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The EMS, the Dollar, and the Future of the International Monetary System

by

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An examination of the political economy of the European Monetary System must necessarily take account of its potential implications for the future of the international monetary system. Will Europe's attempt to create a "zone of monetary stability" enhance or diminish prospects for stabilization of global monetary relations? My own answer to this question, developed at length below, may be summarized as follows:

(i) If successfully implemented, the EMS could make a significant contribution to global monetary stabilization.

(ii) Prospects for successful implementation, however, are not good.

(iii) The most likely outcome, therefore, is an increase rather than a decrease of policy conflict in international monetary relations.

In short, however much we might favor the idea of European monetary union in principle, in practice we would probably be better off had the experiment never been attempted at all. 1/

I.

The starting point of my analysis is the familiar "_n_ - 1 principle" of international monetary theory, also known as the "redundancy problem." 2/ The problem may be readily described. In a world of _n_ sovereign states and currencies, there are only _n_ - 1 exchange rates. Therefore, only _n_ - 1 balance-of-payments policies (be they expressed in terms of exchange-rate targets in a floating world or in terms of reserve targets in a pegged-rate world) can be independently determined. One country (the nth country) is redundant. If all n countries try to set their policies independently, these policies will almost certainly be inconsistent (technically, the system will be overdetermined), and, as a result, the stability of the system itself will be threatened. To preserve monetary stability, some means must be found — some organizing principle -- that will ensure consistency among national policies and reduce the risk of policy conflict. The history of international monetary relations is written in the succession of attempts by the international community to find such an organizing principle.[3/]

In theory, four alternative organizing principles are possible. These are:

(1) Automaticity -- a self disciplinary regime of rules and conventions binding for all nations (e.g., a gold standard or pure floating exchange rates).

(2) Supranationality -- a regime founded on collective adherence to the decisions of some autonomous international organization (e.g., a world central bank).

(3) Hegemony — a regime organized around a single country with acknowledged responsibilities (and privileges) as leader.

(4) Negotiation — a regime of shared responsibility and decision-making.

In practice, only one of these four has ever actually succeeded for any length of time in preserving international monetary stability. That one is the principle of hegemony, which underlay operation of both the classical gold standard in the last decades before World War I and the Bretton Woods system in the first decades after World War II. In each case the monetary system was effectively organized around a single hegemonic leader -- Great Britain in the earlier period, the United States in the later. In both cases, the comparative lack of policy conflict was directly attributable to the stabilizing influence of the dominant national power.

Recent historical analysis[4/] has amply demonstrated that the classical gold standard, far from being the politically symmetrical system of conventional textbook models, was in fact distinctly hierarchical, dominated at the top by Great Britain, the supreme economic power of the day. Stability in the gold standard was ensured through a trio of roles that only Britain at the time had the resources to play: (1) maintaining a relatively open market for the exports of countries in balance-of-payments difficulties; (2) providing contracyclical foreign long-term lending; and (3) acting as lender of last resort in times of exchange crisis. These were not roles that the British deliberately sought or even particularly welcomed. As far as the Bank of England was concerned, its monetary policies were dictated solely by the need to protect its narrow reserves and the gold convertibility of the pound. It did not regard itself as responsible for global monetary stabilization. Yet this is precisely the responsibility that was thrust upon it in practice — acquired, like the British Empire itself, more or less in a fit of absence of mind. This was truly a hegemonic regime, in the sense that Britain not only dominated the system but also gave monetary relations whatever degree of inherent stability they possessed.

A parallel role was played by the United States after World War II. As dominant then as Britain had been in the nineteenth century, America rapidly assumed the same trio of managerial roles -- in effect, taking over as money manager of the world. Since international monetary reserves were everywhere in short supply, the United States itself became the residual source of global liquidity through its balance-of-payments deficits. At war's end, America owned almost three-quarters of the world's existing monetary gold, and prospects for new gold production were obviously limited by the physical constraints of nature. The rest of the world, therefore, was more than willing to economize on this scarce gold supply by accumulating dollars instead. The United States was accorded the unique privilege of liability-financing its deficits; the dollar became enshrined not only as the principal "vehicle currency" for international trade and investment but also as the principal reserve asset for central banks. In the early postwar years, America's deficits became the universal solvent to keep the machinery of Bretton Woods running. The Bretton Woods system became synonymous with a hegemonic regime centered on the dollar.

In effect, the United States became the world's <u>n</u>th country, abjuring any balance-of-payments target of its own. Other countries set independent payments targets; consistency in global monetary relations was ensured by the fact that America could be counted upon to play a passive role in the international adjustment process.

American policy was freed to concentrate largely on domestic stabilization objectives. Its only express international monetary objective was to maintain the fixed dollar price of gold -- although, implicitly, the United States also had an obligation to manage its domestic policies with the needs of the rest of the world in mind. Given America's weight in the global economy, conditions inside the United States inevitably had a considerable influence on the pace of economic developments elsewhere as well. America was the balance wheel of the world economy. (The only recourse other countries had to adjust to movements of the balance wheel was either to modify their balance-of-payments target or else to alter the par value of their currency against the dollar and gold.) Keeping the balance wheel moving stably was what the responsibility of being world money manager was all about.

Like Britain in the nineteenth century, America did not deliberately seek this responsibility. On the other hand, once it had the responsibility, Washington soon came to welcome it, for reasons that clearly were not unrelated to self-interest. Being money manager of the world fit in well with America's newfound leadership role in the Western Alliance. The cold war had begun, and the United States perceived the need to promote the economic recovery of potential allies in Europe and Japan, as well as to maintain a sizable and potent military establishment overseas. All of this cost money: the privilege of liability-financing deficits meant that America was effectively freed from all balance-of-payments constraints to spend as freely as it thought necessary to promote objectives believed to be in the national interest. The United States could issue the world's principal vehicle and reserve currency in amounts presumed to be consistent with its own policy priorities — and not necessarily those of foreign dollar holders. Foreign dollar holders conceded this policy autonomy to the United States because it also contributed directly to their own economic rehabilitation. America's pursuit of self-interest was seen as being in their interest as well.

In effect, an implicit bargain was struck. Washington's allies acquiesced in a hegemonic system that accorded the United States special privileges to act unilaterally to promote American interests. The United States, in turn, condoned its allies' use of the system to promote their own economic prosperity, even if this happened to come occasionally at the short-term expense of the United States. American policy wad demonstrably nationalistic (in the sense that it was clearly motivated by self-interest) — but it was a nationalism that could credibly be described as benign rather than malign. (Malign nationalism seeks national goals relentlessly, even at the expense of others; benign nationalism, by contrast, is prepared to compromise national policy priorities where necessary to accommodate the interests of others. The difference between the two lies in the willingness of a country to identify its own national interest with an interest in the stability of the overall system.) The situation was characterized best by a phrase that became fashionable near the end of the Bretton Woods era: "benign neglect." The United States acknowledged the connection between its own interest and the stability of the overall system -- and acted accordingly.[5/]

Since the breakdown of the Bretton Woods system, the United States has continued to act in a demonstrably nationalistic fashion. The key objective of American policy has always been to minimize any balance-of-payments constraint on the government's decision-making capacity, in order to maximize the country's self-interested freedom of action in domestic and foreign affairs. That has not changed since 1971. Why submit to more external discipline than necessary? For the most part, however, American nationalism has continued to be benign rather than malign. American policy-makers have not needed reminding of the country's pivotal role in world economic affairs. The United States has not suddenly become a rogue bull in the international monetary china shop.

What then <u>has</u> changed? What has changed is the system itself — more specifically, the conditions required to organize and maintain a hegemonic monetary system like Bretton Woods. Two conditions are essential. First, hegemonic leadership must in fact be "responsible" — that is, the economic policy of the world's money manager must truly be stabilizing, imparting neither inflationary nor deflationary impulses to the rest of the world. And second, hegemonic leadership must be regarded as "legitimate," generating neither resentment nor policy conflict over the benefits and costs of the system. Today, neither of these conditions may be said to obtain.

Consider the first condition. What assurance is there that the United States will in fact always act "responsibly"? The answer is — no assurance at all. America's policy-makers may indeed be cognizant of the country's pivotal role in the world economy; they may be fully aware of the obligation of the world's money manager to provide a stable standard of economic performance (especially price performance) around which other countries can organize their own policy priorities. But there is still no certainty that such an obligation will actually be honored -- precisely because, by definition, in a hegemonic regime there is little effective external discipline on the leader. Given the absence of any formal deterrent, the possibility always exists that, sooner or later, accidentally or deliberately, the leader will take advantage of its special position to initiate policies that destabilize the world economy.

In the case of the United States, that is indeed precisely what did happen following escalation of military hostilities in Vietnam after 1965. Before 1965, America clearly had the best long-term record of price stability of any industrial country; the United States could not be justly accused of "exporting" inflation, however much some governments were complaining about a dollar glut. But then President Johnson made a decision to fight a war in Vietnam and a War on Poverty simultaneously. As a result, America's economy quickly began to overheat. The virus of inflation began to spread, and ultimately the whole world was infected, setting the stage for the dramatic events of 1971, when the Bretton Woods system was brought down by President Nixon's decision to suspend the gold convertibility of the dollar. American policy-makers did not fully anticipate the disruptive consequences of their own actions and in the years since have needed little encouragement to try to act more responsibly in international monetary affairs. But now the genie is out of the bottle. American leadership has proved it could be destabilizing, and as a result foreign distrust of American policy has grown to endemic proportions, particularly since the Carter Administration came into office. Many foreigners are now firmly convinced that the United States is no longer able or willing to follow a stable monetary policy.

In any event, American hegemony is no longer regarded as legitimate. Objective circumstances have changed too much since the years immediately after World War II, when the foundations of the Bretton Woods system were laid. In those days the United States bestrode the world economy like a colossus. Other countries may have had reservations about America's leadership role; weakened as they were by war and destruction, however, they were hardly in a position to question it. Today, by contrast, the political and economic conditions that originally made American hegemony acceptable — or, at any rate, tolerable — no longer exist. America's relative position in the international hierarchy has declined enormously. Foreign economies are no longer so weak and uncompetitive as they were immediately after the war, and foreign governments (in Europe, Japan, OPEC, and elsewhere) are no longer satisfied to accept a political role subordinate to that of the United States. America's leadership role has come under increasing challenge. The United States is still acknowledged as primus inter pares in the world economy. But it is by no means still universally accepted as primus motor.

Proof of these changed attitudes and perceptions could be seen in the heated debate in 1976-77 between the United States and its major allies over the so-called "locomotive" approach to recovery from the "Great Recession" of 1974-75. As always, America's own monetary policy — generally expansionary at the time — was being guided essentially by domestic considerations. But since expansion at home could credibly be argued to aid recovery abroad as well, the United States also was urging other "locomotive" economies like Germany and Japan to follow America's lead, stimulating their own growth rates too, in hopes that this would help to pull weaker economies out of the general stagnation that had persisted since 1975. Once, America's leadership in this regard might have been heeded. In the changed circumstances of the 1970s, however, it was resisted. The result was frustration and deadlock. Germany and Japan argued that stagnation elsewhere was not their problem. Further expansion of their economies, they argued, would be neither desirable (because of the inflationary pressures that might be generated) nor even possible (because of domestic political and institutional constraints on policy); and that in any event the stimulative impact on weaker economies would probably be comparatively small. Instead, they criticized the United States for allowing its own balance of payments to get out of control and its currency to depreciate sharply in the exchange markets. In some quarters, America was even accused of trying to use dollar depreciation to gain an unfair competitive advantage -- malign nationalism at its worst.

More recently, much of the heat has gone out of the "locomotive" debate.[6/] But the underlying tensions between the United States and its allies in Europe and Japan remain, symptomatic of a far deeper malaise in international monetary relations -- the global redundancy problem, which still calls out for resolution. Conditions are no longer propitious for an American hegemony, yet the European and Japanese have so far resisted America's blandishments to share explicitly in the responsibility for global monetary stabilization. Some organizing principle remains necessary to ensure consistency among national policies and reduce the risk of policy conflict. If the community of nations is unwilling to submit to the rigors of automatic rules or a world central bank, then, in current circumstances, the solution must be found in a regime of shared responsibility and decision-making. The lesson of the "locomotive" debate is that the means for establishing such a cooperative regime have yet to be found.

That is where the European Monetary System comes in -- more accurately, where it <u>could</u> come in, if successfully implemented. Until now, a fundamental problem for the Europeans in international monetary relations has been their inability to negotiate with the United States on a basis of parity. Divided as they are by their separate currencies and independent policies, they cannot address the United States as an equal. Among European nations, only Germany on its own enjoys anything like America's international monetary influence. The rest individually lack effective means to challenge America's still leading role in monetary affairs. They may resent America's pre-eminence, but in their presently fragmented condition there is rather little they can actually do about it. Any regime of shared responsibility constructed on such terms would only perpetuate the political subordination of the Europeans — and this, in turn, would no doubt only ensure that international decision-making would be characterized more by discord than by harmony.

The great advantage of EMS in this respect is that, once fully effective, it would enable the Europeans to speak with one voice, and thus greatly enhance their overall bargaining strength in international monetary discussions. Greater monetary independence is clearly one of the main motivations for EMS -- to be able, at last, to approach the United States on a basis of genuine parity. One potential consequence is that a regime of shared responsibility could then be established which, because it would not threaten to perpetuate Europe's political subordination, would have a better chance of producing concord instead of conflict. From the perspective of the monetary system as a whole, this could only be counted as a Good Thing. In place of an obsolescent (or obsolete) hegemony, a new organizing principle of cooperative management would finally be within reach. Prospects for international monetary stability would certainly be improved as a result.

From the perspective of the United States, of course, there would be some disadvantage insofar as Europe's enhanced bargaining strength were gained at the expense of America's traditional freedom of action in monetary affairs. Europe's gain, in this limited sense, would necessarily be America's loss. But international monetary relations are hardly a zero-sum game. Quite the contrary, in fact. As I have already emphasized, there is a close connection between America's own interest and the stability of the monetary system as a whole. It should be clear that to the extent EMS encourages the Europeans to share explicitly in the responsibility for global monetary stabilization, America too would benefit from the consequently reduced risk of international policy conflict. As the "locomotive" debate made abundantly clear, U.S. policy leadership today is as likely to be resisted as heeded. The United States surely loses more from such acrimonious deadlock than it could possibly gain by insisting on the prerogatives of a failing (or failed) hegemony.

In any event, America's traditional freedom of action is scarcely what it used to be. Policy autonomy, in reality, has already been seriously eroded by the recent changes of the system, in spite of -- one might even say because of -- continued international use of the dollar. To be sure, insofar as foreigners continue to acquire dollars for vehicle or reserve purposes, the United States is able to continue liability-financing deficits, just as it always has. But the dollar's international roles have now become a two-edged sword, owing to the sheer magnitude of foreign accumulations over the years. The dollar overhang now numbers in the hundreds of billions, and sales out of of these huge stocks (to say nothing of sales of dollars for foreign currency by domestic U.S. residents) obviously tend to cut the other way, reducing America's traditional freedom of action in monetary affairs. It is a moot point whether, on balance, external discipline on U.S. policy today is greater or less than it would be in the absence of an international dollar. What is clear is that when confidence in U.S. policy wanes, as it manifestly has in recent years, and dollar holders decide to pursue diversification of their portfolios into available foreign currencies, portfolio stock adjustments quickly come to dominate current payments flows, with consequent impacts on Washington's ability to pursue its objectives without regard for the balance of payments. The prolonged depreciaions of the dollar in 1977-78 and again in 1979 certainly were no accident: they reflected directly the widespread distrust of American policy that has developed around the world. It is also no accident that U.S. monetary policy now is determined more by external considerations than by domestic stabilization objectives.

In reaction, U.S. policy-makers have now begun to relax their traditional resistance to reform proposals intended to reduce the reserve role of the dollar. At the latest annual meeting of the International Monetary Fund, the United States even agreed "in principle" to establishment of a "substitution account" at the Fund to allow countries holding "excess" dollars to exchange them for newly created SDR-denominated assets. The problem, however, is that -- pending such a reform -- no suitable alternative to the dollar presently exists.

Not many other national currencies are all that attractive to international investors and central banks, and of those few that are, even fewer are available on a scale sufficient to satisfy even a fraction of potential demand. In practice, only the Deutsche mark (the dollar aside) has come to play any significant international role — and even that has been over the determined opposition of the German monetary authorities (who do not wish to find themselves one day in the same sort of position that the American authorities do now). Another way of stating the great advantage of EMS is that, in creating the ECU (the European Currency Unit), it would offer Community members (and perhaps eventually other countries) an attractive alternative asset for reserve (and perhaps eventually vehicle) purposes, thus reducing their historical dependence on the dollar. One often hears remarks to the effect that the ECU would "help to take off the dollar some of the strain of being, still, the world's main reserve currency."[7/] In fact, it is not at all clear what is meant by such remarks, unless it is precisely the improved prospect for cooperative global management that would ensue from greater monetary independence for Europe. Successful creation of its own common asset is the sine qua non for Europe to be able to address the United States on a basis of parity. And that in turn, I have suggested, is the sine qua non for successful resolution of the global redundancy problem in today's circumstances.

II.

All of this begs the question of implementation. If it is successfully implemented, EMS could make a significant contribution to global monetary stabilization. But will it be successfully implemented? In my view, the answer is: No. The more probable outcome is that like its predecessor of the early 1970s -- the so-called "snake in the tunnell" -- EMS will simply fail.

It is instructive to recall that earlier attempt at European monetary union.[8/] Agreed in 1971, but then delayed until 1972 by the disturbances set off by President Nixon's suspension of dollar convertibility, the snake experiment almost immediately ran into trouble. Five of the Community's nine members -- Britain, France, Denmark, Ireland, and Italy -- were forced by economic difficulties to withdraw from the group float (though Denmark later rejoined, while France tried and failed), and the tunnel itself (the margin of permissible fluctuations vis-à-vis non-member currencies) was lost in 1972 when the Bretton Woods par-value regime collapsed. By the middle of the 1970s it was clear that the experiment had failed. Monetary unification in the Community had not been promoted. All that remained, in effect, was a European "Deutsche mark zone," as a special study group appointed by the European Community (the Marjolin Committee) noted in 1975:

> The efforts undertaken since 1969 add up to a failure. The "snake" had exploded and the "narrowing of the margins of fluctuations" no longer exists except between those currencies which are more or less closely linked with the Deutsche mark.[9/]

Why did the snake experiment fail? Originally, it had two motivations, one internal to the Community and one external. The internal motivation was to take another step on the road toward full economic and political union in Europe. The external motivation was to lessen dependence on the dollar and enhance the Community's own monetary independence. It had long been evident that lacking a common currency of their own, the European countries were obliged to rely on the dollar instead to achieve a degree of monetary integration. 10/ Since this also meant dependence on the monetary policy of United States, it implied a partial loss of monetary sovereignty. Formal currency unification was viewed as the necessary condition for elimination of dollar hegemony. In addition, a common currency, which would undoubtedly become attractive to others for vehicle and reserve purposes, might also enhance Europe's bargaining strength in international monetary discussions.

The experiment failed, in the words of the Marjolin Committee, for three principal reasons: "unfavourable events, a lack of political will, and insufficient understanding." 11/. The "unfavourable events" included inflation and the energy crisis; the "insufficient understanding" referred to a total lack of prior analysis, at either the national or the Community level, of the conditions necessary for making a common currency operational. But the most critical of the three reasons was clearly the "lack of political will." At a lower level, national administrative hierarchies resisted all encroachments on their bureaucratic power and privileges; central bankers, in particular, were unwilling to become submerged in a European "Federal Reserve System." And at a higher level, national political leaderships resisted all encroachments on their traditional decision-making authority; governments were unwilling to transfer any significant portion of their formal sovereignty to Community institutions. Neither the internal nor the external motivation was sufficient to overcome these crucial political obstacles. As the late Fred Hirsch wrote in 1972:

> In this sense one can conclude that European monetary integration is not a serious issue. It belong to that category of commitments that are endorsed by national authorities at the highest level, but are in fact ranked low in their priorities when it comes to the test.12/

Regrettably, Hirsch's judgment still seems valid. With EMS, the Community's members have once again endorsed the idea of monetary unification at the highest political level; but they have still not shown much evidence of ranking it high among their practical policy priorities. None of the major governments has yet to demonstrate the "political will" that the Marjolin Committee spoke of. In short, they still do not appear to treat EMS as a truly "serious issue." An objective observer is therefore entitled to a considerable degree of skepticism about the eventual outcome.

The stated purpose of EMS is to create a "zone of monetary stability" in Europe — certainly a worthy objective. But conditions at the time of its debut last March were not really auspicious for linking the Community's currencies together on any kind of a sustained basis. Inflation rates in Europe remain highly divergent, (even more divergent than when the first snake was launched in 1972), ranging from a low of 5 percent in Germany currently to more than 15 percent in Italy. The system, consequently, was bound to come under strain unless the macroeconomic policies of member-countries could be more closely coordinated than they had been previously. However, Chancellor Schmidt, whose country was potentially the largest creditor in the Community, was obliged to promise a tight rein on credit transfers to deficit members in order to placate his own domestic critics (who had no wish to finance the presumed inflationary excesses of others). Coordination in practice, therefore, clearly implied alignment downward towards Germany's inflation rate (as it did in the old snake), and this in turn implied a strong deflationary bias in the system that was bound to produce grave strains among the members.

These strains were not long in coming. Less than three weeks after EMS was formally inaugurated, the Deutsche Bundesbank tightened monetary policy significantly in an effort to reverse an accelerating domestic inflation rate. As a result, capital began flowing into Germany on a large scale, despite competing increases of interest rates elsewhere in the Community (Table 1). By the end of May, both the Belgian franc and the Danish krone were driven to the floor of the EMS parity grid, well past their ECU divergence limits (which are supposed to signal to members when to modify their policies). Yet in June and July Germany continued to tighten monetary policy, despite complaints from the weaker members. According to the Germans, responsibility for adjustment lay with the Belgians and Danes, whose

Table 1

Official Discount Rate Changes in the European Monetary System, March-September 1979

Date	Country	Previous rate (%)	New Rate (%)
March 13	EMS inaugurated		
30	Germany[a/]	3.00	4.00
April	[no changes]		
May 2	Belgium	6.00	7.00
30	Belgium	7.00	8.00
30	Netherlands	6.50	7.00
June 13	Belgium	8.00	9.00
15	Denmark	8.00	9.00
22	Ireland	11.85	13.70
29	Belgium	9.00	11.00
July 6	Netherlands	7.00	7.50
13	Netherlands	7.50	8.00
13	Germany[a/]	4.00	5.00
August	[no changes]		
September 17	Denmark	9.00	11.00
24	Exchange rates realigned (DM revalued 2% against all other currencies except the Danish krone, which is devalued an additional 3% against all other currencies)		

Source: World Financial Markets, various issues.

a. In addition to its discount-rate changes in March and July, Germany also raised its Lombard rate in March (from 4.00 to 5.00 percent) and in June (from 5.00 to 5.50 percent). (The Lombard rate is the rate at which the Bundesbank lends to commercial banks against the collateral of securities.)

currencies were below their divergence limits. According to the latter, however, it was the Germans who ought to be acting to relax monetary policy. That the Deutsche mark had not exceeded its divergence limit was merely a statistical fluke, owing to a concurrent rise of the pound sterling and Italian lira that was making the mark look artificially weak.[13/] The Germans, it was argued, were giving priority to their fight against inflation, even at the expense of their partners in EMS.[14/] Their partners, the Germans replied, would simply have to learn more "discipline."[15/]

In September, the dispute was resolved — at least temporarily — by a moderate realignment of EMS parities.[16/] But recurrence of such tensions is unlikely to be avoided for long. Given present governmental attitudes and priorities, attempts to coordinate members' policies are not likely to reduce inflation differentials sufficiently; or else some of the weaker members may prove unable to bear up under the joint deflationary discipline. Either way, strong centrifugal forces will be set in motion to pull the joint float apart, and speculators will have a field day. Member-governments will then be faced with the Hobson's choice of either altering their exchange rates frequently in order to avoid speculative build-ups, or else defending their linked rates futilely with prolonged and costly intervention. Either course would make a mockery of their avowed goal of a "zone of monetary stability" in Europe.

In the face of such strains, some participants might just decide that the game is not worth the candle and withdraw from the arrangement altogether. That is what happened to the first snake experiment.

There is little in the present EMS design to suggest that history might not repeat itself. The signs are not promising. Governments have still not demonstrated the "political will" to make the necessary sacrifices of sovereignty or commitments to mutually consistent policies. 17/ The most probable outcome, therefore, is that EMS, like its predecessor, simply will fail. Sooner or later, some weaker members will again be forced to abandon the joint float, while the rest struggle on the preserve a truncated zone of stability around the Deutsche mark. Monetary fragmentation within the Community will become more pronounced than ever.

III.

In and of itself, failure of EMS would not necessarily have any serious destabilizing impact on international monetary relations. Dissection of the earlier snake, after all, was managed in a relatively harmonious fashion. But given the high hopes that have been attached to this latest experiment, it is difficult to imagine all residues of acrimony and discord being avoided. More likely, the result would be formalization of the Community's monetary fragmentation -- with non-participants relegated to second-class status -- and even greater difficulty in achieving some international regime of shared responsibility for global monetary stabilization.

Even if EMS does not fail outright, impacts on international monetary relations generally, and on the United States and the dollar specifically, are likely to prove more unfavorable than favorable.

Certainly, exchange markets are likely to remain unsettled so long as EMS participants are constantly under pressure to outguess or outgun speculators in order to maintain their joint float. Not only does this make a mockery of the Community's goal of a "zone of monetary stability." From the U.S. point of view, an additional complication arises owing to the traditional intervention role of the dollar. In principle, EMS participants are supposed to maintain their joint float by buying and selling each other's currencies rather than the dollar; this was the rule in the old snake too. But in the old snake, in practice, intervention was often in dollars; and in EMS too this is becoming common practice, owing to the complicated nature of the formal intervention mechanism embodied in the new arrangement.[18/] In addition to the traditional parity grid, members are supposed to use their ECU rates as a "divergence indicator" to signal when policy actions are required, including intervention in the exchange market, to forestall any systematic deviation of one of their currencies from the average of all the others. The problem is that in such a case it is not clear what currency should be used for intervention purposes. When parity-grid limits are reached, the choice is clear: one need only identify which market cross-rates among partner-currencies have reached their limits. But when ECU divergence limits are reached, it is not at all clear what currency to use unless one uses a non-EMS currency, such as the dollar. In the old snake, at times of strain, dollar intervention was often poorly coordinated if not openly at cross-purposes. Similarly uncoordinated dollar intervention in the new arrangement adds greatly to volatility in exchange markets, and complicates even further America's attempts to stabilize the external value of its currency.

In fact, the relationship between EMS and the dollar is a highly unstable one, in which developments on either side may produce serious repercussions in the other. Even before EMS was formally inaugurated, it was well understood that maintenance of a joint float in Europe would be made more difficult by a weak dollar. Since dollar holders anxious to diversify their portfolios would be attracted to strong currencies like the Deutsche mark or Dutch guilder (or Japanese yen or Swiss franc), rather than to such moneys as the Italian lira or French franc, renewed dollar sales would inevitably mean additional upward pressure on the stronger currencies relative to their weaker partners, and consequently even greater strains in managing the joint float. What was not so well understood was that difficulties might also be created by a strong dollar, as happened for example this past spring. What sparked off the tightening of German monetary policy in March, it is now clear, was the temporary fall of the mark against the dollar (in which many of Germany's imports, including especially oil imports, are priced). In the words of one observer: "Germany gave priority to fighting inflation. By keeping the rise of the dollar in check, it kept down the price [it pays] for oil and other imports."[19/] What resulted, as we know, was tension and acrimony inside EMS — and also, it might be added poorly coordinated intervention in dollars.[20/]

The influence can also run the other way. A weak and troubled EMS, I have said, poses risks for the dollar in the form of uncoordinated intervention in the exchange markets. A strong and confident EMS also poses risks, by broadening considerably the array of currencies available to dollar holders eager to diversify their portfolios. Suppose that EMS beats the odds, not only managing to stay together but even to reduce inflation differentials and effectively coordinate national policies. This could prove to be particularly threatening to the dollar insofar as it makes Community currencies attractive as alternative investment media. And for the dollar the problem would be further exacerbated if and when the ECU, which for now is intended solely for use by central banks within the Community, becomes available to non-member central banks or to private investors. Sales of dollars then could turn into a flood, making the dollar's recent depreciations appear modest by comparison.

Ultimately, prospects for the relationship between EMS and the dollar, and by extension for international monetary relations generally, depend on the Europeans themselves — specifically, on what motivates them to be trying yet again for monetary unification. Greater monetary independence is manifestly one of their prime motivations. But monetary independence for what purpose? Are the Europeans trying to place themselves in a position to share explicitly with the United States in responsibility for global monetary stabilization? Or are they simply trying to shield themselves as much as possible from a hegemonic leadership that they no longer regard as "responsible"?

Put differently, are they animated by a sense of confidence in their relations with the United States, or by a sense of distrust? Here is the real issue of EMS for the dollar and the future of the international monetary system.

An EMS motivated by a sense of mutual confidence would pose few difficulties for international monetary relations. The problem, however, is that cooperation with the United States does not really seem to be what the European have in mind. Much more crucial to their thinking is the element of distrust of American policy that has become so endemic in recent years, symbolized by the system's stated purpose to create a "zone of monetary stability" in Europe (presumably to be distinguished from the zone of dollar instability). The long decline of the dollar in 1977-78 wreaked havoc in European financial markets. A principal attraction of EMS for Community members is that it would help to insulate them from similar instabilities in the future. Europe's leaders, with Chancellor Schmidt and France's Valery Giscard d'Estaing in the vanguard, have made no secret of their goal to create a common front to protect them from what they regard as American economic irresponsibility.[21/] Isolation from the United States, not cooperation, seems more the point of the exercise.

This clearly poses difficulties for international monetary relations. In the first place, it means that even if EMS were to be successfully implemented, it probably would not lead to a regime of shared responsibility for global monetary management. More likely, the Europeans would choose to distance themselves from the perceived threat of "malign" American nationalism, concentrating instead on the pursuit of their own policy priorities mainly within the framework of their regional Community. This certainly would not reduce the potential for policy conflict in global monetary relations. It would also not reduce the danger of further pressures on the dollar through continued diversification of portfolios into European currencies (or into the ECU, if and when it becomes available).

