SPEECH TO THE ASSOCIATION OF EUROPEAN JOURNALISTS
BY THE RIGHT HON ROY JENKINS, PRESIDENT OF THE
COMMISSION OF THE EUROPEAN COMMUNITIES

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THE EUROPEAN MONETARY SYSTEM: RECENT EXPERIENCE AND FUTURE PROSPECTS

Almost to the day three years ago I made a speech in Florence. I then argued that the time had come for a new push towards the monetary integration of the European Community. Reactions were mixed. Many were sceptical. Some were hostile. I was described as impractical and unrealistic. "A Bridge Too Far" was the title of the Economist commentary. I am glad to say that in recognizing the problems which gave rise to my speech, the political leaders of the Community soon came to take a different view. Within nine months the European Council at Bremen took the decision in principle to create the European Monetary System; another nine months after that in March 1979, the System came into operation.

It has now been in existence for just over eighteen months. This may be a short time. But I think it is long enough, at least for those who have been involved in the System since it began, to have formed some impression about how it is working and which way it is going. My purpose today is to undertake that preliminary stock-taking.

I do not intend to go over the arguments which I set out at Florence for an eventual monetary union in Europe. But I want to underline that in my judgment they

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have lost none of their validity. I believe that monetary union favours a more efficient and developed rationalization of industry and commerce. I believe that there is solid advantage in creating a major new international currency backed by the economic spread and strength of the Community. I believe that a monetary union would help produce a new era of price stability in Europe and achieve a decisive break with our present chronic inflationary disorders. I believe that a monetary union would help in coping with the present economic recession and one of its ugliest aspects, unemployment. I believe it would promote a more equitable distribution of economic welfare within the regions of the Community provided it were supported by a properly balanced Community budget and a greater transfer of resources through the Community institutions. Finally I believe it would promote that political development of our institutions which is our common European faith and objective.

To these ends the European Monetary System is an important means. It represents that indispensable practical beginning which I called for at Florence. Today I will start by looking at the real improvements in our situation which have already been achieved. Next I shall turn to its less complete or satisfactory features. Finally I shall suggest in broad terms and without going into technical detail the direction in which I believe the system should evolve in the future.

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First then about the progress we have made. It is I believe no coincidence that the exchange rates between the currencies of the eight countries fully participating in the System have been considerably more stable than before it was set up. I add that they have also been more stable than the exchange rates of such other international currencies as the US dollar, the yen and the Swiss franc. I know that there have been occasions when Community central banks have intervened in the foreign exchange markets to maintain exchange rates within the limits prescribed in the EMS; but stability has been achieved without those violent and disruptive speculative attacks on this or that currency which have occurred in the past. Thus the fears of those who prophesied that the EMS would simply lead to a new and different kind of exchange rate instability have proved to be unfounded.

Equally unfounded have proved the fears of those who believed that return to a system of fixed but adjustable rates would lead to rigidity and that the authorities would insist on defending exchange rates that were unrealistic. In my opinion this was never a serious danger. The lessons of the 60s and early 70s have been well learned. Under the new System there were two small-scale realignments at the end of last year. In both cases these changes were clearly justified by the underlying economic circumstances of the countries concerned. They were carried out promptly, without acrimony and without resulting disorder in the foreign exchange markets.

I add in passing that the special arrangements which were made for the Italian lire have proved their worth. I remember that when the EMS was launched there were many who professed scepticism about the ability of the lire and the deutschmark to live together within the System for more than a few months without a major realignment. In fact the wider margins of fluctuation which the lire was attributed within the System as a temporary measure have worked well, allowing a gradual exchange rate depreciation in orderly fashion over eighteen months without unduly heavy intervention by the Bank of Italy. This has been achieved in spite of Italy's relatively high rate of inflation, in spite of the conversion of a balance of payments surplus into a deficit, and in spite of the uncertainty caused by political developments in Rome.

Exchange rate stability is not of course an end in itself. It is the result - the balance achieved - of the interaction of the underlying economic circumstances of the countries concerned. But firm official commitment to a measure of exchange rate stability can itself contribute towards an improved economic performance. It would be wrong to neglect economic performance for the sake of exchange rate stability; but equally wrong to neglect exchange rate stability in the belief that it does not affect economic performance. In my view there is now wider recognition in Europe, especially in those countries which have suffered from the vicious

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circle of exchange rate depreciation and inflation in the past, of the contribution which a stable exchange rate can make towards controlling inflation. The right balance of stable exchange rate and internal economic policy now seems nearer achievement.

