

Exchange Rates, Interest Rates and the European Parallel Currency

The first official endeavours to bring about European monetary union were made when the system of fixed exchange rates was on the verge of collapse; in the intervening years the situation has hardly been more favourable than at the outset. Recently, however, things have started to look up again. While the dangers with which the world economic outlook is fraught point, no less clearly than in the past, to the crucial role of monetary unification for the survival of the Community, the difficulties which stand in the way of unification now seem to be less forbidding. The following notes draw attention to developments in the world economy and in EEC member countries that seem to justify this statement. In addition, some specific steps are suggested that would advance monetary unification.

The International Economic Context of the Seventies

Discontinuous changes, such as the quadrupling of the oil price at a stroke, have been taking the place of continuous, gradual adjustments, bringing greater instability into the world economy. Disturbances do not generate the forces capable of restoring stable equilibrium. As in the well known "cobweb theorem" of the explosive variety, originally developed to explain the behaviour of the markets for certain agricultural commodities, what seems to happen is a shift from one position of unstable equilibrium to another unstable one. Shocks also upset the smooth working of the market adjustment process because they increase the chances of overshooting the mark by policy responses aimed at driving the economies back towards equilibrium.

Greater instability has been accompanied by slower economic growth. Within the world economy, industrial countries suffer from difficulties of their own making. Trade unions have tended to over-

anticipate inflation. Wage-push has thus not only become an autonomous factor of inflation, it has also reduced the share of industrial profits. The financing of investments has been made more difficult, while shrinking profit margins, at a time when the risk inherent to investment is perceived to be higher, also tend to erode the propensity to invest. Consequently, productive capacity has not been increasing as fast as the labour force, which largely explains the upsurge in unemployment, in recent years, in most industrial countries.

While remarkable progress has been made towards freeing ourselves from bondage to theories of stabilization less relevant to our context today, the remedies actually applied are often the wrong ones. In the face of increased uncertainty, more heed is being paid to all-round endeavours to freeze present patterns of employment and production than is compatible with the need to make fundamental adjustments in the remuneration of labour and capital, in the allocation of resources between uses domestic and external, present and future, public and private, in the structure of output in response to abrupt shifts in relative prices and in the pattern of demand as well as to the emergence of industrial countries in the Third World, whose weight as exporters of labour-intensive manufactures represents a new challenge to the old industrialized countries. In these countries, domestic and external difficulties are not unrelated.

In the past, expansionary demand management often succeeded in creating the macroeconomic conditions for increasing productivity; by eliciting a level of demand close to full capacity utilization, it was possible, even allowing for sizeable wage increases, to curb unit costs; these could be kept in a ratio to prices that made investment rewarding; the sustained investment activity made it possible to maintain high rates of growth and employment. But deficit spending as practised over a number of years has caused the public sector's expenditure to swell in some countries to about one half of gross domestic product. Since current expenditure and especially social transfer payments have been the component of public expenditure that has grown fastest, there has been relatively less available for investment. The sheer size of the deficits too (in some cases equivalent to about 10 per cent of GDP in recent years) has made it difficult to finance them without recourse to the central bank, i.e. without printing money; consequently, deficit spending has tended to be more inflationary, and to affect increasingly the monetary va-

riables (prices), less and less the real ones (production, investment, employment).

Expansionary demand management is therefore now less successful in allowing for a sufficient rate of return on investment while keeping inflation under control. This points to the need for curbing the growth of wage and other labour costs so as to reverse the downward trend of profits in recent years. But, under the present system of flexible exchange rates, in the countries more successful in curbing labour costs, the currency tends to appreciate in proportion to (when not more than) the relative labour cost advantage acquired. The price rise is thus correspondingly curbed, so that the strategic relationship of unit costs to prices cannot be modified in a way that would allow the shift needed in favour of profits. On the other hand, for the countries in a weaker position and with a depreciating currency, the deterioration in the terms of trade means that they must make larger net transfers abroad of what they produce and that, correspondingly, there is less available domestically for the remuneration of capital (and labour).

From a general point of view, the traumatic increase in the price of oil has gummed up the mechanism whereby the largest part of the world's total income was appropriated by the industrial countries, which could thus feed a growing demand for goods embodying a large component of sophisticated technologies, i.e., goods produced by those countries as a group; and this in turn tended to keep the terms of trade favourable to them and their share in total income high.

