

The European Monetary System – Managing the External Relationships

Introduction

It might be useful to start out by summarizing my views on this subject as expressed in December 1979, at a seminar in Geneva devoted to essentially the same topic. At that time, I had raised two questions: (1) could or should the ECU serve as a reserve asset, and (2) could it also become an international intervention currency? In response to these two questions, I had observed that (1) the ongoing diversification out of the dollar into a few other currencies imposed a particularly heavy burden on the DM, and that preference should perhaps be given to a more broadly based instrument, the ECU; and that (2) the ECU could hardly hope to become an international intervention currency unless held and traded on the private market.

Today, I would like to begin by commenting briefly on developments and changes that have occurred since the end of 1979 in the international arena and within the EMS.

In the light of these developments, I shall reflect on ways and means to achieve exchange rate stability. I want then to express my views on the contribution of the EMS to international monetary stability and end up with some considerations on the cooperation with non-member countries.

The International Economic and Monetary Situation

In some respects, not much seems to have changed since the end of 1979. We still have to endure the same crucial problems, i.e. high inflation and unemployment in most countries and very large balance of payments imbalances. To be sure, there are a number of changes but unfortunately the overall picture has hardly changed for the better:

- Despite considerable efforts, inflation is not under control with prices rising even faster than a year ago in several countries.
- Substantial oil price rises breed worldwide inflation while simultaneously increasing their deflationary impact on oil importing countries.
- In addition, the new oil price situation greatly aggravates the balance of payments disequilibria between oil exporters and oil importers, the burden being particularly heavy and worrying for non-oil LDC's and some smaller OECD countries.
- One favourable development is the growing awareness that despite unwelcome short-term effects on output and employment, there is simply no alternative to a vigorous and persistent fight against inflation.
- Unfortunately, again, this fight relies almost exclusively on a restrictive monetary policy whereas fiscal policy continues to be expansionary and inflationary in most countries. As a result, the adjustment burden lies mainly on the private sector and on private investment. This in turn has negative impact on the longer term outlook for growth and productivity. From this perspective the reorientation of US economic policy toward the "supply-side" might indeed be a welcome development.
- As a further result, interest rates are rising everywhere. From a domestic point of view this has the welcome effect of bringing about or maintaining positive real interest rates. This is certainly necessary if inflation is to be brought under control.
- On the other hand, higher interest rates are also influencing the exchange rates. In the short run, this effect even prevails over inflation rate differentials so that considerable changes in real exchange rates are taking place. Currencies that were formerly considered as weak benefit from high nominal interest rates, whereas so-called strong currencies are under pressure. It is quite evident that such a situation cannot last forever, and that the growing disequilibria in real exchange rates are rather disquieting for the future.
- The growing awareness of the inflationary impact of a weak currency has also reinforced the desire to prevent exchange-rate declines. To

some extent, this threatens to lead to a competitive appreciation of currencies, and there is certainly also some kind of competition in the field of interest rates.

- Another important development has been the complete reversal of the situation of the US dollar and the DM. Since the relation between these two currencies is pivotal to the present international monetary system, this reversal has widespread implications. Its causes appear to be rather obvious: Restrictive monetary policy with sharply rising interest rates and an improving current balance in the US, and in the Federal Republic of Germany: lower interest rates in spite of its rising trend and a record current balance deficit. The present situation is very much the reverse of what happened in 1977 and 1978 when the diversification out of the dollar and into the DM put the latter under severe upward pressure. These movements clearly show the vulnerability and fragility of a multi-currency reserve system.

Developments Within the EMS

What has remained and what has changed since the end of 1979?

Several elements have remained unchanged:

- There were, first of all, no exchange-rate adjustments within the system. This might be considered as a great success not necessarily expected at the time by the very critical observers. However, it seems to be generally accepted that this success was mainly due to events having little to do with the functioning of the system. I shall elaborate later on.
- The United Kingdom still does not participate in the system, and it is not for me to say whether this will change in the near future.
- The so-called second phase of the system, originally planned to begin in March 1981, had to be postponed, and it is uncertain how and when it will be implemented.
- No progress has been achieved in reducing economic divergences among member countries. Inflation rate differentials are even larger than before the creation of the EMS. A reduction of divergences,

however, is generally considered to be the most important condition for a success of the system in the longer run.