In this respect the creation of what has been called the divergence indicator in the EMS has proved useful. It has acted as a kind of early warning system to point the need for corrective action before a country's external situation has deteriorated too far.

Again I do not believe it to be a coincidence that since the System came into operation there has been better co-ordination and cohesion in the economic policies of participating governments. All are now going in the same direction: that is to say towards restraint with priority given to control of inflation. Likewise the divergencies in national balance of payments have become less wide. At present largely for oil price reasons both the Community as a whole and almost all its individual members are running current account deficits; but if the Community and its members face a common problem with regard to the outside world, they face much less of a problem within and between themselves.

Less good has been the continuing differences in the inflation rates of Community countries. Unless these differences are reduced, obviously the exchange rate stability we have enjoyed cannot be permanently sustained. These differences reflect deep-seated differences in attitude towards inflation and unemployment in participating countries and not just to differences in the determination of governments and central banks to pursue anti-inflationary policies. Hence I fear that in this area where we face a psychological as much as an economic and political problem, we shall need time and patience as well as effort.

Another area where results have so far been disappointing has been our failure to develop coherent policies towards currencies outside the System. In many ways this is a potential rather than a current source of trouble. Although there have been some fairly large swings in exchange rates between the European Currency Unit and the dollar (and even larger ones between the ECU and the yen), they have not in the last eighteen months caused major difficulties for the Community or upset exchange rate relationships within the EMS. This is perhaps due more to accident than design. The deutschmark has recently been relatively weak on foreign exchange markets, largely as a result of Germany's current account deficit. But while there has been switching out of deutschmarks into dollars and other third currencies, there has been little switching out of deutschmarks into other EMS currencies. The reason is, I think, that in view of Germany's low inflation rate and underlying economic strength, no foreign exchange operator seriously entertains the prospect of a deliberate deutschmark devaluation against the other member countries. But if operators were to start to switch out of dollars into deutschmarks again (and this could

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easily happen) the deutschmark would rise against the dollar which could in turn lead to a scramble out of other Community currencies into deutschmarks. This has happened before and could happen again. If it did it would put the current stability of exchange rates under strain. The lesson for us is, I believe, that we should be in a position to manage the ECU/dollar exchange rate in a co-ordinated fashion so as to avoid or at least minimize the strains which might otherwise arise. It is in our power to do so.

While on third currencies, this is perhaps the moment for me to say a word or two about sterling. Although sterling is formally included in the European Monetary System, it is an outsider so far as existing exchange rate arrangements are concerned. I continue to believe that this is a great mistake, both for the Community and still more so for the United Kingdom. If the British do not become full members of the System, if they do not accept the same risks and responsibilities and enjoy the same advantages as the other members, then they must not complain if the System evolves in a fashion which does not necessarily take account of the particular characteristics of sterling and the particular underlying economic circumstances of the United Kingdom.

I know that there can at times be a conflict between adherence to a domestic monetary target and the observance of limits on exchange rate movements with its effects on domestic money supply. There is more than one way to

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deal with the impact of unwanted inflows or outflows of foreign currency. In any event there is much flexibility in the exchange rate system of the EMS. The United Kingdom could, like Italy, opt temporarily for wider margins; or if the inflow and outflow of foreign currency were to become intolerably large, it could adjust its exchange rate within the System as other members have already done. It is because of the existence of this safety valve that other countries have found it possible to reconcile pursuit of their economic and monetary objectives with full participation in the exchange rate system. There is no reason why the United Kingdom should not do the same. In my judgment the benefits would be substantial. Greater exchange rate stability would be much welcomed by British exporters, and would be good for the British economy as a whole.

The EMS is of course more than an exchange rate system. There are two features to which the European Council drew attention in December 1978 and for which further development was explicitly planned. These are the European Currency Unit and the European Monetary Fund.

The ECU is now firmly established as the unit in terms of which the official business of the Community is conducted. Old habits die hard and people still refer to the European Unit of Account. But this has now been superseded by the ECU, and I hope that the world will now enter fully into our vocabulary. It has the advantage not only of being an acronym for European Currency Unit

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but also of recalling one of the ancient European units of currency.

The ECU is now used in all the Community's internal finance, accounting and statistical functions: the budget, the Investment Bank, the Development Fund and the Common Agricultural Policy. Within the EMS it is the unit in which exchange rates are expressed and it is a reserve asset. It may well be that the Community will shortly float a new balance of payments loan denominated in ECUs.

