

# The EMS and the International Monetary System: Towards Greater Stability \*

## 1. Recent Theoretical Work on Optimal Currency Areas

The literature on optimal currency areas, stemming from the seminal work of Scitovsky, Mundell and McKinnon, has recently been expanded in the debate stimulated by the EMS. Special attention has been focused on the advantages of belonging to a currency union rather than a free floating regime, supposedly able to isolate an economy from external shocks.<sup>1</sup> There is no clear answer since the outcome depends on economies' initial conditions and how they interact. The determinants include:

- a) the behaviour of prices and wages and the degree of indexation inside and outside the countries in the union;
- b) the structure of trade and the importance of the intraunion component (the simple degree of openness used in traditional currency area models is thus no longer sufficient);
- c) the real or monetary nature of the shock;
- d) the positive or negative correlation between external shocks when these arise simultaneously inside and outside the area.

In purely economic terms it follows that joining a currency area should be a reversible decision, as, for example, with monetary policy, where the authorities, judging a shock to be real or monetary, can

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<sup>1</sup> Cf., for example, R.C. MARSTON, "Exchange Rate Unions as an Alternative to Flexible Rates: The Effects of Real and Monetary Disturbances", in Bilson and Marston (eds.), *Exchange Rate Theory and Practice*, NBER, Chicago 1982.

change their intermediate objectives accordingly. By contrast, membership of an exchange rate system, even when this has realignment procedures, requires a commitment that is difficult to revoke if the system is to remain credible. The decision to join a monetary union thus transcends the economic sphere and becomes political.

Two of the conditions for the creation of a currency area that have been highlighted are the coordination of monetary policies and the parallel construction of a flexible and selective "regional" fiscal system.<sup>2</sup> Such "fiscal harmonization" suggests, in conjunction with a single monetary authority, the partial unification of countries' budgets under the control of a special central institution.

With EMS-dollar relations in mind, a study has been made of the effects of different institutional structures on the solution of the  $n$ -th country problem.<sup>3</sup> Formally, the problem reduces to the paradigm of an  $n$  country world in which only  $n-1$  countries can fix their exchange rates (or external balances when rates are fixed). Actually, the  $n$ -th country can play a decisive role — consider that of the US as the residual country in the Bretton Woods system.

In a three-country model in which two countries form a currency area, the economic and financial importance of the third country may allow it to determine both its growth rate and the amount and composition of its foreign financial assets. Acting as the  $n$ -th country, it allows its exchange rate to be fixed independently. Since the other two countries form a currency area, their mutual balance of payments must be in equilibrium in the medium term and this implies that their rates of income growth must be roughly the same.

Two scenarios can be envisaged. In the first, which assumes "dependence", one of the member countries dominates the economic policy choices of the other and pursues an exchange rate objective in terms of the third country's currency. This is a schematic description of the position of Germany, which participates in an exchange rate agreement with other European countries but is concerned primarily by the DM-dollar exchange rate. This objective requires the "dominant" country to keep its growth rate in line with that of the  $n$ -th country and,

<sup>2</sup> Cf. R.S. MASERA, *L'unificazione monetaria e lo SME*, Il Mulino, Bologna 1980, and R.S. MASERA and R. TRIFFIN, "Introduction" in R.S. Masera and R. Triffin (eds.), *Europe's Money: Problems of European Monetary Co-ordination and Integration*, Clarendon Press, Oxford 1984.

<sup>3</sup> Cf. G.C. MARTINENGO and P.C. PADOAN, *Lo SME e il dollaro - Interdipendenza e gerarchia nei rapporti tra aree valutarie*, Edizioni Scientifiche Italiane, 1983.

consequently, requires the "dominated" economy to keep in step. This dependence extends, of course, to the capital movements between the two currency area countries.

The outcome is different if there is assumed to be "cooperation" within the currency area. If the "dominant" country allows its exchange rate to vary in order to promote current payments adjustment, the common growth rate of the currency area countries is no longer constrained and can be freely agreed. Alternatively, the two countries can pursue a common policy *vis-à-vis* the third by agreeing on a common change in their exchange rates against the currency of the third country and adjusting income growth accordingly.

The hypothesis of hierarchical European monetary relations has been tested empirically with a multilateral model of the reaction functions of the EMS monetary authorities.<sup>4</sup> This divided the countries participating in the exchange rate agreement into three groups: Germany; the DM area; and the others. The estimates showed that the EMS had reduced the Bundesbank's scope for manoeuvre *vis-à-vis* the dollar but not substantially. However, the results of more recent estimates with the same model were less significant, suggesting structural changes in the meantime.

For my purposes this brief look at recent theoretical work serves to confirm: that the creation and stability of a currency area cannot be explained on economic grounds alone; that the decision to join one is basically political; that the rules governing inward and outward-looking behaviour depend primarily on hierarchical (dominant/dependent) or cooperative relations; and that, by promoting integration, a currency area probably modifies the relations between the member countries and hence the rules of the game.

I shall now go on to look at the development of exchange rate agreements in Europe to see whether the past can be interpreted in the light of the above hypotheses.

<sup>4</sup> Cf. G.C. BASEVI and M. CALZOLARI, "Multilateral Exchange Rate Determination: A Model for the Analysis of the European Monetary System", in *Exchange Rate Theory and Practice*, *op. cit.*

## 2. European Experience with Exchange Rate Agreements since the Abandonment of the Bretton Woods System

### 2.1. *The First Attempt: The Snake (1972)*

Born in April 1972 to keep the fluctuations of European currencies within narrower limits than allowed by the tunnel of the end-1971 Smithsonian Agreements, in 1974 the Snake was already described by Giscard d'Estaing as "an animal from European monetary prehistory". The six Community countries that created the Snake were immediately joined by the countries then seeking EEC membership: the UK, Ireland, Denmark and Norway.