The interaction of external and domestic events is compounding the difficulties of attaining a satisfactory degree of monetary stability, a rate of economic growth close to the potential rate, and reasonably full employment. The outcome is that, from the national viewpoint of an increasing number of countries, protectionist remedies are appearing more and more as the least costly way out; after all, the argument for free trade rests on the assumption of (reasonably) full employment, and it can hardly stand once that assumption does not obtain. The trend towards administrative controls in international trade and payments is becoming very marked; the costs of enforcing those controls and of dodging them are high, though the misallocation of resources at the international and regional levels through actual trade deviation is perhaps not yet very high.

Be that as it may, "invisible" damage is being wrought by

present policies: the profitability of investment meant to cater for export markets is being undermined by the danger that those markets may be closed by administrative controls or become much less absorptive following sharp reversals of over-expansionary policies. The resulting higher degree of uncertainty is making producers less willing to undertake new investments, and prospective new firms more hesitant to enter markets which may shrink abruptly. This makes for more inelastic supply curves, and tends, ultimately, to frustrate anti-inflationary policies. Stability and growth, to which the Common Market was expected to make a positive contribution, have been dwindling in recent years in Europe too.

Given the tendency of investment and productive activity to stagnate, there is a growing preoccupation that changes in exchange rates (and government subsidies to industries) may be used by industrial countries in the pursuit of aggressive foreign trade policies that are in the process of becoming an arm of nationalistic full employment policies. The countries which would thereby be pushed into deficit would also have to deal with the depressing effects of a negative foreign trade multiplier.

An Intra - EEC Exchange and Interest Rate Arrangement

Owing to the plentiful supply of dollars, among other things, EEC member countries are not likely to be dogged by external liquidity problems, as several of them have been during the 'seventies. It does not follow, however, that conditions are now ripe for introducing an exchange rate arrangement that would in essence anticipate monetary union. It may take a few years before member countries are able to dispense with exchange rate changes to offset the effect of differential inflation on competitive positions. Moreover, present competitive positions may themselves have to be corrected through changes in "real" exchange rates in order to accomplish the process of adjustment to the new relative scarcities, which, in the case of some member countries, also implies eliminating widespread industrial and administrative inefficiency in the public sector. While it would be premature to re-introduce stable parities, what can and should now be done is to *stabilize exchange rate expectations*.

Admittedly, member countries with floating currencies have found the *effective* (i.e. trade-weighted) exchange rate a useful term

of reference — useful, that is, as far as current account transactions are concerned. But the role of across-the-border credit and other financial transactions is important and should acquire greater significance with a view to monetary union; and what counts in this respect are *market* exchange rates. An undertaking on the part of member countries not to let the market exchange rate move by more than, say, 2 or 3 per cent in a (daily? weekly?) moving three/four-month period, might be instrumental in stabilizing expectations, in a context of overall economic and monetary policies aimed at this end. In 1975, an understanding was reached among the EEC central banks on a common policy vis-à-vis the dollar with a view to limiting daily exchange rate fluctuations; the aim was to maintain orderly market conditions. Reduced uncertainty as to exchange rate movements over a three/four-month period would not only help maintain orderly conditions, but would, in addition, encourage the *growth of a credit market* straddling national boundaries.

The stimulus to the development of a common market for short term loanable funds would come from the fact that an exchange rate undertaking of the kind outlined here would allow more scope for (uncovered) interest rate international arbitrage. Residents of countries whose currency was expected to depreciate over a three-month period by an amount (say, 2 per cent) equal to the interest rate differential (in this case 8 per cent p.a.) would still want to borrow in a foreign currency because of the different degree of certainty attaching to an *actual* (interest rate) gain and an *expected* (exchange rate) loss of the same size. What is thus here suggested is an exchange *and* interest rate arrangement, in accordance with which the interest differential would be prevented from falling below the extent to which the exchange rate might depreciate. The arrangement would not necessarily require a perfectly symmetrical behaviour from depreciating and appreciating currencies alike.

