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EUROPEAN MONETARY SYSTEM TO GO INTO FORCE:
FRANCE LIFTS RESERVE ON SYSTEM

Valery Giscard d'Estaing, President of the French Republic, announced today that his government has lifted its reserve on the European Monetary System. The system is expected to enter into force on March 12.

In Frankfurt, Germany last February 14, Mr. Francois-Xavier Ortoli, Vice-President of the European Commission in charge of economic and monetary policy, outlined the reasons for setting up the system and explained how it would work.

The main points of his speech were as follows:

EMS MUST BE A LYNCHPIN OF GREATER ECONOMIC COORDINATION

"The future management of the system...will be demanding. The logic behind it is not purely monetary and it is not merely an intervention agreement between central banks; to be successful it must be the pivot of joint measures to bring our economies more closely into line with regard to their objectives, behavior and achievements."

Earlier attempts to develop a monetary policy for the Community "were prompted by two major considerations", he said. "The first consideration is a political one and reflects the conviction that our countries have a common destiny. The idea of European Union, with all its imprecision, is the expression of this aspiration, and Economic and Monetary Union the key instrument.

"The second consideration is much more practical and of much more immediate significance. It stems from two premises: that monetary instability constitutes a major threat to our economies, and that to put an end to such instability, we must begin by establishing in Europe, between highly interdependent and institutionally linked economies, a zone of monetary stability."

EUROPE YEARNS FOR GREATER STABILITY

"A more detailed analysis of this argument reveals that it has a whole series of components:

Firstly, there is considerable disappointment with the negative impact of the system of floating exchange rates on international competition, market and profit expectations, the growth in investment and, lastly, growth and employment. The absence of monetary rules has very serious practical implications and also a psychological impact since it affects the ability of companies and of economic agents generally to plan ahead, and since it undermines confidence.

Secondly, there is fear about the future of the European Common Market, which is faced with a monetary and economic crisis that might jeopardize its achievements to date and, more generally, a fear that the principle of freedom in international trade may not be upheld.

Thirdly, at a time when our interdependence is self-evident (we transact between ourselves half of our aggregate foreign trade), there is an awareness of the limits to economic policy coordination that is based on good will alone; hence the need to secure a sound and sufficiently stringent basis for the restoration of economic order and a revival of growth by relying on the key role played by the monetary constraint, which acts both directly and as a catalyst for other policies. The construction of Europe, which has been made too exclusively dependent on the good will shown by Member States, needs firmer anchoring points.

Lastly, there is the force of our common interests in determining the new pattern of international economic and monetary relationships.

In short, the world is thirsting for stability; Europe needs it more than any other area, and it must make a start on creating such stability by accepting the constraints and common disciplines that go with it."

THE OBJECTIVES AND MECHANISMS OF EMS

1. "The first objective is to maintain real stability in the relationships between the currencies participating in the system.

(a) In order to do this, any two Community currencies will each have a maximum permissible fluctuation margin of 2.25% against one another, with the exception of the lira, for which the margin will be 6%. Once the limit is reached, intervention will be automatic, but here we see the first difference with the 'snake'. This lies in the scale and time-span of the resources deployed to help ensure that the maximum divergence limit is not exceeded and also in their form since the European Monetary Cooperation Fund (EMCF) will henceforth issue European Currency Units (ECU) against the deposit by the central banks of 20% of their gold and dollar reserves.

In order to deal with any speculation, the unlimited very short-term credit which central banks make available to one another is extended from 30 to 45 days and will be renewable for three months within certain limits. Short-term credit may be granted for nine months instead of six months as in the present monetary arrangement and the amount of 14,000 billion ECU actually available is more than double the previous figure. Both in real terms and as a means of dissuasion, this will considerably strengthen the lines of defense for maintaining the quasi-stable parities which will be established.

"Community medium-term credit machinery will be strengthened and will have a ceiling of 11,000 billion ECU as against 5,450 million ECU today. This is an improvement along the same lines, though its purpose will obviously be different. Short-term credit is essentially a means of containing erratic movements on the market. It ceases to apply as soon as the situation returns to normal. Medium-term credit can either take over from short-term support - thus avoiding any immediate drain on the currency reserves of a debtor country - or, as will more frequently be the case, it can fulfill quite a different role, that is to say it can enable a Member State which pursues an economic policy in line with the common interest but which is in temporary balance of payments difficulties, to avoid the unnecessary constraints involved in the need to restore its external accounts too rapidly.

