

The European Monetary System

European File

Serious economic and social difficulties have plagued the countries of the European Community for a number of years. Remedies are difficult to find and even more difficult to administer. The problem is compounded by the absence of a stable international monetary system; the Community's European Monetary System is an attempt to fill this vacuum.¹

International monetary crisis and Europe's response

For two decades after the Second World War, the world enjoyed a period of comparative monetary stability. Currency values were expressed in US dollars, which could themselves be converted into gold at fixed rates. Monetary reserves in most countries, held in gold and dollars, had a precise value. As sterling declined, the dollar became the undisputed world currency, used in almost all international transactions. It was one of the main pillars of the Bretton Woods international monetary system, whose efficient functioning depended largely on the unquestioned value of the dollar.

Towards the end of the 1960s, however, the dollar's value did come into question as a result of the United States' trade deficit and the widening of the gulf between the US gold reserves and the number of dollars in circulation.² On 15 August 1971, the dollar went off

¹ This leaflet replaces and updates our No 7/79.

² In most countries balance of payments deficits quickly led to pressure on the national currency. But the United States for a time escaped this general rule because of the international standing of the dollar. The US external deficit was financed by transfers of dollars to American creditors abroad. Over the years large quantities of dollars came into foreign hands, especially into the national banks of other States. By 1971 the United States found itself unable to meet all the potential foreign demands for conversion of dollars into gold.

the gold standard and was subsequently devalued on two occasions, in December 1971 and in February 1973.

The system of fixed monetary parities was gone forever, leaving currencies to float on world markets. The disadvantages of the new situation rapidly became apparent:

- Under technical or political pressure, central banks could allow their currencies to fluctuate wildly upwards or downwards. Normal economic business risks were heightened by the hazards of changing currency values on world markets, which disrupted calculations on imports and exports. Such problems further inhibited job-creating investment.
- Moreover, it became apparent that devaluation was not a certain cure for balance of payments difficulties, but simply fueled inflation by increasing the cost of imports and therefore wages, which tended to follow prices. Inflation often led through a vicious circle to further devaluations in the currency.
- Floating exchange rates went hand in hand with erratic shifts in monetary values. World markets were subject to disruption by sudden massive flights of capital from one currency into another, in response to economic events or forecasts, further undermining international monetary stability.

The floating of currencies world-wide increased the urgency – and the difficulties – of 10 years of efforts to achieve monetary union in the European Community:

- The first steps on this long road were the Barre plan of 1969 and the Werner plan of 1970. They laid down procedures for coordinating national economic policies and created mechanisms for mutual credit. Measures for short-term monetary support and medium-term financial cooperation were taken over and reinforced by the European Monetary System in 1979.
- In the wake of the Werner plan and following delays caused by the first dollar crisis in 1971, the EC countries attempted in 1972 to stabilize exchange rates within the Community by a mechanism known as the European monetary 'snake'. Like the EMS, which it presaged in many ways, the snake linked the values of certain European currencies, allowing them to fluctuate only within narrow margins. Very short-term Community credit was made available to help countries to remain within these limits. Born into a world of fixed monetary parities, the snake grew up in a climate of floating exchange rates. By 1979 it contained only five currencies, the German mark, the Danish crown, the Dutch florin and the Belgian and Luxembourg francs. Nonetheless it provided a valuable test-bed for the EMS.
- The European Monetary System was the child of a renewed determination in the Community to achieve the kind of monetary stability needed for the success of efforts to revive economic growth after the first energy crisis. The idea was launched at Florence in October 1977 by the President of the European Commission, Mr Roy Jenkins. The subsequent negotiations spread over four European summits from April

1978 to March 1979, during which the EC Heads of State or Government took a series of increasingly concrete decisions. In April 1978 they decided in principle to ask the European institutions to prepare a study on the possible machinery for a new monetary system. In July the same year they agreed upon the outlines and in December they passed the Brussels Resolution, which became the charter of the present EMS. Finally, on 12 March 1979, they solved the problem of agricultural compensatory amounts¹ and gave the green light for the EMS to enter into usage the next day.

The purpose of the European Monetary System

The EMS aims to establish closer financial cooperation, creating a zone of monetary stability in the Community. In the long term, it is hoped this will lead to economic and monetary unity in the Community.

- The *desire for stability* applies to all international exchange rates but especially those between EEC countries. Before the introduction of the EMS, the very future of the Community, especially in the domain of its agricultural policy, was seriously threatened by the damaging effect of floating currency values. The currencies of the Member States had divided into two camps, those remaining in the snake and those floating independently. One of the main objectives of the EMS was to return the Community countries to a common exchange rate system which would help to stabilize rates and allow the common market to function properly.
- The success of this venture was linked inextricably to the second major goal of the EMS, *the strengthening of economic and monetary cooperation in Europe*. The economies of Community countries are highly interdependent: one half of all EC trade takes place within the Community. Experience has shown that stable exchange rates can only be achieved through coherent economic policies. For instance, a number of countries might accent economic growth, while others might concentrate on tackling inflation. The result would be that the efforts of the former would be hampered by exchange rate crises and devaluation of their currencies, while the latter would face long-term currency over-valuation, harming exports and slowing growth. Finally, growth would suffer in all countries and unemployment would increase. Problems of this type and scale do not disappear overnight, but the EMS can help to solve them. By its very existence and the discipline it imposes, the system encourages a lowering of inflation and promotes a climate more favourable to investment by stabilizing currency values.
- The EMS also fits into the longer-term perspective of *a political and economic union* between Community countries. The Brussels Resolution falls short of proclaiming such an objective for the EMS. But by promoting increased stability and cooperation, it should help to generate conditions more favourable to European unification. This can