Monetary policies hinged (as they tend to be today) on target growth rates for monetary and/or credit aggregates, and letting interest rates find their appropriate level, are proving better suited to produce an internationally consistent relationship of national interest rate levels than the earlier concentration on the interest rate itself as the principal instrumental variable. Interest rate consistency already obtains by and large with the present degree of monetary policy coordination in a context in which monetary authorities are not wholly unconstrained by the consideration of interest rates being

too high, low, or unstable. In addition, this proposal implies circumscribing the options in setting monetary targets with an exchange rate constraint, which would be permitted to shift at a specified maximum speed. As the maximum rate of change was reached, the exchange rate would cease to be an endogenous, residual variable and become a target variable determined by the monetary authorities' interventions on exchange markets. In fact, however, the *ex ante* values of the quantitative monetary variables need not change, if policies are from the outset aimed at balanced progress towards domestic and external monetary stability, and are consistently pursued within the framework of economic integration.

Since the current approach to monetary and credit policy is more apt to create the underlying economic conditions for exchange rate stability, an exchange rate arrangement aimed at stabilizing expectations would rest on firmer ground today than the more ambitious schemes devised in the early 'seventies, when governments were professing adherence to the system of fixed parities, but were in fact acting in their domestic policies as if their currencies were already floating. Progress towards stabilization and integration would now be furthered by an exercise on exchange markets similar in nature to the setting of money and credit targets.

Coordination of national monetary and credit policies, in a way that would contribute to the convergence of price trends and to increasing stability in the exchange rate structure, can hardly be pursued beyond the short term unless other policies are coordinated too. In present circumstances, and with the prospect of the direct election of European MPs, a step in the right direction could perhaps be a pledge by governments to bring matters before Community bodies in the event of, say, an impending increase in public expenditure and/or in the public sector borrowing requirement or a wage rise, on a scale thought to be incompatible with the exchange rate arrangement.¹

Because prospective decisions and actions on a national level would affect the Community's interest in more stable and closer relations between member countries, the participation of Com-

¹ It is not intended to go into the details of the arrangement here. Be it noted, however, that one would have to decide whether monetary authorities should be expected to call public attention to prospective changes in strategic economic and financial variables that would call for an enlargement of the maximum rate by which the exchange rate was allowed to change, and declare what the new maximum would be.

munity bodies in seeking the right solution of national conflicts and crises would be justified. Community participation in crisis management should perhaps also be developed by giving a more important role to dealings between national Parliaments and the European Parliament, at the level of the respective Committees for economic, monetary, financial affairs and industrial relations.

Ultimately, it should be possible in the adjustment process to dispense with any enlargement of the agreed maximum percentage by which exchange rates would be allowed to move in any given period; otherwise, it would mean giving in to domestic policies which would block such convergence as is now being achieved, and lead to divergence.

Under this arrangement, exchange rate changes occurring in different three/four-month periods and going in the same direction might be cumulated. It would thus be possible to adjust, if and when necessary, intra-EEC exchange rates consistently with the moving equilibrium pattern of competitive positions. This, and the fact that countries in a weak payments position have recently been able to bolster their external liquidity, should prevent a credibility problem arising when it comes to implementing the scheme. This is necessary if the scheme is to achieve its objective of promoting the growth of stabilizing capital movements and thereby contribute to the optimal international allocation of liquid savings.

In general, it is the rate of exchange vis-à-vis the US dollar that is the most significant market rate. Official interventions on exchange markets, as well as across-the-border payments and credit transactions by banks, are carried out mainly in US dollars. An exchange rate arrangement among EEC currencies has, for the time being, to be operated through the dollar; it is movements in the rate of exchange of each member currency *against the dollar* that would now be restricted as agreed; the US authorities' co-operation, which is anyway essential for avoiding disorderly conditions on world exchange markets, would have to be sought; cohesion among EEC currencies would be enhanced only indirectly. When a general adjustment in the rate of the dollar itself was needed, then all member currencies would adjust in the same direction vis-à-vis the dollar (though some of them might need to make further individual adjustments). Thus, in cases of general disequilibria between the Community and the rest of the world, adjustment would be facilitated inasmuch as uncertainty would be dispelled as to what each European country might

or might not do; common action (at least part of the way) by all EEC countries would help to make that adjustment without disrupting too much intra-EEC competitive positions. As cases in which a general EEC adjustment was required grew in importance relative to individual adjustments, the connections linking the credit markets of member countries would take on a more markedly European connotation; the use of EEC currencies would increase, and it would become possible to link EEC currencies' exchange rates through a monetary instrument reflecting the (weighted) average performance of those currencies. The following section is devoted to this subject.

