

The European Monetary System

European File

Six million people are currently out of work in the European Community. Whilst the economic crisis has seriously hit most countries, monetary instability has complicated the search for corrective solutions. As of March 1979 we have a new hope : the European monetary system.

International monetary crisis

From the end of the Second World War to the late Sixties the Western world enjoyed a climate of relative monetary stability. The various currencies were traded at rates based on their US dollar values. Dollars themselves were convertible at fixed rates. The US currency was used to calculate raw material prices, to draw up and regulate international transactions. Composed of gold and dollars, national monetary reserves had a precise value : they backed money issues and were used to finance external trade deficits.

Inflationary trends, however, were already evident underneath this apparently calm surface. Rising consumer demand, both private and public, did not match the limited resources available. This has been the case for example with raw materials. Substitutes can be found in most cases but they are usually more expensive. Manufacturers also have a tendency to pass on cost increases to the consumers and — in a vicious circle — tend to cause prices and wages to rise.

When a country experiences higher inflation as a result of its economic position or of its economic policies, the end result is a loss of competitiveness in international trade and, in consequence, growing external trade deficits and a depletion of monetary reserves. Under a system of fixed exchange rate parities, such countries would have to adopt stricter budgetary and monetary policies. They would find equilibrium once more by reducing domestic demand to free resources for export and to reduce imports at the same time. In the case of fundamental and persistent disequilibrium, a country can choose to devalue its exchange rate.

These mechanisms have revealed their limitations in the inflationary conditions we have experienced. The United States has partially escaped the worst of problems given the central role of its currency. In reality their debts have simply constituted reserves for the central banks of other countries. The growing deficit on their balance of payments also stimulated the prodigious growth of the Euro-dollar market i.e. those dollars held outside of the USA.

Lacking any alternative currency to take over this role, the dollar remained the necessary and accepted means of international payments and made it difficult for other countries to operate restrictive monetary policies. Almost everywhere, price rises and growing external deficits were financed — particularly in the case of the USA which was engaged in the Vietnam war — by creating supplementary means of payment. Between 1969 and 1972, world monetary reserves doubled and since then have risen at an average 13% per year.

Given the gap which grew between US gold reserves and the supply of dollars issued, the limit had to be reached sooner or later.

In 1971, the Americans recognized that it had become impossible for them to ensure the gold convertibility of their currency. In 1973, floating exchange rates were introduced and the dollar ceased to have a stable rate.

No other currency or artificial currency unit has been able to replace the dollar in international trade. The result has been a trading climate subject to exchange rate fluctuations. This system does have some advantages however and has, for example, helped offset the rise of oil prices which were fixed in dollars. It also has its inconveniences :

- for both technical and political reasons, central banks will not necessarily intervene on the money market to support their currency. Businessmen can consequently no longer bank on reliable future rates : they consequently hesitate to invest and create jobs.
- currency depreciations no longer automatically bring about a balance of trade. Instead, they tend to feed inflation; imported raw materials prices rise as do wages which also tend to follow prices.
- the floating exchange rates contribute to erratic currency movements. The supply of Euro-dollars currently stands at 700 billion. Financial markets can be upset

at any moment by enormous capital movements which, given the current monetary instability, can cause a flight from one currency into another depending on current circumstances and outlook.

European monetary union — Why ?

The economic and financial crisis has accentuated divergences within the European Community at a time when the Nine themselves are on the point of accepting new members. Also, the competitiveness of national economies, their ability to respond to growing demand and their capacity to resist inflation are not the same. Price rises between 1974 and 1977 amongst the Nine ranged from 25% to 100%. In some countries, economic growth was as little as 1% and in others 10%. The divergent exchange rate movements have caused problems for the prices and free movement of agricultural produce in Europe. The unity of the industrial market has also been pressured by protectionist movements.

These divergences have been further amplified by the individual policies of Member States who have not established between each other the high degree of economic interdependence which should be expected considering the fact that more than 50% of their trade is with Community members. The exchange rate crisis has hindered efforts by deficit countries to increase economic growth. Lacking any growing external demand, the countries which have been in the position to give a new boost to economic growth have not fully used their capacity to stimulate the European economy. In short, unemployment has worsened and the Community's achievements are at risk.

Given this situation, the economic and monetary union of Community countries should bring about the results outlined by Roy Jenkins, President of the European Commission, in Florence, 27 October 1977 :

- *monetary stability* : the Community is the only major economic grouping without a single currency of its own. The progressive introduction of a European currency could provide some shelter for half of our trade against exchange rate fluctuations. Our countries could cope with short periods of deficit more calmly; speculative movements would be less frequent; and eventually a new world monetary order could be created based on large zones of stability linked, probably, by a system of floating exchange rates.
- *moderating inflation* : the inflationary impulses from outside the Community would be limited. Also the control exercised by a European monetary authority would impose a certain economic discipline greater than could be established by Community countries acting in isolation. And European countries would be more closely involved with the creation of corrective policies than has been the case when action is dictated to them (as in the case of persistent disequilibrium) by a body as far away as the International Monetary Fund.
- *Growth and rationalization of the economy* : freed from the risks of fluctuations and the uncertainties created by inflation, industrialists and traders can develop

their business better on a European scale. The advantages of the Common Market which have not yet been completely realized simply by customs union can then bear fruit.