The use of the ECU in the private sector has begun. Many of the major European commercial banks now accept current account deposits in ECUs and some have granted credits in them. The Commission holds ECU accounts and has placed short-term paper denominated in ECU. But so far the scale of operations has been small. This is something which must be left essentially to the market. Financial enterprises and their clients cannot be compelled to substitute ECUs for other instruments, although they can be encouraged so to do, and unnecessary obstacles to the use of the ECU can and should be removed.

Within the realm of official use of the ECU, it seems to me that there are at least two things which need to be done and could be done without delay. The first relates to the role which the European Council declared at Brussels in 1978 that the ECU should have: that is to say it should be the centre of the European Monetary System. Frankly that is not yet the case. But it should be. The intervention of Community central banks

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in the foreign exchange market continues to be predominantly in dollars. There has indeed been some increase in the use of Community currencies for intervention purposes, but I think it fair to say that it is the exception rather than the rule. Then there are limitations to the acceptability of the ECU. At present a creditor central bank has only to accept repayment of 50 per cent of its claims in ECU. The remainder can be settled by the transfer of other reserve assets. This means giving second class status to the ECU. I think this should be changed forthwith.

The second change which I believe necessary concerns the relationship between the ECU and gold. One of the reasons why certain central banks originally insisted that limitations should be imposed on their obligation to accept ECUs in settlement was that they were afraid that too many ECUs might be created, and that if there were an open-ended commitment by creditors to accept payment in ECUs, they could end up by holding far more than they wanted. To understand this difficulty we have to look at the way ECUs are created. They are a counterpart to the twenty per cent of member countries' dollar and gold reserves which central banks are required to deposit with the European Monetary Co-operation Fund. As a result the quantity of ECUs which each receives is a function of the ECU/dollar rate and the ECU price of gold. The ECU/dollar rate has not been too unstable over recent months; but the price of gold has, as you all know, been

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extremely volatile. When the EMS came into operation in March 1979, the free market price of gold stood at US $240 an ounce: today it stands at about $650 an ounce having touched nearly $850 an ounce early this year. This was not of course foreseen when the EMS was set up and some revision of the rules is clearly necessary. Unless such a revision takes place, the quantity of ECUs on the market will partly depend on the price of a commodity which can oscillate wildly in response to extraneous and irrelevant factors. In my judgment we should revise the present rules in such a fashion as to ensure that the quantity of ECUs to be created over a given period are based on an objective assessment of the Community's needs.

In spite of these disabilities, the ECU exists and is flourishing. The same cannot be said for the projected European Monetary Fund. It is normal that there should be divergencies of views between member countries about the functions of the Fund and the degree of independence it should enjoy. These differences have their roots in the different economic philosophies, institutions, and experience of the Member States. It would be premature to claim that the European Monetary Fund should spring into existence as a kind of central bank for Europe. On the other side it would be a wasted opportunity if it were to be no more than a re-vamped version of the European Monetary Co-operation Fund under a grander name. In my view the new Fund should from the beginning have at least some of the features and functions of a central bank. These could be developed and enlarged over time in the light of experience.

I do not wish to enter here into a technical debate about the Fund but I think it should have the following three main functions. First it should determine the quantity of ECUs to be issued and control the timing of issue; secondly it should have the task of co-ordinating the monetary policies of individual Member States; and thirdly it should control intervention policies with regard to third currencies. Decisions on these and other matters should go before the European Council next year. Work is already in hand, and the Commission is playing its due part in it through such bodies as the Monetary Committee. I attach the highest importance to the fact that the European Monetary System, with the European Currency Unit and one day the European Monetary Fund, is a Community institution, and forms part of the construction of the Community as a whole.

The world today faces an uncertain and forbidding economic future, characterized by high inflation, slow growth, and large payments imbalances. The Community cannot of course solve these problems by itself. But the Community has a formidable weight in the world economy. We account for a third of the output of the free world industrial countries, more than half of their exports and about two-thirds of their reserves. We therefore have not only the power to help in resolving the world's ills but also a heavy responsibility so to do. By creating greater financial stability and advancing the economic growth of the European economy, the European

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Monetary System represents a major contribution to the better functioning of the world economy as a whole.