Transition from the European Unit of Account to a Parallel Currency

The recent improvement in the external liquidity position of countries which had suffered sharp losses of external liquid assets following the oil crisis, is not only helpful in view of the orderly implementation of the exchange rate arrangement; it also justifies reviving the proposal to pool reserves. There are several ways in which this might be approached, not all of which were explored at the time the proposal was submitted for consideration in 1973. One possibility would be an arrangement whereby member countries deposit with the European Monetary Co-operation Fund a portion of their gold and/or foreign exchange reserves,² and against that deposit receive an equivalent amount in European Units of Account (EUAs). Since these units would be usable mainly for settlements among EEC central banks, they would represent a kind of European SDRs. More specifically, the European Unit of Account would be upgraded, against the deposit of gold and/or foreign exchange as collateral, to the rank of a currency circulating among official entities. This would still not go beyond what has been achieved on a world-wide scale, i.e. the creation of a reserve and settlement asset (which in the case of the Community would be backed by assets "external" to it). The final aim of monetary union, however, should not stop short of a common currency; it is here suggested that the way already be paved for the transition to a common currency by taking a number of appropriate steps *now*.

² The amount of reserves each country would be expected to pool would not necessarily be determined in strict proportion to its total reserves. Other "keys" might be applied that are already in use in the Community, or other — altogether different — criteria.

The above-mentioned upgrading of the European Unit of Account to the role of official reserve and settlement asset, i.e. currency for official use to start with, would represent one such step. Its development into an intervention currency posits acclimatization with the markets, its acceptance for market uses as a parallel currency during an intermediate period. It is here proposed to make 1 unit of the parallel currency ("Europa") equal to 1 European Unit of Account. The establishment of the "Europa" in the Community markets presupposes that the European Unit of Account as at present defined be competitive with the asset which now fulfills the role of linking the different national capital markets: the US dollar. It is probably true that prospects have never been so favourable to the EUA (relative to the dollar) since its adoption in 1975. The present weakness of the dollar is not entirely due to cyclical factors; it is largely the result of a deterioration in the US energy balance. On the whole, it would appear that the weakness of the dollar is going to be more than short-term — though intermittent, of course.

This, together with progress of the stabilization process in the weak-currency EEC countries, is leading to a situation propitious to the launching of loan issues denominated in EUA. It is not unlikely that EUA loans will be launched on the international market in the near future. An official signal would act as a catalyst: that signal might be given by the European Council next April. It could take the form of an intimation that Governments would not object to the use of the EUA in contracts, including bank deposits; a statement of their intention to employ the EUA when and where appropriate; and an incitement to that effect to the Community institutions (especially the European Investment Bank in its borrowing operations). Because of its "basket" structure, the EUA might be expected to appeal primarily for long-term investments, where the dispersion of exchange-rate risk expectations is greater. The seesaw of exchange rates in the last five years and the wide fluctuations in the relative strength of some of the principal currencies in 1977 should make the EUA attractive to the average medium-term investor too.

In the author's view, it would be neither necessary nor desirable to define the "Europa" in such a way as to give the absolute certainty that it would be stronger than the strongest national currency. For the "Europa" to come into its own, it would be sufficient (and desirable) to make it a *tendentially* strong currency.

If the present basket definition of the EUA were not considered satisfactory in this regard by the strong-currency and potential EUA creditor countries, it might be modified by simply adding to the present mechanism a (semi-indexation) clause to the effect that, if price rises in the Community were to exceed a threshold figure (say 4 or 5 per cent p.a.), there would be an across-the-board revaluation of the "Europa" in order to offset the part of the rise exceeding the threshold.

Full indexation in terms of purchasing power for goods and services would not help in the acclimatization of the "Europa". A monetary instrument should appeal to both lenders and borrowers alike, in strong and weak-currency countries. Furthermore, it should be borne in mind that the course of the "Europa" would not be steered only by means of the one variable pertaining to changes over time in its capital value. An appropriate interest rate policy would also be instrumental in promoting its orderly acceptance in both groups of countries.³ In securing an orderly acclimatization of the "Europa", the interest and exchange rate arrangement outlined earlier in this paper has an essential complementary role to play.

