarterly Review* contains most of the prepared contributions to the Copenhagen seminar. Five sessions were organised; the first four assessed respectively (1) the exchange-market experiences, (2) the degree of convergence in economic policies and performance, (3) the relationship to non-EMS currencies and (4) the issue of exchange-rate vs. monetary targets with special reference to the possible adhesion of sterling to the EMS. A final session was devoted to an overall assessment and to the concluding remarks of Robert Triffin.

Rainer Maser's paper opens with a chronological review of exchange-rate experiences since March 1979 for the seven currencies participating in the EMS. An ordering into five phases is suggested largely by events external to the EMS, notably changes in US monetary policy or in relative income trends in the United States and Western Europe. In some of these phases, the most important European currency, the DM, has been in an extreme position in the EMS, making the DM/dollar rate binding for other EMS-currencies. Thus, in the spring of 1979 the DM was relatively strong within the EMS, but insufficiently strong, in the view of the German authorities, vis-à-vis the dollar; as the *Bundesbank* sold dollars, she strengthened the position of the DM in the EMS and drove two smaller member currencies to the floor. While this type of strain had been foreseen at the time of the EMS-negotiations, the opposite situation, experienced from the summer of 1980 up to mid-February 1981, had not: a steadily rising dollar, strengthening particularly at the expense of the DM and thereby driving it to the floor. In both types of situation, the dollar intervention policies of the *Bundesbank* became of crucial importance to the other EMS-currencies; in 1979 the *Bundesbank* was criticized by her partners for

¹ The proceedings of these three seminars have been published as R. Triffin (ed.) *EMS: The Emerging European Monetary System*, The National Bank of Belgium, Brussels, 1979, "The European Monetary Fund: Internal Planning and External Relations", in this *Review* September 1980 (with an introduction by A.K. Swoboda) and A.L. Swings and R. Triffin (eds.) *The Private Use of the ECU*, Kredietbank, Brussels, 1980.

intervening too much, while in 1980-81 the — somewhat more subdued — criticism was that the *Bundesbank* intervened too little, or was insufficiently prepared to take defensive action by raising German short-term interest rates to match those prevailing in the United States or in her more inflationary partner countries in the EMS.

There is an obvious way of resolving these types of dilemma situations: the EMS-participants could attempt to implement a common dollar policy rather than leaving the matter to the *Bundesbank* and the US authorities; and they could make use of the so-called divergence indicator in designating who should intervene. Maser's paper contains a plausible analysis of why these developments have not occurred. More interventions without supportive domestic monetary measures would hardly have been adequate to the task of dampening the appreciation of the dollar. Germany's reluctance to take effective action to strengthen the DM prior to February 1981 was due to the strong cyclical worsening of Germany's current external account which made a substantial improvement in her competitiveness necessary. It was only when the inflationary impact of continued depreciation became evident that the German authorities took steps to bolster the DM through tighter management of bank reserves. Wolfgang Rieke in his comments broadly confirms that this was also how things looked to a German official; when interest rates were raised, there was hardly any longer a perception of a policy dilemma between internal and external considerations.

The divergence indicator was the most novel and intellectually interesting feature of the EMS. Was this new indicator, measuring the deviation of a currency from the weighted average of the others, going to be used as a trigger for policy coordination, as expected by some of its proponents? The record of the first two years suggests that it has played a minor role only, justifying in some cases defensive policy actions in countries which had transgressed their lower threshold of divergence. But the coexistence of the divergence indicator with the parity grid which remains the operative core of the EMS is an uneasy one. Paradoxical situations can arise, as demonstrated by Spaventa and discussed in some detail by Günther Baer in his comments. And in most cases where it does give easily interpretable guidelines for action, these guidelines already tend to emerge clearly from movements in the parity grid combined with the information on interventions which are available to policy-makers.

Masera is cautious in his conclusions. He finds that the performance of the EMS has been reasonably satisfactory, but that its relative success may have hinged on temporary factors: the unexpected cyclical weakness of the DM and the readiness of some of the inherently weaker economies in the EMS to sustain a fixed exchange rate order to mitigate inflationary pressures. The real test may be expected to come as the German balance of payments improves and the rise in the dollar price of oil abates, developments which have moved much closer in the course of 1981.