¹ Compensatory amounts preserve the common prices fixed by the Community for agricultural products by bridging the gap maintained by some countries between their agricultural or 'green' rates against the ECU and the real rate of exchange for their currencies. France made the gradual elimination of these payments a condition of its membership of the EMS.

be encouraged through developing and streamlining the European economy, but also through the creation of a common European currency. The gradual establishment of a common currency would give the Community an important role in the creation of a new world monetary order, founded on large zones of stability, and centring on particular currencies, such as the dollar, yen and European ECU. Business and industry, when spared currency exchange risks and part of the worries created by inflation, would be better placed to operate on a European scale. The advantages of the common market, only partially developed by the customs union, could then be exploited to the fullest. European monetary union implies a centralization of responsibility for monetary reserves and the management of exchange rates. This should not be feared: it would allow the countries of the Community to regain control, collectively, over problems too large to be tackled by individual States at present.

How the European Monetary System works

All Community countries, except Greece, belong to the EMS. However, the United Kingdom does not participate in the system's exchange rate mechanism and special arrangements have been made for Italy. The system works as follows:

- *The ECU*: the European currency unit (ECU), the principle building block of the EMS, is a monetary unit created from a 'basket' of currencies.¹ It is provisionally backed by deposits, recycled every three months, from the participating central banks which transfer 20% of their gold reserves and 20% of their dollar reserves to the European Monetary Cooperation Fund.

The ECU operates as a credit reserve for the central banks. Currently its use for settling debts is restricted to paying off very-short-term loans agreed to between banks to manage exchange rates. A limit is fixed at 50% of the debt, unless the creditor bank permits more. The ECU is also used in the exchange rate, intervention and credit mechanisms described below. It is used as a unit of account by the Community institutions and increasingly by the private sector for borrowing and lending.

- *The exchange rate mechanism*: A central rate in ECU is fixed for each currency in the system. These rates can be revised if necessary, by mutual agreement and following procedures involving all countries participating in the EMS and the European Commission. The central rates are used to establish a grid of bilateral exchange rates, expressed and published in national currencies. With the exception of sterling and the Greek drachma, which do not participate in the exchange rate mechanism, the grid establishes the central rate for each Community currency against all the other participating currencies. It also fixes obligatory intervention 'floors' and 'ceilings'². The maximum

¹ The basket is composed according to the relative size of national economies. It comprises DM 0.828, UK pound 0.0885, FF 1.15, Lire 109, Florin 0.286, BF 3.66, Lux.F 0.14, Danish Kr 0.217 and Irish pound 0.00759. The weight of each currency in the basket consequently varies with the exchange rate. The Greek Drachma will enter the ECU by 31 December 1985. The composition of the basket is to be reviewed every five years, or, on request, if the weight of a currency alters by 25%. 1 ECU = about £ 0.62, Ir£ 0.69 or US\$ 0.98 (at exchange rates current on 13 January 1983).

² Countries whose currencies floated freely before the EMS were permitted 6% margins but only Italy took up this option. The wider margins are to be progressively eliminated when economic circumstances permit.

margin of fluctuation above and below these central rates is limited, as in the snake, to 2.25%. The only exception is the Italian lire which is allowed a margin of 6% either way. Central banks are obliged to intervene to keep their currencies within these limits.

In comparison with the snake, the exchange rate mechanism of the EMS contains a new element, the divergence indicator based on the ECU. This indicator acts as an alarm bell. It measures the degree of divergence of each currency from its ECU central rate. When a 'threshold of divergence' is crossed, the country concerned is expected to take corrective measures, such as diversified intervention, changes in economic or monetary policy, or a realignment of the central rate. Consultation procedures are laid down and a joint investigation is made if a country wishes to depart from the rules.

- *The credit mechanism:* Three credit mechanisms, already created between 1970 and 1972, were strengthened with the establishment of the EMS:
 - Very-short-term financing helps countries to abide by the fluctuation margins. Central banks participating in the exchange rate mechanism allow each other unlimited credit in their own currencies for a very short period. This is limited to 75 days, compared to 60 days before the inauguration of the EMS. It can, however, be extended, for one additional period of three months subject to certain conditions.
 - Short-term monetary support is a system of mutual credit for all the central banks of the Community. Its scope was increased with the creation of the EMS and currently stands at 14 000 million ECU. The initial loan period is three months but this can be extended to nine months, compared to the six months maximum in the pre-EMS era.
 - Medium-term financial assistance can be granted mutually by Member States for between two and five years. The credit available was more than doubled at the inception of the EMS and now stands at 11 000 million ECU.
- *Aid to less prosperous countries:* To promote economic convergence in the Community and strengthen the economic base of the less prosperous member countries which participate in the EMS exchange rate mechanism, interest rate subsidies of 3%, worth a total of 1 000 million ECU, were granted to Ireland and Italy for the period 1979 to 1983. These were applied to loans worth 5 000 million ECU from the European Investment Bank and the European Commission. The cash was intended chiefly for infrastructure projects which will help to solve structural problems, reduce regional imbalances and create new jobs.