- Finally, no headway has been made to achieve a better coordination of exchange-rate policies towards the dollar.

Likewise, we have observed a number of important changes:

- There were some very substantial current account shifts, particularly the negative swing in the German balance. There is now more uniformity among EC members in the sense that all countries except the United Kingdom are in deficit.
- Even more important is the shift that occurred in the position of the DM toward the dollar. This was at least partly due to the international rôle of the DM and it was also important for the situation within the EMS. I think it is also fair to say that without this much talked-about weakness of the DM, some of the traditionally weak currencies within the EMS would have come under pressure.
- By and large, the stability of nominal exchange rates was achieved not by a convergence of the economic situations or policies of the member countries as envisaged by the founders of the EMS, but by other means such as a compensation of divergences by interest rates and interventions in the exchange market. This of course raises some serious questions about the longer term functioning of the system.
- My last point will be to mention the opinion generally held that the interventions that were necessary to keep the exchange rates within the established limits could be offset by other monetary operations and had no impact on domestic liquidity. It is therefore maintained that the EMS, contrary to what many observers had feared, had so far no inflationary effect.

How to Achieve Exchange-Rate Stability

Based on the last two remarks I would like to add a few comments on how to stabilize exchange rates. To my surprise, some important aspects of this question do not seem to have received much attention although they are of considerable interest both for the external relations and for the internal functioning of the EMS.

In short, there are three ways to stabilize exchange rates:

- *By achieving a better convergence of economic situations and policies.*

This is by far the best way. If divergences are not significant, there should be no major problems for exchange rate stability, and the need for interventions would be limited. This of course is the ultimate goal of the EMS.

- *By compensating economic divergences by interest rate policies.*

The use of monetary policy to offset divergences in fundamentals is what we are watching today. Such a strategy necessitates a subtle play if several currencies are involved. This is particularly true if an important or indeed the key currency like the dollar remains outside the system. Furthermore, it is unlikely that such a strategy can work in the medium and longer term, since pressures to adjust real exchange rates will intensify.

- *By interventions.*

An important aspect of interventions is often neglected, namely their effect on domestic liquidity and the extent to which this effect is compensated by other operations.

Two questions arise:

- 1) Is a compensation of the liquidity effect desirable?
- 2) What is the *overall* effect on liquidity, not just of the intervention itself or of some compensating operation but including all domestic monetary operations? Also, the liquidity effect has to be taken into account for both currencies involved.

According to our own experience, interventions have only a limited effect on the exchange rate of our currency when the liquidity effect is compensated by other monetary operations. The efficiency of interventions thus suffers from operations compensating the liquidity effect. If applied strictly, this would mean that a domestic monetary policy would have to be completely subjected to exchange rate considerations.

Even an ardent supporter of fixed exchange rates would probably not go that far. But one could imagine some intermediate solution. We can ask which of two currencies involved in a particular intervention should be influenced. As an example, when we buy dollars against DM,

are we doing it to support the dollar or because we are worried about the DM's strength? Of course, the effect on the two currencies depends on many factors such as the relative size of the two markets. But as a principle we can say that in the first case the liquidity effect on the DM should be compensated but not the effect on the dollar. In the second case, i.e. if we consider the DM to be too strong, the liquidity effect on the dollar should be compensated but not the effect on the DM. This principle should apply to interventions by both the *Bundesbank* and the Fed.

The key question remains how to decide which currency should be influenced. Within the EMS, the divergence indicator or any other suitable indicator could be used to answer this question. If other currencies are involved, solutions should be found through consultation among the countries concerned.

There is no doubt that such an intervention policy would essentially subject domestic monetary policy to exchange rate constraints. This is what we had under the fixed exchange rate system and what we gave up by moving to floating exchange rates. We face a basic issue of priorities in economic policy: if our goal is exchange-rate stability, the course of action is obvious. Interventions can only be a short term instrument. In the medium and long term, greater convergence of economic policies is the only satisfactory way to maintain exchange-rate stability. My suggestion for an intervention policy would meet the short-term need while at the same time making a contribution to achieving the medium term goal.