(b) A second line of defense in maintaining parities is the establishment of a preventive system based on the use of a divergence indicator, defined in relation to the ECU, i.e. the currency-basket unit of account.

When a currency diverges, that is to say when it moves away from the ECU by more than a certain percentage, there will be a presumption that the relevant country will take action. Notice that I use the word action, which is a broad term, and not the word intervention. This arrangement was included in the system so as to deal with the problem of the involuntary debtor or creditor, i.e. to impose on a country whose currency was regarded as pulling the other currencies upwards or downwards a more specific responsibility in easing tensions."

NEW NOTIONS INTRODUCED BY EMS

"However, I feel that the new mechanism will help to change, in a very desirable way, the nature of the European Monetary System by means which have little to do with the problem of the involuntary debtor.

First of all, as I have said, it introduces the very desirable notion of prevention into the system -- a new notion and one which may make our machinery more flexible and more effective at less overall cost. This preventive action will be accompanied, where necessary, by diversification of the intervention currencies, Community currencies or non-member currencies, thereby ensuring that the measures taken are better adapted to the market situation.

Secondly, the divergence indicator concept gives the system a further characteristic: its use makes it necessary to investigate the causes of the strains which appear on the foreign exchange market at a given time. It induces the authorities to act in the light of these causes and not simply - and automatically - by purchasing or selling foreign exchange with a view to maintaining the spread between two currencies within certain limits."

DIFFERENT CURRENCY STRAINS REQUIRE DIFFERENT SOLUTIONS

"These strains may stem from very different sources, necessitating very different corrective action. They may stem from the system itself:

From the short-term weakness of a currency or from a reaction to a policy - perhaps a monetary policy - which the market judges to be incompatible with the maintenance of the parity chosen, or may even be a judgment on what is now seen to be an unsuitable parity. They may have an external origin: the weakening or, alternatively, the strengthening of a major non-member currency (such as the dollar) acting on the whole of the European monetary system through the pressure of available liquidity."

ON ONE OF OUR CURRENCIES

"Consequently, the remedies will themselves change: it will not simply be a question of intervention - however diversified - on the exchange market. It may be necessary to take measures of domestic monetary policy or to rethink overall economic policy or to change the central rate.

This diversification of action, combined with more effective coordination of policies and with a greater measure of solidarity, and this systematic organization of an effective dialogue, are the best way in which to allay the fears associated with the rigidity of the system and also the fear that it may have an inflationary or deflationary impact.

As you will have noted, I have attempted to show what guarantees of orderly functioning the monetary system itself offers.

These guarantees are, first of all, technical ones, namely mobilization of sufficient funds to combat speculation, provision for preventive measures, establishment of machinery to remedy the causes of strains. Finally the arrangement goes further than a mere agreement on exchange rates concluded between central banks in providing for the use of domestic monetary and economic policy instruments, including, where necessary, those within the sphere of competence of the governments themselves.

A further guarantee is afforded by the flexibility of the system, which readily permits changes in central rates as a safety valve and not a mere convenience."

EMS BOUND TO FACE PROBLEMS

"This analysis, however, calls for three concluding remarks:

- firstly, this system, which is more comprehensive, more complex and more refined, combining automatic mechanisms and potential means of action, must be "got off the ground". It has still to undergo its baptism of fire and difficulties - some of them unexpected - are bound to arise. I trust only - and believe - that we have not failed to see where the real issues will lie.
- secondly, the system will, as I mentioned earlier, have to operate within a disturbed international monetary environment and, in managing it, we will have to take into account the prospective developments in this field;
- finally, exchange rate stability must correspond to economic reality."

BASIC CONDITIONS FOR SUCCESS OF EMS

11. "To ensure that the basic conditions for the success of the European Monetary System are in fact met: the technical condition that it will reflect sufficiently homogeneous economic policies and performance, and the political condition that it will help to solve the main problems confronting Europe's economy.