The record so far

The judgement on the EMS to date is on the whole satisfactory, although clouds of uncertainty still exist.

- *The comparative stability of currencies* and the sensible management of exchange rates rank among the most solid achievements of the system. In a troubled international

monetary climate, marked by large fluctuations in the value of the dollar, currencies participating in the EMS exchange rate mechanism have been more stable against one another than in the past. It is a fact that six realignments of central rates have been necessary since 1979. Such adjustments are and will continue to be inevitable until a better convergence of European economies is achieved. While a cause for concern, these changes do not threaten the credibility of the EMS. They have been neither so frequent nor so large as to turn the system into a rack and pinion which simply notches up changes in exchange rates. Two points should be remembered. All the adjustments have been carried out by mutual consent, as provided for in the Brussels Resolution. Realignments have avoided the necessity for costly defence of no longer realistic exchange rates and, by careful management, prevented excessive economic repercussions in the form of increased prices and raw material costs.

- Nevertheless, *the consolidation of the EMS into a definitive system* has not been accomplished in the original two year period which expired in March 1981. By that time, the ECU was to have come into full use as an instrument for settlement with a reserve of its own. Given the difficulties involved, the deadline was perhaps too tight:
- A number of countries cast doubt on the wisdom of moving to the definitive stage while the lire was still permitted enlarged margins of fluctuation and sterling continued to float independently. There is no reason to suppose that these two currencies will join the fold in the near future. The same applies to a country such as Greece, which has just joined the Community, or countries like Spain and Portugal, which are negotiating their accession. The Community has failed to establish complete exchange rate unity and there is no immediate prospect of it doing so.
- The EMS has been plagued by the failure to draw European economies closer together and by persistently sharp divergences in European inflation rates. In 1982 prices rose four times more quickly in Italy (16.2%) than in the Netherlands (4.2%). It is no doubt unnecessary to make full convergence a precondition for the extension of the EMS, but poor progress in this direction will inevitably delay and complicate the transition to the second stage of the system. A number of countries will prefer to preserve the status quo while broad divergences exist in the economic policies and performances of Member States.

It is apparent therefore that one or more intermediate stages will be necessary for the EMS to pass from its initial to its definitive stage. On 15 March 1982, the European Commission proposed improvements which aimed to simultaneously tighten, strengthen and open up the system. Suggestions made for the development of the EMS included: stabilization of the number of ECU issued, to prevent any inflationary tendency; relaxation or abolition of the limits on how the ECU can be used; extension of very-short-term financing, under certain conditions, to central bank interventions when exchange rate margins are not threatened; and facilities for non-Community countries to acquire ECU within set limits. However, no consensus has emerged so far in discussions between Member States on these Commission proposals.

In conclusion, it can be said that the EMS has survived a baptism of fire in better shape than most would have imagined. For nearly four years, it has operated in an unfriendly economic and monetary climate, marked by the second oil shock and erratic shifts in the value of the dollar. Nevertheless, it must still fully prove its credibility and demonstrate its capacity for development towards a more far-reaching second phase. Until now this development has been delayed largely by the failings in the present system described above: the exceptions granted to some countries in the exchange rate mechanism and the inadequate progress towards economic convergence.

In the long run, the success or failure of the EMS will largely be determined by the convergence of inflation rates in EC countries at the lowest possible level and the ending of structural imbalances between the countries of the Community ■



The contents of this publication do not necessarily reflect the official views of the institutions of the Community.

Commission of the European Communities

Information offices (countries fully or partially English speaking*)

- Ireland** 39 Molesworth Street, Dublin 2 – Tel. 71 22 44
- United Kingdom** 20 Kensington Palace Gardens, London W8 4QQ – Tel. 727 80 90
– 4 Cathedral Road, Cardiff CF1 9SG – Tel. 37 1631
– 7 Alva Street, Edinburgh EH2 4PH – Tel. 225 2058
– Windsor House, 9/15 Bedford Street,
Belfast BT2 7EG – Tel. 40708
- Australia** Capitol Centre, Franklin Street, PO Box 609,
Manuka 2603, Canberra ACT - Tel. 95-50 00
- Canada** Association House (Suite 1110), 350 Sparks Street,
Ottawa Ont. K1R 7S8 – Tel. 238 64 64
- USA** 2100 M Street, NW, Suite 707,
Washington DC 20037 - USA – Tel. (202) 862-9500
– 245 East 47th Street, 1 Dag Hammarskjöld Plaza,
New York, NY 10017 - USA – Tel. (212) 371-3804



* Offices also exist in other countries including all Member States.