- *improving employment* : by creating a favourable climate for renewed investment, by strengthening demand over a large geographical basis — (the Community has 260 million consumers) — by assuring relatively stable prices sheltered from exchange rate fluctuations and erratic capital movements, European monetary union will give a new boost of historic dimensions to our economies.
- *better regional balance* : monetary union presupposes that weaker regions will receive increased aid. By redistributing resources, and orienting more public funds towards the poorest regions, it will be possible to reduce the imbalances which disfigure Europe. The strong regions by contrast would benefit from markets which are more stable, more sure and more prosperous.
- *new division of political roles* : the intention is not to increase indefinitely centralization at the continental level. The concentration of power implicit in European monetary union through the creation of the monetary unit or by exchange rate management, should not cause alarm; it will permit Community countries to rediscover — collectively — the capacity for action which, given the dimension of the problems, is currently beyond them. Other areas of power could quite easily be decentralized so that decisions can at all times be taken at the appropriate level.
- *progress in constructing Europe* : it is clear that monetary union constitutes an important stage on the road to economic and political union which is the ultimate objective of Community Member States.

A long road

The Florence speech was a veritable rebirth of the idea of the economic and monetary union in the Community.

- Some ten years earlier the Barre plan (1969) and the Werner plan (1970) led to the introduction of coordination procedures for national economic policies and to the creation of reciprocal credit mechanisms. An attempt at monetary cohesion also saw the light of day in 1972 in the form of the European monetary “snake” i.e. a system in which currency values in the Community were linked together and allowed to fluctuate only within close margins. This system enabled them to remain stable in relation to other currencies, particularly the dollar. The “snake” was able to function “durably” with the Deutsche Mark, the Benelux currencies and the Danish Krone. This experience is invaluable since it has enabled us to identify more clearly the economic and financial conditions required for monetary mechanisms to function properly.
- One month after President Roy Jenkins’ speech, the European Commission adopted under the impetus of Vice-President François-Xavier Ortoli, a “Com-

munication on the outlook for economic and monetary union”, which stressed the economic aspects of the union. Strengthening economic coordination, developing the Community’s instruments for action and intervention, completing the realization of the Common Market (still held back by several fiscal and technical obstacles) preparing and implementing industrial reorganization, relaunching common policies in the social, regional and energy fields : all these factors are vital to provide a solid base, and to prevent it becoming simply a theoretical construction likely to crumble under the smallest shock. In March 1978, the main arguments of the document were translated into an “action programme” which will be reviewed annually.

- The decision to create a European monetary system was taken by the leaders of the “Nine” under the leadership of the French President Valéry Giscard d’Estaing and the German Chancellor Helmut Schmidt. During the European Council at Copenhagen, 8 April 1978, the first decision of principle was taken and Community institutions were invited to examine the mechanics of the system. This was significantly different to the initiatives taken ten years earlier. Instead of plans being drawn up before the basic political decision was taken, the political decision was taken first and experts then commissioned to resolve the final technical problems.
- 6 July 1978, at the European Council meeting in Bremen, the heads of state and government confirmed their decision and established the outlines of the system together with the timetable. The objective to be attained was defined as “a system for the creation of closer monetary cooperation leading to a monetary stability in Europe” and that such a system must be “durable and effective”. Parallel to the introduction of monetary mechanisms, the coherence of the Nine’s economic policies should be increased to facilitate the convergence of these policies and improve their performance, certain measures must be implemented to reinforce the economic potential of the Community’s least prosperous countries.
- Following intense negotiation, the European Council, meeting in Brussels 4-5 December 1978, adopted a “resolution on the introduction of a European monetary system and related questions”. Six Member States — Belgium, Denmark, Germany, France, Luxembourg and the Netherlands — agreed to take part immediately. Italy announced its adhesion on 13 December, Ireland on 15 December. The United Kingdom declined to participate for the time being in the common monetary intervention system, but agreed to pursue an exchange policy which would assure the stability of the pound in relation to other Community currencies.
- On 12 March 1979, the European Council, meeting in Paris, gave the go ahead. The European monetary system came into force on 13 March following a solution to the problem of agricultural monetary compensatory amounts. Introduced to compensate for the effects of fluctuating exchange rates on European agricultural prices when expressed in national currencies, these compensatory amounts have helped upset competitive conditions in the Nine and France insisted on their progressive removal as a condition for adhesion to the new monetary system.

Operation of the European Monetary System

The European Monetary System (EMS) is a key element in developing European economic and monetary union. A step on the road to complete monetary union, the EMS responds both to immediate demands for monetary stability, economic recovery and the creation of new jobs.