(a) In this field, the first priority is to coordinate economic policies. There is a danger under the system that the relationship between European currencies will not be stable enough. Despite the flexibility which I have just referred to, the EMS will be meaningful only if parity changes are reasonably rare and reflect only objective trends. If this is not the case, there will be no area of monetary stability in Europe, but simply a system of periodically recording variations. In the long run, stable exchange rate relationships can be safeguarded only through the convergence of economic performances, that is to say by bringing down inflation rates and by achieving satisfactory balance of payments positions.

However, although convergence is expressed in terms of figures and performance, it depends on the joint definition and monitoring of objectives and policies, that is to say on coordination. How would it be possible for countries to take part in the same exchange rate system while at the same time continuing to pursue different monetary, budgetary and other policies? The EMS must therefore be complemented by a convergence of economic policy extending to the main fields of macroeconomic policy and to the main instrumental policies.

This means that coordination will have to be much more systematic than at present and will have to take place before major national decisions likely to influence exchange rate relationships are actually taken. It means that the definition of domestic monetary policies, while continuing to be the responsibility of governments or central banks, will become a matter of common concern and will have to be treated as such."

ASSETS FOR IMPLEMENTING THE NEW PROGRAM

"We have three assets at our disposal for implementing this program - the awareness, which was expressed during the preparatory work, of the logical connection between the monetary system and economic policies; recent experience of concerted economic action, which has led us to strengthen our procedures and to breathe new life into the various bodies which work out the beginnings of a Community economic policy; and finally, in the light of these facts, and relying on this improved capacity for managing our affairs, the natural concern to make the major political initiative a lasting success. I do not overestimate these factors. However, bearing in mind the events of 1978 as I saw them, I believe they are very strong."

FUTURE DEVELOPMENT OF EMS

"I now come to the possible ways in which the system might develop. They are difficult to foresee because they will, in large measure, depend on the way in which the system operates. In the normal course of events, developments might take three main directions:

1. The present arrangements for depositing reserves could be transformed into a Community reserve system managed by the EMCF;
2. ECU could be created against the deposit of national currencies and no longer against the deposit of gold and foreign exchange reserves alone, with implications for the conditionality of such creation;
3. The ECU could gradually take on the role of an instrument for settling private transactions and of a reserve currency, and thus no longer serve only as a means of settlement between central banks.

Where credits are concerned, drawing rights on a fund would replace ceilings for swap credits. It is also possible that the ECU will no longer be merely an instrument for carrying out calculations but a reserve instrument, ranking with gold, foreign exchange and Special Drawing Rights (SDR). And I know that there is nothing to prove that the creation of a European reserve currency will be desirable. I am well aware that those seemingly technical developments would, in fact, be a truly revolutionary step.

I am also aware that, if such developments are to take place, the EMS must, during its transitional phase, perform satisfactorily in the eyes of all those taking part. I will be the first to admit that there is no advance guarantee of success. But a failure would be both the consequence and the cause of extreme difficulties in Europe and I am convinced that there is no alternative to success."

EMS AND OTHER INTERNATIONAL CURRENCIES LIKE THE DOLLAR

"As I mentioned earlier, success depends in part on the relationship which can be established, in the immediate future and in the long term, between European currencies, and I am thinking here of all European currencies, including sterling. I hope that the United Kingdom, which is a signatory to the system, will be able to take part very soon. The forging of this relationship depends in turn on a sweeping move towards integration in Europe in the different areas to which I referred earlier. But success also depends to a large extent on the relationship which will be established between the system itself and the international monetary system, and in particular the dollar.

The emergence in Europe of a zone of monetary stability is in no way an indication that the Community wishes to take a stand against the United States but it does mean that, in order to defend this stability, Europe must enter into a constructive dialogue with its major partners on the future of the international monetary system.

This assumes, first of all, that non-member countries with similar interests which play an important role in world affairs could be associated to that venture. I will not attempt to list the countries which, as provided for in the Bremen Communique, should, if they so wish, be permitted to do so. I am convinced, however, that it is in the Community's interests to cooperate closely with the other countries in Europe; it is by no means my intention to propose the setting up of a bloc but, to strengthen the base of the EMS and thereby to increase its chances of success.

Implementation of the EMS is linked to the strengthening of the international monetary system; its durability will largely depend on its capacity to contribute to this objective.

