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## Progress Report on the European Monetary System and the Liberalization of Capital Markets

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(presented by the Commission as requested by the European  
Council at its meeting in Luxembourg on 2 and 3 December 1985)

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**Progress Report on the European Monetary System**  
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**1. Introduction**

The development of the European Monetary System (EMS) and the process of capital liberalization should be seen in the wider context of Economic and Monetary Union, which was endorsed by the Community Heads of State or Government at The Hague in December 1969. The "Werner Report" which was approved by the Community's leaders at their Conference in Paris of October 1972, stated that "Economic and Monetary Union means that the main economic policy decisions will be taken at Community level and therefore that the necessary powers will be transferred from the national to the Community level. The adoption of a single currency could be the final stage of this union, ensuring the irreversibility of the process." The implementation of the first stage of the Werner Plan resulted in several concrete measures, including the institution of a framework for short-term economic policy coordination, the setting up of machinery for Medium-Term Financial Assistance, the founding of the European Monetary Cooperation Fund and the establishment of the Snake exchange rate system.

The collapse of the Bretton Woods system, the first oil shock and sharp divergences in monetary and economic policies during the seventies, prevented the further implementation of the Werner Plan. The Snake was reduced, over the years, to a small block. The process of capital liberalization was all but halted as numerous Member States made use of the safeguard clauses provided for in the Treaty to impose restrictions on capital movements.

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In 1978, the process of monetary cooperation was relaunched by the setting up of the EMS and the creation of the ECU. While the EMS is vital for the completion of the large internal market, it can also be seen as a more pragmatic attempt to progress along the road to Economic and Monetary Union than was the Werner Plan. The Single European Act agreed in 1985 reestablished this link formally.

## 2. The EMS in an historical perspective

### a) The aims of the EMS

The EMS was established to pursue three main objectives :

- Europe should become a zone of internal and external monetary stability (involving both low inflation and stable exchange rates);
- the EMS would provide the framework for improved economic policy cooperation between Member States, leading to more convergence in economic performance, as well as better growth and increased employment;
- the EMS should help to alleviate global monetary instability through common policies vis-à-vis third currencies and by spreading the impact of external monetary shocks over all participant currencies.

### b) The EMS is a success

The EMS has contributed to the improved monetary stability in Europe seen in recent years. Cost and price inflation have fallen further and converged more rapidly in EMS countries than in the rest of the Community. Exchange rate variability is much lower for EMS currencies than for other major currencies. Interest rate variability is no higher than elsewhere and average levels are probably lower because of the smaller exchange rate risk associated with EMS currencies. Most important of all, the misalignments which have so distorted the international monetary system over the past years have been avoided.

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c) The functioning of the EMS

The exchange rate constraint has acted as a focal point for improved policy coordination and the EMS has shown itself to be the most efficient framework to enhance multilateral surveillance within the Community. During recent years, realignments have generally been accompanied by economic adjustment measures implemented by devaluing countries. More generally, participants have gradually opted for a strong currency policy stance, so putting most emphasis on domestic adjustment measures.

The EMS is not a rigid system. Its success derives in part from its flexibility. Also, it is an evolving system, as the EMS rules and procedures can be and have been modified. This is provided for in the Brussels EMS Resolution of December 1978 which describes the initial phase of the EMS and which outlines a final system.

3. The process of capital liberalization

The basic elements underlying the capital liberalization process in the Community until 1986 were contained in the two Directives adopted in 1960 and 1962. These obliged the unconditional liberalization only of those capital operations most directly concerned with the exercise of other fundamental liberties established in the Treaty (direct investment, commercial credits, personal capital movements), as well as acquisitions of securities quoted on a stock exchange.

Attempts to advance the liberalization process were unsuccessful. In fact, during the 1970s, several Member States made broad use of the safeguard clauses contained in the Treaty to introduce and maintain restrictions on an extensive range of capital operations.

The convergence of inflation performances in the Community and the more sustainable external positions of most Member States in recent years have allowed a reactivation of the process of capital liberalization. Substantial moves have already taken place. A number of

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countries have relaxed exchange controls and the Commission has tightened up procedures under the safeguard clauses allowing derogations from Treaty obligations in this area, notably by fixing time limits to their application. Over the past years, the Commission has been able to rescind derogations applying to several countries that have been in place for a long time.

In May 1986, the Commission presented, and the Council endorsed, a programme for the full liberalization of capital movements. The first new Directive in the programme was adopted in November 1986. This first stage, involving essentially transactions concerning non-quoted securities and the admission of securities to the capital market, has already been completed in most Member States.

#### 4. The EMS and capital liberalization in the context of the large internal market

##### a) The importance of the EMS and capital liberalization for the internal market

The EMS is an important element in constructing the large internal market. Without a high degree of exchange rate stability, currency uncertainties would continue to segment the common market and detract from the potential gains it can offer for growth. The objective of full capital liberalization was included in the Single European Act, set in the perspective of the completion of the large internal market by 1992.