The priority objective of the EMS is to stabilize exchange rates between currencies to re-establish the proper functioning of the industrial and agricultural common market and re-establish confidence amongst investors and industrialists. The EMS works as follows :

- For each currency in the system a central rate is fixed in ECUs (European Currency Units). The ECU is a monetary unit based on a basket of national currencies identical to those used to calculate the European unit of account ⁽¹⁾. The composition of the basket can be reviewed in principle every five years or when the weight of one currency has changed by 25%. The central rate can be modified so as to take account of possible economic changes; these adjustments are subject to mutual agreement through a common procedure involving participant States and the European Commission.
- These central rates are used to establish a grid of bilateral exchange rates; a reference rate in relation to other currencies is fixed for each currency. Around these rates fluctuation margins have been established : for Member countries of the "snake" the maximum margin is fixed at 2.25%. The other countries — though this option has only been taken up by Italy — may adopt wider margins up to a maximum of 6%, a rate which can be subsequently progressively reduced as economic conditions permit.
- Obligatory market intervention points are fixed. Each time the agreed margin is likely to be exceeded, Central Banks of the participating countries are obliged to intervene to keep their exchange rate within the agreed margins.
- Participating States place 20% of their gold reserves and 20% of their dollar reserves in the European Monetary Cooperation Fund and receive a supply of ECUs to regulate Central Bank interventions.
- Credit and reciprocal financial support mechanisms between participant states will help alleviate monetary risks. The amounts that can be mobilized are considerably increased. Speculators are thereby greatly dissuaded; the sheer size of intervention resources should be sufficiently dissuasive to limit its use. It is composed of :

⁽¹⁾ This basket is composed of DM 0.828, UK pound 0.0885, FF 1.15, Lira 109, FL 0.286, BF 3.66, F Lux 0.14, DKR 0.217 and Irish Punt 0.00759. The weight of each currency in the basket is as follows : DM 33%, UK pound 13.3%, FF 19.8%, Lira 9.5%, Florin 10.5%, Belgian franc 9.2%, Lux. franc 0.4%, Danish Kroner 3.1% and the Irish Punt 1.1% (12 March 1979). 1 ECU = approx £0.66.

- very short-term credits facilities (settlement within 75 days except when they are converted into short-term credits) agreed by central banks without volume restrictions;
 - short-term credits (settlements within three months, except when renewed) agreed by central banks for a maximum of 14 billion ECUs (about 19 billion dollars);
 - medium-term financial assistance up to a maximum of 11 billion ECUs agreed between Member States and subject to certain objectives jointly set by the Council of the Nine, which the benefiting countries agree to achieve.
- An accounting unit for interventions and credits agreed for the participating currencies and a means of settlement between central banks, the ECU will serve as a basis for establishing a "divergence indicator". This indicator will act as an alarm when a currency risks exceeding the permitted margins. When a significant divergence occurs between one exchange rate and the weighted average of the others (when expressed in ECUs) the country in question will normally take corrective actions which are not limited to monetary intervention and may include changes in economic policy. Consultation procedures are catered for and in cases when the prescribed measures are not taken, the reasons shall be jointly examined.
- So as to help the least prosperous countries and adhere to the monetary and economic disciplines laid down in the system, supplementary economic measures have been decided on. These should help create the conditions for better economic convergence between Member States through a more balanced distribution of industrial activity and wealth. Five billion European units of account can be made available to the least prosperous countries over five years (1 billion per year) in the form of loans to finance infrastructure projects. These loans are made more attractive by interest relief grants amounting to as much as 1 billion EUA over five years, or 200 million per year. European institutions will try to improve the depth and effectiveness of Community instruments such as the European Regional Fund, for example, which occasion transfers of resources towards less well off zones and which permit new initiatives.

△

After two years of operation the European Monetary System will become definitive and this will involve the creation of a European Monetary Fund. The Monetary reserves in gold currently held in the European Monetary Cooperation Fund will become Community reserves and the ECU will be confirmed in its double role as a reserve and an instrument for settlement. At this time, a new decisive step towards European economic and monetary union will have been accomplished ■



Commission of the European Communities

Information offices (countries fully or partially English speaking*)

- Ireland** 29 Merrion Square, Dublin 2 — Tel. 76 03 53
- United Kingdom** 20 Kensington Palace Gardens, London W8 4QQ — Tel. 727 80 90
 - 4 Cathedral Road, Cardiff CF1 9SG — Tel. 37 16 31
 - 7 Alva Street, Edinburgh EH2 4PH — Tel. 225 20 58
- Canada** Association House (suite 1110), 350 Sparks Street,
Ottawa Ont. K1R 7S8 — Tel. 238 64 64
- USA** 2100 M. Street, N.W. Suite 707,
Washington D.C. 20037-USA — Tel. 202-872 83 50
 - 245 East 47th Street, 1 Dag Hammarskjold Plaza,
New York, N.Y. 10017 - U.S.A. — Tel. 212-37 13804

* Offices also exist in other countries including all Member States