The creation of the EMS has, as such, a positive role to play in the development of the international monetary system; it shows, first of all, that there exists in the world a group of countries - and strong countries at that - which is dissatisfied with the present disorder and which no longer accepts that exchange rates should be allowed to fluctuate arbitrarily. Far from facilitating the international adjustment process, the system of fluctuating exchange rates has in part hampered it; apart from the oil-producing countries and the sub-redistribution which has taken place in Europe, the breakdown of the major groups of countries into creditors and debtors has remained the same as in the early seventies.

Furthermore, the scale of intervention on foreign exchange markets has been much greater than under the system of stable exchange rates, and this has exacerbated the problem of liquidity, which the system of fluctuating rates was supposed to alleviate. In this respect, the EMS thus represents a fundamental change in attitudes, i.e. the abandonment of the absolute belief in the virtues of fluctuating exchange rates and, conversely, the certainty that stability, a factor conducive to growth, is the result of strictness and discipline."

DOLLAR NOT THE SOLE CAUSE OF MONETARY DISARRAY

"But the EMS also has a direct practical implication. There is a tendency to attribute sole responsibility for the monetary disorder to the dollar but we should not forget that a number of crises have been triggered by instability in Europe and not by disarray in America. It falls to us to eliminate this occasional cause of world instability.

I believe that demands for the restoration of a sound international order will carry more weight if Europe first sets the example, by encouraging its partners to play their part, too.

Lastly, the EMS possesses what I will term a "diplomatic" force: during the transitional phase in the development of the international monetary system on which we are now embarking, the EMS presents Europe with an opportunity gradually to speak with one voice, on at least equal terms, and thus to defend its own interests more effectively."

GREATER AWARENESS OF THE NEED FOR INTERNATIONAL ACTION

"The directions which the dialogue may take are becoming increasingly apparent, with the collective awareness in industrialized countries of the urgent need for closely coordinated action being one of the most encouraging features of recent years.

The first of these directions concerns moves to combat, through intervention on the markets, exchange rate movements which have no economic justification. It is to be hoped that the decisions taken last November foreshadow a much greater degree of systematic cooperation between major monetary groups aimed at amplifying and diversifying the means available for waging this combat. They are the manifestation of a very welcome common will and, in the case of the United States, of a better appreciation of the dangers of monetary instability. As a monetary entity, the Community can play a major role in this connection, as do some of its Member States already.

The second line of action concerns the formulation of national economic policies that are compatible with the objective of international stability. As I pointed out earlier, in the case of Europe, this will possibly be the greatest challenge since it does not involve simple mechanisms or the direct external constraint.

This can be helped by the more systematic organization of the dialogue, the joint consideration of domestic monetary policies, and the effective application of the provisions giving the International Monetary Fund (IMF) a supervisory responsibility. In this connection, I am convinced that it is in Europe's interests to help to strengthen the IMF. Just as we are trying to organize ourselves, on the basis of accepted disciplines and a stronger common organization, so we must wish for similar characteristics in the international system, and so we would like to see at least part of what we have considered good for ourselves to be practiced at the international level.

It will take time to develop this closeness of policies, this awareness of the international effects of national decisions. However, since there is no international monetary system that would impose, through its own techniques, an obligation to restore equilibria, this is the road which must be followed.

The third major question - the control of international liquidity, and in particular of the Euromarkets - is more controversial. Many arguments have been used to oppose attempts at action in this area. In particular such action has been termed unnecessary (the real source of the liquidity problem is said to be inappropriate national policies), ineffective, and, even dangerous, since the Euromarkets have helped prevent, and are continuing to help prevent, serious disruptions connected with lasting balance of payments disequilibria."

PROSPECTIVE BENEFITS OF EMS

"I believe, however, that we should look more closely into ways of drawing benefit from the system while avoiding its excesses. After all, it is not a question of establishing controls in the adverse sense of the word, but, as central banks do at national level throughout the world, of seeking ways of containing money creation within limits which are compatible with overall equilibrium. This opens up a whole field of thought, and, one day, of action, which I believe to be important.

The factors I have outlined, though inevitably not exhaustive, show that in my view any progress in the international monetary field will depend on methodical pursuit of all the possible avenues of approach, which are linked by the need for close international cooperation. I do not think we should underestimate the results that can be obtained if joint action is sufficiently systematic, sufficiently continuous and, of course, on a sufficiently large scale, for all action has its minimum threshold of effectiveness."