Worse, Europe's "isolationist" motivation suggests that EMS will probably never be implemented successfully at all. To succeed, EMS must be a "serious issue." Preoccupation with outside instabilities is not enough. As the first snake experiment amply demonstrated, there must also be sufficient "political will" -- and this, as I have said, we have yet to see. The prospect, therefore, is for renewed policy conflict on monetary issues, not just across the Atlantic but within Europe as well. In this sense, EMS is not the problem at all. The problem is the continued inability of the nations of the West to find a basis of mutual trust for the cooperative management of their monetary affairs.

Notes

1. For a preliminary version of this argument, see Benjamin J. Cohen, "Europe's Money, America's Problem," Foreign Policy, No. 35 (Summer 1979), pp. 31-47.

2. The "n-1 principle" or "redundancy problem" was first enunciated by Robert Mundell. See his International Economics (New York: Macmillan, 1968), pp. 195-198.

3. The problems of international monetary organization are treated at greater length in my book Organizing the World's Money: The Political Economy of International Monetary Relations (New York: Basic Books, 1977; and London: Macmillan, 1978).

4. See e.g., Charles P. Kindleberger, The World in Depression, 1929-1939 (Berkeley and Los Angeles: University of California Press, 1973).

5. See Benjamin J. Cohen, "United States Monetary Policy and Economic Nationalism," in Otto Hieronymi (ed.), The New Economic Nationalism (London: Macmillan, forthcoming).

6. For an excellent review of the whole "locomotive" debate, see Marina v.N. Whitman, "The Locomotive Approach to Sustaining World Recovery: Has It Run Out of Steam?," in William Fellner (ed.), Contemporary Economic Problems 1978 (Washington: American Enterprise Institute, 1978), pp. 245-283.

7. Christopher Johnson, "The Problem of EMS," The Banker, January 1979, p. 29.

8. For the history of this and even earlier attempts at European monetary unification, see, e.g., Peter Coffey and John R. Presley, European Monetary Integration (London: Macmillan, 1971); and Loukas Tsoukalis, The Politics and Economics of European Monetary Integration (London: George Allen and Unwin, 1977).

9. Report of the Study Group "Economic and Monetary Union 1980" (Brussels, March 1975), p. 1.

10. See, e.g., Benjamin J. Cohen, "The Euro-Dollar, the Common Market, and Currency Unification," Journal of Finance, Vol. 18, No. 4 (December 1963), pp. 605-621.

11. Report of the Study Group "Economic and Monetary Union 1980", p. 3.

12. Fred Hirsch, "The Politics of World Money," The Economist, August 5, 1972, p. 57.

13. Although neither Britain nor Italy is a full member of the EMS, their currencies form part of the ECU "basket". While the ECU rates against which divergence limits are calculated are adjusted to compensate for movements of these two currencies beyond what would be permitted if they were full members, adjustment is not perfect. Inclusion of the two at a time when both are rising tend to make other strong participating currencies look relatively weaker. For technical discussions, see IMF Survey, March 19, 1979, Supplement; and Bank of England, Quarterly Bulletin, Vol. 19, No. 2 (June 1979), pp. 190-194.

14. See e.g., David Marsh, "Europe's Monetary Link Showing Strain," Financial Times, June 6, 1979, p. 4.

15. See e.g., the remarks of Helmut Schmidt in an interview in The Economist, September 29, 1979, p. 48.

16. In the opinion of many market observers, the resolution could only be temporary, precisely because the realignment was so moderate (see Table 1): "really fiddle faddle," said one investment banker, quoted in New York Times, September 26, 1979, p. D2.

17. This point is a recurrent theme among EMS critics. See e.g., Paul de Grauwe and Theo Peeters, "The EMS, Europe and the Dollar," The Banker, April 1979, pp. 39-45; and John Thornton, "On Recent Trends, the EMS Will Probably Collapse," Euromoney, August 1979, pp. 117-119.

18. See De Grauwe and Peeters, op. cit., p. 43; and Bank of England, loc. cit., p. 194.

19. An unnamed Belgian central-bank official, quoted in Wall Street Journal, June 18, 1979, p. 14.

20. See Ibid.; and also Marsh, op. cit.

21. See e.g., James O. Goldsborough, "The New Entente Cordiale," New York Times Magazine, August 26, 1979, pp. 15ff; and Melvyn B. Krauss, "Is West Germany Now the European Monetary Leader?", Wall Street Journal, August 9, 1979, p. 20.

EUROPEAN UNIVERSITY INSTITUTE

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The Political Economy of the
European Monetary System -
its impact on European integration
and US-European relations

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THE POLITICAL AND DIPLOMATIC ORIGINS OF THE EUROPEAN MONETARY SYSTEM, JULY 1977-MARCH 1979

by Peter LUDLOW

The political and diplomatic origins of the European Monetary system, July 1977-March 1979

The purpose of this paper is to analyse the politics of the European Monetary System; it is not, it should be stressed, to discuss in what respects if any the system marks an advance on previous schemes for monetary integration, still less to say whether its prospects for survival are good, bad or indifferent[1]. Technical questions are of course considered, and an attempt has been made both in the text and in the appendix that accompanies it to indicate the more significant movements in the foreign exchange markets during the period under consideration, since disputes about what policies ought to be adopted against a background of sluggish growth and a falling dollar were at the heart of many of the political and diplomatic exchanges that preceded the formation of the system. The principal focus is nonetheless on the political and diplomatic exchanges themselves and the questions that the paper attempts to answer are political and historical in character. Why were plans for monetary integration revived in the second half of 1977 and the first three months of 1978? What conditions favoured their implementation? What light does the episode throw on the political structure and balance of power in the European and North Atlantic Communities? How did the principal actors in the story define their national interests and envisage the future of the international community?

The paper is divided into three sections, corresponding to the three main phases in the story :

1. The background, until December 1977
2. The evolution of the Schmidt plan from January/ February 1978 until the Franco-German summit at Aachen in September
3. The completion of the System, from Aachen until the Italian and Irish decisions to join in mid-December 1978.

The coda, necessitated by the French decision to block the inauguration of the system until their objections to MCAs had been accepted, though in its own way immensely revealing, is dealt with only cursorily at the end of the paper because it had little to do with the monetary system itself.

Given the need to compress the history of extremely complicated multilateral negotiations into relatively few pages, the argument is focussed on developments within and between the four larger member states of the Community, France, Germany, Italy and the United Kingdom and the European Commission in Brussels. Representatives of the smaller countries figure occasionally, but space does not allow an extended discussion of the debate that went on within these states and the influence of their goverments beyond their frontiers was only rarely felt. The attitude of the United States, which was in several respects of critical importance in the emergence of the system, is alluded to at various points, but no attempt has been made to provide a systematic discussion of the question, since it is being dealt with in another paper for the conference.

There were needless to say many different levels of contact and conflict between the five major actors, and alignments at one level did not necessarily correspond to those at another. The distinction between the heads of government on the one hand and ministers and officials in the economic and finance departments or the central banks on the other is fundamental to the whole story. The preoccupations and perspectives of the first group were only partly shared or understood by the other, and lines of communication between the two levels were not always clear or efficient. It would however be an oversimplification to interpret the division in terms of a straightforward cleavage between politicians and technocrats. Technical problems were dicussed at the highest level: four of the leaders involved, Herr Schmidt, M. Giscard d'Estaing, Mr Jenkins and Mr Callaghan were after all for

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ministers of finance, and each of them drew heavily on the advice of expert advisers who were by no means always in accord with their fellow-experts in goverment departments or central banks. Conversely, amongst the 'technocrats', there were those who were political heavyweights in their own right: Dr. Emminger and Mr. Healey are two examples that come readily to mind. When all due allowances are made, however, the Chancellor, the presidents and the Prime Ministers formed a club apart, with its own hierarchy, its own evolving conventions and its own special powers. The politics of this exclusive society are at the heart of the politics of the emergent monetary system.

Beneath the heads of goverment was a complex network of intergovermental committees. For the purposes of this paper, three were particularly important: the Finance Council, composed of the finance and economics ministers of the Community; the Monetary Committee, attended by officials and bankers, and the Committee of Central Bank Governors, which was itself serviced by several extremely active sub-committees. A fourth committee, the Economic Policy Committee, which was instructed in July 1978 to carry out 'concurrent' studies on the transfer of resources in the Community played no more than a minor role in the proceedings. The formal committee structure as a whole was however frequently bypassed in bilateral meetings between experts and in ad-hoc multilateral sessions, such as a meeting of senior officials in Frankfurt a few days before the European Council session of December 1978.

The role of professional diplomats is somewhat harder to assess, but it was at certain moments and in certain capitals quite significant. In Italy, Signor Andreotti seems to have drawn heavily on the advice of the diplomatic consellor in the Prime Minister's office and used him as an emmissary to Bonn in December 1978. In Brussels, Mr. Jenkins used Herr Sigrist , the German Permanent Representative in his first approach to the German Chancellor on the monetary issue, while in London, the Foreign Office, aided and abetted by heads of mission such as Sir Nicholas Henderson in Paris and Sir Donald Maitland in Brussels, mounted a determined rearguard action in November 1978 to draw attention to and mitigate the dangers of British isolation. Non-governmental actors, though important within individual countries, seem to have played only minor roles at Community level. There were contacts between both Communists and Socialists in Italy and differen groups in the Labour Party, and an Italian Social Democrat was involved in the last minute talks with the Germans that preceded the Italian decision to join the system in December 1978. These transnational activities by national politicians were however exceptional and marginal, while the contributions of Euro-MPs, though sometimes lengthy, would not appear to have been any more significant. Elsewhere,some of the more active non-political pressure groups rushed to make their views known from time to time, but again it would be difficult to argue that they had any real impact on the proceedings, which were dominated from beginning to end by the heads of government and the President of the Commission.

I

The decision to authorise the preparation of proposals for a European Monetary System was first taken by the leaders of the nine Community government as a group at their meeting in Copenhagen in April 1978. This meeting and the events that immediately preceded it will be discussed in detail in the second section of the paper. Before moving on to 1978 however it is important to give a brief sketch of the general background to the debate about monetary integration in the European Community and of the fresh impetus that was given to this debate by the decision of Roy Jenkins, the President of the European Commission to make monetary integration the central theme of his presidency.

Monetary union had been a recurrent feature of the debate about the future of the European Community since the earliest years of its existence and a central one since 1969. There is no need here to retell a story that has recently been reconstructed in the excellent book by Dr. Loukas Tsoukalis[2]. It will be enough simply to draw attention to three points which emerge from the work of Dr. Tsoukalis and others and which are particularly relevant to the events of 1977-79. The first is the longstanding interest of M. Giscard d'Estaing-in the problem, the second the persistent scepticism of the German financial establishment since the early 1970s about the feasibility of linking the currencies of countries whose governments had such widely divergent economic priorities as the four larger Community states and a corresponding emphasis on the need to maintain the smaller experiment in monetary cooperation, the Snake, at all costs, and the third, the tendency of the idea of EMU to revive like some phoenix from the ashes when all around presumed that it was dead and buried. The first two points will be taken up again in the second section of the paper: the third requires some amplification. It can be illustrated by events between 1974 and 1977[3]. At their meeting in Paris in December 1974, the Community heads of government had quietly shelved the ambitious commitment to Economic and Monetary Union by 1980. Despite this, schemes for monetary integration, some modest, some far-reaching, kept on being produced. In 1975 the Marjolin Report discussed the matter; so too did the Tindemans Report and more specifically still, the Foucarde plan. These were followed in due course by the proposals of Dr. Duisenberg while in 1977 M. Giscard d'Estaing made at least two calls in January and February for renewed efforts to achieve greater monetary stability[5] and the Belgian Finance Minister, Gaston Geens, came up with fresh proposals in June which though undoubtely 'a diluted version of earlier suggestions for greater economic and monetary integration'[6] gave yet another proof that the aspiration was still alive. Various explanations could be given for the recurrence of the theme,including the fact that despite the setbacks that had destroyed the more farreaching plans, there had been real, if unspectacular improvements in the machinery for monetary cooperation between the member states, which though still irrelevant in major currency crises such as those that befell the Lira and sterling in 1976 had achieved results that were useful and might in time be important. It is in fact arguable that the EMS negotiations which are the subject of this study can only be properly understood if they are seen within the context of a long-term trend towards the emergence of a European monetary bloc.[7]

Be that as it may, there is little doubt that in 1977 itself, despite the statements by the French President earlier in the year and the initiative by Mr Geens in June, the call for a new debate about monetary integration by Mr Jenkins,the President of the Commission came as a considerable surprise, and that the majority of his colleagues and well-informed observers of Community politics regarded his decision to place the question in the forefront of his work as President as quixotic and ill-judged. When all allowances are made for the earlier developments, therefore, Mr Jenkins' initiative marked a new beginning in the search for EMU and it is the natural point of departure for a detailed account of the events that led up to the formation of the EMS.

Mr Jenkins' best known statement of the case for European monetary union was of course his Monnet lecture at the European University Institute on 27 October 1977 and it is an indispensable source for an analysis of his motives.[8] It is not however the only source and in assessing both the timing and the political objectives of the initiative it is necessary to take account of the remarks that he made to a small group of advisers at his English country home at East Hendred in July 1977 and his actions on returning to Brussels in September.[9] As far as the <u>economic</u> arguments are concerned, however, the Florence speech gives by far the fullest statement. They were essentially five in number: monetary union would favour a more efficient and developed rationalisation of industry: it would provide the Community with the advantages that accrue to the "issuer of a world currency", which in the light of the "current problems of the dollar" would be no small gain: properly implemented and administered it would contribute to the battle against inflation: it would help to reduce unemployment and finally it would reinforce policies designed to even out regional imbalances within the Community These arguments were rehearsed and embellished in speech after speech throughout the autumn and winter of 1977/78, and there seems little doubt that whatever many, though by no means all professional economists may have said about them, Mr Jenkins himself attached considerabl weight to them. There is even less doubt however that they were less important in determining the timing and manner of his initiative than a number of political calculations.

As the winter wore on and the dollar crisis worsened, the second of the economic arguments assumed greater prominence, but the initial inspiration for the call for monetary union stemmed not so much from the problems of the United States as from Mr Jenkins' assessment of the political situation in the European Community itself in the middle of 1977 and of the opportunities and limitations of his own office as President of the Commission. Stated in the simplest possible terms, Mr Jenkins' aims in pressing for monetary integration would seem to have been to restore political momentum in the Community, to bolster up the morale of a Commission that seemed to many observers as well as its new President to be profoundly demoralised and to create a new and distinctive role for the President himself in a Community in which the chances of any fresh accumulation of supranational powers were limited or non-existent. The call for monetary union was intended in the first instance to serve these highly political ends. It was not the only stratagem that was considered. One at least of those present at the East Hendred meeting in July 1977 where Mr Jenkins first explained his ideas, Signor Ruggero, urged that the President should make industrial policy the central theme of his endeavours over the coming months.[10] Mr Jenkins himself however was firmly committed to the monetary theme: this, he argued, was the most likely to further the political objectives that they had in mind. Why? There would appear to have been two related, but distinct groups of arguments.

The first was based on a general and not particularly cheerful appraisal of the state of the Community in 1977. Traces of this appraisal can be found in the Florence lecture. Increasing economic divergence and dwindling political enthusiasm for the European ideal had created a situation in which the prospects for further advances towards European unity seemed extremely gloomy. "The last few years", Mr Jenkins noted, "have seen a retreat rather than an advance"[1]. Enlargement seemed likely to pose still more threats. "The prospect of enlargement will face us with the clear choice either of a strengthening of the sinews of the Community or of tacit acceptance of a loose Custom Union, far removed from the hopes of its founders, and without much hope of recovering momentum".[12] The need for an "adventurous idea" was imperative: the prospects of finding one that was

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remotely realistic in such an unpropitious political climate were however very slender. The strength of national self-consciousness all over the Community excluded the solutions or approaches of an earlier generation. Any proposal that appeared to involve "the creation of a new and cumbersome bureaucracy in Brussels" was out of the question. "We must build Europe upon the bases of our late 20th century nation states".[13] By emphasising industrial policy - Signor Ruggero's preference - or regional policy - to which the British, including Mr. Jenkins himself had attached such high importance at the time of the United Kingdom's entry into the Community and the subsequent referendum compaign - the Commission would be almost certain to provoke outcries against Brussels dirigisme or complaints from the Germans that they could not be expected to contribute ever larger sums of money to subsidise their inefficient partners. Monetary integration by contrast promised a real transfer of power to the centre of the Community without however creating 'a monolitic concentration of political and economic power'. The two halves of the proposition were spelled out in the sixth and seventh points in the Florence lecture.[14] The debt to the MacDougall report[15] was obvious and was acknowledged. It provided, Mr. Jenkins claimed, 'a new and realistic model for a highly decentralised type of monetary union in which the public procurement of goods and services is primarily in national, regional or other hands. The public finance function of such a Community would be stripped down to a few high-powered types of financial transfer, fulfilling specific tasks in sectors of particular Community concern, and assuring the flow of resources necessary to sustain monetary union. These characteristics also make for a quite small central bureaucracy, which I think we would all consider an advantage.'

The second set of arguments which would seem to have influenced Mr. Jenkins' choice of the monetary theme related to the politics of the Commission itself and his own role as its President. The malaise that afflicted the Commission when Mr. Jenkins took office was profound and longstanding. Its causes were multiple, but by far the most important and all-pervasive was the failure of successive Commissions to define their tasks in a Europe which, as Mr. Jenkins noted at Florence, could only be built 'on the basis of our later twentieth century nation states'. Mr. Jenkins' predecessor, M. Ortoli, who continued to serve as a vice-president in the new Commission had seen his own and his colleagues' role as essentially that of very senior, but nonetheless non-political international civil servants, responsible for administering and where possible improving the complex arrangements devised by their political masters or more political predecessors to further the cause of European integration. Not all M. Ortoli's colleagues had shared his views, and in some respects at least the Ortoli Commission had been less independent of external political pressure than several that had gone before it,[16] but M. Ortoli's approach was the dominant one and set the tone for the Commission as a whole. 'The concept of gradualism' Mr. Jenkins observed, 'has come to supplant more ambitious schemes'.[17]

As vice-president, M. Ortoli continued to adopt the same ~~approach, with the same limited objectives in mind. During~~ the first six months of 1977, for example, when Mr. Jenkins himself seemed to many observers to be floundering, M. Ortoli, who had assumed responsibility for financial and monetary questions in the new Commission, set about creating a position for himself in the Central Bank Governors Committee, where previously the Commissioner holding this portfolio had only attended when invited. It was typical of the Ortoli strategy, a strategy of small steps, which precisely because it was unambitious, was frequently successful. The Brussels correspondent of the Neue Zürcher Zeitung, who appears to have had a particular admiration for M. Ortoli, wrote regularly and enthusiastically in the summer and autumn of 1977 about the quiet way in which the latter had brought order into his section of the Commission,(formerly the domain of Herr Haferkamp), and about the general air of wordly wise pragmatism that he conveyed. His belief in the efficacy of the small step, the Neue Zürcher Zeitung noted, was rooted in long experience of Brussels and the Community.[18]

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The new President had neither the temperament nor the experience to fit him to the kind of role preferred by his predecessor. He was a professional politician : M. Ortoli was a fonctionnaire. The focal point of most of his working life had been the British Parliament and his reputation as a 'good European' had been made not so much in office, as on public platforms. Europe was a cause, not a complicated network of administrative arrangements. Above all, however, Europe was an amalgamof nation states in which power to the extent that it was exercised at all in a Community setting, had passed decisively to the European Council composed of the heads of government. It was at that level that the President of the Commission had to make his mark, if in the end he was to make his mark at all, and it was in terms of that constituency, where the priorities and conventions were very different from those that obtained even in the Councils of ministers that the President had to choose his themes and define his policies.

For all his ambitions, however, Mr. Jenkins' first six months in office had been singularly unhappy.[19] He had been obliged by the obduracy of certain member governments to accept colleagues in the Commission in whom neither he nor the governments concerned had any confidence. He headed a bureaucracy which functioned quite differently from the Civil Service to which he had grown accustomed after ten years as a minister in London and his attempt to coax the Secretary-General into assuming something like the role of a Permanent Secretary had been conspicuously unsuccessful. Instead he had had to rely on a Cabinet which was young, English and with one or two exceptions as inexperienced as he was in Brussels affairs. Not surprisingly perhaps his grasp over the administration seemed clumsy and unsure. What made matters still worse however was that his local problems within the Commission had not been offset by any notable successes outside.
M. Ortoli's strategy may have been an inadequate response to a decisive shift in the power structure of the Community, but in its own quiet way and in terms of its limited objectives, it had at least been reasonably effective. Mr. Jenkins' political instincts may have been right : his fortunes were not.

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The worst moment had probably been at London in May at the meeting of the heads of government of the 'Seven'. President Carter had treated him civilly enough: so too had Herr Schmidt. But M. Giscard d'Estaing had boycotted a working dinner for heads of government alone, because Mr Jenkins was present, and his former Labour Party colleagues, warmly supported it would seem by at least some of their officials, went out of their way to show that he did not belong. At the final press conference, for example, seats were reserved for all the delegations except Commission officials accompanying Mr Jenkins.

When he invited his closest advisers to his country home in July, therefore, the Commission over which he presided badly needed an idea, while he himself was looking for a programme that would enable him to establish his claims to be treated as an equal of the heads of government who were becoming the dominant force in Community politics. There is a considerable amount of evidence to suggest that the choice of the monetary theme was related to these two political requirements, and particularly to the latter. It was a gamble, but less perhaps of a gamble than it seemed to many observers at the time if, as Mr Jenkins' actions after he had made the choice suggest he was, one was interested mainly or even exclusively in the reactions of the European Council.

Outside and below the European Council, however, Mr Jenkins proposals very quickly ran into difficulties. His troubles began in the Commission itself. His closest advisers, most of them English, accepted his political judgement loyally enough, and one of them in particular, Mr Michael Emerson, played an important part in drafting the President's statements on EMU during the early months of the campaign. Mr Jenkins' colleagues on the Commission, however, were a good deal more sceptical. He would seem to have briefed them as a group for the first time during a weekend conference at a hotel in the Ardennes in the middle of September 1977.[20] He spoke at some length and provided them with a fifteen page text developing his ideas. Of those present only one, his British colleague, Christopher Tugendhat, would

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seem to have endorsed his initiative wholeheartedly. Tugendhat was however by far the youngest of the Commissioners, and his views did not carry any great weight. Much more important was the evident scepticism of a small group of senior Commissioners, led by M. Ortoli.

M. Ortoli's objections to the Jenkins proposals were essentially two: they were politically unrealistic and they threatened to damage the more modest, but nonetheless significant initiatives that he himself had taken or was taking in the monetary field. M. Ortoli's general philosophy has been alluded to already. His detailed proposals were entirely consistent with it. Before Mr Jenkins' intervention his plans seem to have been piecemeal. In June, for example, he urged the Finance Ministers to approve the creation of a new Community loan mechanism worth 1 billion units of account.[21] In September a paper was prepared under his direction which called for measures to promote economic growth in the stronger countries without raising costs.[22] In October and November, partly it would seem in response to the Jenkins initiative, M. Ortoli developed a more comprehensive, five year plan, but the approach was still gradualist and low key.[23] It constituted an action programme for 1978/82, which was to be reviewed each year but which was aimed in general terms at encouraging a lasting convergence between the national economics of the nine, at fostering, through tax harmonisation and the liberalisation of the movement of goods, services and capital a single market and at 'structural' policies in industries, especially in depressed sectors such as textiles, steel and shipbuilding and in 'growth' areas such as energy, telecommunications and aerospace. His proposals were intended to prepare the way for EMU, not to inaugurate it.

When M. Ortoli's paper was eventually presented to the Finance Ministers at their meeting of November 21st, it appeared as part of a larger document sponsored by both Mr Jenkins and himself and containing an introductory chapter which incorporated some of Mr Jenkins' arguments for a more radical approach,[24] but this and other attempts to paper over the gap that existed between the President and

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his deputy were scarcely convincing in the light of M. Ortoli's open criticism of the Jenkins approach in other settings. Presenting the annual report of the Commission at a press conference on October 20th, M. Ortoli was alleged by one newspaper to have described Mr Jenkins' ideas as "politically absurd", and even those who missed this particular remark agreed that he had given his President a surprisingly public rebuff.[25] The Commission document in November was in fact widely seen not as a genuine compromise, but as a serious defeat for Mr Jenkins by M. Ortoli and the majority of the Commission. Mr Jenkins' wild ideas were given token endorsement, but the heart of the document was the 'more realistic' Ortoli plan. The identity of M. Ortoli's allies in the Commission was never precisely established in the press, but the Brussels correspondent of the Neue Zürcher Zeitung, who was, as has already been suggested above, particularly well informed about the feelings of M. Ortoli and his advisers, claimed in the middle of November that Mr Jenkins' hold over the Commission had been weakened still further by the dispute over the monetary plan and that Commission affairs were now virtually dictated by a group composed of MM. Ortoli, Davignon, Gundelach, Cheysson and Natali.[26]

Mr Jenkins' difficulties did not end with the Commission. His proposals were dismissed too by most of the officials on the two key expert committees, the Central Bank Governors Committee and the Monetary Commitee, and still more publicly by the Finance Ministers. The German representatives on the Finance Council were particularly scathing. Herr Apel, the minister of Finance described the proposal as 'Quatsch', while his colleague Count Lambsdorff told journalists at the November meeting of the Council that the European Community was not ready for such a radical venture at present, because economic conditions were unsuitable and because of lack of 'political will' amongst governments.[27]

Irritating though these setbacks and criticisms undoubtedly were however, the evidence suggests that Mr Jenkins himself was chiefly preoccupied with developments elsewhere, and that he did not see his problems with M. Ortoli or with Herr Apel as a fundamental threat to his strategy. From the very beginning in fact, Mr Jenkins appears to have played a game on two tables. Although as we have seen,

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he did not ignore his colleagues on the Commission, it is nonetheless significant that before he briefed them at their weekend conference in the Ardennes, he took the opportunity offered by a meeting with M. Tindemans, who as Belgian Prime Minister was due to chair the European Council meeting in Brussels three months later, to secure the latter's agreement that further steps towards monetary union should be taken at the December summit 'irrespective of present difficulties'.[28]

It was only the first of a series of moves related to the Council. Given the lack of adequate documentation, it is clearly impossible to piece together every development in this diplomatic campaign at the highest level. The game that was played at the lower table was widely reported: the other game which went on at the same time by contrast remained largely unknown. Some idea of the different atmosphere that prevailed can however be obtained if we compare the reports by Heinz Stadlmann, the Frankfurter Allgemeine Zeitung correspondent in Brussels, who almost alone it would seem, amongst his colleagues in Brussels, sensed the significance of Mr Jenkins' conversations with the German Permanent Representative, Herr Sigrist in October and with Herr Schmidt himself in November, and most if not all the other press reports emanating from Brussels in October and November. In his first report of October 12th,[29] Stadlmann was somewhat sceptical about the content of Mr Jenkins' ideas: the plan would cost money and that could only mean German money. But unlike many other observers, he was not prepared to believe that Mr Jenkins had taken leave of his senses. The President, he observed, was a "gewiegte Taktiker" who knew first that he could almost certainly count on the support of M. Giscard d'Estaing who had made a pointed intervention on the monetary question at the last Franco-German summit in February 1977, and secondly that if he was to achieve any success for his plan, he would have to concentrate above all on persuading Herr Schmidt of its advantages. With this object in mind, Stadlmann noted, Mr Jenkins had already had a lengthy discussion of the issue with Ambassador Sigrist, the German Permanent Representative, in the previous week, and had indicated his desire to see Mr Schmidt.

The contrast between Herr Stadlmann's reports and those of most of his colleagues becomes even more striking in November. Thus on the day when one of his British colleagues announced that Mr Jenkins had "lost the battle over EEC currency"[30] and M. Ortoli's admirer in the Neue Zürcher Zeitung spoke of Mr Jenkins' "astonishing

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clumsiness as a political tactician"[31] Herr Stadlmann wrote an article entitled, "Mr Jenkins' great leap".[32] While his colleagues had their eyes fixed on the forthcoming Finance Ministers' meeting, Herr Stadlmann alluded to a two-hour conversation in Bonn between Mr Jenkins and the Federal Chancellor during the previous week. He did not profess to know how Herr Schmidt had reacted to the ideas "of his old friend Mr Jenkins" but he himself was now prepared to accept that against the background of world and community problems, it might after all be wise for the Germans to consider whether the price of a monetary union would not in the long run prove less expensive than the situation that might develop if nothing was done.

Herr Stadlmann though clearly very well informed, did not of course speak for Herr Schmidt and there is evidence to suggest that the German Chancellor himself was still disinclined to take any new initiative on the question when he saw Mr Jenkins in November and when the heads of government discussed the problem at the European Council meeting in December. But at the very least he did not come out against the idea. Shortly before they both went in to the Brussels Council meeting on December 5th, Mr Jenkins is alleged to have said to the German Chancellor: "You may not be very keen on the idea, Helmut, but at least do not kill it". Herr Schmidt gave him the assuranc he wanted and kept his word. Furthermore when he returned home, he gave a surprisingly positive assessment of the summit which had in many respects been dominated by the discussions of money to his Cabinet colleagues.[33] Other heads of government were more forthcoming at the Brussels meeting itself.[34] M. Giscard d'Estaing was clearly not prepared to become involved in any new European initiative until the French elections had taken place in the following March, but he was nonetheless ready to give his approval in principle. With the exception of Mr Callaghan, all the other leaders present, and particularly the Danish, Irish, and Belgian Prime Ministers were reported to have been even more positive. Even Mr Callaghan, who claimed that he was "not convinced" did not rule out the possibility on principle.