To Pieter Korteweg the past record of the EMS is rather less positive. He argues, certainly convincingly at the level of abstract analysis, that the emphasis on fixed nominal exchange rates inside the EMS creates severe distortions as long as inflation rates are not converging. It would be a rare accident that the changes in real exchange rates which result when allowance is made for inflation differentials corresponded closely to the changes in competitiveness required to restore sustainable current account positions of the participants.

Niels Thygesen's survey of the experiences of the seven participants in 1979-81 suggests that such an accident has been approximately observed. Membership in the EMS has not precluded the three economies with the largest external deficits — Belgium, Denmark and Ireland — from improving their competitiveness. They have achieved this by different routes: Belgium primarily by maintaining a relatively low inflation rate, Denmark by using the scope for devaluing inside the low EMS more actively than others while inflating at near the EMS-average and Ireland by having her high inflation rate more than offset by sharp depreciation of the effective exchange rate because of the strength of sterling, the currency of her main trading partner. Germany and the Netherlands have also significantly improved their competitiveness and this has also been welcome in the light of their emergent external deficits. Among the EMS-participants only France and Italy have not, because of their persistent high inflation rates, achieved any correction of the substantial overvaluation vis-à-vis the main non-member currencies with which the participants had collectively moved into the EMS two years earlier. But in these two countries the efforts to restrain inflation had, during the first two years of the EMS, assumed prime importance, so that the added element of external discipline was not unwelcome.

The fact that the EMS proved able to accommodate such different policy preferences and to be consistent with rather massive collective

depreciation is another way of saying that it turned out to be a much softer currency option than anticipated. It also explains why inflation differentials not only did not continue to narrow as they had done in 1977-78, but began to widen, particularly following the new inflationary impulse from the rise in oil prices. In retrospect, the promising experiences of the pre-EMS period emerge as a temporary interruption of divergence rather than as a new trend which the EMS could consolidate. Although the renewed divergence is less marked than during the years following the first oil price increase, it raises serious doubts as to the future viability of the EMS. The fear, expressed by Alexander Swoboda in the discussion, must be that the emphasis on very infrequent changes in EMS central rates was being overdone in the light of underlying divergence in economic performance.²

The paper presented by Pierre Languetin, Deputy-Governor of the National Bank of Switzerland, looks at the EMS from the perspective of an outside observer vitally interested in the success of the EMS in stabilising not only its internal currency relationships, but also those with non-member currencies, notably the dollar. Languetin sees no conflict between these two purposes, while he recognises that there is no alternative to floating between the major international currencies. He sees encouraging signs of improved cooperation between the US and the European authorities on coordinated interventions which developed in 1980, but sees possible further scope for improvement in the idea of Jacques van Ypersele to set-up dollar/ECU swap arrangements between the European Monetary Cooperation Fund and the Federal Reserve. He would like to extend such forms of cooperation to other major international currencies, notably the Swiss franc, and refers to two specific instances in which the Swiss authorities have intervened against EMS-currencies in preference to using the usual intervention medium of the dollar. Generally the EMS countries have, however, been reluctant to see their currencies used in interventions against third currencies and the discussion revealed no major change in the official position, though informal arrangements like those referred to by Languetin might be feasible.

The discussion on external aspects of the EMS was initiated by Rimmer de Vries and Kumiharu Shigehara. De Vries concentrated on the outlook for the dollar, a decisive factor in assessing the future

² The subsequent Italian devaluation in late March has not basically modified that concern, while the more expansionary policies in France following the May-June elections have rather accentuated it.

environment for the EMS. His predictions of a further rise of the dollar due to tight US monetary policies, a major structural improvement in the US current account and more realistic energy policies combined with broader domestic and international political developments have already materialised. The prospect of "a sort of renaissance for the dollar in the 1980s in considerable contrast to its dismal performance in the 1970s" has to be seen in conjunction with the much greater readiness of the Reagan Administration to leave the determination of exchange rates to the market; and the combination is bound to offer a serious challenge to the cohesiveness of the EMS, though a less difficult one than that posed by a weak and depreciating dollar.