I end as I began. The European Monetary System represents an indispensable practical beginning towards the creation of that European monetary union which I continue to believe should be our aim. We have come a long way since I spoke at Florence in October 1977. The difficulty now is to maintain the sense of priority which led to the decision of Bremen, and not to prevent day-to-day difficulties obscuring our more distant objective. I make this speech as a contribution to that end.

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Brussels, 24 October 1980

EXTRACTS FROM SPEECH BY MR ROY JENKINS, PRESIDENT OF THE COMMISSION OF THE EUROPEAN COMMUNITIES, TO THE ASSOCIATION OF EUROPEAN JOURNALISTS, ROME, 24 OCTOBER 1980

"THE EUROPEAN MONETARY SYSTEM: RECENT EXPERIENCE AND FUTURE PROSPECTS"

Almost to the day three years ago I made a speech in Florence. I then argued that the time had come for a new push towards the monetary integration of the European Community. Within nine months the European Council at Bremen took the decision in principle to create the European Monetary System; and another nine months after that, in March 1979, the system came into operation.

In my judgment the arguments I set out at Florence have lost none of their validity. I believe that monetary union favours a more efficient and developed rationalization of industry and commerce; would help produce a new era of price stability in Europe and achieve a decisive break with our present chronic inflationary disorders; would help in coping with the present economic recession and one of its ugliest aspects, unemployment; would promote a more equitable distribution of economic welfare within the regions of the Community supported by a properly balanced Community budget and a greater transfer of resources through the Community institutions, and would promote that political development of our institutions which is our common European faith and objective.

To these ends the European Monetary System is an important means and indispensable practical beginning. Real improvements have already been achieved.

An area where results have so far been disappointing has been our failure to develop coherent policies towards currencies outside the System. We should be in a position to manage the ECU/dollar exchange rate in a co-ordinated fashion so as to avoid or at least minimize the strains. It is in our power to do so.

Another disappointment is that although sterling is formally included in the European Monetary System, it is an outsider so far as existing exchange rate arrangements are concerned. I continue to believe that this is a great mistake, both for the Community and still more so for the United Kingdom. If the British do not become full members of the System, if they do not accept the same risks and responsibilities and enjoy the same advantages as the other members, then they must not complain if the System evolves in a fashion which does not necessarily take account of the particular characteristics of sterling and the particular underlying economic circumstances of the United Kingdom.

There is much flexibility in the exchange rate system of the EMS. Other countries have found it possible to reconcile pursuit of their economic and monetary objectives with full participation in the exchange rate system. There is no reason why the United Kingdom should not do the same. Greater exchange rate stability would be much welcomed by British exporters, and would be good for the British economy as a whole.

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There are two features of the EMS for which further development was explicitly planned. These are the European Currency Unit and the European Monetary Fund. The ECU is now firmly established as the unit in terms of which the official business of the Community is conducted. Use of the ECU in the private sector has begun. But so far the scale of operations has been small. This is something which must be left essentially to the market.

Within the realm of official use of the ECU, it seems to me that there are at least two things which need to be done without delay. First it should be the centre of the European Monetary System. The intervention of Community central banks in the foreign exchange market continues to be predominantly in dollars. Then there are limitations to the acceptability of the ECU. At present a creditor central bank has only to accept repayment of 50 per cent of its claims in ECU. I think this should be changed forthwith.

The second change which I believe necessary concerns the relationship between the ECU and gold. The price of gold has been extremely volatile since the EMS came into operation. This was not of course foreseen. Unless a revision takes place, the quantity of ECUs on the market will partly depend on the price of a commodity which can oscillate wildly in response to extraneous and irrelevant factors. In my judgment we should revise the present rules in such a fashion as to ensure that the quantity of ECUs to be created over a given period is based on a objective assessment of the Community's needs.

In spite of these disabilities, the ECU exists and is flourishing. The same cannot be said for the projected European Monetary Fund. It would be premature to claim that the European Monetary Fund should spring into existence as a kind of central bank for Europe. On the other side it would be a wasted opportunity if it were to be no more than a re-vamped version of the European Monetary Co-operation Fund under a grander name. In my view the new Fund should from the beginning have at least some of the features and functions of a central bank.

First it should determine the quantity of ECUs to be issued and control the timing of issue; secondly it should have the task of co-ordinating the monetary policies of individual Member States; and thirdly it should control intervention policies with regard to third currencies. Decisions on these and other matters should go before the European Council next year.

The question now is to maintain the sense of priority which led to the decision of Bremen in 1978, and not to prevent day-to-day difficulties obscuring our more distant objective.

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