These ideas about interventions are mainly of interest to the situation within the EMS. But I think they also apply to other currencies and to interventions in EMS currencies against other currencies such as the dollar.

The Contribution of the EMS to International Monetary Stability

I shall now turn to the special question of the EMS contribution to international monetary stability. Serious problems are to be solved, such as:

- inflation
- exchange-rate stability
- balance of payments adjustment and financing
- international reserve asset diversification.

Inflation

According to the December 5, 1978 decision, stable exchange rates are not the ultimate goal of the EMS. Beyond that, the system should contribute to more economic and mainly price stability. This implies that it should have a disciplinary effect on member countries and that its intervention and credit mechanism should have no substantial inflationary impact.

Looking at the recent past, there is no doubt that domestic policy in EC countries, mainly in those with high inflation, has become more restrictive in order to fight internal but also to avoid external depreciation. To what extent was this due to the existence of the EMS or to the growing internal awareness of inflation's problems, or to external factors such as the strength of the US dollar?

Until recently, the EMS was in a rather unusual situation; currencies of high inflation countries were rather strong and the D-Mark with the lowest inflation is deemed to be weak. This meant that the disciplinary pressure of the EMS was rather on Germany — in addition to Belgium, whose currency was also and still is at the lower end of the prescribed band.

As to the impact on third countries, I see no *a priori* reason why the existence of the EMS *per se* should have either an inflationary or a disciplinary impact. It depends on the degree of stability within the EMS, on the policy vis-à-vis other currencies and on the policy of third countries vis-à-vis the EMS.

However, we can reasonably assume that the EMS could have a certain disciplinary effect on third countries if a greater price stability were achieved within the EMS.

Exchange-Rate Stability

In Europe, the EMS made an important contribution to more exchange-rate stability during the past two years. This had positive effects on trade and economic integration and most likely also on investment and economic growth. Other participants are undoubtedly in a better position to assess these effects. My question is the extent to which the EMS did or could contribute to more exchange-rate stability in a global perspective.

On a worldwide basis, there is at present no viable alternative to floating, and no chance for a return to a system with fixed exchange rates. But there is also a growing recognition that some kind of management of flexible exchange rates is necessary in order to avoid highly unwelcome developments such as massive overshooting. Close economic relationships between countries laterally reinforce the need for a common management of exchange rates, and represent a powerful incentive for cooperation.

It seems therefore quite logical to me that cooperation and concertation should be initiated on a regional basis. In such a closer cooperation among countries in similar economic situations, I do not see a threat to the international monetary cooperation. On the contrary, I agree to the view Mr. Triffin expressed in an article last year that a success of the EMS might give an example and an incentive to the rest of the world for greater efforts to closer cooperation in the exchange rate management.

Therefore, the best contribution of the EMS to more exchange-rate stability on a global scale shall be its own success. If the EMS works well, it will also help preventing serious disturbances for the international monetary system.

Balance of Payments Problems

The EMS should provide a framework for as much adjustment as possible among its members and for the necessary facilities to the extent that some financing is inevitable. This of course is what the EMS was created for. It could include some efforts for the recycling between

surplus countries and EMS countries to the extent that they have an overall balance of payments deficit. On the other hand it is hard to see why and how the EMS — in addition to an active participation of its members in efforts undertaken in organisations such as the IMF — should play a major role in the recycling process between other countries.

The ECU as an International Reserve Asset

The instability inherent in a multicurrency reserve system is well known in theory and in practice. We know of the problems of the gold-silver standard, of the gold-dollar standard, of the dollar-sterling standard and more recently of the dollar-DM standard, if you allow this expression.

Today, the US dollar is the only currency assuming all the functions of a currency on an international scale (unit of account, medium of exchange and store of value).

In recent years, some reserve currencies emerged, but up to now, all of these national currencies are too "small" to assume a rôle similar to the dollar. Unless the dollar remains stable in the longer term, — and possibly even if the dollar remains stable — the need for some currency diversification will or may still exist. A major problem of such a diversification process is the fact that, by and large, it is undertaken with the sole aim of value storing. As a medium of exchange, the position of the dollar is still largely unchallenged. This in my view entails the risk of more shifting from one currency to the other than if both were used as a medium of exchange.