In the early stages the Snake had a troubled existence. After only seven weeks the pound had to drop out, a few months later the lira followed suit, as did the French franc at the beginning of 1974. The DM, moreover, had to be repeatedly revalued against all the other currencies still participating.

Notwithstanding the difficulties of the early years, the Snake had a long life and, though restricted to the strong currencies, served as an example and objective for the other European currencies. At the end of 1975 the French franc re-entered the Snake, but this attempt was also shortlived. Parallel projects were formulated to allow the weak currencies to participate through more elastic rules, such as target zones. None of these were ever implemented, however.

The achievement of a larger area of exchange rate stability was hindered in this period not only by cyclical difficulties but also by other factors. One was the lack of sufficient political will in some quarters. Many central banks were worried about the consequences of a more extensive return to fixed or semi-fixed exchange rates, since this might have jeopardized the independence of national monetary policies at a time of turbulence and uncertainty. Moreover, many national economic policymakers were sceptical about the effectiveness of a strategy designed to artificially link the currencies of such structurally different economies.

The Bundesbank, in particular, did not hide its dislike of a fixed rate regime, which it considered incompatible with its monetary responsibilities and hence with its control of inflation. In France there was no question of eroding national sovereignty. The UK, which had

balked at EEC membership for so long, had no desire to push for monetary union and preferred to use exchange rate policy to sustain economic growth. Finally, though Italy held pro-European principles, it suffered from serious economic and social imbalances that made constraining economic policy inadvisable. The political and economic conditions for a European area of exchange rate stability did not yet exist.

### 2.2. *The Second Attempt: The EMS (1978)*

The almost unexpected decision in early 1978 to move further towards European monetary unification was the result of numerous factors, including: the crisis in international politics and especially in the relations between Europe and the US; the economic disorder stemming from the crisis of the dollar; the changed political climates in the two major countries promoting the new initiative; and the personalities of Chancellor Schmidt and President Giscard d'Estaing, as well as their personal relationship.

For the Germans, the weakness of the dollar brought huge inflows of foreign capital. The consequent strengthening of the DM undermined the competitiveness of German industry, which thus stood to gain from a return to stable exchange rates in Europe. On the other hand, the Bundesbank continued to resist being hamstrung and feared that fixed exchange rates *vis-à-vis* countries less bent on achieving stability would entail excessive liquidity creation and imported inflation. German participation in the EMS was willed primarily by Chancellor Schmidt, who committed all his personal prestige to this advance towards European unification.

The French saw exchange rate stability as an opportunity to revive economic growth and supported the initiative on convergent economic and political grounds. For Italy, the problem was both more simple and more complicated. The political will to proceed towards European union had never faltered, but the serious difficulties and dangers the system might entail for the Italian economy were also fully appreciated. There was, however, equal awareness of the potential benefits of exchange rate stability for adjustment in the medium term. In addition there was the political desire not to lose touch with the more advanced European countries.

### 2.3. *The Dollar, the EMS and Parity Realignment (March 1979-September 1985)*

Ever since the inception of the EMS the dollar-DM relationship has exerted a decisive influence on its working. For long periods the appreciation of the US currency created pressures outside the system that fostered the cohesion of the participating currencies. In particular, at the beginning of 1980 the change in Fed policy under Volcker initiated a phase of growing dollar strength, fuelled by a large increase in US interest rates and a highly expansionary fiscal policy. The DM weakened against the other European currencies as well as the dollar. The period of calm in the EMS continued, notwithstanding the inflation differentials between the member countries, until early 1981, when the Bundesbank took restrictive measures to counter the high dollar interest rates. This immediately triggered a devaluation of the lira and towards the end of the year the tension between the DM and the dollar led to a general realignment of all the EMS currencies, followed a few months later by a devaluation of the Belgian franc.

German attempts to pursue an "active" policy *vis-à-vis* the dollar created new tensions in the EMS, leading to general realignments in June 1982 and March 1983. From then until July 1985, when the lira was devalued as a precautionary move, was the longest period of calm in the EMS. This can be attributed to the persistent strength of the dollar and the corresponding weakness of the DM, which damped the tensions in the system.

The preferential and autonomous character of the Bundesbank's monetary and exchange rate policy *vis-à-vis* the dollar, which was behind the general EMS realignments, reflected a dominance/dependence order that was revealed in all its crude simplicity in the October 1981 resetting. On this occasion Germany's partners were faced with a sort of report card with marks that served to fix the new central parities. It is noteworthy, however, that the March 1983 realignment was of a cooperative nature, which may explain its resilience, despite the long and difficult negotiations.

The various devaluations of the lira, the Danish crown and the Belgian franc fall outside the above interpretation insofar as they were made independently and were due to the failure of domestic policy to achieve economic convergence with the rest of the EMS countries.

## 3. Stability within the EMS Area

### 3.1. *The EMS and Members' Different Objective Functions*

In view of the EMS countries' different economic policy priorities — Germany stressed the curbing of inflation, while the other countries gave greater emphasis to employment — many believed that the area of monetary stability would not survive long.

Nonetheless, despite the eight realignments described above, important results have been achieved since 1979 in reducing exchange rate variability. All the EMS currencies fluctuated against each other less than against the dollar and much less than in the period of floating rates prior to the EMS.

At the same time there has been a gradual convergence of the EEC countries' economic policies. The average growth rates of monetary aggregates have fallen and their correlation increased. Inflation rates have slowed and inflation differentials have narrowed, albeit not sufficiently. Unemployment rates, moreover, have moved together.

The cohesion of the EMS has been enhanced both by the state of the international economy, which has forced member countries to revise their objectives and stress disinflation, and by the appreciation of the dollar, which has prevented the DM from rising excessively against the other currencies.