All in all therefore Mr Jenkins' original calculation that, whatever the lesser players might think, the game was still worth playing at the higher table, would seem to have been vindicated by December 1977. The Commission's proposals, he noted in the press conference following the Council meeting,[35] had received a fair wind, and although there were still many who believed that the wind would blow itself out, he had some cause for satisfaction at the end of the first year of his presidency. There were hints of a change in the Commission too. Towards the end of December, Mr Jenkins appointed the first non-Englishman to his Cabinet, M. van den Aabeele.[36] The significance of this appointment was not simply that M. van den Aabeele was not English, nor that he was a monetary expert, but still more that he had been until then a senior member of M. Ortoli's cabinet. The relations between Mr Jenkins and his vice-president in 1978 were to provide a useful confirmation of Mr Jenkins' Florence axiom, that "the idea of an antithesis between gradual evolution and dramatic advance is misconceived".[37]

I I

Some time in either January or February 1978, the German Chancellor decided that a new initiative on European monetary integration was opportune after all. His decision which seems to have been entirely his own, and was kept secret from all but his closest advisers in Bonn, was communicated to Mr Jenkins at a meeting in the German capital on February 28th and either then or shortly afterwards to M. Giscard d'Estaing. On April 2nd, the French elections now safely out of the way, Mr Schmidt met the French president at Rambouillet and gave him a fuller account of his views. A day later Mr Jenkins, who had himself seen Mr Callaghan on April 1st, wrote to all the heads of government proposing that at their forthcoming meeting in Copenhagen, they should move beyond a general discussion of principles of the kind they had had in Brussels in December, to a more definite plan of action.

The discussion of the monetary issue at Copenhagen took place at a special evening session in Marienborg Castle.[38] The occasion was an informal one and apart from Signor Andreotti's interpreter, nobody else but the heads of government and Mr Jenkins was present. It was described afterwards by one of those who had been present as the first European Cabinet meeting. Mr Jenkins opened the conversation, followed by Herr Schmidt, who was followed in turn by M. Giscard d'Estaing and Mr Callaghan. The most important contribution by far was the statement by Herr Schmidt. Having emphasised the global context in which their policies had to be formulated, and in particular the serious problems posed by the dollar crisis and the need for European solidarity in the face of it, the Chancellor explained why he felt that a new monetary initiative was the most promising course that they could follow, and what the principal features of this system should be. The key elements, he suggested, should be a new European Monetary Fund, which would "swallow up the existing Snake" and to which each member state would contribute 15 to 20% of its reserves, and the transformation of the European Unit of Account into a parallel reserve currency for use in stabilization operations between central banks. There was also a strong hint that the Germans and the other strong currency members would be prepared to help the states with weaker currencies, though the ways in which help might be available do not appear to have been spelled out, and emphasis was also laid on the need to preserve the discipline of the Snake in any new system. Herr Schmidt is reported to have complained before the previous meeting of the European Council in Brussels in December 1977 that Council sessions were being bogged down by officialdom and papers.[39] His statement at Copenhagen reflected his conception of what the summit meetings should try to do and what not. It was a contribution to the formulation of grand strategy, not a discussion of tactics and logistics. There was quite enough however to show that the German Chancellor intended to give his full backing to the creation of a new monetary system: too much indeed for Mr Callaghan whose contributions at the session itself mirrored his surprise at the scope of Herr Schmidt's ideas and whose late-night briefing of key members of his staff, including Mr Couzens conveyed his anxiety.

From April 1978 onwards, Mr Schmidt's personal commitment to a new European Monetary System was the single most important element in the negotiations. It created a totally novel political balance as far as the monetary problem was concerned. The events that had preceded the German Chancellor's change of mind are none the less still important in any analysis of the political significance of the EMS negotiations. Mr Jenkins' campaign for a new European monetary initiati was only one and probably not by any means the most important of several influences that "converted" Herr Schmidt to the idea. The Chancellor had good reasons of his own for acting as he did. Mr Jenkin was therefore like any good politician in certain senses lucky that

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events appeared to point in the same direction as his own arguments. Viewed in another perspective, however, Mr Schmidt's decision was the clearest possiblevindication of the political strategy that Mr Jenkins had pursued since he became President of the Commission and more particularly since his meeting with his advisers at East Hendred in July 1977. In a Community of nation states, it was inevitable that the crucial decisions would be taken by the heads of national governments and more particularly by the heads of the most powerful ones. For a President of the Commission, the best hope of playing a useful and distinctive role was to be present at their table and either by anticipating or reinforcing their arguments to establish himself as a trusted and indispensable colleague. Either through good luck or good judgement or a combination of the two, Mr Jenkins' adoption of the monetary theme in 1977 secured him a place in the higher direction of the Community, which though in no way comparable to the position occupied by Herr Schmidt or M. Giscard d'Estaing, was nonetheless a major advance on anything achieved by his predecessors, including Herr Hallstein who had after all to cope with General de Gaulle from the beginning. Mr Schmidt was perhaps doing little more than observing the common courtesies to an old friend when he told Mr Jenkins on February 28th that he had come round to his point of view on the monetary question, but Mr Jenkins' role in the subsequent negotiations at the highest level was inferior only to those of Herr Schmidt himself, M. Giscard d'Estaing, and in a quite different way, Mr Callaghan. He was not only "present at the creation", but contributed significantly to the process itself.

That said, the new phase in the history of the movement towards monetary integration which began secretly with Mr Schmidt's change of mind and formally at the Copenhagen European Council meeting was dominated by the German Chancellor. Even he could not have carried the negotiations through to a successful conclusion however, had he not been able to count on the unreserved support of the French President Indeed, the essential unity of the phase between April and September 1978 is provided by their agreement, worked out at Rambouillet on April 2nd, misinterpreted and misunderstood by both critics and subordinates thereafter, but dramatically and in the eyes of some brutally confirmed at Aachen on September 14th. Their motives and the nature of their consensus must therefore be analysed before a detailed account of the negotiations.

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Mr Schmidt's motives for his change of front between February 1978 have been variously explained.[40] Common to almost every explanation, however, is his profound disillusionment with American leadership of the Western alliance. Signs of a divergence between Bonn and Washington had been evident from the beginning of President Carter's assumption of the American presidency; indeed during the election campaign itself, Mr Schmidt had come as near as any foreign leader could to indicating a preference for Mr Carter's opponent, President Ford. The grounds of this divergence were complicated and extended far beyond the monetary field. In part they reflected a straightforward failure by two men to understand or appreciate one another: in part they stemmed from a profounder conflict of interests between the two countries over, for example, the nuclear issue: in part they mirrored a significant ground-swell of opinion in many sections of German society against American leadership and culture. It was however the dollar crisis of November-December 1977 that brought matters to a head. The course of this crisis is plotted in Appendix A to this paper: the emotions that it aroused can be seen in German newspapers of the time which reflected a curious amalgam of fear for the future of the international economy and therefore of German prosperity and pride that the Germans at least knew how to run their own affairs. Mr Schmidt's contribution to the discussions at the Copenhagen summit in April 1978 showed that he was strongly affected by these developments and shared the feelings of many of his fellow-countrymen.

It would be a mistake however to see Mr Schmidt's advocacy of a European monetary system simply in terms of anti-Americanism. There was at least one other recurrent theme in his contributions to the exchanges about the European economy throughout 1978 that needs to be noted if the course of the negotiations is to be understood and that was his rejection of both the "locomotive" and "convoy" solutions to the lack of growth in the economies of Western Europe and the OECD area as a whole. In a recent interview with the Economist, Herr Schmidt spoke of "this ridiculous little locomotive theory".[41] The passage of time has permitted him to speak with contempt of an idea which in 1977 to 1978 he clearly regarded with real anxiety. Calls to the strong to reflate in the interests of all had become commonplace in exchanges about the international economy, and although by 1978, there were signs that the locomotive had given way to a convoy - a co-ordinated approach to growth in which each government made the contribution that best it could - Herr Schmidt and his colleagues still believed that the Germans would be expected to take special responsibilities and therefore rejected the strategy out of hand. Signs of their disapproval were to be found not only at successive meetings of the EEC Finance Council and related committees,[42] where despite at times a majority of eight to one against them, German representatives stood out against this type of policy co-ordination, which M. Ortoli[43] placed high on the list of priorities for his five year plan, but also, still more significantly, in Mr Schmidt's personal contribution to and comments about his discussions with Mr Callaghan in Bonn in March 1978. Mr Callaghan's views will be discussed later. Suffice it to say at present that it was, according to one well-placed observer, a "dialogue of the deaf". The monetary plan would seem therefore to have been at one and the same time a defence against calls from Mr Callaghan and anybody else for German reflation and an alternative strategy.

This second motive in Mr. Schmidt's adoption of a programme for monetary integration is in some respects even more important than the first for understanding the intra-European negotiations. It was - indeed it still is - often alleged that Herr Schmidt, the "non-economist started off on the monetary negotiations with a grand design which went far beyond the scope of the Snake and that his generous impulses were gradually undermined by a conservative coalition of domestic forces, headed by Dr. Emminger, President of the Bundesbank. A refinement of this thesis is that President Giscard accepted Herr Schmidt's plan at face value in April 1978 and that it was only because he had committed himself so irrevocably to a new monetary system that he had to "capitulate" to the German standpoint against his better judgement at the Aachen summit in September. These interpretations, though in certain respects understandable, are nonetheless based on serious misconceptions of at least three aspects of the politics of April-September 1978: the nature and extent of Herr Schmidt's differences with Dr. Emminger, the agreement reached between Herr Schmidt and M. Giscard d'Estaing and the significance of the expert discussions in which French officials seemed frequently to take sides with the British and the Italians against the German position.

The first of these points will be discussed later in the paper. The second and third, and particularly the second are however of such fundamental importance for an understanding of events in the summer of

1978 that they must be looked at now. The hard line taken at the Aachen summit in September on the more contentious issues that had arisen during the monetary discussions of the previous months took many commentators by surprise and there was a widespread feeling that M. Giscard d'Estaing had conceded a great deal of ground to the German position. A closer examination of the evidence however suggests that the conservative consensus at Aachen had in fact been foreshadowed in the talks that the two leaders had had in April. Mr. Schmidt was in other words already more orthodox than was widely believed, while M. Giscard d'Estaing for reasons of his own was much readier to accept the"hard" German line than many of his subordinates. The key to the Giscard-Schmidt agreement is probably to be found in a remark made by the French President at the Copenhagen summit. After echoing Herr Schmidt's strictures on American policy, he announced that Europe was at the crossroads and that if Britain and others were not prepared to go along with the Schmidt plan, France would rejoin the Snake and the Community would be irrevocably split. There is little evidence to suggest that M. Giscard was bluffing: on the contrary the remark is entirely in keeping with his actions throughout this second phase of the monetary story, culminating in the dénouement at Aachen. However rash many of his subordinates and domestic critics may have found his policy, he consistently put stability at the heart of his programme throughout the period under consideration. In the short term, the EMS proposal was designed to provide an international buttress to the domestic programme associated with his Prime Minister M. Barre:in a somewhat longer perspective, it formed part of a strategy the ultimate object of which was to make France the equal of Germany.

The general characteristics of M. Barre's policies are too familiar to require repetition. The Prime Minister's own role in the monetary negotiations themselves was not comparable to the President's own or M. Clappier's, but it was widely reported that M. Barre shared M. Giscard d'Estaing's view that the monetary plan would provide an invaluable support to his own domestic programme. M. Barre's importance in the history of the monetary negotiations was not however confined to a quiet supporting role in Paris. His presence in the French government seems to have been a major factor in persuading Herr Schmidt that whatever the British or the Italians might decide, the French at least could be relied upon to put stability first. As for the President, his preoccupation with monetary union was of long standing. As French Finance minister from 1962 onwards his name had already been associated with calls for monetary union in the middle 1960s.[44] When France left the Snake for the second time, he is alleged to have told some of his officials, who were dismayed at the news, that it was his firm intention to restore the French franc to the system as soon as possible. In April 1979, he had an exceptional opportunity to implement his wishes. Those who spoke to him in February, at about the time that Herr Schmidt was formulating his own priorities, reported that he was piano, unable to think of much besides the forthcoming French elections. With the elections safely behind him, however, he embarked on a few months of almost unparalleled political peace, free to support M. Barre and to indulge openly and with remarkable candour his dreams of a France that could bargain with Germany on a basis of equality. The clearest statement of his views is to be found in a television interview that he gave in the autumn.[45] Although strictly speaking it belongs to the third section of this paper, it casts such a strong light on the underlying aspirations of the President during the EMS negotiations that it is legitimate to examine it here.

The key passages in the interview dwelled on France's relations with her two larger European partners, Germany and Britain. Of Britain, the President said that when he became Finance Minister in the early 1960s he felt that one of the principal objectives of French economic policy should be to enable France to overtake Britain. By 1967 this had been achieved. There remained however the German problem.
"If we do what is necessary we can attain the same economic development and the same power as West Germany inside fifteen years ...". "What was needed" included economic policies broadly comparable to those that the Germans themselves had adopted and a link between the franc and a European "monetary structure". By these means, France could become Germany's equal and the stability of the "European Confederation" which the President apparently favoured, would be increased. "Why do I talk so much about Germany? Because it would not be a good idea for Europe to be dominated by one country. What I want France to achieve is to make sure that there are in Europe at least two countries of comparable influence ... Germany and France."

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France's hopes of prosperity and power seemed therefore to the French President to lie in collaboration with Germany even if it meant that at times France and her representatives might appear as "tools" of German policy. The EMS was presented to the world as a Franco-German plan. In fact it was a German idea which the French president accepted because he considered it to be in France's long term interests to emulate Germany. The evidence of M. Giscard's public statements was corraborated by his behaviour in and contribution to the European Council meetings at Copenhagen and Bremen , not to mention Aachen itself in September. The records of these meetings give the clearest possible indications of why the German Chancellor, unlike his compatriots in the Bundesbank or the Ministry of Finance, who dealt only with senior French officials, felt that France could be relied upon to support Germany's insistence on stability as the absolute priority of monetary and economic policy. There was simply no question of a realignment at this level, with M. Giscard joining forces with Mr. Callaghan and Sig. Andreotti against the German chancellor. There was of course an Achilles heel in this relationship, but it was not the power of Dr. Emminger in the Federal Republic, so much as the political vulnerability of the French President once the effects of his March election victories began to wear off. The fragility of his political base became apparent before the end of 1978, and deprived the final moments of the formation of the EMS o the "glory" with which the French President might otherwise have wished to invest them. But in April , euphoria was the order of the day, and with the presidential elections of 1981 the next major electoral battle involving a French institution, M. Giscard d'Estaing had a better chance than ever to set about advancing some of his more ambitious plans.

The third point referred to above is already familiar from the first section of this paper. In interpreting the events of the summer of 1978, no less than the politics and diplomacy of 1977-78, it is vital to grasp the fact that the game proceeded at two tables of which one, the higher one, was incomparably more important than the other. The contrast between the two levels will become apparent as th section proceeds . At this point it is necessary only to correct a misconception about the chronology of the technical discussions which would seem to have arisen.[46] These detailed discussions at the lower table did not, as is sometimes asserted, begin only after the

Bremen summit. On the contrary, the Finance ministers asked both the Monetary Committee and the Central Bank Governors Committee to examine options for monetary integration in May,[47] and by June, well before the Bremen summit, as a result of these studies and of the Finance Ministers' own discussions, the main technical issues had been identified and the more important cleavages of opinion brought out into the open.[48] As far as these latter are concerned, the most important feature is the clear alignment of the French with the Italians and the British on most of the points at issue. The discrepancy between what French officials and ministers were saying at one level and what the French President and M. Clappier were saying at another was to be a constant source of misunderstanding for much of the second phase. It seems not unlikely that it was one of the factors contributing to the miscalculations made by Mr. Couzens, the British negotiator, who for a brief time at any rate operated at both levels.

The central focus of any account of the origins of the EMS in this period must however rest on developments at heads of government level. The major set pieces were the summit meetings of the nine at Copenhagen in April and at Bremen in July and of the French and German leaders at Aachen in September. These public events were however linked by a series of more informal and on occasion secret meetings between the heads of government themselves or between their aides. Examples of the lesser summits in the period before September include the meetings between Herr Schmidt and Sig. Andreotti on June 17th, between Mr. Jenkins and the French president on June 22nd and between Herr Schmidt and M. Giscard d'Estaing on June 23rd. Their closest advisers were also active for much of the time on secret or semisecret exchanges. The best known example of these top level negotiations between officials specially selected by the heads of government is of course the meetings of the three wise men, Dr. Schulmann, M. Clappier and Mr. Couzens. There are however other instances too. M. Clappier for example was sent on a mission around several European capitals at the end of June in order to prepare the ground for the Bremen summit, while Mr. Jenkins was kept informed of developments in the Couzens-Clappier-Schulmann talks partly at least through the contact between his own chef de cabinet and Dr.Schulmann in Bonn.

Between the Copenhagen and Bremen European Council meetings, the principal theme of these high level discussions was the growing divergence between the German and the French heads of government on the one hand and the British Prime Minister on the other. Mr. Callaghan's discomfort at the Copenhagen summit has already been commented on: in the weeks that followed the gap separating him from his colleagues widened still further. The most dramatic sign of this process was the breakdown of the negotiations between Dr. Schulmann, Economic Adviser in the Bundeskanzleramt, M. Clappier, Governor of the Bank of France and Mr. Couzens, Second Permanent Secretary in the British Treasury. Their talks, which seem to have started at the beginning of May, were kept secret at the time and their course is still obscure. What is quite obvious however is that the effort to formulate a tripartite position had failed by the middle of June if not earlier and that the manner in which it failed left and still leaves traces of bitterness on both sides. Mr. Couzens played no part in the final preparations of the Bremen paper and although one or two phrases from his original draft may have survived in the document, the latter was to all intents and purposes a Franco-German proposal.

The origins of this breakdown, which was to cast its shadow over relations between Britain and her two major European partners throughout the remainder of the EMS negotiations, were needless to say extremely complex. It stemmed partly from a conflict of interest between the United Kingdom and her partners and partly from a different assessment of the economic and financial policies appropriate to the time. These difficulties might in the end have proved insuperable in their own right, but the situation was made much more complicated by political miscalculations and fumbling in London. In discussing the differences that arose over interest and policy, it is important to cut through much of the rhetoric which very quickly clouded the issues on both sides of the Channel. It would for example be quite mistaken to assume, as was often done at the time, that the differences which arose between the British and the Germans were simply another chapter in the long history of Anglo-German disagreement about whether full employment or stability should have priority in economic and financial policies.

It is true that some of the more sensational predictions of the ill effects that membership of the new system would have on the British economy placed great stress on the rise in unemployment that would almost certainly result.[49] It is also true that in successive meetings of the Finance ministers throughout the first half of 1979, Mr. Healey, the British Chancellor of the Exchequer was the most conspicuous advocate of a coordinated commitment to growth policies, and that he undoubtedly irritated his German colleagues because of the position that he took. But though the most prominent, Mr. Healey was by no means the only advocate of reflation. At the level of the Finance Council at least, it was the Germans and not Mr Healey who found themselves in the minority of 8 to 1, or 9 to 1 if one reckons M. Ortoli's vote as Commissioner as an independent one.[50] Mr. Healey and his senior colleagues in the Labour government had in fact moved a long way since 1974 and although they were understandably anxious about the possible consequences of non-growth their anti-inflationary policies were at least as fierce and in many ways more effective than those which were currently being implemented by M. Barre in France.[51] It is in fact arguable that in 1978, hardly less than now, one of the more important underlying objections to linking the pound to the new system amongst British monetary experts was precisely that it would put their hard won control over monetary policy in jeopardy. As Paul Fabbra of Le Monde noted, the achievements of the British authorities in reestablishing control over money supply had been one of the more conspicuous success stories of recent months.[52]

In the conversations between Mr. Couzens and his two partners however monetarist arguments seem to have been less important than four other points:[53]

1. The proper way to set about devising a solution to the crisis in the international system was through the IMF and in cooperation with the United States.
2. Whatever regional arrangements were made in Europe, they must represent a substantial advance on the Snake.
3. In particular, there would have to be a symmetry of obligations, with an onus on the strong as well as the weak to take corrective measures if their currencies deviated from the norm.
4. Steps must be taken through and in conjunction with the monetary changes to facilitate a transfer of resources from the richer countries to the poorer in the Community.

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British insistence on the first of these points was somewhat weakened when, as a result of the Franco-German démarche, the American administration indicated its approval of the scheme in principle:[54] it could not however totally eliminate the preoccupations that underpinned it. The pattern of British overseas trade was still significantl different from that of all her Community partners and her vulnerability to movements in the dollar was considerably greater. The second, third and fourth points were however in this context even more important and on the second in particular, there was a straightforward disagreement.To Dr.Schulmann and M. Clappier the Snake was the starting point: to Mr.Couzens it seemed an irrelevant and dangerous obstacle to any serious reconstruction of the European Monetary System.

The conflict over interest and policy which emerged in the course of their talks, was a major factor in the breakdown of the Couzens-Schulmann-Clappier conversations. The situation was however made much worse by political miscalculations on the part of Mr. Couzens himself and still more of his Prime Minister. Neither he nor Mr. Callaghan would in fact appear to have understood the strength and significance of Herr Schmidt's political commitment to developing a new system. Not for the first time in recent British history the Treasury's entirely legitimate preoccupation with ensuring that a system would work prevented its officials from seeing the larger political implications of their concern for detail.

Mr. Couzens' frustration and anger at the way in which matters had turned out and his underlying approach to the negotiations were revealed in the most striking manner in a briefing which he gave to journalists immediately after the Bremen summit. A Times correspondent reported it as follows:[55] "while still accepting the goal of greater monetary stability, the Treasury remains sceptical to the point of contempt of most of the detailed content of the Franco-German scheme for currencies presented at the Bremen summit...(it) fails to answer most of the important questions which have to be answered (and) if anything workable is to be achieved... there will have to be major changes and considerable clarification". Mr Couzens himself later regretted the tone of his outburst and referred to it rather charmingly as the outpouring of "a suspicious and elderly Treasury mind".[56]

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It is also true that later in the summer and autumn, despite the reservations they felt, both he and his colleague, Mr. Jordan-Moss, played a conspiculously constructive role in the technical discussions that preceded the setting up of the system, so much so that the French went out of their way on several occasions to draw attention to the fact.[57] Mr. Couzens was not therefore in any way like his Treasury predecessor, Mr. Waley, whose scepticism "to the point of contempt" about French proposals for Anglo-French monetary union in 1939-40 provoked Keynes to complain to Churchill.[58] Nor, however, was he a Keynes and although it is in many ways unfair, it is nevertheless instructive to compare his behavior with that of Keynes in the still more famous negotiations that preceded the setting up of the Bretton Woods System.[59] Like Mr. Couzens, Keynes was negotiating from a position of weakness. It is also obvious that Keynes frequently felt about the Americans as Mr. Couzens felt about the German government when he referred in his briefing to his "considerable resentment at what is seen as the success of the German government in presenting its national interest as being a move for the greater good of Europe". The essential difference between Keynes and Mr. Couzens however was that Keynes , though able to argue better than anybody at the lower table, understood both the balance of power and the perspectives of the top table. The principal problem about Mr. Couzens during these negotiations was in fact that he was no more and no less than an extremely competent Treasury official.

The ultimate blame for the political breakdown in which Mr. Couzens was involved, lies not therefore with him but with his Prime Minister who after all had experience of affairs at the top table but who nonetheless misread the signs from both Paris and Bonn. For everything there is a season, but the season between April and July 1978 was not for a Treasury official however capable he might be. (Nor for that matter, as Herr Schmidt recognized, was it a season for the President of the Bundesbank .) Quite why Mr. Callaghan selected Mr. Couzens as his wise man is still not clear. There is strong evidence to suggest that the German Chancellor himself hoped that his British colleague would nominate Harold Lever, who was a personal friend, a member of Mr. Callaghan's cabinet and also its chief link with the City. Later in the year Herr Schmidt

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actually sent Dr. Schulmann to London on a special mission to Mr. Lever and much to the annoyance of both Mr. Healey and his Treasury officials, the German visitor did not call on the Treasury. Speculation about who would have been a more suitable personal representative however is of less interest than the light which the mistake itself throws on Mr. Callaghan's outlook during this phase. It is one of several indications that throughout the early and as it proved decisive exchanges about European Monetary System, the British Prime Minister could not decide where his government's interests lay. One British official who was much involved throughout the negotiations and who had also worked with Mr. Callaghan in earlier international talks, commented that during this episode, as distinct from others, the more important civil servants involved were never once called round to Number 10 Downing Street for a general discussion of strategy. Like Mr. Healey, whose moods swung from enthusiasm to hostility and back again with bewildering speed and remarkable frequency, the Prime Minister seemed to several close observers to be incapable of formulating a consistent policy. He clearly saw the potential dangers of isolation at the European top table and, as will be noted in the next section, he took active steps at the very end of the negotiations to salvage what he could of his position there, but in the spring, summer and autumn he seemed more strongly influenced by other considerations and priorities. One factor was his deeply felt Atlanticism, which made him mistrust what he saw as a threat to the dollar and another a long standing preference for a global approach to the international currency crisis through the IMF. Rightly or wrongly Mr Callaghan regarded himself as the creator of the SDRs and his experience as Chancellor of the Exchequer during the 1960s profoundly affected his thinking on monetary problems. More important still however was the fact that unlike the French President, he was not politically free. His elections were imminent, (they were widely expected to take place in the autumn of 1978) and he, no more than M. Giscard d'Estaing in the winter of 1977-78, could not risk a major split amongst his supporters over Europe.

With the disappearance of Mr Couzens from the tripartite talks, it was left to M. Clappier and Dr. Schulmann to draft what became in due course, with very few modifications, the Bremen plan. It was still stronger on strategy than on tactics or logistics, but it nevertheless represented a considerable advance on Herr Schmidt's in-

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formal speech at Copenhagen and gave as clear an indication as could have been expected that the EMS, for all its novel trappings, was to take the Snake as its point of departure. This question was dealt with in the first of the five points later published as the "Bremen Annex".[60] The new system, the document claimed, would be at least as strict as the Snake. To overcome the obvious problems that this discipline might entail for certain countries, wider fluctuation limits might be arranged for a transitional period, but the majority of members would be subject to constraints as strong if not stronger than those which operated in the Snake. The explicitness of this first point in the Schulmann-Clappier document is and was easily forgotten. It is however only against this background that the subsequent and more novel proposals in the Bremen programme can be properly appreciated: the transformation of the EUA into an ECU, the pooling of reserves, the coordination of policies in relation to non-EMS currencies and the proposal to establish an EMF no later than two years after the inauguration of the system.

The Schulmann-Clappier paper was ready not later than June 23rd, when the French President and the German Chancellor met in Hamburg.[61] Even before that meeting, however, both the French and the Germans had begun an intensive round of diplomatic consultations, aimed not simply at explaining the proposal, but more basically still at allaying some of the disquiet that had obviously been aroused in other Community capitals, first by the disclosure that unknown to all but the three governments concerned, three officials had been meeting in secret, and secondly by the debacle of the Couzens affair. Thus a week before M. Giscard d'Estaing went to Hamburg, the German Chancellor received Signor Andreotti.[62] On June 22nd the French President consulted in Paris with Mr Jenkins.[63] After the Hamburg meeting, the consultations continued. M. Clappier was sent on a tour of European capitals, beginning in Rome,[64] while on July 3rd, Mr Jenkins saw Mr Callaghan in London. The number of people who were brought in to the secret remained even so remarkably small and there were complaints at the Foreign Ministers meeting on the 28th of June by several senior officials that they had no inkling of what was to be proposed at Bremen.[65] But at the

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very top at least, all those who were to attend the Bremen meeting had been briefed before it took place on July 6th and 7th.

For the majority of the heads of government who assembled for the meeting of the European Council whatever reservations they may have had were concerned more with style than with substance. Their currencies belonged to the Snake and they remained committed to the idea of an area of currency stability. Once their pride had been satisfied therefore the prime ministers of the smaller countries seem to have had no difficulty about endorsing the Bremen document. The positions of Sig. Andreotti, Mr Lynch, the Irish prime Minister, and Mr Callaghan were however different. At Copenhagen, the Italian Prime Minister had apparently said virtually nothing, perhaps because he was the only person present at the party who spoke no English. Subsequently, when the existence of the Schulmann-Clappier-Couzens working party became known, there was considerable resentment in sectior of Italian public opinion that the Italians had been excluded. The Corriere della Sera headlined its report of June 7th on the activities of this group: "Tre saggi (Italia esclusa) studiano il futuro assetto delle monete CEE". There is reason to believe that the Italian government shared these feelings. As almost throughout the history of these negotiations however Sig. Andreotti and his closest advisers, particularly the diplomatic advisers in the Prime Minister's office, remained convinced that the most fruitful policy would be to give maximum proof of their government's good will towards any proposal for further steps towards European integration, whatever reservations they might have about the manner in which the plan had been prepared and its substance. This point was underlined in the briefings that preceded and followed the Prime Minister's visit to Hamburg on June 17th, since although it was in one respect a routine meeting in the 6-monthly schedule that had now become an established feature of the bilateral relationship between the two countries, the political situation in Italy, where President Leone had just resigned, was far from being routine. Sig. Andreotti's decision to leave Rome nonetheless was therefore represented as a sign of the importance that he attached to good relations with Germany in particular and the rest of the Community in general.[66] The fears felt by almost all Italian economic experts about

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yet another attempt at joining a Snake-like system, after the disastrous and very costly experience earlier in the decade, could not however be concealed and Sig. Pandolfi, Sig. Baffi and their advisers had already begun well before the Bremen meeting to canvass various looser arrangements for the lira.[67] Some at least of these special options would seem to have been discussed at the meeting of Sig. Andreotti, Sig. Pandolfi and Sig. Baffi with M. Clappier on June 30th in Rome.[68] There was therefore evidence of profound misgivings in Rome about any new monetary system, but the overwhelming impression that emerges from the discussions within Italy and between Italian representatives and their Community partners during the pre-Bremen weeks is that although they recognized the dangers, they were still convinced of the profound political advantages that might accrue to Italy if she joined and the even greater dangers that might result if she did not. Monetary integration might from an expert's point of view seem impossible, but to the politically minded it was necessary.[69] When Sig. Andreotti spoke at Bremen therefore he made no secret of the problems that might face Italy if she were to adhere to these new arrangements, but his attitude was basically constructive and positive. So too was that of Mr Lynch the Irish Prime Minister. The difficulties that would confront his government if the British decided to stay out of the new system while they themselves opted to join could not of course be dismissed lightly, but Mr Lynch added some cheerful flourishes to the final version of the Bremen document at a late night drafting committee and it is no coincidence that shortly after the meeting, both the Irish and British press began to speculate about the possibility of a break between the two currencies.[70] All of which left Mr Callaghan very much alone. He secured a promise that "concurrent" studies of the transfer of resources problem would be initiated but the indecision that had characterized his handling of the monetary issue since Copenhagen was still very much in evidence and unlike Sig. Andreotti whose fears must have been in some respects even greater, he found himself politically isolated.[71]

The Bremen summit was represented by many observers at the time as a turning point in the negotiations and even in some cases as the beginning of them. In retrospect however it seems no more than

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a particularly important moment in a phase which stretched from the beginning of 1978 to the Aachen meeting between President Giscard d'Estaing and Chancellor Schmidt in September. The principal themes of this phase, the development of a joint German-French position on monetary integration and the determination of Herr Schmidt and M. Giscard d'Estaing to proceed in their way regardless of the objections of the British, the experts or indeed anybody else, had already been announced well before Bremen. What the Bremen meeting did was to make public what had hitherto remained largely secret and to bring some order into a political situation which was in some respects rather ragged. The experts were now given a firm time-table to which to work and the British a sharp reminder of their isolation at the top table, but there was nothing particularly new about either of these developments. The experts had begun to work on the various options six weeks before the meeting of the European Council, and had already sketched out the more important possibilities, including incidentally what later became known as the "Belgian compromise", which was mentioned in at least one newspaper as early as June 8th.[72] As far as the British were concerned, though still more often than not amongst the majority at lower levels of the European decision-makin machinery, their isolation at the very top had already been evident at Copenhagen and had been underlined by the Couzens episode.