Shigehara's comments centered on three issues: (1) exchange-rate cooperation with non-member countries, (2) the ECU as an instrument of reserve diversification for non-EMS reserve holders, and (3) the relationship with world-wide financial institutions, the IMF in particular.

On the first point he referred to the conclusion of swap agreements between the Bank of Japan and the German and Swiss National Banks. He reiterated the Languetin view that the EMS could be seen as a useful building bloc in the international monetary system also by non-members and that the latter were highly interested in an improved cohesion of the EMS-currencies through greater convergence of economic performance. On the second point, Shigehara — in contrast to de Vries — foresaw some useful role for the ECU as an international reserve asset, particularly if the future EMF, at a time when the dollar has ceased to strengthen vis-à-vis the EMS-currencies, were to engage in substitution operations, issuing ECU-denominated assets off the market in exchange for dollar balances held by diversifiers. On the third point he saw no obvious conflicts between the EMS and the IMF including the surveillance provisions entrusted to the IMF.

During the EMS negotiations it was long unclear whether the United Kingdom would in the end join. A negative decision was reached by the then Labour government, partly on the grounds that membership could lead to excessive appreciation of sterling. The Conservative government which came into office in May 1979 stood by that decision, but the main argument changed in that the difficulty of reconciling intervention obligations with the achievement of monetary targets, the central element in the new government's anti-inflationary strategy, came to the fore. It therefore seemed appropriate to devote one session to the relative merits of exchange-rate vs. monetary targets.

Michael Artis takes up the theoretical issues in his paper in the framework of both static and dynamic analysis. He argues, on the basis of the criterion of minimising the variance of prices around their target value, that an exchange-rate target outperforms a monetary target under most conceivable types of disturbances in a static analysis. The picture is less clear when the dynamics of adjustment are explicitly brought in. In any case, the discussion is only indirectly applicable to the question of UK membership in the EMS, since experience has shown that such membership is a highly erratic proxy for choosing a definite target for the effective exchange rate, the concept which is relevant in evaluating price (and output) performances in alternative regimes. Although the UK experience of monetary targeting, associated with massive appreciation, and the theoretical case in favour of exchange-rate targets both lean in the direction of advocating EMS-membership for sterling, Artis is careful to remind the reader of the limitations of the analysis.

His paper was discussed by Rudiger Dornbusch, Hermod Skaanland and Michael Balfour. While being critical of some of the details in the Artis paper, the main thrust of Dornbusch's analysis is to strengthen the case against monetary targets as a stabilisation strategy in an open economy on a floating exchange rate. Both theoretical analysis and the practical experiences of countries that have tried to follow such a strategy — in addition to the United Kingdom, Argentina and Spain might be mentioned — suggest that it leads to initial sharp appreciation in real terms as the exchange markets react faster than product and labour markets. He also points out that as inflationary expectations decelerate, the demand for real balances rises — a factor that monetary targeting often leaves out of account, thereby causing unintended deflation. There is also the risk that the appreciation cannot be sustained and that the subsequent downward adjustment rekindles high inflation. By contrast, Dornbusch points to the fairly successful ending of hyperinflations after World War I, achieved by a mixture of fixed exchange rates, fiscal stabilisation and massive money creation, though the relevance of these experiences for the ending of moderate inflations remains questionable.

Hermod Skaanland, Deputy Governor of the Bank of Norway, approached the subject from the viewpoint of a small European country which has always opted for an exchange-rate target, presently in terms of a basket of currencies, approximately reflecting an effective exchange rate. In the case of Norway with her fairly strict foreign exchange

controls there have been no major problems of controlling the money stock; and Skaanland finds that controls on capital movements are essential for pursuing exchange-rate targets in a small-open economy.