Inflation is, or is near to be, under control in most European countries, while unemployment remains serious everywhere. New tensions could develop if different priorities were given to the objective of employment or if different policies were adopted in this field. After the experience of the two oil crises, no country can consider itself a closed economy. This is especially true in Europe, where floating exchange rates failed to isolate any country from these external shocks or from economic policy decisions in other countries. Exchange rate coordination and cooperation have been increasingly necessary for the European economy. The EMS has thus served as an example to the member countries, which now appear more willing to increase the convergence of their objective functions and to modify the latter's parameters.

### 3.2. *The EMS and the Theory of the Public or Collective Good*

With the switch from the Snake to the EMS, countries traditionally linked to the DM were joined by others that were more independent of German monetary policy. This entailed a difference in monetary authorities' preference functions with regard to the exchange rate agreements.

For the countries of the DM area participation in the EMS, in the same way as in the Snake, can be justified by the strong currency option, *i.e.* by a link with a much more important economy and currency.<sup>5</sup> The smaller country is linked to the larger not only by monetary, financial and real ties but also by political considerations. From this point of view the desirability of the EMS as a source of monetary stability can be analyzed by applying the theory of public choices to monetary unions.

If the EMS is accepted as a public good, insofar as it is an area of monetary stability, the problem of its supply arises. When the monetary union includes one country that is considerably more important than the others, the supply of the public good is guaranteed by this country, which bears a larger-than-proportional share of the cost of its production. The country in question will, of course, be prepared to bear this cost only if the public good is indispensable to it.

This makes it easier to understand both the survival of the nucleus of the Snake, comprising the strong currency countries around the DM, and Germany's interest in acting as leader. The smaller countries enjoyed the collective good consisting primarily of an area of exchange rate stability, while Germany accepted to pay a larger-than-proportional share of the cost — for example, in the form of, otherwise undesired, interventions in support of the weaker currencies — since the union increased German scope for action at world level in other fields. The desirability of a union also increases with the perception of a threat from outside. In the monetary and exchange rate field the threat is that of instability; for the EMS this is the instability associated with the dollar. Public choice theory suggests that the pyramidal foreign currency structure of the EMS will remain a powerful incentive for the strong currency countries of the DM area to maintain the exchange rate agreements.

<sup>5</sup> Cf. N. THYGESEN, "The Emerging European Monetary System: Precursors, First Steps and Policy Options", in R. Triffin (ed.), *The Emerging European Monetary System*, Bulletin de la Banque Nationale de Belgique, no. 4, April 1979.

The situation is rather different for Italy and France, which are more independent of the DM. The public good of exchange stability might be an insufficient incentive for them to bear the cost of participation if it were not coupled with that of growth. According to the theory of collective action, as a group grows, its ability to produce a public good or to concert and implement a common external strategy decreases. In the case of an area of exchange rate stability, this means that the larger the number of participating countries, the more frequent the realignments needed to maintain stability and the higher the corresponding negotiating costs.

The application of public choice theory to the EMS exchange rate agreements enables the *n*-th country problem to be examined in a new light. In a national reserve currency system the reserve country can, as such, act as the *n*-th country. It accepts the burden of supplying the public good of monetary stability by bearing the cost of restrictions on its freedom in the management of its domestic monetary policy. In a system such as the EMS with an exchange rate objective and a plurality of reserve instruments of varying quality, the solution of the *n*-th currency problem is not immediately forthcoming. However, to maintain the system's equilibrium a positive answer is needed.

### 3.3. *The ECU and the Choice of the European Area Currency*

Both analytically and politically the difference between the Snake and the EMS lies in the ECU, which has been called the pillar of the system. It is precisely the existence of a common currency that tends to transform an area based on an exchange rate agreement into a monetary zone with an identity of its own, specified both by the monetary yardstick and by the bodies and rules governing its issue.

The ECU can also be reinterpreted by considering the creation of an area of monetary stability as the production of a public good.

One possible solution to the problem of a common currency would be to make the ECU coincide with the DM. This would make just one member country wholly responsible for the production of monetary stability. It would have to bear the cost of supplying this collective good, which could be more than proportional compared with the seignorage benefit. On the other hand, not being involved in the production of the public good, the other member countries would only agree to join the area of exchange rate stability and recognize Germany's monetary

leadership if the quality of the public good remained high. In the absence of active participation, the other member countries would only feel bound by the advantage that might accrue indirectly.

By contrast, in a system based on a supranational reserve currency (or a basket currency such as the ECU) there could be an agreement to transfer production of monetary stability to an authority endowed with its own sovereignty, which could be invested with monetary policy responsibilities or simply coordinate the policies of the participating countries' central banks. In other words, the production of this public good would not depend on the willingness of one country to bear the cost of the supply, but on a cooperative agreement.

The procedures for common decision-making would require a significant qualitative change in the EMS. The likelihood of greater cooperation will increase with the mutual confidence among the parties concerned with the production and consumption of the collective good. This common commitment is also an increasing function of the institutions and agreements that may be added.

### 3.4. *The Role of the ECU*

The original plan for the EMS foresaw that the first phase, consisting primarily of the exchange rate agreements now operating, would be followed by a second involving the permanent creation of ECUs and a mechanism to ensure their balanced growth. Phase two appears unlikely to start in the near future, but the growth of the ECU in private markets has gathered a momentum that has offset the institutional delays. The expansion of private lending and bond issues in ECUs has been very encouraging, though their use for trade transactions has been more limited. However, further expansion will require institutions making the ECU's existence less uncertain. Some, such as a clearing system, do not call for an official decision, albeit the delay accumulated suggests that this may no longer be entirely true.

In addition to the question of all the EMS countries recognizing the ECU as having currency status, there is that of providing a "constitution" for the ECU and the EMS, not to replace individual countries' monetary structures but to create a parallel European financial system and allow the ECU to develop a reserve currency role. The growth of the ECU, not only as an instrument of exchange and investment but also as an international reserve currency, would considerably enhance the stability of today's multipolar world.