Events between the Bremen European Council meeting and the Aachen summit confirm this impression of continuity. The Finance Council met at Brussels at July 24th, amidst loud trumpetings in several quarters - by no means all British - that now at last the experts, who according to one report, "had become acutely aware of the ambiguity and vagueness of the Bremen document in key parts" could turn what was still only an aspiration into a plan.[73] The ministers themselves remitted the task to their advisers and throughout the latter part of July and the whole of August, officials on the Monetary Committ and the Central Banks Governors Committee worked at preparing detailed recommendations for their political masters. The pre-Brussels options reappeared and were disputed, refined and codified in reports

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one of which at least was alleged to have run to 70 pages.[74] Even the alignments amongst the officials followed pre-Bremen patterns, though according to some reports French officials who had openly admitted their misgivings about the Schmidt-Giscard proposals - or what was known about them - before Bremen, tended in this new round of official talks to hide behind the Bremen text as if it was some tablet of stone handed down from above. Outside the formal meetings however where there were no minutes taken they were apparently as forthcoming as ever. Officials from the other "sceptical countries" were less inhibited, but also - a point repeatedly stressed by those who were present, whatever their position on the main issue - extremely constructive. The contributions of Rainer Masera of the Banca d'Italia, of Mr MacMahon of the Bank of England, of Mr Jordan-Moss of the British Treasury and of course of M. van Ypersele of Belgium are frequently singled out for praise. In the final analysis however there is something rather melancholy about all this industry by officials, some of whom missed their summer holidays as a result. They failed to reach any agreed position and they failed still more significantly to exercise any serious influence on the calculations of their masters. When the Central Bank Governors met on September 12th at Basel, M. Clappier was allegedly even more inscrutable than usual. He had good reason to be: a document which he, Dr. Schulmann, and two other colleagues were to draft in a couple of hours at Aachen two days later while their leaders listened to gramophone records and talked about European history was to have more influence on the development of the system than the 60 or 70-page papers assembled by conscientious officials during weeks of hard work.

Probably the most significant developments between the Bremen and Aachen meetings in fact were not international at all, but occurred within Germany, where the Schmidt-Giscard initiative caused a flurry of public and private debate. The central figure in the controversy, other than Herr Schmidt himself, was Dr. Emminger president of the Bundesbank, and his interventions at both Bonn and

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Brussels in July seemed to many at the time, and still more since, to lead to a hardening of the German position which totally altered the character and scope of the proposals. This question is clearly of considerable importance for the interpretation of the monetary negotiations as a whole, but in discussing it it is necessary to distinguish between two aspects of the problem: the nature and origins of the internal German criticisms of Herr Schmidt and the effect that they had on the development of the German negotiating position.

Dr. Emminger himself was it need hardly be said a model of discretion throughout the debate and an interview that he gave to Die Zeit on July 28th was a masterly exercise in loyal scepticism.[75] But from what was said by his less inhibited colleagues or pieced together by observers of the Cabinet or other meetings at which he expressed his doubts more openly there would seem to have been two different sources of trouble: the first was fundamental doubt about the utility of any new move towards monetary integration in the prevailing economic circumstances, and the second an understandable disquiet at the manner in which the idea had been conceived and pushed forward.

There was nothing particularly novel or surprising about the doubts expressed by leaders of the German financial community over the whole notion of a new move towards monetary union. As Dr. Kloten observed in a paper written for a conference in Bologna last year, it was Herr Schmidt's attitude that came "as a surprise" and which seemed to "signal a turn-around in German monetary thinking".[76] The orthodox position with which Herr Schmidt appeared to have broken was advanced by so many German leaders in late June and July - and afterwards - that it is difficult to decide whose views to choose by way of illustration. Two contributions to the debate do however seem particularly noteworthy: the first by Dr. Pöhl, Dr. Emminger's deputy, who was widely believed to stand nearer to the government than his president, and the second by Dr. Klasen, Dr. Emminger's immediate predecessor. In an article published in the Sparkassenszeitung during

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the last week of June, Dr. Pöhl issued a highly orthodox warning against any new initiative on the monetary front.[77] Only when the Member states had arrived at a far more fundamental consensus about economic policy in general could there be any progress towards monetary union. He welcomed the anti-inflationary policies of some of Germany's European partners, but, he implied, it was too early to say whether these would be successful and until the position had become clearer there could be no serious talk of new monetary arrangements. In the meantime, the Snake had given ample proof of its utility and it was to be hoped that other countries would in due course be able to accept the strong rules that operated within it. Given the differences in inflation rates that still persisted however, it was for the time being scarcely conceivable that any of the non-members could accept these disciplines. Dr. Klasen's statement, an interview published in Die Zeit of July 14th and entitled, "Es geht um unser Geld" was even more forthright and fundamental. Whatever the French President might have told the Federal Chancellor, Dr. Klasen averred, assurances from this quarter were simply not an adequate basis on which to build a new monetary system. Once the fund is established, Dr. Klasen argued, we shall not be dealing with M. Giscard d'Estaing but with the French bureaucracy and in coping with them no amount of pro-European sentiments would be sufficient. They were the inheritors of a tradition that went back centuries and they were vastly superior to the Germans in the "diplomatic defence of national interest".

What these and other public criticisms suggests is that the German financial establishment was unhappy about any move beyond the Snake. Dr. Emminger himself, it is true, never seems to have adopted such a radical position in public, preferring to single out particular problems, such as the impossibility under German law of the pooling of reserves, but it was generally believed at the time by both journalists and foreign bankers who had dealings with the Bundesbank that the latter with a few exceptions did not want any new link with the French franc, let alone with the pound or the lira. Despite Dr. Emminger's discretion, it is difficult to believe that he was any more enthusiastic about the Schmidt proposals than either his deputy, his predecessor or his subordinates, not to mention almost all

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other leading figures in the German financial community.

Dr. Emminger's difficulties with Herr Schmidt's proposals did not however stem merely from a fundamental difference over policy: they were also the result of disquiet at the way in which the proposals had been conceived and prepared. It is alleged that the president of the Bundesbank was briefed by Dr. Schulmann shortly after the Copenhagen Council, but even if this is true, it seems quite obvious that he had very little influence on the negotiations that took place between Copenhagen and Bremen. Perhaps not surprisingly therefore he tended to underscore the significance of these latter. The main message that emerges from his interview with Die Zeit on July 28th was that the experts would now be able to give what was by implication still an extremely vague proposal substance and plausibility. In the weeks that followed Bremen, Herr Schmidt appears to have gone out of his way to listen to the views of Dr. Emminger and his colleagues about the monetary plan. Dr. Emminger attended a cabinet meeting on July 12th where he gave a detailed exposition of his reservations.[78] Two weeks later he was a member of the German delegation at the monthly meeting of the European Finance Council in Brussels.[79] Six weeks later, on September 14th, his deputy Dr. Pöhl joined Dr. Schulmann in the late-night session which produced a more precise formulation of the Franco-German position at Aachen.[80] Finally towards the end of the negotiations, shortly before the December meeting of the European Council, Herr Schmidt made a gesture which was unprecedented in the history of the Bundesrepublik by going to Frankfurt to take part in a meeting of the Bundesbank board, after which it was announced that he and the directors of the Bundesbank were in full agreement about the proposed system.[81]

All this suggests that the Bundesbank took their initial exclusion from the planning of the monetary system very seriously and that in his turn Herr Schmidt acted extremely energetically to soothe their feelings. It does not necessarily mean however that the Bundesbank or the German economic establishment in general, having been kept out of the secret for several months suddenly moved in and dominated proceedings. On the contrary, all the evidence suggests

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that the real novelty of the EMS negotiations in terms of German domestic politics was not Herr Schmidt's journey to Frankfurt, but his early exclusion and continuing independence of the president of the Bundesbank. The Frankfurt meeting was not a new Canossa, but a final and dramatic stage in a sustained campaign by the German Chancellor to convince sceptical experts in the Bundesbank and beyond of the virtues of a scheme which he had launched and which he was determined to proceed with whatever they might feel. The criticisms of the Bundesbank which were widely reported at the time may have influenced some details in the final plan - the constitutional obstacles to the pooling of reserves are an obvious example - and they certainly strengthened Herr Schmidt's negotiating position on the international stage. But if the Chancellor had listened to the Bundesbank and other voices in Bonn and Frankfurt, there would have been no EMS at all, and nothing in his behaviour after July suggests that he shifted from his initial feeling that this was an area and an issue in which the broader political view was more important than expert opinion.

The Franco-German summit meeting at Aachen on September 14th confirms the impression that despite the increased activities of the Bundesbank in the negotiations, it was still Herr Schmidt who determined at which speed the plan proceeded, and provides a fitting conclusion to this second phase as a whole.[82] The summit took place against the background of the discussions amongst experts that had been in progress since the latter half of July. The general impression left by these talks was that the gulf between adherents of the parity/grid system already familiar in the Snake, and those who favoured rules for intervention formulated in terms of a basket of currencies could not be bridged and that the French were to be numbered with the British and the Italians amongst this latter group, while the Germans were the leaders of the former. The issues were extremely serious and the divisions of opinion profound. Despite this, the French President and the German Chancellor managed to sweep aside the obstacles that appeared so important to lesser men and with the help of M. Clappier and his deputy and Dr. Schulmann and Dr. Pöhl, to produce a brief document setting out a joint Franco-German approach to the problems in dispute. The paper containing the Aachen accord was never communic-

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ated to either the Finance Council, which met shortly afterwards, or the European Council, but according to the German government spokesman, Herr Grunwald,[83] the two governments had reached agreement on the monetary unit, which as his French counterpart explained,[84] was to be a real money capable of being used in payments, the rules governing intervention and the nature and size of the Fund. The second point of agreement was the one that was most widely commented on at the time, because it seemed to most observers that on the vexed issue of intervention rules, the French President had abandoned any claim to symmetrical obligations and had accepted the German philosophy, which according to the British and the Italians at any rate, placed more onus on the weak than on the strong to intervene. A British newspaper expressed a widely held view when it stated:[85] "The French, in a remarkable about-turn, have fallen in with the West German view that the new system should be modelled on the existing Snake". But was it really a turn-about? The evidence available of what was said at Copenhagen, the dispute between M. Clappier and Dr. Schulmann on the one side and Mr Couzens on the other, and the Bremen document itself all suggest that whatever French experts might have thought or wanted, the President himself never really doubted that the Snake should provide the starting point for the new system. Neither he nor the German Chancellor needed the advice of the bankers therefore on this point. And on the other points apparently covered by the Aachen paper, the ECU and the EMF, as later on the so-called Belgian compromise, they simply ignored the cries of those in Germany and elsewhere that they were going too far and too fast. In September as earlier in other words the initiative lay as it had done from the beginning of the affair, with the heads of government rather than with the officials in the central banks or finance and economic departments. The debate about the technical problems associated with establishing a monetary system was to continue for several months, and there was on occasions to be renewed speculation about Franco-German discord, but with the Aachen summit the terms and implications of Franco-German agreement were spelled out and despite appearances to the contrary from then until the European Council

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meeting in December, the real issues at stake were not so much whether the French and Germans might still disagree, as whether the other European states would accept what was now more obviously than ever their common approach.

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The extent to which the Aachen summit settled not only Franco-German differences, but the Community discussion of the principal technical problems as a whole is indicated by the events that followed. Although no joint document was produced, the French and German delegations preserved a united front at the Finance Council on September 18th, and much to the annoyance of Mr Healey managed to rally all the other national delegations, including the Italians and the Irish, to their standpoint.[86] Divisions reappeared amongst the experts in the weeks that followed and at the next Finance Council on October 16th, Mr Healey, in a speech which one very senior and seasoned observer described as the most impressive rhetorical performance that he had witnessed at a European Council of Ministers, made a devastating attack on the Franco-German accord which helped significantly to widen the gap between the Germans and several of their partners. For a short while indeed, it seemed as though there would be a three-way split on the monetary issue, with the British, the Italians and the Irish in one group, the French and the Belgians whose currency came under considerable pressure during October, in another and the Germans, supported by the other members of the Snake, in the third. Once again, however, divergences at the technical or departmental level proved to be of relatively little significance. Arguably the only practical consequence of Mr Healey's rhetorical triumph was that neither he nor Mr Callaghan found their German hosts particularly warm or forthcoming when they visited Bonn for a bilateral meeting a few days later.

The only significant modification made to the position agreed by the French and Germans at Aachen - and even this may not have been a modification - was the acceptance by the German govern-

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ment of the Belgian compromise, so called because of the nationality of its author, M. van Ypersellе. The essence of this compromise was that alongside the parity/grid arrangement which was used in the Snake, a new indicator should be introduced based on the ECU basket. It would not have the same binding force as the parity/grid, but a country whose currency crossed a "threshold of divergence" measured against the ECU would nonetheless be expected to take adequate measures to correct the position. The nature and extent of the obligation to take corrective action were left rather vague, but the proposal was even so an innovation of considerable potential importance.[87] The acceptance by the Germans of this use of the basket, albeit in a limited role, came as a surprise, since it ran counter to the official advice being given to the Chancellor by the Bundesbank and government departments concerned with finance and economics. Quite why it was accepted is still not clear, but it cannot be excluded that this proposal, which had been floating around since June if not earlier, was already considered in the Aachen agreement. Even if this is not the case however, it is difficult not to see the German change of mind on this issue as yet another example of the triumph of politics over economics in the Bonn government.

The Belgian compromise apart, the chief focal points of interest during the third phase stretching from the Aachen summit until the Brussels meeting of the European Council at the beginning of December, are the reactions of the British, the Irish and the Italians to the Franco-German proposals and, right at the end, the uncertainties introduced into the political and diplomatic situation by the French President's increasing problems in Paris. About the Irish, it is alas impossible to say very much in this paper. Space will not allow. This is particularly sad, because as one might expect the story is not without an above average share of improbability. As at the Edinburgh Festival indeed, so in the history of the EMS, much of the best entertainment is to be found on the fringe or beyond it. Not the least of the delights is the sight of British speculators marching their pounds westward in the hope of a quick killing against sterling only to find that contrary to their expectations when the

the system came into operation it was the punt that went down and the pound that went up. The Irish for their part turned this latest example of the Englishman's incapacity to understand them to quick advantage; amongst the main beneficiaries it would seem were young married couples who found the Building Societies, temporarily flush with English investments, unusually generous towards prospective house purchasers. This episode as a whole needs its historian, but within the confines of a paper such as this, the task cannot be carried out here.[88]

Even the discussion of the debate in Britain and Italy must be truncated, partly because the paper is already overlong, but even more because to give an adequate account of the behaviour of the two governments between September and December 1978, one would have to delve deep in to the domestic politics of each country. The EMS issue complicated and was complicated by political conflicts which in origin had little or nothing to do with it in both countries.

As far as the British are concerned, the early ambivalence of Mr Callaghan and Mr Healey continued to be the chief characteristic of the handling of the issue at the very highest levels in the British government from the Bremen summit until the first week in October. Mr Healey in particular veered from affirmative to negative positions with remarkable speed. Immediately after the Bremen meeting and the bitter Treasury briefing given by Mr Couzens, the Chancellor of the Exchequer went out of his way to counteract the view that the British had already made up their minds to stay out of the system.[89] So successful were he and his officials in conveying their desire to be constructive that by the beginning of September, even Le Monde, whose Brussels correspondent had taken particular delight in emphasising British isolation at Bremen, reported that British participation now seemed quite probable.[90] A few days later however after the Aachen meeting, Mr Healey's mood had changed once again to outright hostility and the Financial Times in particular felt obliged to take him to task for remarks that he made during the IMF meeting in Washington.[91] A few days later at the beginning of

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October, his position had changed yet again. Mr Callaghan meanwhile had remained more silent than his Chancellor, but by the beginning of October he too was believed to be in favour of British entry and on October 5th Samuel Brittan writing in the Financial Times, was ready to wager odds of 2 or 3 to 1 that the United Kingdom would join.[92]

As events only a few days later were to prove however, the personal feelings of Mr Callaghan and Mr Healey were no longer as important as they had once been. The issue of British membership had become by the beginning of October as it had not been earlier a subject of widespread public discussion. This was in itself only natural and necessary. What made the situation much more difficult however was that this public debate took place in a political climate which had been transformed by the decision of Mr Callaghan in the middle of September not to hold an election in the immediate future. By taking this decision, Mr Callaghan became the prisoner rather than the master of domestic political forces. With an election near, but still in the future, every problem including the EMS had to be considered in terms of electoral profit or loss. Party unity, or at the very least the semblance of it, became for him as it had been earlier for Mr Wilson the overriding priority. It is not perhaps surprising therefore that according to Mr Peter Jenkins of the Guardian, who was usually the best informed political correspondent about opinion within the Labour party and government, Mr Callaghan and Mr Healey decided during the weekend of October 8th, following the Labour Party conference, which had voted against the EMS, that there was no way in which they could obtain sufficient party support for British membership and that they were not prepared to risk the serious splits that were bound to emerge if they tried.[93]

The political situation inside the Labour Party was almost certainly the most important single factor determining the position taken by the British government in the last phase of the negotiations about the EMS. It must however be said that even if the election had

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not been postponed, any British government would have found it difficult to overcome the widespread scepticism felt towards the scheme. Participation in a system of the kind defined at Aachen, was opposed by a wide range of influential figures, the great majority of whom could not by any stretch of the imagination be identified with the anti-European Labour Left. In the Cabinet itself, for example, the divisions that appeared cannot simply be explained in terms of pro-Europeans versus anti-Europeans. Those who spoke most strongly in favour of entry, Mr Lever, Mrs Shirley Williams and Mr William Rodgers were, it is true, "good Europeans". But so too were several who argued against the scheme, including notably Mr Edmund Dell, Secretary of State at the department of Trade. Mr Dell, who was shortly afterwards to be nominated by the European Council as one of a new group of wise men to prepare proposals for the improvement of the institutional structure of the Community, was a convinced "European". He nevertheless opposed British entry into the monetary system because, given the pattern of British overseas trade, which was still much less orientated towards the Community than that of every other member, and the undoubted fillip which the fall of sterling in 1976 had given to British competitiveness, he could not accept that it was in the national interest to tie the pound to a system dominated by the German mark.[94] His misgivings were shared by many others, both within the government (politicians and civil servants) and outside, who in every other respect could be counted amongst the supporters of the European ideal.[95] Not all these others of course used identical arguments. Mr Biffen, a leading Conservative Party expert on financial affairs, for example, opposed British participation in the system on monetarist grounds,[96] and the Conservative leadership generally, though careful to take advantage of the irresponsibility which any Opposition can enjoy, was scarcely enthusiastic.[97]

There were of course influential voices in favour of the system. The governor of the Bank of England and his most senior advisers were widely reported to be more positively disposed than their colleagues in the Treasury. Elsewhere in the City, three of the four chairmen of the Clearing Banks, including Sir Jeremy Morse, whose career in the IMF and elsewhere gave him peculiar authority in these matters, came out publicly in favour of British entry.[98] So too did the Financial Times,[99] and more raucously and emotionally, the Economist.[100] (The latter, as so often in recent

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years, tended to spoil a good case by a sycophantic attitude towards the French President and the German Chancellor, which was neither dignified nor justified.) Within the government too there were powerful groups and individuals who favoured a positive response on the British side. Mention had already been made of the attitude of Mr Lever, Mrs Williams and Mr Rodgers at Cabinet level. Amongst the Departments, the Foreign Office, though never totally united on the question, emphasised as might have been expected the dangers of Britain's political isolation if all the other members of the Community joined the system and the United Kingdom alone stayed out.

As the European Council approached, the political argument which emphasised the dangers of isolation became more and more prominent and exercised a direct influence on the formulation of British policy during the latter half of October, the whole of November and the first few days of December. Given the balance of forces inside the Labour Party, it is almost certainly true that neither Mr Callaghan nor Mr Healey seriously contemplated rescinding the decision that they had taken about October 8th after the Labour Party conference not to link sterling with the new system. But within the parameters set by this decision, the Prime Minister and an increasingly large group of ministers and officials began to work for a "half-way house" solution, which would as far as possible mitigate the political dangers.[101] The proposal eventually arrived at seems to have emerged from discussions involving the Cabinet, the key Cabinet committee concerned with the EMS and presided over by the Prime Minister himself, the Treasury, the Bank of England and the Foreign Office. Outside the government, a series of articles in the Guardian by Mr Peter Jenkins also played an important part in strengthening the political will of the Cabinet.[102] The nature of the proposal - sterling to be reckoned in the ECU but not subject to the constraints of the EMS and the British to be party to all discussions about the future development of the system - was on the surface at least not exactly designed to secure the approval of either the French or the Germans. The Brussels correspondent of Le Monde, whose outstanding feature as a commentator on European affairs is that he makes no attempt to conceal his prejudices, was on this occasion probably not alone in concluding that the British were trying to enjoy the benefits of membership without accepting its responsibilities.[103] As far as the German and

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French governments are concerned, it seems likely that the special arrangement that Herr Schmidt and President Giscard would have preferred was along the lines of the package that they subsequently negotiated with the Italians, the key feature of which was a wider band within which the lira would be permitted to fluctuate. The British authorities however made it quite clear that this particular option held few attractions and they therefore pressed for the other and in certain senses more privileged arrangement described above.

Much to the surprise of at least some commentators, Mr Callaghan secured what he wanted at the European Council at Brussels in December[104]. Quite how and why he achieved this success is not absolutely clear. There was a great deal of diplomatic activity in November and early December the details of which are of course unknown. One person who was felt in Bonn to have played a useful mediatory rol was Mr Jenkins, the President of the Commission. He saw both Herr Schmidt and Mr Callaghan on several occasions between the end of October and the Brussels Council meeting in December. As on other occasions however the key decisions appear to have been made in Bonn and Paris. Of the two leaders, Herr Schmidt probably required less convincing. Unlike his expert advisers, he seems throughout the EMS negotations to have been committed to doing everything possible to bring all Community members within the system. The French President's position was much more difficult. A special arrangement for the British was almost bound to arouse criticisms inside France and by the latter half of November, the period of post-electoral peace which had given President Giscard the freedom that he wanted for most of the year was clearly coming to an end. Despite these difficulties, however, the French President seems to have accepted that a radical break with the British was to be avoided if at all possible and at the Anglo-French bilateral meeting in Paris on November 24th contrary to the gloomy predictions that had been made before the meeting on both sides of the Channel, he would appear to have been remarkably forthcoming.[105] His acceptance of the British case was confirmed two weeks later at the Council meeting even though in the same setting he adopted a much more negative line towards the Irish and the Italians than had been expected even by Herr Schmidt. In the end

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therefore the British found themselves accommodated in a temporary dwelling adjacent to the principal residence, rather than in the detached but somewhat dilapidated housing for which they seemed to be heading two months earlier.

The problems that were bound to confront Italy if the government decided to link the lira to a new version of the Snake were already obvious to well-informed observers both within and outside Italy long before the meeting of the Bremen Council. Italy's brief association with the Snake four years earlier had been a costly and painful experience. Since then the obstacles in the way of a successful association between the lira and the stronger European currencies had been exacerbated by the increasing divergence between Italian inflation rates and those of her principal European partners. Even the British and the French had reduced their rates well below 10% by the middle of 1978, while the Italians were still struggling with a rate which was nearer 12 or 13%. As has been suggested earlier in this paper however, the Italian government managed to avoid the opprobium that the British attracted to themselves by stressing their political good will and their desire to join a new system if at all possible. Sig. Andreotti is said to have left the Bremen meeting preoccupied and worried, but the political credit that he and his government enjoyed remained intact. Despite certain similarities therefore between the Italian and British problems, which gave rise to visions of sterling-lira diplomacy on both sides, the points of departure of the two countries were in fact radically different. In Italy the ultimate objective was never in doubt: what was questionable was whether Italy either on its own or through the Community's help had sufficient means to achieve it. In Britain, even the objective was obscured by political doubt and division.

This consensus about political ends embraced even those like Sig. Pandolfi and Sig. Baffi who because of their expertise and the positions that they held were the most keenly aware of the difficulties that would have to be overcome at the technical level. This point is well illustrated by the development of the Pandolfi Plan with which for better or for worse, the EMS proposal was closely linked from the beginning. Indeed the first public hint of the govern-

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ment's intention to introduce a three year "austerity plan" would seem to have been given by Sig. Pandolfi not in Rome but in Brussels in July 1978 on the occasion of the first post-Bremen meeting of the Finance Council.[106] It was rather as if Mr Healey had decided to unveil his Budget proposals not in the House of Commons but to his European colleagues. The plan itself, when it eventually emerged, underlined the political commitment of the Italian government to the European Community even more forcibly. For M. Giscard d'Estaing as we have seen above membership of the EMS was an essential buttress to the domestic programme of M. Barre: for Sig. Andreotti and Sig. Pandolfi the Pandolfi Plan was the indispensable buttress to membership of the EMS. This point was spelled out with extreme clarity in paragraphs 59 and 87 of the Plan published on September 1st.[107]

> "59. Le decisioni del Consiglio Europeo di Brema del luglio scorso hanno impresso un moto accelerato all'integrazione tra i paesi della CEE. L'area comunitaria si avvia ad una più stretta disciplina monetaria. I processi di integrazione saranno avvalorati dalla elezione a suffragio diretto del Parlamento Europeo l'anno prossimo. Il cammino è difficile, ma si è ormai oltre il punto di non ritorno. L'Italia non può dissociarsi da questo sforzo. Tutto, tradizione culturale, sentimento popolare, orientamento politico, ci porta verso l'Europa. Ma molto nella nostra realtà economica tende a spingerci ai margini. E' una contradizzione che tocca a noi risolvere. La strada che ci conduce verso l'Europa è la stessa che ci porta verso gli obiettivi di sviluppo nella stabilità, è la stessa su cui si muove la strategia che qui si propone.
>
> 87. La stabilità della lira mantenuta in quest'ultimo anno ha consentito l'equilibrio tra due necessità contrastanti: da un lato non allargare il differenziale tra inflazione interna e inflazione internazionale, dall' altro non abbassare l'argine costituito dall'attivo di bilancio dei pagamenti e dalle riserve accumulate. Rivalutare la lira significa dare un contributo a restringere il differenziale ma al tempo stesso abbassare l'argine; significa altresì, nel primo impatto, ostacolare l'espandersi delle esportazioni e quindi della domanda globale. Ove non siano assicurate le altre condizioni dello sviluppo nella stabilità, all'effetto depressivo del torpore della domanda interna si aggiungerebbe l'altro di un più stentato flusso dell'esportazione e di un incremento dell'importazione. Non è pensabile una politica attiva del cambio che sostituisca una politico sull'altro propagatore dell'inflazione, cioè la scala mobile. Una azione simultanea sulle due leve accorcerebbe i tempi del risanamento e indirizerebbe il cambio ad attaccare direttamente

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> l'inflazione. Ciò senza compromettere l'ingresso in condizioni favorevoli nel nuovo sistema monetario europeo, e nella misura in cui perduri la presente debolezza del dollaro."

For some of the most important political groups in Italy, notably the Communists and the trade unions, the price of membership set out in the Pandolfi Plan was simply too high to pay. Even for the government however these sacrifices could not be contemplated if, alongside the measures of self-discipline that they sought to impose, the Community and in particular its richer members were not ready to allow special arrangements for the lira and to take steps to facilitate a transfer of resources. At this point, Italian and British interests clearly coincided and in the summer of 1978 the Italian government took serious steps to consolidate the de facto alliance that had emerged in the expert discussions before the Bremen Council. Thus, immediately after the July meeting of the Finance Council, Sig. Pandolfi and Sig. Baffi set out for London where they had talks with Mr Healey and Mr Richardson the governor of the Bank of England.[108] These high-level contacts were matched by a good deal of practical cooperation in the expert committees that worked through the summer holiday. Despite the Italians' efforts however and the spontaneous growth of cooperation within the multilateral committees, less came out of the Anglo-Italian alliance than its supporters had hoped. Various reasons can be found. The first, at a purely technical level, was the fact that the British seem to have ruled out from the beginning the particular type of special arrangement which the Italians sought, namely a wider band of fluctuation for the lira against the rest of the Community currencies. The failure went deeper however than a mere difference over modalities. Undermining the whole venture was the profound difference in political outlook to which attention has already been drawn. The Italian government wanted to enter the system if it possibly could: the British government was not sure that it wanted to even if the terms were all right. Hence occasions such as the Finance ministers' meeting in Brussels in September where, following the Aachen summit, Mr Healey found himself deserted even by the Italians who rallied to the Franco-German position,

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presumably for political reasons.[109] Second thoughts in Rome led to a brief revival of the alliance at the October Finance Council,[110] but the effect was not particularly long-lasting and by the latter half of October, if not earlier the prospect that the two governments might be able to formulate a joint position was becoming more and more improbable in Italian eyes. When Sig. Andreotti and his colleagues went to London on November 22nd therefore their primary objective would seem to have been not to explore with the British what the two countries might do if they both stayed outside the system, but to tell Mr Callaghan and Mr Healey that the Italians had in fact virtually decided to enter and to encourage them to do the same.[111]

With the weakening of ties with Britain, the attention of the Italian Prime Minister and his colleagues was focused primarily on securing the best possible terms from France, Germany and the other members of the Snake, and on surviving the political crossfire in which they now found themselves as the Communists threatened the break-up of the "majority" if Italy joined the system, while the Republicans and many Christian-Democrats threatened trouble if she did not. The crucial negotiations with the remaining Community partners took place from the last week of October onwards, in a series of bilateral or tripartite talks in both Italy and Northern Europe. The first of these meetings was between Sig. Andreotti and M. Giscard d'Estaing in Rome on October 26th and 27th.[112] It was followed on November 1st by a meeting between the Prime Minister and Herr Schmidt at Siena.[113] The basic objectives of the Italian negotiators appeared to have been three: to secure wider fluctuation limits for the lira, to try to modify the hard line position on the basket versus the parity/grid taken by the French and the Germans at Aachen, and to press for a substantial transfer of resources. No progress was made it need hardly be said on the second of these points. On the first and the third however the Italians managed little by little to extract the kind of concessions that they were after. It was no easy or quick victory. The meetings with M. Giscard d'Estaing and Herr

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Schmidt were conspicuously cordial, but press reports after the meetings emphasised that the gap between the Italians and both the French and the Germans was still wide. The Germans in particular seem to have felt that the fluctuation limits requested by Sig. Andreotti and his colleagues were too wide and after consultations between Herr Schmidt and President Giscard at Rambouillet on November 2nd, following the Siena meeting, the Italians were offered a band of no more than 4.5% on either side instead of the 6 or 8% margins which they were reported to have pressed for.[114] Even this was however an advance and over the following two weeks the German government moved still further towards the Italians on both the major questions at issue. Thus at the meeting of the Finance Council on November 20th,[115] the Italians were offered 6% margins, and either then or shortly thereafter, they would seem also to have received assurances that additional credits would be available to the Regional Fund.