##### b) The relation between the EMS and capital liberalization

The world's financial markets have seen an explosion of activity and innovation. The global market has already become a reality. Capital liberalization, together with the financial innovation, create the potential for larger destabilizing capital movements. At the same time national monetary policies will become more interdependent since any changes in policies affecting market expectations on relative inflation and possible exchange rate movements will be rapidly reflected in financial variables. Thus monetary policy adjustments in one EMS

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country will alter monetary conditions correspondingly in other EMS countries. In this way, capital liberalization will increase the need for policy convergence within the EMS.

c) The 1987 strengthening of the EMS

The September 1987 package agreed at Basle and Nyborg is an appropriate response to the changes in the economic and financial environment that have taken place recently as regards both actual and prospective capital liberalization and the considerably improved, but by no means perfect convergence situation in the Community. This improvement implies the need for a more balanced implementation of the exchange rate commitment by all participants.

The measures adopted are designed :

- to further promote coordination of economic policies in order to reduce the threat of destabilizing capital movements, to counter potential external monetary shocks and to broaden the convergence process within the EMS.

This is to be achieved by intensifying EMS short-term monitoring procedures against the background of a closer consensus on policy reactions to EMS strains. Furthermore, a medium-term surveillance procedure, using macroeconomic indicators in line with the Group of Seven procedure, will be established.

- to refine the EMS intervention and credit mechanism in order to counter the potential for larger speculative flows and to take account of the need for a more balanced use of instruments.

This resulted in a recognition of the usefulness for the System itself of intramarginal intervention, by allowing for the presumption of its very short term financing subject to certain conditions.

The fundamental objectives of the EMS remain unaltered, but the Basle/Nyborg agreement marks the beginning of a new phase. Experience will show how far these improvements can cope with the challenges they were designed to counteract. This will also depend on the actual effects of the relaxation of capital controls. First indications, including the recent concerted interest rate moves, are encouraging.

d) The final phase of capital liberalization

These measures to strengthen the EMS permitted the Commission in November to table the final phase of its programme for the full liberalization of capital movements, which involves abolishing restrictions on operations of a monetary or quasi-monetary character. The proposals are designed to achieve complete capital liberalization while:

- guarding against the risk of monetary and exchange rate disturbances in Member States from speculative capital movements by including a specific monetary safeguard procedure ;
- promoting improved coordination of policies concerning capital movements to or from third countries ;
- taking into account the positions of newer Member States and those with less developed financial sectors by including appropriate transitional arrangements ;
- allowing for the possibility of using medium-term balance of payments support to accompany liberalization efforts.

e) The need to extend the EMS throughout the Community

For the completion of the internal market, the full EMS obligations need to be extended throughout the Community. The EMS narrow band represents the minimum degree of exchange rate stability necessary for there to be no segmentation of markets.

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The United Kingdom and, when appropriate, Greece, Spain and Portugal, should participate in the EMS exchange rate mechanism. The LIT should join the narrow band. The Belgo-Luxembourg Economic Union should relinquish its dual exchange market.

The extension of the EMS to the whole Community, as well as the progress already made on convergence, will allow the System to play its full role as a framework for better coordinating economic policies towards growth, investment, employment and external equilibrium in a stable monetary environment.

f) The European financial area

Full capital liberalization and the smooth functioning of the EMS throughout the Community are necessary but not sufficient conditions to attain the degree of financial integration necessary to create a common financial area. This requires also the free provision of financial services, for which the movement of capital is often only a support. It requires that there be no discriminatory treatment, that conditions of competition between suppliers of financial services should not be distorted by factors such as divergencies in prudential regulations or excessive disparities in taxation. The Commission has also raised the question of how to counteract the increased possibilities for tax evasion linked to the abolition of capital controls.

The above questions should not be prior conditions for capital liberalization, but will require the Council's attention if the common financial area is to be achieved. This financial integration will not necessarily progress at the same pace as capital liberalization. The strategy involves accepting certain temporary disequilibria with the objective of creating a dynamic process in the framework of a coherent programme.

A common financial area would be considerably enhanced by the wider use of the ECU as a vehicle for commercial and financial transactions, and as an international reserve asset. The increased use of the ECU

would aid competition and promote the unity of the financial market. It would lead to the sharing of exchange risk on cross-border transactions and reduce the complexity of foreign exchange management. Just as important, the ECU's role as a reserve asset and an intervention currency would contribute to the multilateralization of the Community's external monetary relations and enhance the resilience of the EMS parity grid vis-à-vis external disturbances.

##### **5. What's next ? 1992 in the context of Economic and Monetary Union**

The creation of a common financial area in the Community in the context of the large internal market would represent substantial progress from the present situation and would stimulate the competitiveness of European industry. The Community would, however, remain a long way from Economic and Monetary Union and its full potential benefits.

Under Economic and Monetary Union there would be total and irreversible convertibility of Community currencies at fixed rates, or, more probably, a single Community currency. This would completely remove the uncertainties that remain even within the EMS due to potential currency movements. The loss of autonomy of national economic policies, that is already apparent due to the interpenetration of economies, would be compensated by the common formation of Community policies. In this way, areas of potential distortion to the internal market would be avoided.

The implementation of such a union will effect a lasting improvement in welfare in the Community and will reinforce the contribution of the Community to economic and monetary equilibrium in the world. The conditions for moving successfully towards Economic and Monetary Union lie in the continuation, indeed acceleration, of efforts to achieve convergence in economic policies and performances. Also a clear vision of the institutions that will be necessary, as well as the tasks they will undertake, is required.