## 4. Relations between Monetary Areas

### 4.1. *The Position of the United States*

The US does not speak with one voice on the EMS or the ECU. In conformity with a long tradition, the Administration generally favours a monetary dimension that will help to unite Europe, but those responsible for economic policy are noncommittal. Basically, the Americans are not really concerned at the prospect of the development of a European reserve currency competing with the dollar. The prevailing attitude appears to be one of benign neglect.

By contrast, there is lively interest in the EMS and the ECU in US academic circles. The proposals for reform of the international monetary system formulated in American universities attribute, especially in the theoretical analyses, great importance to the exchange rate system introduced in the EEC in 1979. The EMS is often cited as a mechanism that has succeeded, even if in a limited area, in curbing exchange rate volatility.

### 4.2. *Dollar Instability and the Need for a Common EMS Response*

From the all-time low recorded in 1978, the effective exchange rate of the dollar rose by a maximum of 80 per cent. In real terms the dollar appreciated against the DM and the yen, recently recording peak gains of 95 and 65 per cent respectively. Even starting from the rates of the December 1971 Smithsonian Agreement, the dollar rose in real terms by over 40 per cent against the DM and by 10 per cent against the yen. These developments were accompanied by increasing short-term volatility.

Notwithstanding all the uncertainty surrounding the determination of the exchange rate of the dollar, which has led to the use of models of the random-walk type, the most reasonable position remains that the exchange rate will move in accordance with inflation differentials in the long term and that deviations from purchasing power parity are bound to be annulled in the end.

The instability of the US currency reimposes the need for the EMS countries to adopt a "common dollar policy", which is difficult to formulate and one of the most controversial issues in the system. If the

DM did not play a "special" role, it would be much easier to coordinate the European currencies with respect to the dollar. But, besides being the only major international reserve currency, the DM has a tendency to appreciate in the EMS owing to Germany's lower inflation rate. The substitutability of dollar and DM-denominated assets means that a depreciation of the US currency pushes up the DM in the EMS (and *vice versa*). Unless it is wished to radicalize and institutionalize the hierarchical relationship in the EMS and make the ECU equal to the DM, the cooperative option will have to be adopted in the European monetary area.

Such cooperation *vis-à-vis* the dollar would not only avoid actions and objectives that would be incompatible *ex ante* but should also aim at an optimal ECU/dollar exchange rate, consistent with curbing the tensions in the system and achieving price stability and greater employment.

Finally, though less harmful than one-way movements that can carry the exchange rate to an unsustainable level, the daily volatility of the dollar is a shortcoming in the leading reserve currency. In the long run this lack of stability could allow other currencies greater scope in international markets.

#### 4.3. The Yen

The yen is the major currency that has depreciated least against the dollar and it also fluctuated moderately. The movements in the effective exchange rate have been small because the losses against the dollar have been offset by gains against the other currencies. The stability of the yen is mostly due to the developments of the economic fundamentals in Japan and, in particular, to the persistent current external surplus, price stability and relatively fast income growth. In addition, the monetary authorities have given priority to the exchange rate over domestic objectives.

More recently, and contrary to expectations, the agreement with the US on the liberalization of Japanese financial markets and the internationalization of the yen have initially weakened the latter, primarily owing to an outflow of capital. In the longer term this deregulation and internationalization may strengthen the yen in line with the fundamental solidity of the Japanese economy.

Though a start has been made on using the yen in international markets, this development still has a long way to go. For trade purposes it has obvious limits. While 40 per cent of Japan's exports are invoiced in yen, nearly all its imports, consisting almost exclusively of raw materials, are invoiced in other currencies. A large international market for yen deposits is nonetheless needed if the Japanese currency is to develop further as an investment and reserve currency.

#### 4.4. The Effects of Exchange Rate Variability on Trade

Exchange rate variability increases businessmen's uncertainty and thus discourages the flows of trade and investment between countries — at least in theory. Such risk-averse behaviour tends to shift demand and supply back to domestic markets. Apart from higher costs, riskier international trade conditions can redistribute resources among the sectors and branches of production. Wide fluctuations, especially if prolonged, tend to increase the cost of adjustment with deleterious effects on economic activity.

Cover against exchange rate risks can, of course, be bought, in the forward market, for example. But when this market is thin or non-existent, especially in the medium/long term, or it is difficult to foresee payment dates, the risk remains and costs increase.

Exchange rate fluctuations have been wider, more frequent and more erratic since 1973 than was expected. Exchange markets' reactions to external shocks, announcements of economic policy changes, and no more than rumours, fears and suggestions of policies have sometimes been excessive. Even though empirical research has often failed to demonstrate a negative correlation between such variability and the volume of world trade, greater stability is not only desirable but a political necessity.

### 5. How to Ensure Greater Stability between Currency Areas

The disruption in trade flows caused by a highly overvalued currency, the latter's effects on the efficiency of the allocation of resources, the social consequences of accelerated deindustrialization in

the sectors most exposed to international competition and the political pressure to create a bulwark with overt and hidden protectionist measures against competition considered to be unfair, all encourage the search for ways of making exchange rates less unstable. The last ten to fifteen years show that, even with the floating rate regime, exchange markets on their own cannot prevent volatility or curb band-wagon effects that cause a country's exchange rate to diverge from that consistent with any definition of the basic equilibrium of its economy.

The search for ways to reduce instability has involved Treasuries, central banks and academics. The proposals can be divided into those based on new rules and sometimes new roles for certain institutions and those based on judgmental ability, which are attractive for the flexibility and discretion they allow, in closer conformity with the principles of sovereignty that govern relations between states. The first can be called strong options and the second weak.

### 5.1. *A Return to the Gold Standard*

Whenever monetary conditions at home or abroad are especially unstable, the appeal of gold as a yardstick and foundation of money becomes stronger, as the Commission on the role of gold in the domestic and international monetary systems recognized.<sup>6</sup> This Commission was set up in the revival of market economy principles under the Reagan Administration. This climate of restoration could have led not only to a curbing of the Fed's discretionary powers in the creation of money by pegging it to gold but also to gold's reinstatement at the centre of the international monetary system to solve the problems of inflation, high interest rates and budget deficits.