If national currencies are not significant enough to take over the rôle of a widely used alternative to the dollar, why not use the ECU? The ECU as an alternative reserve asset could certainly alleviate the burden of the DM that led to its excessive appreciation in 1978 and to its exaggerated depreciation these days. It could also reduce tensions within the EMS inasmuch as they are caused by large shifts between the dollar and the DM. Using the ECU as a reserve asset would of course pose some technical problems, such as the question of how to create and to use these ECU's. In addition, I think the ECU can only play such a rôle if its use is allowed in the private market, as is true for the SDR.

Steps in this direction of course depend on further progress on the way to a European monetary fund.

Such a rôle of the ECU requires much greater economic convergence among member countries. As long as there are national currencies — even within the EMS — which are clearly more or less attractive than the ECU because of anticipated re- or devaluations, the ECU could not really hope to alleviate the situation of individual currencies.

Cooperation with Non-Member Countries

Within the EMS, the possibilities of a closer cooperation with other currencies have been hardly discussed up to now. Quite often one hears complaints about the lack of coordinated policies towards the dollar. But with few exceptions the ideas do not seem to be very specific as to how this situation could be improved. Currencies other than the dollar are hardly ever mentioned although the decision of December 5, 1978, points out the possibility of a closer cooperation with other European currencies.

With regards to the *dollar* it is often said that the EMS has no common policy. In my view, this is not quite true. As Mr. van Ypersele recently mentioned in a speech there is *de facto* a common policy because the external position of the EMS is determined by the key currency of the system — the DM — and to the extent that the other currencies accept such a domination and keep their relation to the DM stable. To an outsider, such an arrangement is not necessarily bad as long as the key relation is managed in a responsible way. One could even argue that the decision making is easier than in the case of a common policy determined in consultation among all members. Whether member countries share such a technical view might however be debated.

From time to time there have been complaints that the dollar interventions against the DM did destabilize the EMS. There have been no such complaints in recent time. In some cases the US authorities began to intervene in other EMS currencies in order to avoid a destabilizing effect on the EMS. This clearly shows that a closer cooperation is feasible without formal agreements.

Intensified cooperation along these lines between the EMS and the dollar should be seriously considered. In this context, Mr. van Ypersele's idea of dollar/ECU-swap arrangements between the Fed and the FECOM deserves further thought. It would allow to choose in a more systematic way the EMS-currency best suited for interventions against the dollar according to the situation within the EMS.

What I said about the cooperation of the EMS with the Fed can also be applied to *other currencies* such as the Yen or the Swiss franc. Such a cooperation could be advantageous for both sides. There are situations — within the EMS — where the selection of an intervention currency can create problems. Very often, the solution in the past was to intervene in dollars. But this might be undesirable due to the particular position of the dollar. In such a situation, it would be helpful if a currency of a third country were available for interventions.

Monetary authorities outside the EMS could be in a similar position. They may want to intervene in the exchange market against their own currency at a time when interventions in dollars are not convenient for one reason or another. By intervening in a EMS-currency, selected according to its situation within the system, third countries could contribute to the stability of the EMS.

These ideas are not purely hypothetical. I remember two cases where interventions in Swiss francs against EMS-currencies took place. In one case we bought the currency of an EMS-member when it was weak within the system and our currency was strong so that we had to intervene anyway. In the second case, when the Swiss franc was relatively weak, we allowed a member of the EMS whose currency was close to the upper limit in the system to purchase Swiss francs against its own currency.

These examples show that cooperation between central banks of EMS countries and other countries can be beneficial for both sides and is possible without formal agreements. I can imagine, however, that some kind of agreement on technical aspects might be desirable if this kind of cooperation should be applied more often and in larger amounts than in the past. As I mentioned on another occasion, the exchange rate risks and the interest rates paid on foreign currency claims and obligations from interventions do pose a problem. One solution could be the denomination of these claims and obligations in ECU's. The official interest rate on ECU could then be used for these claims and obligations. In addition some principles about settlement or credit facilities could be established.

Without delving further into these technical details, I am sure that if the need emerges some kind of arrangement in the mutual interest of both sides could be worked out. From our side, we are willing to continue and to strengthen our cooperation with the central banks of the EMS members. We are also open to discuss and examine any possibility that could enhance this cooperation.

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