Pressure on Herr Schmidt to make these additional concessions came not only from the Italians themselves but also it would seem from at least two other quarters. The first was Mr Jenkins, who though very much involved in the efforts to reduce the gap between London and the rest of the nine, was also to the fore in discussions with and about the Italians and the Irish. The other parties who became involved were the Benelux Prime Ministers, who met Sig. Andreotti in Luxembourg on November 11th and played an active role there and thereafter in the search for a compromise.[116]

By the last week in November therefore the external problems associated with Italian membership appeared to have been largely overcome. For reasons that will be referred to shortly, the difficulties were to reappear in the most striking manner at the December summit itself, but before moving on to that rather surprising occasion, it is necessary to look briefly at the domestic political scene. The problems that Sig. Andreotti faced at home were it need scarcely be said by no means solely or even mainly connected with the issue of the EMS, but given the close association between the monetary scheme and the much stricter policies which his government were now

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pursuing at home, particularly in relation to public sector wages, it was only to be expected that the monetary issue would be caught up in the broader political conflict. As in England, the lines were not always clearly drawn. As successive numbers of the Corriere della Sera and 24 Ore from November 1978 show, a substantial cross-section of the financial and business establishment in Italy, including for example Dr. Carli, felt that the lira would not be able to survive in the new system without considerable damage to the economy or the reserves or both. The same people however supported the austerity measures associated with the Pandolfi Plan wholeheartedly. Opposition to both strategies came mainly from the left and from the Communists in particular. Given the position that the latter held in "the majority" this opposition was more than usually significant. By pushing forward with Italian membership of the EMS Sig. Andreotti ran the risk of destroying the majority on which his government depended for survival. The same threat confronted him however if he decided to bend to these pressures, for from October onwards if not earlier, it was equally obvious that if he did not press for Italian membership of the system, he would be faced by a revolt from important sections of the Christian-Democrats and from the small, but important Republican Party. On October 25th for example Sig. Giorgio La Malfa issued a warning that the Republicans would withdraw their support from the government if the latter failed to adhere to the monetary system at the Brussels European Council meeting on December 4th and 5th.[117] Sig. Andreotti was therefore in a peculiarly difficult position. Whichever way he turned, the majority appeared to be in danger.

Despite these problems however he would seem to have acted with a consistency and resolution that many observers felt him to be incapable of. As at the very beginning at Copenhagen, so now at the end, he appears to have felt that the political dangers of exclusion from the system outweighed both economic and domestic political arguments to the contrary. His attitude was already clear before he went to the Brussels meeting: it was made even clearer how-

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ever in the days that followed when his conviction that Italy's best interests lay in participation in any new advance towards European integration was put severely to the test by the sudden change in the attitude of the French President at the Brussels summit.[118] In an outburst which was as inappropriate as it was unexpected, M. Giscard d'Estaing told both the Italians and the Irish Prime Minister that he could not support an increase in the Regional Fund of the order for which Sig. Andreotti and Mr Lynch were pressing. The Italians and the Irish, the French President continued, should give proof of their good Europeanism and their political sense, rather than seeking to use the system to their advantage. Sig. Andreotti was evidently shaken by this outburst. As the events of the following few days show however he stood by his conviction that Italy's interests were best served by membership, even though the material incentives that he had formerly expected were no longer available. Between December 5th when the fresh difficulty first appeared and December 13th when the decision to join the scheme was finally announced, there were several meetings between Sig. Andreotti's representatives and the Germans[119] and there is alleged to have been a long telephone conversation between the Italian Prime Minister and the French President.[120] As far as one can tell however no fresh material offers were forthcoming even from the Germans. Italy joined in the final analysis because the Prime Minister of the day, under pressure it must be said from both Christian-Democrats and Republicans,[121] still believed as he had done already in April 1978 that the political risks involved in non-membership were greater than the economic problems entailed by participation.

The unexpected twist to the story given by President Giscard's pronouncement at the Brussels summit provides a useful reminder of the fact that however interesting and important the discussions within Italy and the United Kingdom may have been, the context in which both British and Italians had to reach their decisions was largely determined by the French and the Germans. Their continuing cooperation has already been alluded to at several points in the present section. The most widely publicised example during October

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and November was the meeting of the two leaders at Rambouillet on November 2nd when they would appear to have coordinated policies towards all three countries whose attitudes were still in doubt. This public demonstration of solidarity was however preceded and followed by an almost continuous process of consultation by other channels. The change in the French position, and the fact that Herr Schmidt appears to have been genuinely surprised and disapointed, is therefore all the more remarkable. Energetic diplomacy particularly by the Germans in the week following the Brussels summit helped to overcome the obstacles to both Italian and Irish membership: in the latter case, in contrast to the former, fresh funds do appear to have been made available.[122] Despite these successes however there was a new and even more damaging case of French obstructionism a week later, when they threatened to veto the launching of the EMS if their opposition to MCAs were not met.[123] As is well known, the dispute over this question did in fact delay the inauguration of the system until March 1979. Given the previous commitment of the French President to the new monetary system, it is legitimate to ask why at this late stage, he seemed ready to put its existence in jeopardy.

The answer seems for once to be relatively simple. Towards the end of November, the President came under increasing domestic pressure. The relative tranquillity that had prevailed since the March elections came to an end. Criticisms by the Gaullists and Communists of the EMS were only to be expected, but for much of November it still seemed that the President might be able to ride out the storm. In the end he could not. With the direct elections for the European Parliament now approaching, he was obliged to declare that France would not approve any increase in the powers of the Parliament.[124] On December 3rd, he suffered an even more conspicuous setback. A bill designed to bring French VAT into line with the rest of the Community was rejected by the National Assembly.[125]

From then until March 1979 at the very least, the French President remained shackled by developments on the domestic political front. The inevitable result was that a scheme that had been proclaimed as a great step forward by its sponsors now lost some of its original glamour, and that Community politics as a whole became bogged down in acrimonious disputes about issues that were more arcane than important. The period coincided with the first few months of the French presidency of the Community, and it was widely believed that the President had hoped to acquire extra kudos from the happy coincidence between this period of office and the beginnings of the new monetary system. His hopes were disappointed as once again agricultural ministers in both Germany and France revealed their ability to hold their governmental superiors to ransom. It was an absurd state of affairs and a rather sordid conclusion to a negotiation which until almost the very end had reflected considerable credit on both the German Chancellor and the French President. Perhaps the most appropriate comment was one made by Mr Jonathan Carr of the Financial Times in an article on January 5th."What does it matter, it is asked, if the system were to start

> operation, let us say, one month later when the farm ministers have sorted out matters to their satisfaction?
>
> The answer is that it matters very much when the heads of state or government of the nine Community countries take a unanimous decision on what they say is of historic importance on December 5 and then permit discord among farm ministers to undermine it on December 19. Even to those whose minds are dulled by excessive consumption of alcohol over Christmas and New Year (or by stultifying discussion of the history of Monetary Compensatory Amounts in EEC farm trade), it must be clear that this topsy turvy procedure undermines the credibility of Europe's leaders and is the worst possible psychological preparation for the eventual introduction of the EMS. If the Europeans want to be taken seriously by the Americans, they will surely have to do better than this."

CONCLUSIONS

In assessing the overall significance of the episode that has been described in this paper, it will probably be useful to group the observations around the following questions. Firstly, what type of events were those that have been discussed here? Secondly, what light does the episode throw on the institutional structure of the Community? Thirdly, what are the more important characteristics of the changing relationships between the five principal

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groups of actors referred to at the beginning of the paper? Finally what was the global significance of the creation of the EMS?

History undergraduates in British universities used frequently to be set an essay question which ran something like this: "The English Reformation was an act of state". Discuss. Good students would of course hasten to point out that there were many profound social, economic and cultural forces pushing the English Church towards a break with Rome, and that professor Pollard, the author of this single-sentence judgement on a complex historical phenomenon, was guilty of over-simplification. This paper doubtless lays its author open to a similar charge. There were, or there would seem to have been, profound forces pushing Western Europe towards monetary union. It is also possible to argue that most, if not all the components of the system as a working mechanism had been proposed or experimented with earlier in the decade. And yet, in a very real sense, the European Monetary System, like the English Reformation, was an "act of state", an act that is of high politics conceived and implemented at the highest political level.

This does not of course mean that a detailed analysis of the nuts and bolts of the system is irrelevant. But it does suggest that if we want to assess the significance of the EMS in the history of European integration we would be well advised to look not only at the behaviour of the EMS in the international monetary system, but at the political processes which gave rise to it and the political consequences that have flowed from it. The history of European integration since the Second World War is in many respects the history of a series of symbolic political acts or initiatives which did not have the immediate practical outcomes which at least some of their authors willed, but which had profound political and therefore also in the end profound economic consequences. The most conspicuous example of this type of event is needless to say the Schuman Plan itself, which was less important for the European Coal and Steel industries than it was for the political integration - and division - of Western Europe. From this political development profound economic consequences have flowed too. The creation of the EMS was an event of this type and because it was, it will remain an important and highly illustrative episode even if the system fails to produce what was promised, for reasons which experts both at the time and since have repeatedly pointed out. Even heads of government cannot walk on the water, but the fact that they occasionally try, and even more occasionally almost succeed, is noteworthy in itself.

This leads on to the institutional question. The EMS was not only an act of state, it was also to a remarkable extent the act of a very small group of men in and around the European Council. In the long term of course, the character of the system is bound to be determined as much if not more by those who have to make it work, the majority of whom were initially sceptical about its feasibility. It is also true, as Jonathan Carr observed in the article already quoted, that in the final act of "the European Community circus ... the farming clowns ... managed to pull the rug from beneath the troupe of acrobats, the European Council". But despite these qualifications, the overriding impression left by these events is of the determinative role played by the heads of government. The Foreign Ministers, to whom the Treaty of Rome accorded a special position in the European polity, were scarcely to be seen. What was still more significant however was the limited and in many ways rather confusing role of the Finance Council. Samuel Brittan made the point nicely when he observed just after the final summit at Brussels in December 1978:"While government heads were ... in Brussels, Mr Healey was looking around some second-hand bookshops in London - and probably Signor Pandolfi was in Rome revising his translations of St. Augustine. (And do Germany and France have Finance Ministers at all?)"[126] This concentration of power at Community level in the hands of the European Council was of course

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the fruit of a process that had been developing for several years: the formation of the EMS is nevertheless an important landmark in this development. Before the Brussels meeting of December 1977, Herr Schmidt is reported to have complained that the meetings of the European Council were being spoiled by too many minor items which ought to have been solved at the lower levels in the Community decision-making machinery. In the EMS episode, the Council regained the initiative and lower instances far from determining the agenda of the higher one, were obliged to organise their own affairs around the time-tables and preoccupations of the Council.

The evolution of this new institutional structure was not without its problems, as the EMS history itself shows. The Couzens affair illustrates one danger. Decision-making in one member state is not necessarily or even usually carried out in the same way as in others. In Britain it was in many respects perfectly natural for Mr Callaghan to ask a senior Treasury official to take charge of monetary negotiations. Indeed had any member of the Cabinet office or still more the Prime Minister's office tried to conduct these negotiations, he would almost certainly have run into severe problems with the Treasury. In a European context however as we have seen above, the choice of a Treasury official was inappropriate. Another obvious problem, well illustrated by the final crisis, is that a small body like the European Council is even more vulnerable to domestic political pressures than an organisation underpinned by a bureaucratic establishment. Without a properly organised secretariat and a modicum of conventions and rules, the Council is likely to remain a somewhat brittle institution, subject to sudden political storms such as the one that nearly wrecked the meeting in December 1978. But there were signs during the EMS negotiations that at least some form of underpinning was being provided through the proliferation of bilateral summitry between Council meetings. Allusions have been made already to some of these mini-summits of heads of government or their aides at several points in the essay. There were however far more of them than those specifically cited above. Some were of a strictly ad hoc character,

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but there does seem to have been a trend which the EMS negotiations accelerated towards the institutionalisation of bilateral relations.

The institutional framework provides the background against which the roles of the principal actors can be briefly assessed. There is no space at this point to rehearse once again the motives which underlay the actions of the four governments and the Commission. It is sufficient to make three general points which are implicit in much that has been said, but which ought perhaps now to be referred to more specifically. The creation of the EMS provided the occasion and the Franco-German bilateral relationship and the European Council the instruments for the first major exercise of German leadership in the European Community. The near inevitability of German primacy in any Western European system designed to further cooperation rather than to perpetuate conflict has been a central theme of European politics since well before the First World War. The factors that have prevented its realisation hitherto need no explanation here. What makes the EMS episode politically so significant is that it was the first occasion since the Second World War on which the Germans have felt able or willing to launch and prosecute a major European Community initiative of their own. That they did so, and that furthermore they were able to escape without too many references to previous and less happy examples of German hegemony, was in large measure due to the personality of Herr Schmidt and the method that he chose to further his plan. This leads on to the second point. The Franco-German relationship and more generally the European Council were at one and the same time instruments of German leadership and barriers against its abuse. There can be little doubt that Herr Schmidt as the Chancellor of the most powerful state in the Community enjoyed a special authority in the Council and also in the bilateral relationship with France. The institutionalisation of the heads of government relationship which, as has been noted above , was accelerated by the EMS negotiations, provided however a check on the abuse of this superiority which is of considerable potential importance. Probably the best parallel is the war-time alliance of the Big

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Three. Long before the war ended it was clear to many that there were in reality only two great powers, but the mere existence of the machinery of the alliance and the personality of the British Prime Minister gave the United Kingdom opportunities - power - which it otherwise would not have had. So too in the case of the European Council. Herr Schmidt is undoubtedly primus, but he is also equally certainly primus inter pares. No amount of summitry can mask discrepancies in national power, nor will the formation of a Cabinet of heads of government provide any automatic solution to genuine conflicts of interest between member states. But the reduction of every nation whether weak or strong to one representative in an institution which meets regularly is one of the more effective ways of compensating the weak and allowing a hearing for parties in dispute.

Mr Jenkins and Sig. Andreotti saw this all along: Mr Callaghan, though doubtless aware of it, gave it insufficient attention until it was too late. As this paper has pointed out on several occasions, there were and there are serious conflicts of interest between Britain and the rest of the Community both in the monetary sphere and elsewhere, and the defence of national interests in a community of nation states cannot simply be dismissed as "bad Europeanism". The trouble was that Mr Callaghan's and Mr Couzens' handling of the early stages of the negotiations deprived the British of whatever credibility they still retained at the only level at which they could hope to protect their national interest. Herr Schmidt's initial decision to bring Mr Callaghan in to the inner directorate, coupled with his subsequent handling of both the Italians and the Irish, suggests that he, unlike the great majority of his advisers, who thought legitimately enough in terms of <u>their</u> national interests, genuinely wanted all the non-Snake members inside the new system. His comments since the formation of the EMS, notably in a recent Economist interview, suggest equally strongly however that the United Kingdom's failure to join the

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system, notwithstanding Mr Callaghan's late success in securing a half-way house, has seriously affected his attitudes towards Britain as a whole. Reading the Economist interview, one cannot help concluding that the EMS has acquired for the German Chancellor the status of an article "stantis et cadentis ecclesiaè". This is probably a personal opinion, just as the proposal which eventually led to the system was in itself a personal initiative; it is also presumably true that Herr Schmidt will not always be the German representative on the European Council. But when as was true in the history of the EMS, technical matters become so highly politicised and personalised, the outlook and mood of the leader of the most powerful member of the Community assumes considerable importance. Membership of the inner club can give the weak considerable benefits: self-exclusion can do them serious damage. Fortunately for the British, the decision by the Italian and Irish governments to enter the system prevented this act of self-injury from becoming in addition an act of self-relegation to the European Second Division.

The final question, the global significance of the EMS and in particular its importance for the development of EEC-American relations, falls within the province of the next paper more than of this one. A few observations may not however be out of place. As was noted above, during the discussion of Herr Schmidt's motives, it seems unlikely that the EMS would have come into existence at this particular juncture and in this particular way had it not been for the weakening of the dollar. In a speech to the European Parliament in April 1978, Mr Jenkins spoke of the "fundamental asymmetry about the United States having withdrawn from the responsibilities of Bretton Woods while dollars, like legions without a central command, continued to dominate the currency transactions of the world".[127] In a situation like this, a European monetary system could be seen as an act of legitimate self-defence. Whether it was no more than a simple act of self-protection however it is extremely hard to say. There were in some of the utterances of the principal actors disturbing hints of the sort of unconstructive negativism which - to return to Mr Jenkins' parallel with the leaderless legions - could well bring about conditions much worse than those that had obtained under the old Empire. Mr Schmidt is widely reported to have called on one occasion for the banning of the dollar from Europe. Even if he did not make this extraordinary comment, he is on record in the recent Economist interv with what in many ways is a still more extraordinary observation: "We were the first government in the world who learned really about economic and financial interdependence." Despite his positive attitude towards the Atlantic alliance, the French President too seems on occasions to have joined in the demolition of the American effigy. Faced with evidence such as this, it was not particularly surprising, though no less regrettable, that critics of the monetary system, particularly in Britain and Italy, alluded to the years in which American hegemony had been established as an alternative to another continental New Order.[128] The lessons of history need to be learned on one side perhaps just as much as they need to be forgotten on the other. Neither crude anti-Americanism nor the "spirit of 1940" will contribute much to the creation of a new Atlantic system in which an EMS, either the present one or another that develops later on, becomes as it could and ought to, a significant contribution to the welfare of both Europeans and Americans and the stability of the international system as a whole.

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Note on sources

Footnotes for this paper are available on request, but as the paper is already rather long, it seems sensible to restrict circulation to those who actually need them. The sources for the paper fall into two main categories: the press and interviews with a large number of people in several countries who were involved at one or other stage or level of the negotiations. As far as these latter are concerned, much of the information that was disclosed was of a confidential character, and nothing obtained in this way has therefore been attributed. Research on the press was considerably facilitated by access to the press cuttings library in the Royal Institute of International Affairs, London. At several points however I have checked particular episodes against intact copies of the newspapers concerned. The following are the more important newspaper sources:

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CORRIERE DELLA SERA

DAILY TELEGRAPH

ECONOMIST

EUROPEAN REPORT

FINANCIAL TIMES

FRANKFURTER ALLGEMEINE ZEITUNG

GUARDIAN

INTERNATIONAL HERALD TRIBUNE

LE MONDE

NEW YORK TIMES

NEUE ZÜRCHER ZEITUNG

OBSERVER

DER SPIEGEL

SÜDDEUTSCHE ZEITUNG

SUNDAY TIMES

TIMES

DIE ZEIT

Provisional version

3

The Operation of the EMS: a European View

by

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Prepared for the Conference on "The Political Economy of the European Monetary System", Bologna, Italy, November 16-17, 1979.

The operation of the EMS: a European view.(*)

1. Introduction.

The task I have been assigned is to evaluate critically the operation of the EMS - in the light of the objectives which were set when the system was conceived, established and put into force - with particular emphasis on the need to complete, and possibly revise, the set of rules and engagements that constitute the basis for the EMS.

Before attempting to pass judgment on the workings of the EMS it is indeed necessary to define clearly the perspective which is being adopted: I find it appropriate to assess the system with reference to its rôle as a decisive contributory element to the cohesion of the Community and to the process of European integration. The resolutions of the European Council in Bremen (7/7/78) and in Brussels (5/12/78) show the determination to set up a scheme for the creation of closer monetary co-operation, leading to a zone of monetary stability in Europe. The efforts to relaunch the process of monetary and economic union - which presupposed a "coordinated approach in all areas of economic policy" - were to take place along three main lines to be followed simultaneously : a) the European exchange rate agreements, b) the reciprocal credit mechanisms, to be consolidated with the creation of the European Monetary Fund and c) the measures in favour of the less prosperous member states. These latter were seen as an integral part of the overall scheme ("such measures will be essential if the zone of monetary stability is to succeed"), which represented a recognition of the need for an approach to monetary integration based on an active contribution of the Community budget.

The debate on the EMS has so far been extremely technical as regards the exchange rate aspects. The coexistence of the parity grid and the ECU basket, the bilateral exchange rate margins and the unilateral indicator of

(*) The views herein are those of the author and do not necessarily represent those of the Banca d'Italia.

divergence polarised general attention, which detracted from a general analysis of the overall features and desirable properties of a scheme aimed at creating a homogeneous regional zone of monetary stability. In this vein, the question of "parallel measures" in favour of less prosperous economies has been treated in isolation from the general context of integration, thus progressively moving away from the original conception of the EMS - which stressed the synergism resulting from concurrent action in the three areas previously mentioned (1).

In order to examine the EMS in the broad perspective which has been set in this Conference it seems therefore necessary to offer some general considerations on the rôle of exchange rates in the adjustment process. Time limitations will only allow a cursory analysis of these questions. On the other hand, I feel that without clarification of these basic issues an examination of the recent and prospective operation of the EMS would not be meaningful.

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(1) In particular, the question of a simultaneous treatment of the parallel measures and the restructuring of the Community budget along the lines suggested, for instance, by the MacDougall report has been deferred. The interest rate subsidies granted to Italy and Ireland have often been referred to as an illogical and illegitimate pretence and treated as a kind of bribe. On the other hand, the general discussion on the rôle of the Community budget developed into a mechanical assessment of net budget receipts for the various countries. This is highly unsatisfactory, in the first place because it prevents a global analysis of the process of monetary integration, secondly because the Commission's documents are vitiated by the omission of "net trade receipts" in respect of C.A.P., as has been shown by R. Bacon and his Cambridge group (see, for instance, Bacon, 1979).

2. Some theoretical considerations

2.1. The traditional view according to which exchange rates do not play a major rôle in the adjustment process is based on extreme monetarist lines. Fixity of the exchange rate for a small open economy implies that the nominal stock of money balances is determined directly by the public: but if money is neutral - in the sense that relative prices and the real rate of interest are independent of the quantity of money - the loss of national monetary sovereignty does not imply that real adjustment costs must be borne by the domestic economy. The assumptions needed in order to establish the neutrality of money are very restrictive (1): in particular, they require the existence of flex-price (competitive) markets (2) for goods, labour and money.

More recently, however, the conclusion on the inefficacy of exchange rate changes has been reached on the basis of a "Keynesian" approach, in the case where rigidity in real wages is assumed. As Corden (1972, p. 39) put it: "The effectiveness of exchange rate adjustment depends on real-wage flexibility and hence - in the presence of money-wage rigidity - on money illusion or wage contracts in money terms". Extremes often touch: also according to this line of argument exchange rate adjustment is at best irrelevant: in the special case of inflexible real wages, unemployment (and migration) is the only way to solve balance-of-payments problems.

The Corden approach suggests that, in general, the losses from a monetary union consist in requiring countries to depart from the optimum (national) points on the unemployment-inflation trade-off curve. If the assumption of very high wage indexation

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(1) Wage and price flexibility with no money illusion, and inelastic expectations, absence of government debt or open market operations, absence of distribution effects and homogeneity of bonds. Cfr. Johnson (1965, pp. 6 ff.).

(2) A revolutionary attack on the theory of markets which is instead based on the analytical separation of fix and flex price sectors can be found in the recent fundamental works of Hicks (e.g. 1977).

is superimposed on the Phillips curve scheme in an open economy setting, the conclusion is that no true extra costs are incurred in fixing the exchange rate for high-inflation countries vis-à-vis the rest of the union. The immediate practical consequence of this line of thought is that within the EEC no real cost would be encountered by high inflation countries with highly-indexed wages if they were to lock exchange rates and monetary variables vis-à-vis strong currency countries. In particular, the requests for "parallel" measures are indeed illogical.

2.2 These arguments are to my mind unsatisfactory: in the first place they reveal an inadequate theoretical understanding of the process of exchange rate determination in open, integrated and highly industrialised economies. In the second place, and this is especially regrettable, they do not lead to a clear identification of the actions and the forms of behaviour on the part of economic authorities and social partners that would be truly consistent with European integration and development.

The first, and more obvious, line of response to the above arguments can of course be found in a detailed empirical examination of the pass-through of price changes stemming from devaluation (revaluation) into nominal wage rates(1). Available evidence tends to show that, if the exchange rate change is correctly backed by appropriate domestic policy measures, there is a significant and lasting (at least two to three years) influence on profit margins, in respect of all industrial countries, including those with very high wage indexation clauses, such as Italy.

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(1) I do not have the time to enter into an analysis of empirical data. I may, however, refer simply to the statistics on cost and price comparisons and nominal exchange rate movements published monthly in the IFS.

The less orthodox, but to mind more important line of response -and the one I want to take up here - is based fundamentally on the recognition of the non-neutrality of money, even leaving aside the fix-price character of the goods and labour markets, but allowing for the operation of the Government sector. Once a correct integration between stock and flow analyses is made in a variable-price context, it is easy to perceive that inflation, by reducing the real value of the government debt, represents a source of taxation, which reduces real disposable income - and in general the total real wage bill (1). In this connection it is appropriate to recall that, as Hicks (1977, p. 12) pointed out, "the real wage bill is just the difference between final product and what is taken out of that product for other purposes. What is taken out will include not only 'consumption of profits', but also the consumption of public bodies".

It is my contention that the existence of a short-run Phillips-curve type of relationship (2) between the rate of inflation and unemployment can be explained on the basis of "fiscal illusion", whereby wage earners do not realise that the perceived (3) loss in real net financial wealth stemming from the inflationary consequences of monetary base financing of Government deficits effectively reduces their disposable income by more than what is apparent in terms of wage flows.

Thus the compensatory adjustments in terms of nominal wages - even in the limiting (unrealistic) case represented by the presence of 100 % wage indexation - need not represent a full compen-

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(1) I tried to develop these points and offer some empirical evidence of their relevance in Masera (1979,a) The emphasis is here on the real-wealth effect of price-level changes (different inflation rates). There is of course a substitution effect too, which sets the maximum amount of revenue (and the corresponding rate of inflation) that can be obtained in a steady state growth by the Government via inflation. Available evidence tends to suggest that in the recent past the wealth effect has indeed been predominant.

(2) It should be stressed that the economic rationale behind the schedule considered here and the Phillips curve is completly different.

(3) Assuming no money illusion. I would also assume little fiscal illusion in respect of ~~f~~ explicit taxation.

sation for the losses deriving from inflation: hence the reduction in the true "real wage bill".

Note in this respect that in certain high-inflation European countries - and notably in Italy - a significant part of the overall government expenditure is devoted to direct transfers to the corporate sector. The inconsistency between "autonomous" wage costs (1) and labour productivity at given employment levels is thus initially offset by means of "compensatory" government interventions, which reduce the "overall" unit cost of labour to enterprises.

However, if, given an insufficient elasticity in total explicit fiscal revenues (2), a structural (current account) government deficit builds up, recourse to monetary-base finance becomes sooner or later (3) a necessity. In this situation the tax from inflation on government debt effectively reduces - in real terms - the government deficit. In this devious way the gap in nominal (explicit) tax revenues is made good by means of the inflation tax, which lowers the true real wage bill, since it falls ultimately on the

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(1) Note here that the word "autonomous" is not altogether satisfactory, since these costs do include the effects of the government sector's operations in respect of the services which are provided (and priced) on a monopoly basis- such as social security contributions.

(2) I cannot here make a full analysis of the real impact of a given government deficit. I would like to stress, however, that in my opinion the simplistic textbook (constant-price) version of the Keynesian multiplier is definitely not applicable to present-day conditions. The misallocation of existing labour demands and supplies, mainly deriving from structural changes in international relative prices, cannot be offset by new investments and actual movements of labour in view of the rigidities in relative real wages. Supply constraints in key sectors imply that price pressures can develop even in the presence of relatively high average unemployment rates. From this point of view I would concur with Hayek, when he stresses the chief fault in the belief that all present important unemployment is due to an insufficiency of <u>aggregate</u> demand and can be cured simply by an increase in that demand.

(3) The relative rigidity in fiscal revenues makes it impossible to increase taxation in order to cover interest-rate payments. Even if this were possible, problems of dynamic instability could well arise.

household sector (1).

These "net aggregate wealth effects" represent a dynamic reinterpretation of the well-known Pigou effect, by taking explicitly into account the operation of the Government budget restraint. In a highly interesting critical commentary of naive "theories" purporting to explain exchange rate and price determination as the interaction of stock supply and demand for money - along lines reminiscent of "neutral" money approaches - Basevi (1976, p. 228) correctly pointed out that "Monetary policy is but a particular form of Government's budgetary policy, and in many countries it is subsidiary to the need for the Government to finance its deficit. If this cannot be done by issuing bonds, and if the private sector is in portfolio equilibrium, the pressure falls on foreign exchange reserves or on the exchange rate."