The complications of a progressive devaluation of the dollar in terms of gold in order to allow an acceptable rate of increase in fiduciary money coupled with awareness that this solution amounted to a rule for the growth of the money supply in disguise led the Commission to reject such a role for gold and to recommend studies to improve the conduct of monetary policy through, for example, the adoption of a rule for the stable growth of money.

At the international level the return to the gold standard would have implied the reintroduction of fixed exchange rates. This would have run counter to the monetarist credo, which favoured exchange rate flexibility and the independence in economic policy that this appeared to offer. Moreover, even if it were possible to reconcile the interests of the countries producing and holding gold and achieve its international acceptance, there would still be the problem of the convertibility of the huge quantities of different currencies in circulation today. The return to fixed exchange rates implied by a gold standard remains an ideal or, at most, a touchstone. Only a few writers, such as R. Mundell, recommend it, together with policy coordination, as an alternative to the present international monetary system. At their meetings in Rome (May 1984) and Tokyo (June 1985) the G-10 ministers and governors excluded a return to fixed exchange rates as unrealistic.<sup>7</sup>

### 5.2. *The Stabilization of the World Money Supply*

The second strong option does not turn to the past to increase stability but seeks to apply the monetarist credo to the whole world. To respond appropriately to the persistent and unforeseeable shifts in international portfolio preferences, McKinnon claims that countries must adjust their national money supplies so as to stabilize exchange rates.<sup>8</sup> Moreover, cyclical fluctuations in "world" money, *i.e.* the sum of the transactions balances of the strong currency countries, are to be avoided. This means, for example, that the Fed should make US monetary policy more symmetrical *vis-à-vis* countries such as Germany and Japan.

The synchronization model considered to have dominated in the seventies and early eighties thus needs to be replaced by a pattern of compensation to be achieved by international agreement. According to McKinnon, the cause of exchange rate instability is the substitutability in investors' portfolios of assets denominated in strong currencies, which undermines control of the monetary aggregates owing to the frequent shifts in the demand for money. Unsterilized interventions

<sup>7</sup> Cf. *Il Gruppo dei Dieci e il miglioramento del sistema monetario internazionale - Il contributo italiano*, Ministero del Tesoro - Istituto Poligrafico e Zecca dello Stato, Rome 1985.

<sup>8</sup> Cf. R.I. MCKINNON, *An International Standard for Monetary Stabilization*, Institute for International Economics, no. 8, March 1984.

<sup>6</sup> Cf. US TREASURY DEPARTMENT, *Report to the Congress of the Commission on the Role of Gold in the Domestic and International Systems*, March 1982.



designed to meet the changes in demand would be offset by reductions in the money supplies of the other strong currency countries. According to monetarist logic, the invariability of the total money supply would ensure world price stability.

This model can be criticized firstly with regard to its political feasibility at a time when floating exchange rates and a monetarist approach appear to allow policy makers in the major countries maximum independence in a world that is nonetheless integrated. Secondly, analytical objections can be raised. It has been maintained that exchange rate movements due to capital flows have their origin in shifts in the composition of portfolios comprising bonds denominated in the different currencies and not in movements between currencies. Another criticism is that exchange rate instability is not necessarily due to a change in the demand for money but may stem from a change in its supply produced by stabilization policies. Even if this objection is rejected as conflicting with McKinnon's proposal, which is for the world money supply to be kept constant, turbulence may still be the result of real and financial factors with which McKinnon's simple and rigid proposal does not appear able to cope adequately. Finally, the mechanism of the model has been criticized in the light of the different sizes of the economies that should keep the world money supply constant by their compensatory behaviour and of the initial conditions of the system. Since these must be of monetary and financial stability if the system has to reach equilibrium, McKinnon proposes an initial phase during which deviant currencies' real, but not their nominal, exchange rates would be stabilized.

### 5.3. *The Setting up of a World Monetary Authority*

Another economist advocating a radical reform of the present international monetary system is R. Cooper,<sup>9</sup> who, though recognizing the merits and usefulness of a floating exchange rate system, believes it cannot give good results in the long term owing both to movements in real exchange rates, with their impact on national economies, and to the ever-present temptation to manage exchange rates to promote national interests such as curbing inflation or reducing unemployment. In both

<sup>9</sup> Cf. R.N. COOPER, "Is There a Need for Reform?" in *The International Monetary System: Forty Years After Bretton Woods*, Conference Series, Federal Reserve Bank of Boston, no. 28, 1984.

cases this implies a country exporting the undesired condition to its trading partners.

Since the danger is seen in the long term, the transformation of the system is projected for the year 2010, when electronics and improved mass communications will have substantially modified our behaviour and increased our ability to react. Further, in a much more sensitive and reactive system, real exchange rate movements will have pronounced effects on profits, production and employment. The same factors, moreover, will rule out recourse to adjustable peg mechanisms, which require discrete changes in market rates.

Cooper's conclusion after examining past international monetary systems in the light of their ability to contribute to adjustment, meet the need for international liquidity and be inherently stable is very pessimistic. No system has ever simultaneously met the three above mentioned requirements and the only solution, albeit futuristic, is to eliminate the whole exchange rate problem by having one currency for international transactions, regulated by one monetary policy and one issuing authority.

This proposal is so radical that it appears to be hardly feasible even in the very long run. It envisages the unification of responsibility for monetary matters at the supranational level without foreseeing a prior or parallel process of political unification, which appears improbable. Moreover, recent history refutes Cooper's thesis — the difficulties encountered on the path to European monetary integration being just one example. More analytically, Cooper is undoubtedly right to allow countries scope for independent fiscal policies to achieve allocative and distributive objectives even after the renunciation of monetary sovereignty. However, whereas full monetary control allowed a certain objective to be achieved with a certain mix of fiscal and monetary policy, after it is renounced, this will only be possible without welfare losses if monetary and fiscal instruments are perfectly substitutable. In today's imperfect world this would be an implausible assumption.