The weakness of the dollar puts strains on intra-EEC exchange rates, since EEC currencies are not equally attractive havens for "hot money" fleeing from the dollar. It tends to upset the obtaining intra-EEC exchange rate structure when it would be viable from the viewpoint of intra-EEC transactions, by putting further upward pressure on currencies with a better record in the field of monetary stability. The use of the "Europa" might eventually reduce this "mirror effect" of the weakness of the dollar, which in the last few months has actually affected currencies with a less good monetary record and, in at least one case, has confronted the authorities with embarrassing policy dilemmas.

At the outset, the role of the "Europa", midway between a unit of account and an infant currency, would, of course, be a modest one; but it would be rash to conclude from this that the parallel currency approach is not worth pursuing. A common currency is an essential ingredient of monetary union; the evolutionary approach through a parallel currency makes economic and political

³ To start with, the "Europa" would be usable for transactions above a given minimum amount; as the willingness of larger classes of users to deal in "Europas" emerged, the issue of large-denomination certificates and notes would be followed by the issue of gradually smaller denominations.

sense under present conditions, and therefore makes it possible to take steps in that direction now. This approach would bring market mechanisms more actively into the process of monetary unification, which could then be envisaged — as indeed it should — as a succession of official measures and market responses interacting along a path leading gradually to monetary union. How gradually cannot be foretold; experience suggests that monetary unification does not lend itself to a rigid timetable. Yet the process, once under way, might rapidly gather momentum.⁴ The point here is that the process would be nursed by the markets; it would have to stand the test, and this would give a more reliable assurance of acceptability and soundness than can be afforded by politico-administrative decisions alone.

Moreover, the parallel currency approach would not require national monetary authorities to divest themselves wholesale of their present monetary functions, which most people would agree is not a realistic goal in the near future. For the time being, an arrangement is needed that would make the Community share real monetary powers in parallel with national authorities. Monetary policy coherence can be arrived at without, *and hence before*, transferring *all* monetary powers to a central Community body, as more recent experience seems to show. What must be aimed at is making consistency of national policies and convergence of cost and price trends *less episodic* than in the past. A dual monetary system, which would obtain as the "Europa" grew into a ready-at-hand competitor for (often badly managed) national currencies, is probably better suited to achieve that goal. The introduction of the "Europa" could give the Community the power (it now lacks) for helping to implement systematically and more effectively a European money supply policy: a big carrot also means a big stick. Money creation in national currencies can be, and in different degrees has been, inflationary. What is needed is control of *all* money creation in the Community as a condition for making it an island of stability. The introduction of the "Europa" should bring us closer to that goal before we can have its benefits bestowed upon us by an exclusive decision-making common monetary authority. In the meantime, too,

⁴ As the President of the EEC Commission remarked in a recent speech on the prospects of monetary union, "evolution is a process which, once begun, goes both gradually and in jumps".

money users throughout the Community would have a larger range of choice; less inflation and more welfare would be the net outcome.

This paper is intended as a contribution to the relaunching of the debate on monetary union, as recently advocated by the EEC Commission in the prospect of the direct elections of the European Parliament. It only deals with some aspects of *monetary* unification. The steps suggested do not add up to a set of conditions sufficient to give a decisive turn to Europe's economic integration. Disequilibria in external transactions and divergences in income trends between member countries are not a purely monetary phenomenon; we would be confronted with them in a system of barter as well. They require far-reaching structural changes in the economies and societies of member countries, which are less likely to cause tensions in the weaker countries if carried out with the aid of adequate income and capital transfers from outside. But it would be wrong to argue that, because the monetary steps here suggested are not a sufficient condition, they are not necessary; for that would be tantamount to saying that monetary arrangements gradually compelling greater policy convergence and economic integration would be no different from arrangements incapable of helping to achieve those goals. The steps suggested would of themselves contribute to changing the European economies' present cobweb-type behaviour from the explosive to the convergent variety — convergent, that is, on positions of *stable* equilibrium.

Since they are necessary, they should be adopted now that the European and world scenarios look less unfavourable than at any other time since the late 'sixties. We should not let the hesitations, rooted in the setbacks suffered in the past, prevent us from taking the tide at the flood, for we would most probably lose our ventures irretrievably.

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