The outcome of my analysis is precisely that, via exchange rate depreciation and inflation, real wages are adjusted, thereby reducing, in the short run, the unemployment cost which would be encountered by following the alternative course of letting the nominal stock of money adapt automatically to the contractionary impulse stemming from the decline in the foreign component of the domestic monetary base.

2.3 I have questioned the wisdom of inferring from a rigidity in perceived real wages the ineffectiveness of exchange rate changes in the adjustment process. The previous analysis is however consistent with the view that inflation is not reconcilable with full employment

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(1) Time limitations do not make it possible to consider here another important facet of the problem, related to distribution effects within the private sector, in connection with movements in real interest rates brought about by inflation. These points have been recently stressed notably by Modigliani.

and steady growth in the medium term. The long-term schedule connecting inflation and unemploymen may well be positively sloped: this conclusion follows however mainly from (i) consideration of the negative impact on investment generated by the higher uncertainty as to relative prices and as to the posture of economic policies, necessarily connected with high but variable inflation rates, (ii) recognition of the "social function" of prices, and the consequent costs in adapting the operation of the economy to high inflation (1).

The different degrees of imbalance and rigidity which exist in the sectoral and regional wage-productivity relationships and in the public sector financial impulses - and which have been exacerbated, also in varying degree, by the structural changes in some key relative prices, notably that of energy, with the consequent need to effect the oil-related transfer - determine very different potential inflationary pressures in the EC countries. True enough, these potential impulses could not become actual without an elastic money (liquidity) supply in high inflation countries, as suggested by the relative stability of real demand functions for liquid assets in all EC countries.

I have tried to indicate that, in these conditions, an attempt to impede inflation based merely on monetary constraint would result in some EC nations in very high unemployment costs (mainly due to the rigidities in the labour market), quite apart from the consideration

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(1) Referring to the "folly of some 'neo-Keynesians', who think only in terms of employment and output, and are prepared to let prices go hang" Hicks (1977, p. xiii) recently observed that "It is just because we do not live in a world of the old type that prices, money prices do matter. Not just wages, but many other prices also, have social functions as well as economic functions. In a fix price world, in which so many prices are administered, and have to be administered, the social functions have become more important, and more sensitive than they were". For an analysis of these points see Hicks (1977, esp. chapters 3 and 4).

that in many countries this scheme would simply not be feasible, owing to the limited degree of autonomy of central banks.

Under these circumstances, while it would not be sensible to ask (let alone force) relatively low-inflation countries, characterised by a higher degree of rationality (and flexibility) in the behaviour of social parties (1) to adopt policies conducive to more domestic inflation, it does not appear desirable either to require weak-currency countries to pursue disinflationary policies simply by locking exchange rate (and monetary) variables to strong currencies.

If this approach is accepted, three main consequences appear worth spelling out: (i) the control of inflationary impulses originating upstream of monetary flows must be undertaken simultaneously with a program of exchange rate integration, in order to embark on a gradual process leading to monetary unification, (ii) the convergence in overall economic and structural policies may well imply certain short-run costs in high-inflation countries – which are also characterised by relatively low income levels. To this end, as has been shown by the Mac Dougall Commission (1977) (2) a certain increase in the overall Community budget and, above all, a restructuring of expenditures able to cope with cyclical and regional problems, is required, (iii) the strategy towards the implementation of EEC exchange rate agreements must allow for the problem posed by movements in third-currencies. This consideration is immediately derived from the recognition of the well-known n-currency question(3). Pursuit of desired independent relationships vis-à-vis third currencies tends to impose immediate strains on EEC bilateral relationships. On the other hand,(a)

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(1) The degree of social consensus in a country like Germany on the desirability of avoiding excessive government sector deficits, and in granting the central bank a significant degree of autonomy is, in my opinion, a rational manifestation of relatively low "fiscal illusion", derived from historical experience. Other countries, alas, appear to have shorter memories!

(2) On these points see also Masera (1979,b), Majocchi (1979) and Forte and Brosio (1979).

(3) For an analysis of these issues see Basevi (1979) and Baffi (1979).

movements vis-à-vis third currencies have a different objective weight in the external transactions of European countries and (b) desired relationships may also differ according to the relative short-run importance attached to the fight against inflation and unemployment by the monetary authorities, especially in the case of exogenous price shocks; in respect of this latter issue the considerations developed above are thus clearly applicable.These general questions are of course especially relevant, when account is taken, on the one hand, of the key rôle of the dollar as an intervention currency also within the EC, and on the other, of the process of diversification of international reserves, which can lead to strains in the dollar-DM exchange rate, as recognised by direct monitoring of this rate on the part of US authorities, since November 1,1978.

3. An overview of the EMS experience.

3.1 A review of the first eight months of the EMS's operations and of certain features of the system can be conveniently broken down into three periods, on the basis of the evolution of the ECU vis-à-vis the dollar (see Chart 1).

The first phase of the system covers the period from 13th March to end-May. This period was characterised by a relative strength of the dollar vis-à-vis the DM, and by bilateral tensions within the EMS, between the Danish Crown and the Belgian Franc. Three relevant features of this period are worth specific mention. First of all, the bilateral margin between the Crown and the Franc was met well before the indicator of divergence singled out the Belgian Franc as the diverging country. This was perfectly possible in view of the relative amplitude of the unilateral margin vis-à-vis the ECU and the bilateral limit of 2.25%. One may however question the efficacy of an early-warning system which sends its signal ... after the horse has gone.

A more relevant point refers to the workings of this indicator when intramarginal interventions (in third currencies) take place: it is clear in fact that such interventions can distort the functioning of the divergence indicator. During the period under review substantial amounts of such interventions did take place. In particular, while the Banca d'Italia was buying in dollars to prevent what was regarded as an excessive appreciation of the Lira, the Bundesbank was intervening in the opposite sense, to prevent a depreciation of the DM, which would have worsened the problem of domestic inflation.

What is relevant here is that such interventions on the part of the Bundesbank continued also in May, when the DM first (see Charts 2 and 3) crossed the 0 line of the divergence indicator and subsequently (May 23rd) reached the maximum 2.25% spread vis-à-vis the Belgian Franc.

The second phase of the system covers the period from June to Sunday 23rd September, when the first realignement took place in Brussels. During this period, characterized by the progressive decline of the dollar, the DM stood permanently at or very near to the 2.25% spread vis-à-vis the Belgian Franc and the Danish Crown, and interventions at the bilateral margins acquired significant proportions. It should be noted that interventions in EC currencies were covered largely by spot settlements; recourse to very short-term financing also was had, but no resort was made to short-term monetary support or medium-term financial assistance.

During this period measures of monetary policy were introduced by the various central banks to combat inflation or defend the currency. In the main, these measures consisted in raising interest rates: the escalation which took place during the period (see Tables 3 to 6) was no doubt influenced by the increase in rates in Germany - whose currency was, as recalled, at the top of the narrow-margin agreement - prompted by the desire to counter the inflationary impact of the energy price rise (1).

The fall in the dollar in this period coupled with the EEC links also implied significant - but varying - movements in effective (and real) exchange rates. This was one of the factors which was taken into account during the (difficult) negotiations that took place in Brussels on 23rd September, where the German monetary authorities made it clear that the combination of intra-EC tensions and dollar weakness would have implied too heavy costs in terms of their domestic stability.

The third period goes from the Brussels realignment up to today. In this phase too the relevance of the dollar evolution has been of paramount importance.

The agreements reached in Hamburg between the German authorities and Secretary Miller and President Volcker were followed by the measures annonced by the FED on 6th October, which made it possible to reverse the declining trend of the dollar. Short-term tensions within the EMS subsided, although stabilization of exchange rates continued to be achieved by means of sizable intra-marginal interventions, mainly in dollars and to support that currency.

Interest rates continued their upward trend both in nominal and in real terms: in particular the Bundesbank increased again its discount rate by 1% to 6% on 1st November.

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(1) It may be recalled in this context that the domestic pass-through of the international increase in these prices varied considerably in the EC countries. While certain countries delayed and resisted the process, other countries (notably Germany) immediately allowed the rise to be felt domestically. Thus, in Germany, the " fuel and electricity " item in the consumer price index had shown in August 1979 a 27 % increase with respect to the previous year. The corresponding rise had been, for instance, 5.6%, 17% and 18.5%, respectively in the Netherlands, France and Italy.

3.2 In the light of the theoretical considerations developed in the previous paragraph, a few general comments on the evolution of the EMS can be made here. The first question deals with the very object of the exchange rate agreements. While it is clear that the original idea behind the scheme put the emphasis on a relatively rigid approach, capable of leading to homogeneous monetary and exchange rate conditions, the logic of the system is evolving towards some kind of crawling-peg scheme. This stems, in my opinion necessarily, from the fact that no serious attempt has been made to reduce divergencies in the key factors which are ultimately called into question to explain divergences in inflation rates - namely wage - productivity and public finance trends. Thus, on the one hand, Germany could pursue a policy of allowing a complete and immediate pass-through of energy prices, because no explicit sliding-scale arrangement exist and an informal agreement was reached with trade-unions on the acceptance by the latter of a certain relative decline in real wages as a direct consequence of these phenomena. In this situation recourse to a strict monetary policy to contain inflation (in terms of total ~~domestic~~ aggregates, not in terms of domestic credit expansion) acquires the connotation of a wages-and-prices policy, because it affects expectations, and, at least in principle, also profit margins.

At the other extreme, a country like Italy during this period, did not accept some eminently sensible proposals which were made in order to neutralise (in part) the escalator consequences of the energy price rise, but moved instead to a more frequent application of the clauses; in addition, if my analysis of the public sector financial impulses is correct, one must also look with some preoccupation to the fact that the public sector deficit on current account with respect to GNP is now expected to be in 1980 over 2 percentage points higher than the 5.5% recorded in 1978. This runs against the explicit commitments undertaken by the Italian Parliament when it asked the Government to enter into the EMS and specified the need to lower inflation "following a course alternative to that of a mere credit crunch... by means of a reduction in the public sector deficit on current account".

The progressive opening out of inflation differentials within the EC – which has been partly masked so far by the above mentioned differences in the approach to the pass-through of energy prices, is thus evidence of the concern which can be expressed regarding the viability of the EMS as a scheme leading towards European monetary unification.

The evolution of the philosophy behind the system towards a snake-cum-crawling-peg regime can, in my opinion, be clearly seen from the fact that, as mentioned, the dilemma between "indicator-of-divergence" and "fight-against-inflation" considerations was always solved in favour of the latter – first in terms of exchange interventions, and then in terms of overall monetary policy (interest rate) impulses. It is the very logic of the divergence indicator which is called into question: if the reason for deviation is lower inflation and higher domestic financial stability, it is hardly reasonable to give priority to the return to some EC exchange rate average, which would imply importing more inflation. This explains why the German monetary authorities always rejected the symmetry argument contained in the ECU approach during the negotiations which led to the creation of the EMS.

These general considerations on the rôle of the ECU can be supplemented by some more technical observations concerning the distortions in its signals which stem from the unsatisfactory treatment of the Italian lira and the pound sterling, whose movements outside the narrow 2.25% margin are conventionally neutralised. This artificial element of inertia can, and in my opinion, did give rise to biases in the designation of divergent currencies (1).

(1) For a mathematical analysis of these points see Masera (1979,b) and Papadia and Rossi (1979).

These technical issues are however dwarfed by the more general point concerning intra-marginal interventions, both in third currencies and in EC currencies, which were in the region of 10 to 1 with respect to interventions at the limit. This fact undoubtedly reflects a high degree of cooperation and concertation within central banks to prevent tensions and to ensure orderly market conditions; admittedly, however these interventions can alter the indications to be derived from a "pure" indicator-of-divergence system where interventions would only begin after the threshold of divergence has been reached (1).

The final point I want to make here concerns the relative importance of dollar and Community currency interventions: total gross interventions within the EMS can be roughly put at some $ 60 billion: over two-thirds of which took place in dollars. These simple figures highlight the relevance of the question of a coordinated determination of the dollar policy (see appendix).

3.3 The following five rules set out in the European Council's Resolution of 5th December 1978 can be regarded as a short summary of the EMS - as originally conceived:

a) The most important concern should be to enhance the convergence of economic policies towards greater stability.

b) The scheme aims at creating closer monetary co-operation leading to a zone of monetary stability in Europe, with the ECU at its center.

c) In principle, interventions will be made in the currencies of countries participating in the system.

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(1) Note in this respect that intra-marginal interventions in EC currencies were exceptional under "snake" rules.

d) Interventions will be diversified, especially in connection with the information furnished by the divergence indicator.

e) The scheme requires co-ordination of exchange rate policies vis-à-vis third countries and, as far as possible, concertation with the monetary authorities of those countries.

In the light of the above brief remarks on the actual evolution of the system, one can see the reasons why I have advanced the argument according to which the system is de facto evolving towards a kind of crawling-peg agreement between central banks.

4. Conclusions.

If the EMS is to represent a step forward towards the establishment of conditions leading to a zone of monetary stability and, eventually, to European monetary unification, the emphasis must be on guaranteeing gradual eradication of domestic inflationary impulses and differentiated price pressures in response to external shocks. The analytical considerations I have briefly outlined would suggest that, while coordination of monetary policies is an integral (necessary) part of any such arrangement, it is not a sufficient one. Public sector deficits (especially on current account) and wage-productivity relationships have been singled out as the most significant factors which have to be considered in a broader perspective.

It is also clear that, insofar as all countries agree in principle on the fact that inflation has to be fought in order to promote a soundly based growth process, the symmetrical virtues of the ECU as an indicator of divergence must be questionable: the onus of adjustment should fall essentially on countries which diverge from the lowest recorded rate, and not from the average.

If this approach is adopted, gradual harmonisation of "fundamentals" should be pursued simultaneously with the EMS agreements. The two efforts might be linked by reducing gradually the size of central rate changes: maximum presumptive limits for a given period of time on movements vis-à-vis the Community average would be agreed and accepted by Governments, with the endorsment of central banks, domestic trade unions and entrepreneurs' confederations:infringement of these limits would put in motion a conditionality procedure. More specifically,countries which fail to respect the agreement would see their ability to use EEC financial facilities and budget funds curtailed: redressment plans dealing with fundamental variables would also be drawn up at Community level (1).

In this perspective, the enlargement of the Community budget, so as to provide a selective and diversified system to deal with "regional" problems - offsetting existing "external" diseconomies-would not only provide a necessary instrument to foster EC integration, but also give some real incentive to pursue policies leading to domestic and European stability.

In this context of true integration and higher internal cohesion, where the ECU could play a central rôle, both in terms of the European Monetary Fund and in private markets,the question of the formulation of a common dollar policy would naturally acquire a dimension which could relate directly to the workings of the international monetary system.

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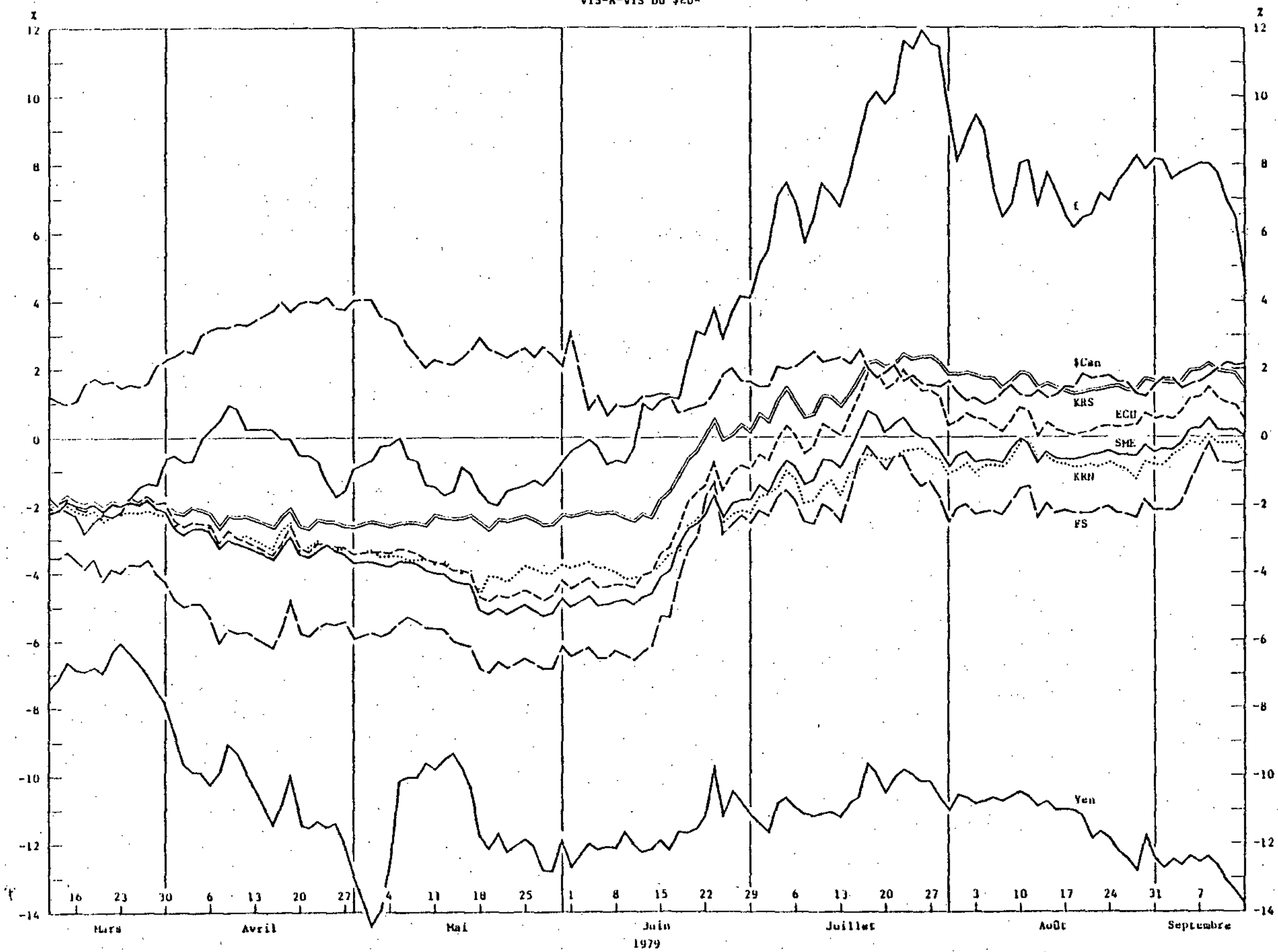
(1) For an analysis of these points see Andreatta (1978) and Masera (1979,b, Essays 3 and 4).

Chart 1

EVOLUTION DE L'ECU, DU COURS MEDIAN DES MONNAIES [illegible]
ET DES MONNAIES DES AUTRES BANQUES CENTRALES PARTICIPANT A LA CONCERTATION SUR LA BASE DES COURS RELEVES LE 28 DECEMBRE 1978 VIS-A-VIS DU $EU*



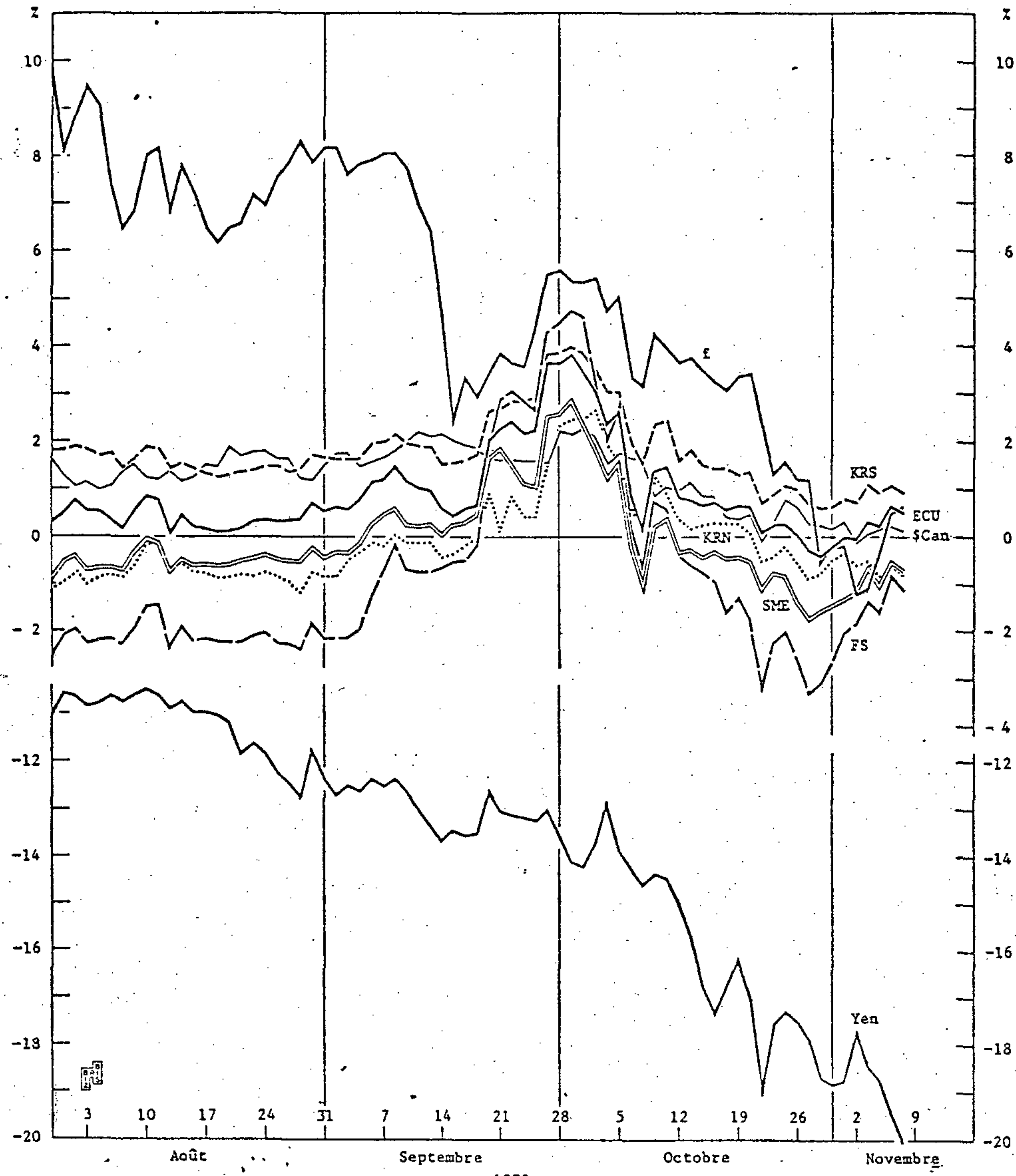
*ECU 1,37773; cours médian des monnaies participant au SME 1,3806;
£ 0,48040; $Can 1,18652; FS 1,6215; KRS 4,2850; KRN 4,9910; Yen 193,30.

14 septembre 1979/MED

Source . B.I.S.

Chart 1

EVOLUTION DE L'ECU, DU COURS MEDIAN DES MONNAIES PARTICIPANT AU SME ET DES MONNAIES DES AUTRES BANQUES CENTRALES PARTICIPANT A LA CONCERTATION SUR LA BASE DES COURS RELEVES LE 28 DECEMBRE 1978 VIS-A-VIS DU $EU*



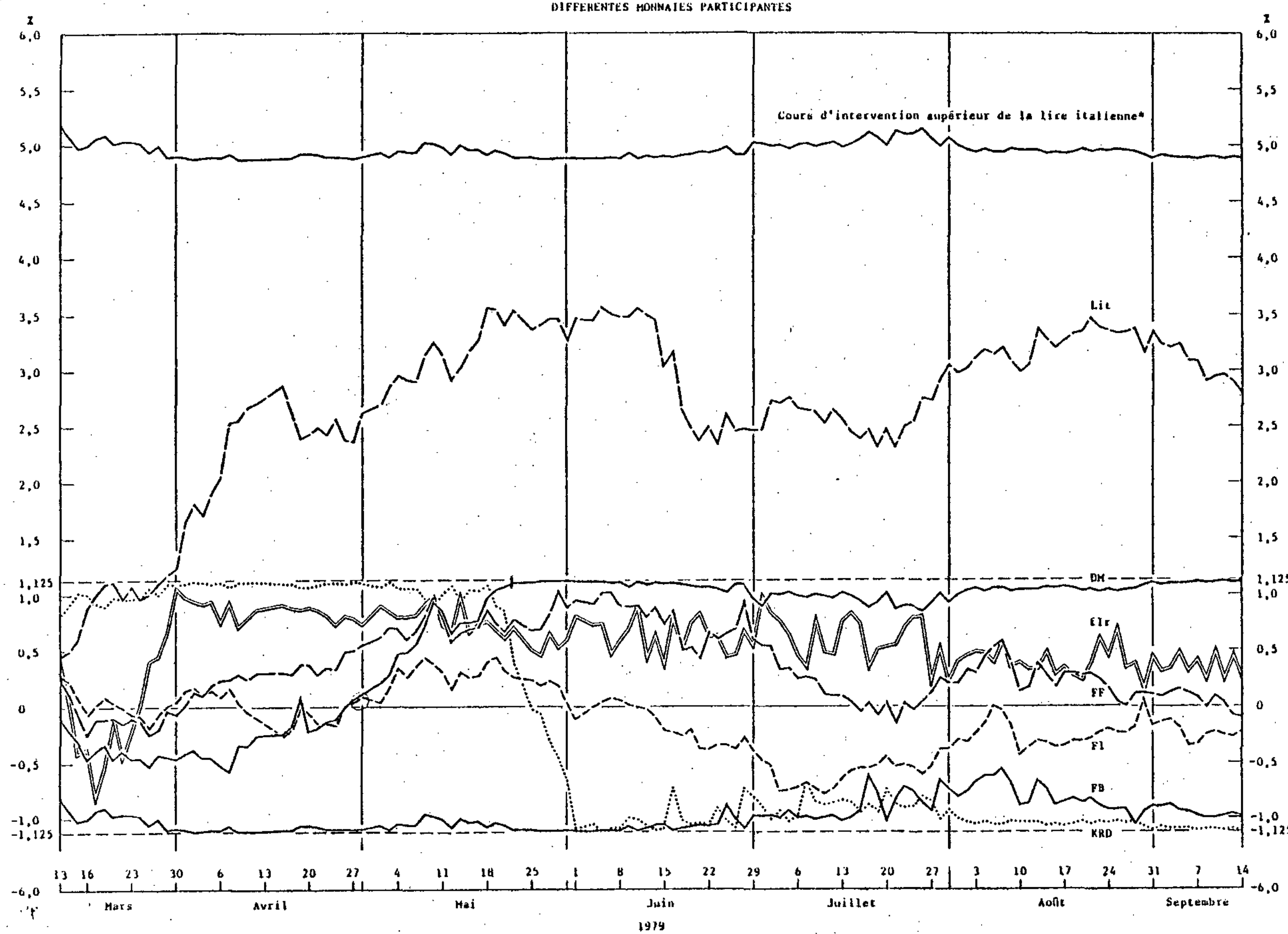
*ECU 1,37773; cours médian des monnaies participant au SME 1,3806; £ 0,48040; $Can 1,18652; FS 1,6215; KRS 4,2850; KRN 4,9910; Yen 193,30.

8 novembre 1979/MED

Sources: B.I.S.

Chart 2

MOUVEMENTS A L'INTERIEUR DE LA GRILLE DE PARITES DU SME
CALCULES SUR LA BASE DES COURS OFFICIELS DE L'ECU DANS LES
DIFFERENTES MONNAIES PARTICIPANTES



* Le cours d'intervention supérieur de la lire italienne représente l'écart maximal théorique par rapport à la monnaie la plus faible dans la bande de fluctuation étroite de ± 2,25%.