### 5.4. *The Simultaneous Pursuit of Sound and Anti-inflationary Policies*

The philosophy underlying the positions and actions of the US Administration in the first part of the eighties was highly sceptical of the effectiveness of rules designed to regulate exchange rate movements.

According to the leading exponent of this school, B. Sprinkel, the answer to the widespread calls for greater exchange rate stability lays in greater efforts to promote sound and stable policies and achieve more convergent economic results, since an important cause of exchange rate instability with floating rates was the failure of both macro- and microeconomic policies to remove structural rigidities or prevent problems such as foreign debt crises.

The monetaristic basis of this approach is primarily evident in the insistence on the stability of policies over time and the identification of "inadequate" economic policies as the main cause of exchange market turbulence. Supply-side economics provides another cornerstone through the repeated references to microeconomic policies and the elimination of the obstacles to the free deployment of market forces. This suggests that a monetary policy designed to keep the growth in the money supply constant coupled with competition in all markets is a necessary and sufficient condition for convergence of economic results and hence exchange rate stability.

Completely ignoring fiscal and budget policy and their interaction with monetary policy is not possible in the foreign exchange field — as recent dollar, DM and yen developments show, notwithstanding the converging trend of monetary policies and the attitude in favour of strengthening market discipline in the countries issuing these currencies. A peculiar feature of this approach is that it neglects the existence of the business cycle, either because the pursuit of sound and stable policies is supposed to eliminate it or because it is too strong to be controlled, so that countercyclical measures and efforts to coordinate them are wishful thinking and a harbinger of further disequilibria.

Convergence is therefore seen as the result of independent decisions by each country to follow the same course, if possible using an automatic pilot. Any divergences should be dealt with by international surveillance, designed primarily to identify the government policies that prevent the exchange and capital markets from working efficiently, together with any that distort market operations in general. It follows that trust in official intervention in exchange markets is not only misplaced but also contrary to the hands-off principle, costly for public finances and socially unfair in that it allows private speculators to gain at the expense of taxpayers.

### 5.5. *Economic Policy Coordination*

On the other side it is argued that reliance on self-discipline is not sufficient to make international economic relations and especially exchange markets stable. Sovereignty, the different importance that ruling classes give to the same economic objectives, the phase differences between electoral cycles, disparities in economic openness and more generally in economic integration, the changing mix of economic policies, the belief that the business cycle can and must be regulated to ensure satisfactory non-inflationary growth are all factors explicitly, or more often implicitly, invoked to support the view that exchange rate stability cannot be pursued without some coordination.

The rationale of coordination lies in the existence of externalities. When the costs and benefits of measures extend appreciably to other countries, economic policy decisions are usually sub-optimal in the absence of coordination. This is due to the natural tendency to neglect the instruments that transfer a large part of the benefits abroad and to make full use of those that unload the costs. The internalization achieved through coordination makes policy choices less sub-optimal. This philosophy, which was fashionable in the fifties and sixties and the banner of the OECD, appears to be regaining ground as faith wanes in the ability of floating rates to simultaneously ensure adjustment and the independence of national policies.

The superiority of coordinated policies among countries is easier claimed than achieved, since the process is voluntary. Moreover, even when countries are prepared to consider others' actions when taking decisions, it is far from clear how coordination is to proceed, which policies it should embrace, what importance has to be given to the different initial conditions and, more importantly, the political constraints existing in each country, or at what level and frequency it should be conducted. On the other hand, as R. Cooper<sup>10</sup> has pointed out, it is not true that rule-based systems such as GATT and Bretton Woods are always superior to continuous coordination.

Different ideas have been put forward recently as to the best fora for strengthening the institutions and procedures of macroeconomic coordination. Noting that not even the Group of Five has been very

<sup>10</sup> Cf. R.N. COOPER, "Economic Interdependence and Coordination of Economic Policies", in R.W. Jones and P.B. Kenen (eds.), *Handbook of International Economics*, Vol. 2, North Holland, 1985.

effective in convincing the United States to follow policies more in tune with its international responsibilities, S. Marris has suggested returning the cooperation process to the international institutions, such as the IMF, set up specifically for this purpose.

The Italian Deputies in the Group of Ten have proposed the objective of guaranteeing the compatibility of domestic policies to ensure a more stable exchange rate system. This is to be achieved by complementing the IMF's bilateral surveillance with peers' pressure or multilateral surveillance. This exercise would involve a limited group of countries such as the G-10, precede the formulation of domestic economic policies and be particularly concerned with the budget and the money supply.<sup>11</sup>

Both types of surveillance are probably necessary, but not sufficient since the success of international coordination depends more on the political constraints in each country than on the way it is carried out. It is noteworthy that the kind of international surveillance adopted in the report of the G-10 Deputies<sup>12</sup> focuses on the examination of the external repercussions of national policies and of their interaction in shaping the world economic situation. In other words, the focus is on the analytical phase, which is common to almost any coordination programme, while little or nothing is said about what action should be taken or how to divide the cost of adjustment. This rather static concept of multilateral surveillance is the compromise reached between those who claim that a more stable international monetary system can be achieved through sound and stable domestic policies and those who believe that without some coordination the house-in-order principle will prove insufficient.

### 5.5.1. Exchange Market Intervention

The advocates of international coordination consider market intervention to be effective, especially when it is coupled with other economic measures, its effects are not sterilized and it is coordinated among the various monetary authorities. The first of these requirements clearly indicates that it is unrealistic to expect lasting results from

<sup>11</sup> Cf. R.S. MASERA and M. SARCINELLI, "Il rafforzamento della sorveglianza multilaterale", in *Il Gruppo dei Dieci e il miglioramento del Sistema monetario internazionale ...*, op. cit.