A final session aiming at an overall assessment of the workings of the EMS was introduced by Erik Hoffmeyer, Governor of the Bank of Denmark, followed by a panel discussion in which also participated Michel Vanden Abeele, Conrad Oort and Luigi Spaventa, and concluded by Robert Triffin.³

Speaking from many years' experience in the Committee of Central Bank Governors, Hoffmeyer began by noting that discussions on monetary and exchange-rate policy have improved fundamentally since 1979 and not only since the start of the EMS. These promising developments and the difficulties of designing an EMF which is at the same time clearly more effective than the present more informal methods of cooperation and acceptable to national politicians in the sense that it does not require of them to demonstrate a degree of Community political cohesion which is presently unrealistic, notably by accepting a genuine common currency, made Hoffmeyer hesitant to support any big-leap blueprints for the final stage.

Yet he does speculate on what he calls two basic versions of an EMF. The first, "the pressure fund", a regional IMF, which makes policy recommendations to member countries and administers conditional credits. But in such an intergovernmental body pressure on borrowers ultimately has to be applied by other member governments who will be weakened in their resolve by the thought that their policies may also come under scrutiny. In contrast to the IMF, the Community may be too small a group to assure firm implementation of conditional programmes, a theme also discussed in Jacques Polak's paper at the second seminar.⁴

The second version, labelled "the power fund", would delegate more power to an EMF on the basis of explicit rules for interventions in foreign-exchange markets and in the monitoring of national monetary actions. But this scheme which would lead towards a European central bank is likely to run into similar problems of inability to formulate

³ Space limitations have obliged to omit the publication of papers and comments presented to the Seminar by Günther Baer, Rimmer de Vries, Erik Hoffmeyer, Kumiharu Shigehara, Hermod Skaanland, Luigi Spaventa and M. Vanden Abeele. They are available on request from Niels Thygesen, Institute of Economics, University of Copenhagen, Studiestraede 6, DK- 1455 Copenhagen K, Denmark.

⁴ See this *Review*, Sept. 1980, pp. 346-67.

sufficiently clear rules and sanctions to enforce them. As long as the scope for borrowing in private international markets is virtually unlimited for highly creditworthy governments, it is difficult to see how a member could be effectively constrained to adjust.

While most participants in the seminar accepted that moving to the final stage would involve the crossing of a threshold which most politicians would consider dangerously high, Michel Vanden Abeele recalled how the decision to launch the EMS had rather dramatically grown out of an unpromising state of affairs three years ago, as the main political leaders seized the initiative and managed to dramatise the need for resumption of progress towards monetary unification. The two other panelists, Luigi Spaventa and Conrad Oort, largely shared Governor Hoffmeyer's skepticism and his preference for a gradualist approach. Spaventa spoke of the disillusionment of that important segment of public opinion in the high-inflation countries that had favoured entry into the EMS in 1978 because they saw membership as a reinforcement of, or even a proxy for, internal constraints to the growth of labour costs and public sector deficits. The disillusionment was not due to any technical weakness of the exchange-rate system — if anything, exchange-rate stability had been overdone — but to the failure of the external commitments to operate so as to exert any discipline on internal policies in the high-inflation countries.

The final session was, as always in this series of seminars, closed by Robert Triffin's concluding remarks, not intended as a summary of the discussion, but as a statement of his personal views. I shall not attempt to summarize his remarks, since it is not possible to improve on the way Triffin, here as elsewhere, succeeds in articulating what most economists who have thought about European monetary integration hope could be done.

In ending this introduction, I should like to record some of the debts of gratitude we incurred in preparing the Copenhagen seminar: to Robert Triffin for taking the initiative to bring together officials and academics for the series of four seminars, to the Ford Foundation for generous financial support, to *Danmarks Nationalbank* and *Privatbanken* for offering facilities and hospitality, to authors of papers and comments who agreed to supply revised manuscripts, to Rigmor Lundgaard for excellent secretarial help and last, but not least, to the *Banca Nazionale del Lavoro Quarterly Review*, for accepting the proceedings for publication. In addition to the authors of papers and comments mentioned above the seminar was attended by Svend Andersen, Jesper Andreasen, Henning Dalgaard, Mohieddin El Ghareeb, Frédéric Boyer de la Giroday, Alfonso Jozzo, Peter Ludlow, Jean-Jacques Rey, Peter Ruof, S. Samuel-Lajeunesse, Arthur Schmiegelow, Niels Ussing, Gabriel Vangrevelinghe and G. Willmann.