14 septembre 1979/MED

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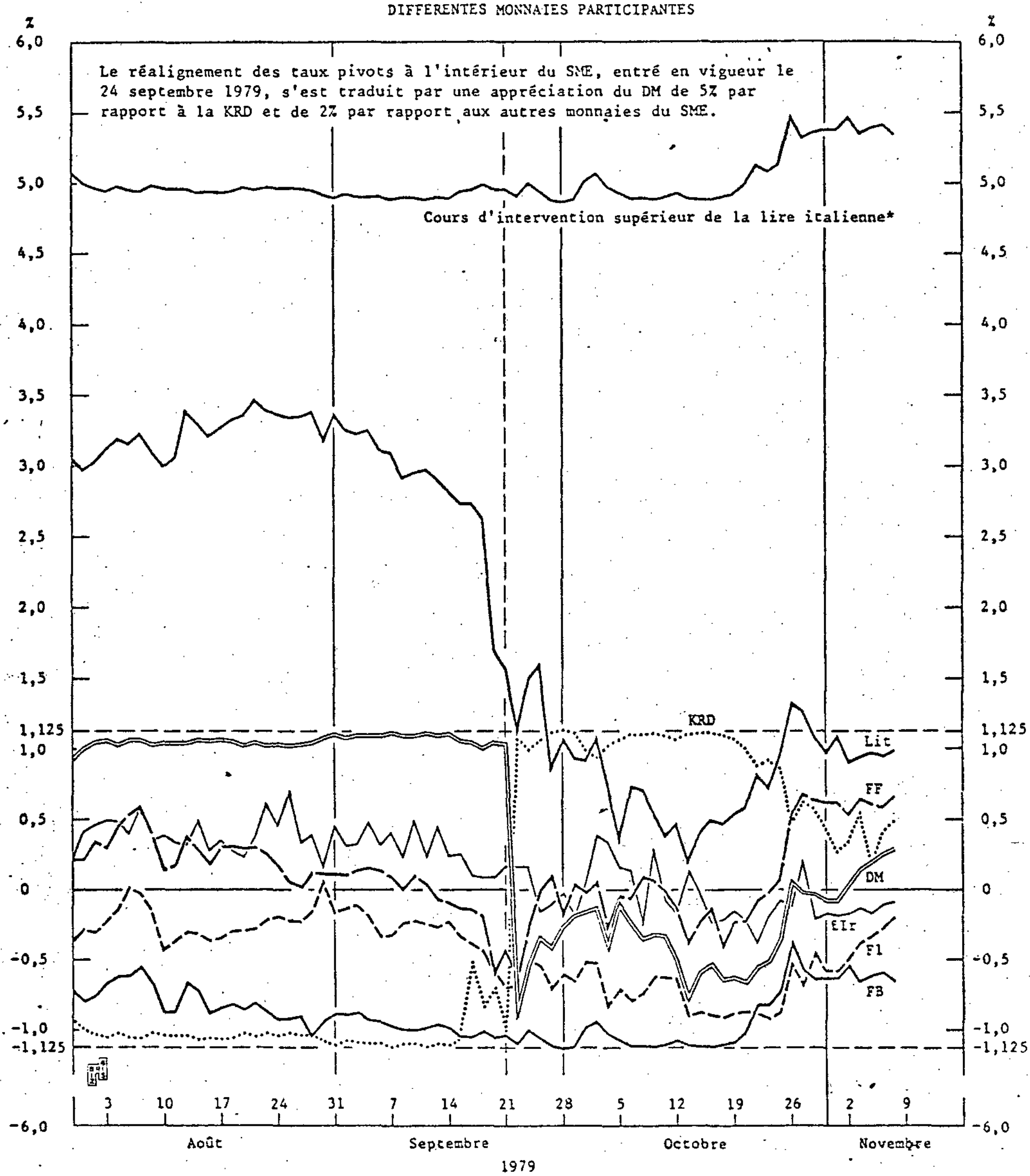

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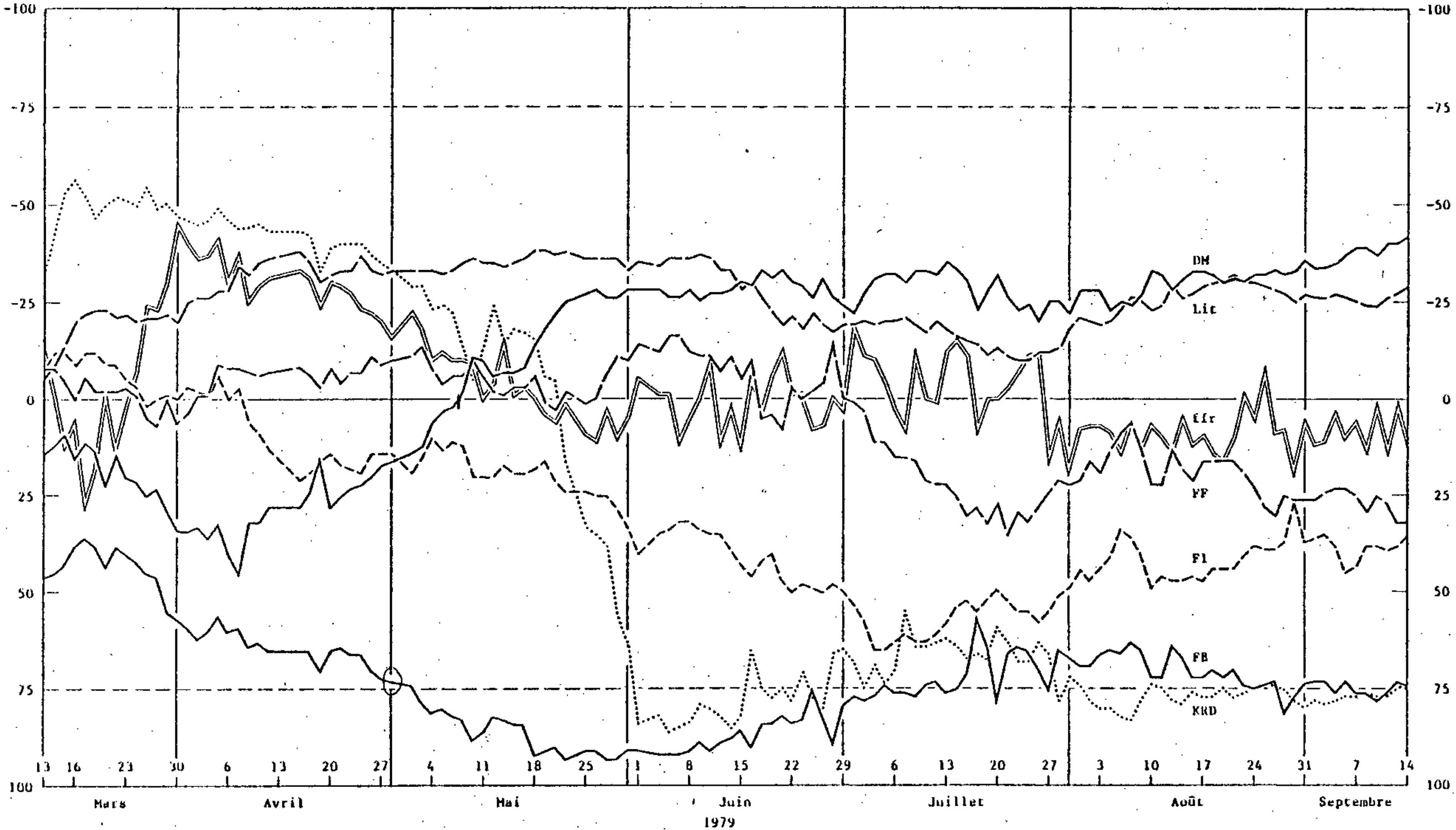
8 novembre 1979/MED

Sources: B.I.S.

Chart 3

EVOLUTION DE L'INDICATEUR DE DIVERGENCE*



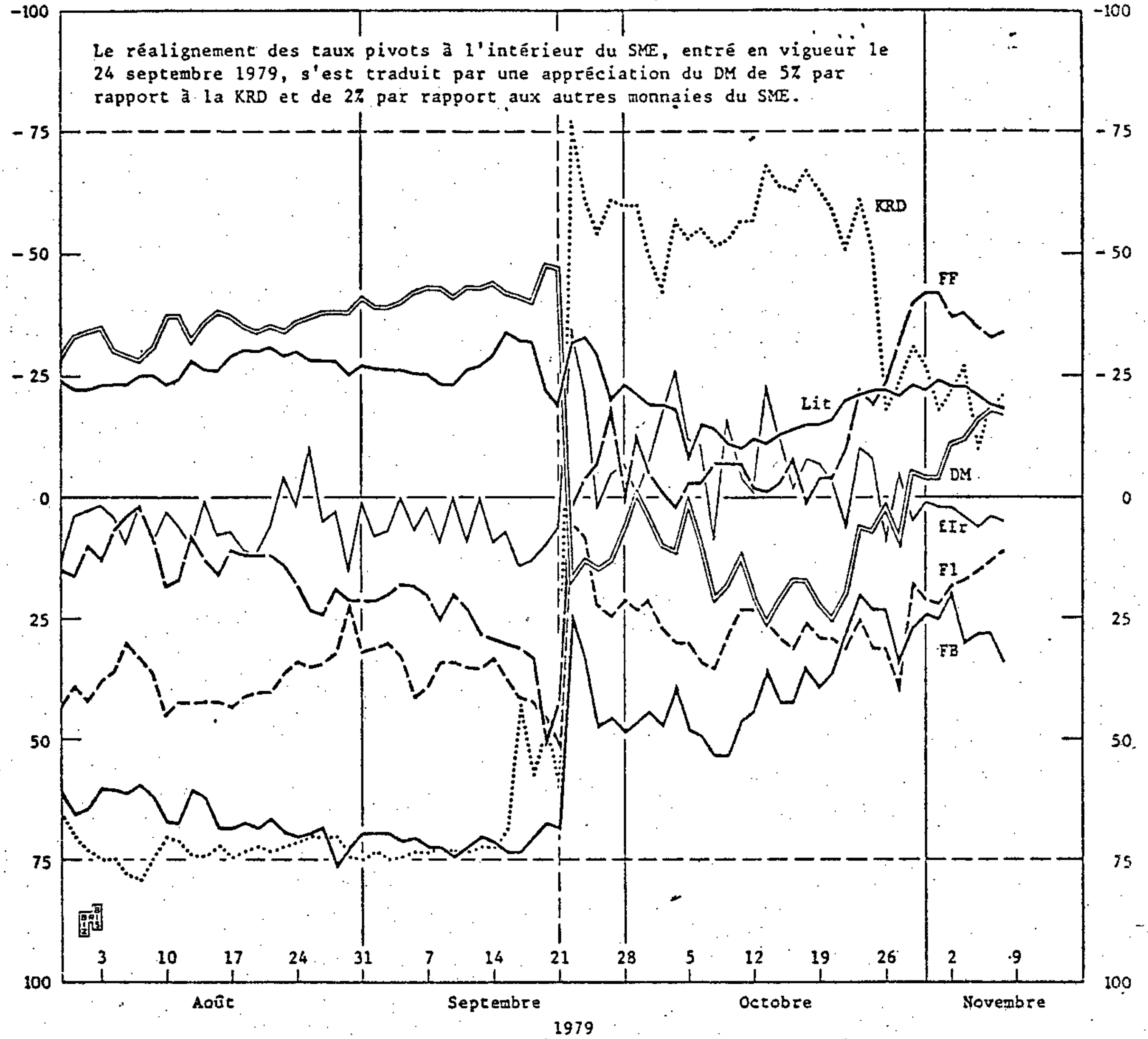
* L'indicateur de divergence a pour but de mesurer, sur une base comparable pour toutes les monnaies participant au mécanisme de change européen, la position d'une monnaie vis-à-vis de son cours-pivot Ecu. L'écart maximal de divergence est le pourcentage maximal par lequel le cours de marché de l'Ecu dans chaque monnaie peut s'apprécier ou se déprécier par rapport à son cours-pivot Ecu; il est exprimé par ± 100, le seuil de divergence étant ± 75. Les données qui ont servi de base à l'établissement de ce graphique sont les cours de l'Ecu exprimés en termes de diverses monnaies, cours qui sont toutefois corrigés des effets des fluctuations de la lire italienne et du la livre sterling au-delà de la marge de 2,25% vis-à-vis des autres monnaies participant au SME.

14 septembre 1979/MED

Source: B.I.S.

Chart 3

EVOLUTION DE L'INDICATEUR DE DIVERGENCE*



* L'indicateur de divergence a pour but de mesurer, sur une base comparable pour toutes les monnaies participant au mécanisme de change européen, la position d'une monnaie vis-à-vis de son cours-pivot Ecu. L'écart maximal de divergence est le pourcentage maximal par lequel le cours de marché de l'Ecu dans chaque monnaie peut s'apprécier ou se déprécier par rapport à son cours-pivot Ecu; il est exprimé par ± 100, le seuil de divergence étant ± 75. Les données qui ont servi de base à l'établissement de ce graphique sont les cours de l'Ecu exprimés en termes de diverses monnaies, cours qui sont toutefois corrigés des effets des fluctuations de la lire italienne et de la livre sterling au-delà de la marge de 2,25% vis-à-vis des autres monnaies participant au SME.

8 novembre 1979/MED

Source: B.I.S.

1979

Table 1

CONSUMER PRICES (twelve-month rate of change)

Countries	january	february	march	april	may	june	july	august	september	october	november	december
Belgium	3.9	3.9	3.7	3.8	4.0	4.5	4.7	4.7	4.6			
Denmark	6.7	6.9	7.0	7.0	7.9	8.6	10.4	12.3				
France	10.2	10.1	10.1	10.0	10.1	10.2	10.3	10.8	11.0			
Germany	2.9	2.9	3.3	3.5	3.7	3.9	4.6	4.9	5.2			
Italy	12.6	13.1	13.1	13.5	13.7	13.6	13.9	14.7	15.8	17.1		
Netherlands	4.1	4.2	4.4	4.3	4.1	4.2	3.8	3.8	3.9			
United Kingdom	9.3	9.6	9.8	10.1	10.3	11.4	15.6	15.8	16.5			
EEC	6.4	6.5	6.7	6.8	7.0	7.3	8.1	8.5				
United States	9.3	10.0	10.2	10.5	13.2	12.7	11.3	12.0				

Sources: IFS, FMI; Uff. Contabilità nazionale, Banca d'Italia.

1979

Table 2

WHOLESALE PRICES (twelve-month rate of change)

Countries	january	february	march	april	may	june	july	august	september	october	november	december
Belgium	3.5	4.6	5.7	5.3	6.3	6.8	7.4	6.8	6.5			
Denmark	4.2	4.2	5.0	5.8	6.6	8.1	9.5	10.0				
France	9.8	11.2	13.0	13.3	13.3	14.1	14.3	14.4	14.3			
Germany	2.3	3.0	3.7	4.1	4.2	4.7	5.4	5.9	6.2			
Italy	12.6	13.1	13.1	13.5	13.7	13.6	13.9	14.7	17.7			
Netherlands	1.8	1.8	0.9	1.7	1.7	2.6	2.9	3.5				
United Kingdom	7.8	8.3	8.6	10.8	11.2	11.7	13.5	13.8	15.5			
EEC	5.6	6.4	7.1	7.7	7.9	8.5	9.2	9.5				
United States	9.7	9.7	11.1	10.6	10.2	10.6	11.4	11.1	11.8			

Sources: Rassegna congiunturale, Banca d'Italia; IFS, FMI.

1979

Table 3

DISCOUNT RATES (end of period)

Countries	january	february	march	april	may	june	july	august	september	october	november	december
Belgium	6.00	6.00	6.00	6.00	8.00	9.00	9.00	9.00	9.00	10.00		
Denmark	8.00	8.00	8.00	8.00	8.00	9.00	9.00	11.00	11.00	11.00		
France	9.50	9.50	9.50	9.50	9.50	9.50	9.50	9.50	9.50	9.50		
Germany	3.00	3.00	4.00	4.00	4.00	4.00	5.00	5.00	5.00	5.00		
Italy	10.50	10.50	10.50	10.50	10.50	10.50	10.50	10.50	10.50	12.00		
Netherlands	6.50	6.50	6.50	6.50	7.00	7.00	8.00	8.00	8.00	8.00		
United Kinglom	12.50	14.00	13.00	12.00	12.00	14.00	14.00	14.00	14.00	14.00		
EEC	7.20	7.40	7.60	7.40	7.70	8.10	8.50	8.60	8.60	8.80		
United States	9.50	9.50	9.50	9.50	9.50	9.50	10.00	10.50	11.00	12.00		

Sources: IFS, FMI.

1979

Table 4

THREE-MONTH MONEY MARKET RATES (end of period)

Countries	january	february	march	april	may	june	july	august	september	october	november	december
Belgium	8.75	8.10	8.05	8.05	9.00	11.00	12.00	12.00	12.10	13.10		
Denmark	7.00	7.00	7.00	7.00	8.00	8.00	8.00	10.00	10.00	10.00		
France	6.69	7.19	7.19	7.19	8.63	9.19	10.25	11.50	11.75	12.81		
Germany	4.15	4.20	4.70	5.65	6.20	6.60	6.75	7.40	8.00	9.80		
Italy	11.63	11.63	11.75	11.63	11.38	11.38	11.62	11.63	11.63	13.25		
Netherlands	8.00	8.00	7.38	8.00	8.88	8.75	9.50	9.75	9.88	9.88		
United Kingdom	13.31	12.50	12.25	11.88	11.81	13.94	14.06	14.16	14.13	14.88		
EEC	7.47	7.41	7.48	7.80	8.41	9.16	9.63	9.79	10.47	11.63		
United States	9.75	9.95	9.70	9.63	9.88	9.55	9.62	10.25	11.50	14.38		

Sources: The Economist.

Table 5

"REAL" MONEY MARKET INTEREST RATES(*)

Countries	january	february	march	april	may	june	july	august	september	october	november	december
Belgium	4.85	4.20	4.35	4.25	5.00	6.50	7.30	7.30	7.50			
Denmark	1.70	0.10	-	-	0.10	- 0.60	- 2.40	- 2.30				
France	- 3.51	-2.91	-2.91	- 2.81	- 1.47	- 1.01	0.05	0.70				
Germany	1.25	1.30	1.40	2.15	2.50	2.70	2.15	2.50	2.80			
Italy	- 0.97	-1.47	-1.35	- 1.87	- 2.32	- 2.22	- 2.28	- 3.07	- 4.17			
Netherlands	3.90	3.80	2.98	3.70	4.78	4.55	5.70	5.95	5.98			
United Kinglom	4.01	2.90	2.45	1.78	1.51	2.54	- 1.54	- 1.64	-2.37			
EEC	1.07	0.91	0.78	1.00	1.41	1.86	1.53	1.28				
United States	0.45	- 0.05	-0.50	- 0.87	- 3.32	- 3.15	- 1.68	- 1.75				

Sources: see Tables 4 and 1.

(*) Estimates on an ex post basis, calculated as the difference between the nominal data (Table 4) and the 12-month rate of increase in consumer prices (Table 1).

Table 6

THREE-MONTH EUROMARKET RATES (end of period)

Countries	january	february	march	april	may	june	july	august	september	october	november	december
Belgium	8.38	8.00	7.63	7.81	9.50	11.10	12.00	12.25	12.50			
Denmark	12.38	12.92	12.44	10.08	10.81	14.08	15.65	15.60	21.00			
France	8.00	7.75	8.13	9.00	11.25	10.75	12.19	12.56	13.25	14.00		
Germany	3.94	4.00	4.94	5.47	5.94	6.25	6.56	7.38	7.50	9.25		
Italy	12.51	12.29	11.64	12.08	13.61	14.17	16.97	14.75	15.16	16.70		
Netherlands	7.32	7.13	6.57	7.19	8.88	8.50	9.13	9.28	9.72	9.50		
United Kinglom	13.44	12.81	12.19	12.31	12.00	14.25	14.88	14.25	14.31	14.72		
EEC	7.82	7.64	7.77	8.19	9.26	9.83	10.77	10.85	11.31			
United States	10.38	10.63	10.69	10.88	10.69	10.56	11.38	12.19	12.81	15.31		

Sources: COC, Banca d'Italia.

1979

Table 7

"PRIME" RATES (end of period)

Countries	january	february	march	april	may	june	july	august	september	october	november	december
Belgium	9.25	9.00	9.00	9.00	10.00	11.00	12.50	12.50	13.25			
Denmark	10.00	9.50	9.50	9.50	10.00	11.00	11.00	11.00	13.00			
France	10.95	10.95	10.95	10.95	11.30	11.60	12.20	12.20	12.50			
Germany	5.50	5.50	6.00	6.75	6.50	7.50	7.75	7.75	8.25			
Italy	15.00	15.00	15.00	15.00	15.00	15.00	15.00	15.00	15.00			
Netherlands	11.00	9.50	9.00	9.00	10.00	10.00	11.00	11.00	11.00			
United Kingdom	14.00	15.00	14.00	13.00	13.00	15.00	15.00	15.00	15.00			
EEC	9.60	9.60	9.70	9.70	9.90	10.60	11.09	11.09	12.72			
United States	11.75	11.75	11.75	11.75	11.75	11.50	11.75	12.75	13.50			

Sources: World Financial Markets, Morgan Guaranty Trust.

1979

Table 8

"REAL" PRIME LENDING RATES (*)

Countries	january	february	march	april	may	june	july	august	september	october	november	december
Belgium	5.75	4.40	3.30	3.70	3.70	4.20	5.10	5.70	6.75			
Denmark	5.80	5.30	4.50	3.70	3.40	2.90	1.50	1.00				
France	1.15	-0.25	-2.05	-2.35	-2.00	-2.50	-2.10	-2.20				
Germany	3.20	2.50	2.30	2.65	2.30	2.80	2.35	1.85	2.05			
Italy	2.40	1.90	1.90	1.50	1.30	1.40	1.10	0.03	- 2.70			
Netherlands	9.20	7.70	8.10	7.30	8.30	6.40	8.10	7.50				
United Kingdom	6.20	6.70	5.40	2.20	1.80	3.30	1.50	1.20	-0.50			
EEC	4.00	3.20	2.60	2.00	2.00	2.1	1.89	1.59				
United States	2.05	2.05	0.65	1.15	1.55	0.90	0.35	1.65	1.70			

Sources: see Tables 7 and 2.

(*) Estimates on an ex post basis, calculated as the difference between the nominal data (Table 7) and the 12-month rate of increase in wholesale prices (Table 2).

APPENDIX

In this Appendix we shall examine, albeit briefly, the main lines of the problem regarding a simultaneous analysis of the divergence with regard to the ECU and in terms of effective and real exchange rates. In order to prevent the treatment of the question from being excessively complex, a number of simplifying hypotheses will be made (1).

The ECU divergence indicator in absolute (not relative) terms can be expressed as (2):

$$(A.1) \qquad I'_j = \sum_{i \neq j} \pi_i \dot{x}_{ij} \Big/ \sum_{i \neq j} \pi_i = \sum_{i \neq j} \frac{\pi_i}{(1-\pi_j)} \dot{x}_{ij}$$

where x_{ij} denotes the price of the reference currency j in terms of the i^{th} currency (number of units of i for one unit of j), π_i is the weight of each currency in the ECU basket, the summation (Σ) extends to all EC currencies, and the percentage changes in the exchange rates are indicated by the superscript ($\dot{}$).

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(1) An analytical treatment of the subject in more general terms is to be found in Rossi (1979).

(2) For an analysis of these points see Masera (1979).

In general, the expression of the divergence indicator with regard to the effective exchange rate can be written as:

$$\text{(A.2)} \quad IE_j = \sum_{i=1}^{z} \dot{x}_{ij} \, \rho_{ij}$$

where the index of the currencies covers, in principle, all the currencies and ρ_{ij} is the weight to be attributed to the change $\dot{x}_{ij}$, normally defined as the ratio of the trade (exports + imports) between the countries i and j $(M_{ij} + X_{ij})$ and the total trade of the country j $(M_j + X_j)$.[3]

For the sake of simplicity, we shall assume in the first place that there is only one important currency external to the EEC currencies: the dollar, which is the n + 1[th] currency. With regard to the weights, while those of the dollar in the various EEC countries are defined as $\rho_{n+1,j}$, for j = 1...n, the intracommunity weights (ρ_{ij}, for $i \neq j$ and $1 \leqslant i \leqslant n$) are derived from the ECU weighting, suitably scaled (given $\rho_{n+1,j}$) so as to bring the total back to unity:

$$\rho_{i,j} = \pi_i \, \frac{1-\rho_{n+1,j}}{1-\pi_j} .$$

On the basis of these assumptions we therefore obtain as a simplified expression of (A.2):

$$\text{(A.3)} \quad IE'_j = \sum_{i \neq j}^{n} \pi_i \frac{(1-\rho_{n+1,j})}{(1-\pi_j)} \dot{x}_{ij} + \rho_{n+1,j} \dot{x}_{n+1,j} = (1-\rho_{n+1,j}) I'_j + \rho_{n+1,j} \dot{x}_{n+1,j} \; ;$$

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[3] We have, therefore: $\sum_{i=1}^{z} \rho_{i,j} = \dfrac{\sum_i (M_{i,j} + X_{i,j})}{M_j + X_j} = 1$, where $\rho_{ii} = 0$

taking account of equation (A.1). Equation (A.3) shows that the divergence indicator with regard to the effective exchange rate of the EEC currencies, as defined here, is a weighted average of the ECU indicator and the percentage change with regard to the dollar since the date when the central rates of the EMS were fixed. It is obvious that, depending on the relative weight of the dollar, a movement of the same size in the Community currencies vis-à-vis the dollar will have different effects on the various economies and, in particular, ceteris paribus, will modify their respective competitive positions as measured by their so-called real exchange rates. It should be noted in this connection that, denoting the real bilateral exchange rate between currencies i and j by $r_{ij} = x_{ij}\, P_i/P_j$, we can define the indicator of the "real" divergence of currency j, in a manner corresponding to the simplifying assumptions introduced above, as:

$$(A.4)\quad IR'_j = \sum_{i \neq j}^{n} \pi_i \frac{(1-\rho_{n+1,j})}{(1-\pi_j)} (\dot{x}_{ij} + \dot{P}_i - \dot{P}_j) + \rho_{n+1,j}(\dot{x}_{n+1,j} + \dot{P}_{n+1} - \dot{P}_j) =$$

$$= (1-\rho_{n+1,j})\, IR'_E + \rho_{n+1,j}\, IR_{US}$$

where $IR'_{jE} = \sum_{i \neq j}^{n} \frac{\pi'_i}{1-\pi'_j} (\dot{x}_{ij} + \dot{P}_i - \dot{P}_j)$ is the index of real divergence with regard to the European currencies, while $IR_{jUS} = (\dot{x}_{n+1,j} + \dot{P}_{n+1} - \dot{P}_j)$ is the real divergence vis-à-vis the United States.

The divergence formulas derived in this Appendix show , in the first place, that the European exchange rate agreements are incomplete without the operational definition of coordination procedures in exchange rate matters with regard to third currencies, and especially the dollar. This is particularly important in an international context such as the present, in which the American authorities' policy of benign neglect has been replaced by one of active interest in the course of the external value of the dollar. The setting of the (moving) band of fluctuation between the ECU and the dollar should, in fact, be agreed upon between the European central banks and the Federal Reserve. In the medium term, EEC coordination could be within the ambit of the EMF and take place in direct interventions in ECU, were the European scudo to circulate as a parallel currency. In the immediate future, considerations of a practical nature suggest that, when market quotations vis-à-vis the dollar do not appear appropriate and require corrective action, the definition of the ECU-dollar relationship should implicitly result from actual intervention in the most important EEC currency. It is nonetheless clear that the European intervention policy should in any case depend on a weighted assessment - preferably with the weights of the ECU basket - of the " preferences" of the individual European central banks concerning desired relationships for each currency vis-à-vis the dollar.

The analysis of the exchange rate movements among the EEC currencies in "effective" terms is naturally important in that it allows reference to be made to changes in real exchange rates, i.e. in overall competitive position. Thus, for example, if the agreed movement of the ECU vis-à-vis third currencies brings about a particularly large change in the index IR'_j, the currency in question would have good grounds for having recourse to a change in its central rate vis-à-vis the ECU. From a general point of view, it should be noted that the operative configuration of the EMS is considerably different from those generally proposed after the crisis of the Werner approach and the insuccess of the Marjolin (1975) and Tindemans (1976) reports, which were explicitly based on the evolution of real exchange rates.[4]

On the other hand, it is evident that it is not possible to ignore the evolution of real exchange rates so as not to run the risk of the EMS causing distortions in productive processes instead of contributing to balanced growth and the correct allocation of resources within the Community.[5] For this reason, I consider it would

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[4] See, for example, the plan officially proposed by the Minister Duisenberg and the Optica report (1977). In this connection see also Basevi (1979).

[5] Fears of this nature have been authoritatively expressed by Giersch (1979) on the basis of the following reasoning: 1) the German trade unions fully accept responsibility for price stability, thereby giving rise to an undervaluation of the DM vis-à-vis the other EEC currencies

note [5] cont.

2) the changes in exchange rates in the EMS are delayed, so that unit labour costs in Germany encourage investment by both residents and non-residents; 3) a deutschemark tied within the EMS is less attractive compared with the dollar, so that unit labour costs in Germany are not too high compared with the United States. In this way Europe uses the German trade unions as a disciplinary force of its monetary system, compensating them with the offer of investment and full employment with higher real wages in the medium term.

be worth introducing, in addition to the existing exchange rate agreements, certain "rules of the game" for real exchange rates as well. These rules should promote the convergence of nominal exchange rates and the lowering of inflation rates. As indicated in the text (pp.) with regard to the "permitted" evolution of costs and prices in individual countries, the definition of these rules should involve the commitment of the economic authorities, employers and unions. In analytical terms this would require the definition of "permitted" margins also with regard to real exchange rates, which, when they were exceeded, would allow a change to be made in the ECU exchange rate, though within a certain previously agreed limit set, for example, every year. [6]

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[6] It is obvious that these limits would have to be fixed bearing in mind a certain expected evolution of third currency exchange rates, and would be reviewed if these developed in a manner different from that which had been expected.

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The EMS, the Dollar, and U.S.-European Monetary Relations -- An Historical Perspective*

by

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This paper offers some observations about the connections between efforts at European monetary unification and U.S.-European monetary relations. Presenting this paper gives me an opportunity, for which I thank the organizers of this conference, to get off my chest a number of reactions I have had to views put forward on this subject both by members of my own profession and by political scientists.

U.S. Hegemony

One often comes across the proposition that efforts in Europe over the past decade to accelerate economic integration in general and monetary integration in particular have been a reaction to what has been termed the loss or disappearance of American hegemony. By hegemony is meant, I take it, the ability of the United States to successfully exert its will over Europe. It seems to be widely believed, particularly among political scientists I have read, that such American hegemony evaporated over the weekend of August 15-17, 1971.

It has been my observation that the ability of the United States to have its way, so to speak, in Europe weakened markedly way back in the late 1950s. I shall not try to put a precise date on this event but one only needs

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to study the negotiations over the General Arrangements to Borrow (GAB) to learn that in the early 1960s European economic and monetary officials felt themselves to be quite strong in relation to the United States. The agreement on the GAB incorporated procedures under which, it was thought at the time, the Europeans would be able to have a strong influence on American economic policy. The GAB was established on American inspiration in order to provide a defense against a possible run on the dollar. In order to get the Europeans to go along, the Americans had to agree that the policies of a country drawing on the International Monetary Fund in sufficient magnitude to require activation of the GAB would be subject to scrutiny and approval in two international bodies dominated by the European countries, in addition to examination in the I.M.F. executive board. Both the Group of Ten deputies and the Working Party Three of the O.E.C.D. were given a significant role in the procedures established under the GAB.

I dredge up this history because it seems to me to demonstrate the rather weak position in which American officials felt themselves to be. It also demonstrates the sense of strength and self confidence that European officials, led by French Finance Minister Wilfred Baumgartner, had come to feel and exercise.

Further examples of the loss of American hegemony can be found in an examination of the negotiations over the establishment of special drawing rights. While it is true that the Americans took the leadership in this effort and that the effort was ultimately successful, it is also true that the Americans had to compromise again and again in order to bring the Europeans along. In particular, French recalcitrance and the desire of the European negotiators to maintain European unity led to many compromises along the way. The result was that the SDR that finally emerged was described by Americans as a new reserve asset and by French officials as simply another credit facility. This led Otmar Emminger to quip that "a zebra can be regarded as a white horse with black stripes or a black horse with white stripes."

Another example is provided by the failure of the American-led effort to introduce greater flexibility into the par value exchange rate system in 1969-71. This effort failed, in part, because the proposed increased flexibility would have applied to all currencies except the dollar, under the Bretton Woods arrangements where only the dollar was convertible into gold. I have argued elsewhere that this effort failed while the SDR effort succeeded because the latter seemed to move the system toward greater symmetry whereas greater exchange rate flexability would have made the asymmetries more apparent.*

From this evidence, and additional evidence could be marshalled, I would conclude that the reactivation of efforts toward European economic and monetary union in the late 1960s cannot be ascribed to a loss of American hegemony. That hegemony had weakened much earlier.