<sup>12</sup> Cf. GROUP OF TEN DEPUTIES, *The Functioning of the International Monetary System - A Report to the Ministers and Governors*, 1985.

massive and prolonged intervention unless the basic causes of imbalance are attacked. Moreover, intervention loses credibility as reserves dwindle or are borrowed.

The extent to which the effectiveness of intervention depends on the non-sterilization of its impact on the money supply and hence interest rates is more controversial. Those who believe most imbalances stem from sudden shifts in international (bond) portfolios advise no change in the degree of monetary restriction and recommend that the central bank should make offsetting changes in its own portfolio. However, if this is not large enough and the fluctuations in exchange markets are not caused by fortuitous (often political) factors but by deeper problems, intervention cannot be expected to have any effect unless it is reflected in the money supply and interest rates.

Finally, intervention is held to be most effective when it is coordinated among the authorities concerned. Other things being equal, the broader the range of authorities participating and the more determined their intervention, the more market expectations are influenced. It has been suggested that central bank intervention is credible if there is an exchange rate objective, which can be a level, a range or simply a direction. However, faced with freedom of capital movements, financial sophistication, better and cheaper telecommunications, and multinationals that can optimize multicurrency portfolios equal to, if not bigger than, those of the central banks of major industrial countries, great caution is required today in passing *a priori* judgement on the effectiveness of exchange market intervention in all circumstances.

### 5.6. Target Zones

Many advocates of the international coordination of economic policies believe that the search for compatibilities and the internalization of costs would be made easier and less indeterminate if the major monetary authorities fixed zones for the free fluctuation of their currencies.

The difference compared with the Bretton Woods mechanism or that of the EMS is that reaching the limit of fluctuation would not entail an obligation to intervene. Hence, as J. Williamson rightly argues,<sup>13</sup>

<sup>13</sup> Cf. J. WILLIAMSON, *The Exchange Rate System*, Institute for International Economics, no. 5, September 1983.

target zones provide perhaps the only possible form of floating in a world that rejects fixed rates as unrealistic and recognizes the limits of pure floating in view of its apparent tendency to produce real exchange rate misalignments.

The French and Italian Deputies in the Group of Ten argued that "...a credible commitment to target zones would contribute to stabilizing market expectations and would promote greater international policy consistency by reinforcing multilateral surveillance" (paragraph 31 of the Deputies' Report cited). The criticisms of the other Deputies focused on the difficulty of determining the width of the zones (too wide, they would hardly serve to anchor market expectations; too narrow, the market might be tempted to test the authorities' determination), the difficulty of allocating the costs of adjustment and the constraints on domestic policies. The majority thus concluded that "the adoption of target zones is undesirable and in any case impractical in present circumstances" (paragraph 32 of the same Report).

The difficulty of fixing target zones nonetheless appears considerably exaggerated, especially since every IMF adjustment programme and consultation necessarily involves an assessment of whether exchange rates and exchange rate policies are consistent with the objectives set. It is also necessary to consider the improvement in accuracy that would follow experience with a necessarily trial and, unfortunately, error process.

If a fluctuation band were fixed and announced for the leading currencies in each area — by international agreement or independent decision — instruments have to be identified which could be used to make it work and permit the slippage needed to reflect inflation differentials and dissimilar productivity performances. One of the aims of economic policy, and especially of monetary policy, should be to keep exchange rates within the target zone and intervention, especially unsterilized, could be used for the same purpose. If the situation became unsustainable or the external constraints were judged incompatible with domestic objectives, the problem of the slippage of the zone would arise. Williamson recommends making these adjustments continuously to avoid the exchange crises typical of the fixed rate regime and the EMS. However, such a procedure would reduce the effect of target zones on expectations. Moreover, since intervention would not be compulsory monetary authorities could not be criticized for allowing speculators a safe bet because they would always have the right to give priority to domestic needs over exchange rate requirements.

While this solution lacks the symmetry and clarity of the obligations found in other parity-plus-band systems, it appears not only better suited to the delicate equilibrium between domestic and international objectives but also as an unavoidable stepping-stone on the path to a more stable international monetary system.

## 6. How to Improve International Monetary Stability

### 6.1. *Impossibility of Extending the EMS Model*

"While useful lessons can be drawn from the experience of the EMS as regards the promotion of policy convergence and exchange rate stability, the Deputies recognize that it cannot be dissociated from the particular political and economic environment in which it operates and therefore cannot be readily extended to a broader and more heterogeneous context characterized by a plurality of reserve currencies". This is the rather summary but basically correct conclusion of the G-10 Deputies Report (paragraph 24). The European Monetary System is not only an exchange rate agreement between the central banks of the seven participating countries, even if this agreement is the core. Other features involving wider participation include: a basket currency — the ECU, which has so far been used in private markets more than in official transactions; and, more importantly, credit mechanisms, some of which are automatic and unlimited but very short term, while the others are longer term but conditional, limited in amount and little used to date. This can be attributed, however, to the system having worked better than originally expected and in any case confirms its resilience in the face of strong pressures.

Compared with the instruments provided by the 1979 agreements, much greater contributions to Community cohesion have been made by the common external tariff and the progressive, albeit incomplete, creation of a single domestic market. Another important cohesive factor has been the pursuit of a common agricultural policy, which, even if it is a source of conflict and acrimonious discussion today, has long supported agricultural income and promoted cross-frontier social unification. Finally, embryonic executive and legislative authorities exist in the form of the Commission and the Parliament, though the latter's powers are primarily advisory.

This means that coordination, which is indispensable where externalities persist, is not only conducted in a particularly favourable environment but also ceases to be mainly voluntary owing to the existence of institutional mechanisms. Moreover, in some fields, such as international trade, coordination is no longer needed because authority has been transferred to a supranational body. The fact that the EMS has not achieved even more significant results is to be attributed to the lack of convergence caused by the persistence of differences between member countries' objective functions, and not by inadequate instruments or lack of opportunities for comparison and discussion.

### 6.2. *In Favour of International Cooperation*

With the present structure of the international monetary system and the impossibility of extending the EMS model to a wider area, the only way to prevent distortions from accumulating in real exchange rates, trade balances and external net debt positions, and thereby threatening free trade, is a renewal of international cooperation. The recognition that in September 1985 the dollar was more than 30 per cent overvalued taking 1980 as normal, the view shared by H. Wallich that two thirds of the US trade deficit is attributable to the appreciation of the dollar, the fact that America has become a net debtor again (for the first time since the end of the First World War) and increasing protectionist pressure must all have contributed to the shift in the US authorities' position revealed by the communiqué the G-5 issued in New York.

This states not only that convergence of results has increasingly been fostered by economic policy initiatives but also that all the member countries are committed to introducing further measures to strengthen favourable convergence and make the present expansion last longer. This suggests a revival, after the phase of non-interventionist dogma, of confidence in the superiority of an approach designed to regulate the economic cycle. In addition, the member countries reaffirmed their intention of honouring their international obligations. The Group also stated that it shared special responsibility for ensuring the mutual consistency of individual members' policies. The recognition that no major industrial country's actions are free from international constraints and the conclusion that greater welfare can be achieved by taking account of the spill-over effects of each country's actions suggest that

coordination will once more be the "philosophy" of official economic relations.

For the working of the international monetary system this approach was bound to arouse new interest in exchange rates and a revival of the monetary authorities' interest in controlling them.

To judge by the interventions made immediately after the G-5 meeting, by the Bank of Japan and the Bundesbank, as well as by the Bank of Italy, although it was not privy to the agreement, the decision to encourage the market to reduce the value of the dollar was taken then. Moreover, the length of the communiqué and the publicity given to a meeting, the very existence of which had been denied on previous occasions, are evidence of the participants' desire to influence market expectations and simultaneously reduce the pressure of protectionist demands in America. Only time will tell how far these aims can be achieved.

Barring an overvaluation of the dollar based on inflows of funds in response to self-fulfilling expectations of further rises, a lasting inversion of the US currency's upward trend cannot be obtained with prolonged intervention, even on a large scale, but requires a broad change in US policies to make them consistent with those of the other major countries.

Apart from the commendable rejection of protectionism, the second part of the communiqué differs very little from the declarations made after the Bonn summit, except that Japan appears marginally more willing to increase public expenditure by local authorities. In May the markets did not believe these policies sufficient to make the DM and the yen rise against the dollar, now the greater determination of the authorities and the prestige they have committed seem to have started a change in market sentiment.

If the operation succeeds, it will permit a soft landing of the dollar, but will it convince Congress not to pass protectionist legislation? Since 1986 is an election year in America and since the scope for US industry to improve its share of the domestic market depends in part on the pricing policies of Japanese and European exporters, whose currencies will tend to appreciate, only export-oriented firms are likely to judge a substantial depreciation of the dollar as sufficient to restore competitiveness.

If the operation succeeds because the US budget deficit is narrowed by progressive cuts in expenditure and, possibly, tax increases, would this not involve the risk of the downturn in US demand not being compensated elsewhere? An outcome that could lead to recession.

Finally, if the operation succeeds as a result of an easier US monetary policy, might inflation not accelerate in the absence of the curb imposed by cheap imports? International coordination is only a method, it is not the solution to the problems facing us, which has to be patiently sought in the light of the macroeconomic interrelations and political constraints.

### 6.3. *A Growing Consensus for Target Zones?*

At this point two questions arise. Is it conceivable that the change in America's attitude will lead the other industrial countries to prefer a less "amorphous" international monetary system, to use S. Marris's term?<sup>14</sup> Are target zones, which are favoured by an increasing number of economists, closer to being accepted than when the Report of the G-10 Deputies was published? The answer to both questions is undoubtedly yes, but this still leaves much ground to cover. Firstly, the results of coordinated intervention will strengthen the confidence in the authorities' ability to "guide" exchange rates within zones judged to be "reasonable". Secondly, even if zones were informally agreed at the Plaza Hotel to provide a framework for intervention, they could hardly be viable for the medium term or possess the potential stability, market credibility and breadth needed to leave monetary policy some independence. Finally, until significant progress is made towards correcting America's internal and external imbalances, the zone for the dollar would have to be so wide as to be virtually useless. It is also important that new rules for the conduct of monetary policy should be formulated making today's rather flexible practice of fixing and announcing quantitative objectives compatible with keeping exchange rates in the desired zones, which can, but do not have to, be defended.

There has recently been growing international support for target zones. The Group of 24 has stated that their adoption for the major currencies would imply "a commitment to promote greater international compatibility of policies" and advocated further study of the scheme.<sup>15</sup> One factor underlying this position is undoubtedly the belief that the international debt situation has been aggravated by America's

high interest rate policy. Indeed, at this year's IMF and World Bank meetings in Seoul the US showed greater appreciation of the difficulties of both the poorest developing countries, which rely heavily on public aid, and those with intermediate incomes but with a heavy debt burden.

It is to be hoped that the revision movement will acquire the necessary momentum and enable the industrial countries to autonomously determine the best way, taking account of the constraints, to ensure reasonable exchange rate stability and a "normal" configuration of external balances. Since the four major IMF countries and Australia still oppose a further small issue of SDRs, we can look forward to another lengthy exercise in the art of international persuasion.

*Roma,*

MARIO SARCINELLI

<sup>14</sup> Cf. S. MARRIS, *The Decline of the Dollar: Some Policy Issues*, Group of Thirty, April 1985.

<sup>15</sup> Cf. Report of the DEPUTIES OF THE GROUP OF TWENTY-FOUR, *The Functioning and Improvement of the International Monetary System*, Washington DC, August 1985.