The U.S. Balance of Payments

Another possible explanation for the activation of European efforts in the late 60s might be related to what was happening to the U.S. balance of payments. Were the Europeans trying to defend themselves against the "excesses

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* Robert Solomon, The International Monetary System, 1945-1976: An Insider's View, Harper & Row, 1977, pp. 212-13.

of the dollar" when they took up efforts at monetary union in the late 60s?*

One immediately has to note, of course, that the resignation of General deGaulle and the accession of President Pompidou must have had something to do with the improved prospects for European monetary integration in 1969.

What was the condition of the U.S. balance of payments and of international monetary stability in the period leading up to the revival of unification efforts in 1969? It is worth remembering, first of all, that in 1968 there was a monetary crisis in Europe involving the French franc and the German mark -- a crisis that had nothing to to with the dollar. The events of May 1968 had led to a weakening of the franc while the recession of 1967 had led to a marked strengthening of the Deutsche mark. Thus there was a mark-franc crisis in November 1968 necessitating a meeting of the ministers of the Group of Ten. There was a widespread expectation that the franc would be devalued -- an expectation that General deGaulle brusquely turned away in an address to the French public.

The franc was finally devalued quietly and efficiently in August 1969 and at the end of September 1969 the Deutsche mark was revalued. Meanwhile in 1968 and 1969 the overall balance of payments of the United States was quite strong. Under the impact of tight money and high interest rates, the United States attracted a large inflow of short term funds from the Eurodollar market. This plus other factors -- restrictions on investment outflows and an inflow of European funds to the U.S. stock market -- required a number of European countries to sell dollars. Some of them had to raise their interest

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* Niels Thygesen, "The Emerging European Monetary System: Precursors, First Steps and Policy Options," EMS: The Emerging European Monetary System, 1979.

rates to protect their reserves, as some have recently had to do to maintain their position in the E.M.S.

While the U.S. balance of payments position turned around in 1970 it didn't become seriously in deficit, and the so-called dollar crisis did not begin, until sometime in 1971. Thus the general balance-of-payments situation does not seem to me to offer an explanation for the desire of the European countries to renew their efforts at integration, particularly monetary integration. On this point I seem to be in some disagreement with Niels Thygesen.

As an American I am not able to give a full explanation for what motivated the thinking of 1969-70 in Europe. I would only venture to guess that the motivation came from within Europe rather than as a reaction to the United States. Moreover, the device of narrowing exchange rate margins was seized upon as a means of, shall I say, forcing economic integration. I well remember extensive discussions with European friends at the annual meeting of the International Monetary Fund and World Bank at Copenhagen in the autumn of 1970. There was no crisis atmosphere at that time, as I said earlier. One of the major topics of corridor discussion was the Europeans' plan for narrowing margins among themselves. This plan was being examined from a technical point of view and one of the concerns that we Americans had was the following: how would it be possible to introduce greater flexibility into the worldwide exchange rate system -- a project that was under consideration in the International Monetary Fund and elsewhere -- while the Common Market countries were in the process of trying to lock their exchange rates together? This created a dilemma which my European friends were unable to resolve.

Thus it seems to me that we cannot attribute the monetary efforts of ten years ago to a European reaction to instability in the U.S. balance of payments.

I might note that at that time, as now, Americans were not particularly opposed to European monetary integration efforts. The position was, as it seems to be now, one of sympathy for European aspirations and a wish that the steps the Europeans take to achieve those aspirations would remain consistent with an open world trading and financing system.

The E.M.S. and U.S.-European Relations

I am not prepared to argue that more recent efforts in Europe toward unification, specifically the establishment of the E.M.S., were not a reaction against what was regarded in Europe as dollar instability. I believe many Europeans felt that the exchange rate movements between the autumn of 1977 and the autumn of 1978, when the effective exchange rate of the dollar fell by 16 percent, ~~was~~ were a reflection of unstable American policies. There was a reluctance in Europe to see European performance and policies as also providing an explanation for the exchange rate movements that occurred.

As I analyze what happened in 1977-78, certainly a part of the sharp increase in the current account deficit of the United States is explainable by the rising imports of oil into the United States in 1977. But that's only part of the story. It is also true that in 1977 there was a near recession in Europe and Japan. This shows up in industrial production figures and it appears in a very slow expansion of imports into the European countries and Japan. Meanwhile the American economy was expanding in 1977 and 1978. As a result of this difference in rates of economic expansion the imports of the United States increased much faster than did the exports. The reversal in current account positions over the past year, when the rate of economic expansion in Europe and Japan has accelerated as a result of more stimulative policies adopted in Germany, Japan, and other countries, offers supportive evidence for this point of view, it seems to me.

But that is simply analysis and what matters is not analysis but perception. No doubt Europeans perceived that exchange rates were unstable largely as a result of what was happening in the United States. Thus even though analysis might point in one direction, perceptions pointed in another and the heads of government of Germany and France looked in that other direction. The result was the establishment of the European Monetary System.

Now that the E.M.S. is in operation, what can we say about its future in terms of U.S.-European relations? We could talk about the role of gold in the E.M.S. There is a bit of uneasiness in America about the fact that gold has been taken into the European Monetary Cooperation Fund at something close to market prices but I don't think it would be terribly fruitful to pursue this subject. I suspect that the European Fund will simply lock up the gold and serve in effect as a gold substitution account.

Can we also regard the European Fund as a substitution account for dollars? It is easy to imagine that as time goes on the members of the E.M.S. will continue depositing dollars and possibly also gold in the European Monetary Fund in exchange for E.C.U.s. In the process the European Monetary Fund would become a European substitution account for dollars and gold.

Meanwhile it is to be hoped that there will be agreement in the International Monetary Fund for a worldwide substitution account for dollars. And if such an account is to be successful it will be necessary for the European countries to participate. Thus one can imagine substitution taking place in two different accounts. One in Europe regionally and one in the International Monetary Fund. This is technically compatible, and it need not be politically or psychologically incompatible. As a counterpart, of course, there will be an increasing amount of E.C.U.s created and there might begin to be some concern as to whether the development of the E.C.U. is not throwing a shadow over the SDR. As long as the use of the E.C.U. as a reserve asset is confined within Europe, there is no reason to be concerned about the continued vitality of the SDR.

I doubt that Europe will need its own reserve asset when monetary unification is complete. Once exchange rates are irrevocably locked together, as they are between Massachusetts and Connecticut, there will be no need for transfers of reserve assets among members of the EMS. Their currencies will circulate freely throughout Europe. If I am right, the E.C.U. should be regarded as having a temporary existence.

Since it is my assignment to look backward rather than forward, I shall refrain from trying to make any further predictions about the operation of the EMS or about relations between Europe and the United States. What I would conclude from this bit of economic history is that it is possible for Europe to go on with its understandable and even laudable efforts at economic and monetary integration without the spur, in one form or another, of anti-Americanism.

5

Luigi SPAVENTA

I. Introduction

I am presenting to this Conference some parts of a more detailed research on the economic and political history of Italy's joining the EMS. The complete outline includes the following sections besides the introduction: one on the developments of the official and unofficial Italian attitude from Copenhagen to Bremen; one on Italian economic diplomacy after Bremen; one on the internal dispute on the EMS; and one on Brussels and the week after. I have gathered material for all these sections, but only the one on Italian economic diplomacy and the first part of the last one have reached a semi-finished form and are submitted to this conference.

Why should an economist bother with the history--and a fragment of history at that--of the EMS and not with its economics? There are three reasons which pushed me in this direction. First, from Copenhagen to Brussels, in the evolution of the negotiations and in all the relevant national and international decisions concerning the EMS, political elements by far outweigh economic considerations. Second, whereas everything or almost everything has been said on the economic merits and demerits of the EMS, there still are, at least in the case of Italy, several unanswered questions concerning its history. Third, it may be useful to collect some material before it is dispersed and to gather the recollections of the insiders when they are still vivid.

On some of the issues I have considered there is even an excess of published material: thus, on the internal political debate three volumes of articles published in newspapers or periodicals have been collected by the documentation centre of the Senate. Not surprisingly, hardly anything has instead been published on the negotiations and on the way in which a number of decisions were taken. I therefore had to rely on the courtesy and patience of a number of persons, who, having taken some part--large or small--in the events, were good enough to talk to me and supply me with some valuable material. They are the former Prime Minister Hon. Giulio Andreotti, Governor Paolo Baffi of the Bank of Italy, Hon. Luciano Barca, Dr. Guido Carli, Hon. Fabrizio Cicchitto; Dr. Rainer Masera of the Bank of Italy, Hon. Giorgio Napolitano, Dr. Rinaldo Ossola, Treasure Minister, Hon. Filippo Maria Pandolfi, Professor Antonio Pedone, Hon. Altiero Spinelli. Alphabetical order does great injustice to some of them, who deserve my particular gratitude.

III - Italian Economic Diplomacy after Bremen.

3.1 In surveying and appraising the negotiations, bilateral and multilateral, between the Italian government and the European partners, two problems arise, which remain to some extent unsolved. (i) Had the Italian government decided to join in any case or was entry made conditional upon certain minimal requirements? (ii) Which were the objectives of the Italian negotiators? What did they seek to obtain from their partners and how successful were they?

The first question requires further specification, as the picture very much changed according to whether Britain decided to join or not. In the former case, there was, I believe, a fairly widespread conviction, even amongst those more hostile to the new system for technical reasons, that it was hardly possible for Italy to stay out by herself: the political significance of being the only EEC country left out would then outweigh other technical considerations; with Britain in, on the other hand, the lira -some felt- would be less exposed to speculative storms and, owing to British pressures, better conditions could be obtained. Even with this qualification, however, the problem stands, as the British attitude during the negotiations ranged from ambiguous to discouraging and by November it became clear that, with the elections postponed until the following spring, Britain would not join. It is therefore legitimate to ask if the Italian government had clearly in mind what to do on the increasingly plausible assumption that Britain stayed out.

As we shall better see in the following section, in the internal debate the dividing line was between those who believed that the external and/or internal political aspects of the EMS were far more important than the balance between economic costs and benefits and those, instead, who gave greater emphasis to the economic side of the question. The former were in favour of joining even without Britain (though with some initial hesitations); the latter thought that Britain's refusal would remove the major political reason for joining, so that the decision should depend on whether certain minimal conditions were satisfied. It is possible to detect the same split between the two bodies which assisted or represented the Government in the negotiations: the Foreign Ministry's bureaucracy on the one hand and the Bank of Italy on the other.

3.3 The Foreign Ministry's opinions (which was not always identical to the Foreign Minister's view) was that, though negotiating, we should eventually accept the EMS, whether it included Britain or not: one could even say that they did not care much whether Britain was in or out. Not only does this position emerge from accounts of people directly or indirectly involved in the negotiations; it was stated in unambiguous terms by Minister Renato Ruggiero, who was in charge of the negotiations, at a conference held by a Christian-Democratic group (a somewhat unusual occasion for a civil servant to express his views) at the beginning of September:

> "I believe that it is very important for us, and there is the clearest political will of the Government in this sense, to participate to the EMS since its inception, negotiating the conditions in the best possible way. Today we need the Community more than ever. If we did not participate to the EMS, this would show that we are unwilling to accept the challenge...of being a fully European country" (1).

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(1) In AREL, La lira e lo scudo: la scommessa europea, Bologna 1978 pp.100-101.

The Bank of Italy's view was different. As we have already seen, in the preparatory work which took place between Copenhagen and Bremen, the Bank had supported a rather loose arrangement: reference rates expressed in terms of effective exchange rates without compulsory interventions. The underlying view was that a system as rigid as the snake, but including the former floaters, had little chance to survive; that, in particular, the time was not ripe for us to join such a system and that a revaluation of the lira could, in our conditions, be the effect, and not the cause, of a reduction in our inflation rate; that an early collapse of the new system would be a serious and undesiderable setback (1). After Bremen, as there emerged "an apparently wide and precise will of our European partners to build a truly new European Monetary System", the Bank was ready to accept more binding arrangements (2): more binding, but nonetheless possessing certain minimal requirements of flexibility which were also considered as minimal conditions for joining. The existence of such conditions was considered all the more important if Britain decided to stay out. Unlike the Foreign Ministry, the Bank attributed the utmost importance to the presence of Britain in the system, both because, with sterling in, the forms of speculation would not concentrate on the lira in times of crisis, and for more general economic and political reasons. Troughout the negotiation the Bank often attempted to establish a common front with the English, by trying, on the one hand, to allay the growing British criticism of the system (3), and by inducing our Government, on the other hand, to

(1) See Bank of Italy, Annual Report, 1978, Baffi, 1978a, Baffi 1978b.
(2) Baffi, 1978b.
(3) This aim was pursued with great energy and ingenuity in the preparation of the bilateral meeting between the British and the Italian Prime Ministers in London, on November 22.

support British views on particular points. These attempts found an obstacle both at the technical level, as it was realized that the British authorities were not interested in the same things as we; and at the political level, as the feeling developed on our side that their behaviour was entirely dictated by internal political considerations, and on their side that the German influence was stronger and that we could not be trusted to take a tough line.

3.4 The impression one gathers at first sight from the little one knows is that the Italian government, pulled by two different forces, failed to work out a consistent line and kept hovering about different positions, none of which was pursued with great conviction. A more careful examination, however, may lead to a somewhat different, but even less encouraging conclusion.

Suppose the Government had decided that Italy should, on the whole, enter the new system, though seeking to obtain better conditions. One should then expect the Government to secure a preliminary internal consensus from the political forces by which it was supported, without however fully showing its hand in external negotiations. In other words, one would expect it to adopt a tougher attitude abroad than at home, in order to strengthen its bargaining power, and to avoid, at the same time, a dangerous feedback between the evolution of the negotiations and internal political feelings. What happened was, more or less, the opposite. A rather velvety hand was shown during the negotiation with our partners, while an iron glove was often displayed at home, the assumption being that, somehow, we would obtain in the end some of the things which we had failed to obtain before. When the assumption proved unfounded a change of attitude was attempted: but, as we shall see in a later section, it was then too late to cut the internal political losses and to reach a more satisfactory external result.

This conclusion, of course, not only requires some proof, but it implies an answer to the second of the two questions we set at the beginning of this section: what were our objectives during the negotiations and how successful was our diplomatic action? In a short essay written ex post factum, Minister Renato Ruggiero gives the following answer:

> "In the monetary field the most difficult dispute concerned the definition of intervention obligations...With respect to the initial formulation of 'compulsory consultation', Germany eventually accepted the clause of 'presumption of intervention'... For the rest, our request of a 6 per cent. floating margin was accepted and so were, with minor changes, our requests concerning the financing mechanisms. On the issue of the 'involuntary debtor' we obtained an explicit promise that the problem would be considered six months after the beginning of the EMS. It is less than what we had asked, but it is all the same a substantial result.
>
> The results achieved in the field of the 'measures aimed at strengthening the economies of the less prosperous member states' were less satisfactory;" but some good progress was achieved later, with the statement of the European Council of Paris in March 1979"(1).

This is, I fear, a somewhat oversimplified answer; or, rather, an ex post rationalization of a far more complex and less clear-cut story, in which the targets of our action were not very clear at the beginning and, as they became clear, were subsequently discarded or modified as a result

(1) R. Ruggiero, b, p.168.

of the opposition of our partners. This, at least, is the impression one gathers from a tentative and summary reconstruction of the evolution of the Italian negotiating position, to which we now turn in order to provide some factual basis to what has been said so far.

3.5 We may begin with the first official presentation of the Italian position after Bremen. At the joint session of The Foreign Affairs and Finance and Treasury Committee of the Chamber of Deputies on July 20, the Treasury Minister, Mr. Pandolfi said that the Government "does not attribute too much importance to the possibility that some countries are temporarily allowed to float within a wider band and does not consider essential to engage in an attempt to obtain an increase in the credit facilities of the European Monetary Fund... Far greater importance should be given to the procedures and to some flexible mechanism for altering the central rate, even without asking for a special status for our country". The procedures, in the Government's view, should be simple and rapid. Further, an explicit community policy vis-à-vis the dollar is requested (1).

This outline of the Italian position is remarkable for two reasons. First, it is at variance with the positions taken by the Italian Government in the following weeks and months: the width of the band will be considered, or at least be presented, as a key condition; considerable importance will be attributed to the size and composition of the credit facilities, and to devices, such as the "involuntary debtor clause", which ought to ensure some simmetry of obligations; great stress will be laid on the "parallel measures" in favour of the less prosperous economies; the procedures for altering the central rate, instead, will hardly be mentioned again. Further, the Pandol-

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(1) Pandolfi (a), pp. 8-11, 16,17, italics mine.

fi presentation differs from the account given in retrospect by the then Governor of the Bank of Italy, Dr.Baffi. According to Dr.Baffi, the tenets of the Italian position after Bremen, were the following:

a) an economic, rather than a mechanical interpretation of the principle according to which the new system should be at least as rigorous as the snake;

b) a difference of margins, for different members, sufficient to accomodate different inflation rates and compatible with forward rates;

c) simple conditions for changing central rates;

d) correction of the asimmetry built into the ECU (1).

Here again, we note that importance is attributed to conditions which are explicitly or implicitly disregarded in the Minister's presentation.

3.6 If the Italians had thought that they could easily find a common ground of negotiation with the English, they were soon going to be disappointed. At the meetings in London, on July 24 and 25, between the two countries' central bankers and between Chancellor Healey and Minister Pandolfi it emerged that the English were not in the least interested in attempting to make the new system looser than the snake: in particular, they were not interested in either the wider band or a mechanism which may resemble a crawling peg. The system should, in their view, be strict, though allowing any member the possibility of occasionally opting out.

We, on the other hand, wanted the new system to be not only different from, but looser than the snake and conceived a greater looseness as its general characteristic, rather than as a special concession for us: in this

(1) See Baffi (b).

context, the wider band acquired far greater importance than it appeared from the words of Minister Pandolfi in Parliament. I further surmise that we, instead, were not much interested in opting-out clauses: our political interpretation of national pride being such that leaving the system, even temporarily, after having joined, would be for us a far more traumatic affair than for the English.

The points of agreement were rather less specific, or at least less operational than the points of disagreement: an emphasis on symmetry of obligations; the size of credit facilities; an aversion to a parity-grid system; the importance given to "parallel measures" in the field of regional policies. On the issue of symmetry, the specific British proposal that the ECU basket should be composed of fixed proportions and not on fixed quantities of EEC currencies was not, to my knowledge, seriously considered either by the others or even by us.

3.7 Technical work continued in the month of August in a great flurry of activity. Between the end of August and the beginning of September a technical paper by the BIS, the report of an hoc group appointed by the Committee of Governors (Heyvaert Group), an interim report by the Governors' substitutes, and a report of the Monetary Committee became available. The major casualty of these joint efforts was the Ecu as a yardstick for measuring the floating margins. After the political exilharation of the first days, the more sober analysis of the experts revealed that the French enthusiasm for the new unit was misplaced while the German skepticism was not. As the Ecu had been widely publicized, however, also the appeal value of the system received a blow: as the fancy clothes were torn, the skin of the old snake was beginning to reappear. To avoid too strict a resemblance, the Belgian compromise was proposed as a way to identify the truly deviant currency in a parity grid system.

The work done by these various bodies was of high technical level, but, just because of this quality, uncovered vast expanses of unchartered political territory. Since Bremen, the number of options and suboptions, which the experts could identify, but on which they could not decide, had increased at each fresh meeting. It may well be that setting up the new system was, as some enthusiasts kept repeating, a positive sum game: national representatives were however behaving as if it were a zero-sum game, where a participant's benefit would always imply another participant's loss. Matters should therefore be settled, and settled quickly, at a political level.

As things grew more complicated, it became clear that the Councils of finance ministers were not the best place to settle them: it is somewhat ironical that, in the process of moving a step further towards European integration, bilateral diplomacy became more prominent than joint Community decision-making. More important, but not always very conclusive, as the Italian record shows.

3.8 As the new round of negotiations began in September, some interesting developments in the Italian position can be noticed. On the exchange rate agreements there had been some positive - and not purely defensive - thinking on the part of the Bank of Italy. If a new system was to come into life, it was preferable to try and make it workable, lasting and acceptable to the generality of its members, rather than attempting to snatch piece-meal concessions. The effort to design the new system as a consistent whole, rather than as a sum of probably inconsistent parts, finds its expression in the

"Blueprint for the European Monetary System" (1), a thorough document, providing a set of solutions to the problems outlined at the September Council of Finance Ministers, which was submitted to EEC Monetary Committee and to the Committee of EEC Governors. Without attempting a summary of this rather complex technical document, I shall only list its major features: (i) acceptance of the Belgian compromise; (ii) new criteria to define the initial weights of European currencies in the ECU (which no longer coincides with the EUA) and to revise the amounts of each currency in case of realignment; (iii) a general band of bilateral intervention limits wider than the snake band, so as to accommodate forward quotations and to allow parity changes without necessarily disturbing market quotations; (iv) narrow ECU margins for the early-warning system, with definition of the consultation procedures and intervention rules such as to ensure symmetry when the alarm goes off; (v) a project for the European Monetary Fund in its definitive form. The key element in the part on exchange rate agreement was the combination of the wider bilateral band with the much narrower ECU band: the purpose of such combination was to make the system more flexible and durable, without making it looser, especially if obligations in case of early warning were accepted. As we shall see, Italy tried again and again, but without success, to have this part of the plan accepted as a general feature of the new system.

In contrast to the activism on the monetary front, little had been done in the field of parallel measures for the less prosperous economies – either at the Community level or even by the Italian government, which was

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(1) Banca d'Italia, <u>A Blueprint for the European Monetary System after the Ecofin Meeting of the 18th September</u>, 2 October 1978, mimeo.

supposed to be the interested party. Now the Italians came out with some ideas: pilot projects for the protection of natural sources in the South, to be financed with sizeable Community loans. One suspects that the stage of elaboration of such ideas was hardly more advanced than that of thinking aloud; still, it was better than nothing.

The Italian delegation may have found reasons of encouragement to proceed on both fronts in the meeting with the French Finance Minister Monory and the French Central Bank Governor Clapier, which took place in Bergamo on September 8. The French were rather emphatic in stating their dislike for the snake or any snake-like system and, therefore, their liking, in contrast with the Germans, for a system with symmetry and flexibility built in or ensured by adequate procedures. On the issue of parallel measures their major worry was to make sure that common agricultural policy would not be discussed. They, however, lent a courteous and not unreceptive ear to the Italian entreaties for substantial soft financing and went so far as to express a general agreement: which was something, though not much, considering that no figures were mentioned, common agricultural policy did not come under discussion and no doubt was left as to Italy's will to join the new system.

3.9 This may help explain both the toughness and the optimism which Minister Pandolfi displayed on three separate occasions in Italy.

On September 9, at a conference held by the Christian-Democratic group, AREL he declared:

> "One thing is certain as far as the position of the Italian Government is concerned: we cannot and will not be satisfied by formal changes hardly sufficient to conceal a reality

which would be that of the snake. It is essential for us to achieve a symmetry of intervention obligations between strong and weak currencies; it is further essential that the system fits all Community currencies and is therefore endowed with adequate elements of flexibility, of which one is certainly the width of the margin..."

"On the issue of parallel measures we obtained an important result yesterday ...We secured the French support to our proposal that the Community should finance great national development projects" (1).

There was then a short statement in the same vein at the Finance and Treasury Committee of the Chamber of Deputies on September 27. Finally, on October 10, Mr.Pandolfi, in his introduction to the Budget debate, devoted part of his speech to the Italian position towards the EMS. It was a remarkably lucid, consistent and informative pronouncement, with a famous passage which was to become the obvious reference for those more hostile to Italy's joining the EMS:

"We fought to obtain that the negotiations...would progress simultaneously along three lines: the exchange rate agreements, the European Monetary Fund, the measures in favour of the less prosperous economies; *with the warning that there are minimal requirements which, if not satisfied in one of these three sectors, cannot be compensated by concessions in the other two"* (2).

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(1) Pandolfi (b), pp. 136-37. The last paragraph quoted deserves to be remembered in view of what happened in Brussels in December.

(2) Pandolfi (c), p.22050, italics mine.

Such minimal requirements appeared to be the following: in the exchange rate field, a substantial difference of the new system from the snake and conditions ensuring symmetry of obligations - in particular, sufficiently wide generalized margins and compulsory action once the signal of the early warning system had flashed; for the EMF, pending its institution, an immediate activation of adequate credit facilities; in the field of development, expansionary policies on the part of stronger countries and sizeable transfers of resources to the less prosperous economies.

3.10 If there had ever been a spell of optimism, it did not last for long. Even before Pandolfi's speech in Parliament, there had been a disappointing meeting of the substitutes of the Monetary Committe, where the French gave the impression of having considerably watered down their quest for a system different from the snake. Bilateral diplomacy was working again - but this time effectively - behind the scenes. On october 14, President Giscard and Chancellor Schmidt met at Aachen and, sweeping away much technical work which had been done, neglecting the British position, relying on the possibility of gaining Italy's acquiescence by means of some costless concessions effectively agreed on what the new system was eventually going to be: something which was certainly rather far removed from the French initial wishes (as had been expressed not earlier than the beginning of September).

The effects of the Aachen bilateral summit were soon felt. At the meeting of the Economic and Finance Ministers on October 16, the French supported a compromise version of the Belgian compromise, which, though different from the German interpretation (mere consultations after the sounding of the ECU alarm) was even more distant from the direct and indirect constraints which the Italians and the British wanted to impose upon the divergent country. The new compromise, to quote an Italian source, was such that, especially within a 2.25% band, the ECU alarm would be of relatively little consequence. The Italian attempts to induce the other partners to think in term of a truly new system - along the lines of the Bank of Italy's blueprint - received, it would appear, little audience. As an English source aptly put it at the time, attention was progressively being narrowed down to options diverging from the requisites some had in mind, so that what was emerging was conspicuosly like the snake, though a little larger; nor there appeared to be any readiness on the part of stronger economies to recognize their obligations towards the less prosperous ones. These reasons, on top of internal political difficulties and the irritation for the Franco-German diplomacy, were making English participation less and less likely.

3.11 Immediately after the Ecofin council, on the same day, the Italian delegation adjourned to Frankfurt for a bilateral meeting with their German counterparts: owing to the blunt frankness (and the good economic sense) of the Bundesbank Governor, Dr. Emminger, this meeting is a rather refreshing episode in a tale where wishful thinking and hypocrisy too often prevail. The Italian delegation made a fresh attempt to win some consensus for a solution centered on a generalized wider band, narrower ECU margins and compulsory intervention after the early warning. We were not interested - it was added - in the wider band as a special concession to Italy; it would, on the contrary, be difficult for us to accept a special status. Dr. Emminger's replies were clear: no objections to the wider band for those who wanted it, but, as far as he knew, neither the British (as we have already seen) nor the French were in the least interested; a flat no to any obligation of intramarginal interventions arising from early warning, with a reminder that his Chancellor and the French President had already reached an agreement on this point at the Aachen meeting; and, in an aside, some surprise for Italy's decision to join and a great deal of skepticism on the workability of the system.

The refusal of the Germans to accept any constraint other than the bilateral intervention limits, the French Realpolitik and their desire to be *plus royaliste que le Roi*, the British indifference and, not last, a certain lack of political initiative and bargaining strength on our side had already made the essence of the Italian blueprint a lost cause. Still, two more attempts were made: in the course of the meeting between the French President and the Italian Prime Minister in Rome, on October 26, and at the meeting of the EEC Central Bank Governors on October 30.

On October 26 Governor Baffi submitted to the French President an extremely lucid and rigorous summary of the Italian position. A generalized wider band would make changes of central rates less frequent and discourage speculators:

> "Une bande élargie permettrait de laisser qu'une monnaie glisse vers le bas ou grimpe vers le haut à l'intérieur de la bande et que, à un certain moment, elle adopte, comme nouveaux taux central, la cote qu'elle aurait atteinte sur la marché."

Further, existing differentials of inflation rates imply a similar differential of interest rates and equilibrium requires that the latter equals the discount on the forward market. With a high discount and a narrow band,

> "le change à terme se placera *au dehors* de la bande. Cela pourrait être interprété comme une manque de confiance dans le système de parités existant, en éveillant...des attentes déstabilisatrices".

Whence the proposal of a general wider band:

"Le serpent serait un système spécial à l'intérieur d'un système général. Un pays quelconque pourra se placer où il voudra. S'il se place dans le serpent, lorsque sa monnaie atteint la peau du reptile, il disposera de trois options, à savoir: intervenir à outrance, changer la parité ou passer dans le système général sans changement de parité".

With a narrow ECU margin for the divergence indicator, intervention obligations and a severe discipline for changes of central parities, the system would be as strict as, but more flexible and more workable than the snake.

This was, as it were, the swan's song. At the Committee of Governor it became certain that no other country was interested in a wider band system, though there was some readiness to grant us a wider band. We were thus compelled to abandon a position which was justifiable on general grounds and to choose between what we deemed politically undesirable - the special status - and what we considered economically unfeasible - the narrow snake band. Not unnaturally, we opted for the special status and confined ourselves to fight a rear-guard semantic action to obtain that the wider band be considered a (theoretical) option for all the former floaters and not merely a special concession to Italy.

An agreement along these lines received the grudging placet of Chancellor Schmidt, at the meeting with Prime Minister Andreotti in Siena on November 1st, was approved by the Monetary Committee (notwithstanding some French opposition) on November 6 and 7 and by the Committe of Governors on November 11 and received a final sanction at the Council of Economic and Finance Ministers on November 21.

3.12 Though the possibility of creating a truly new system had by now completely vanished, a number of individual questions were still open, on which Italian interests were at stake: the size of the credit facilities; the term of the settlement of the very short-term support; a generally accepted interpretation of the franco-belgian interpretation of the Belgian compromise; connected with this, the introduction of the "involuntary debtor" clause. There were then two issues of paramount importance for Italy: the nature of the parallel measures and the amount of financing involved and the British decision on whether to join or not.

On the former set of issues, only one was settled, and settled satisfactorily, at the Ecofin Council of November 21: support facilities would amount to 25 billion ECU, instead of the smaller figure proposed by the Germans and the Dutch. The question of how this amount should be divided between the short and the medium term, as well as all the other issues listed above, were left for the European Council of December to decide. It was already clear, however, how the wind blew for two points which Italy considered of great importance: the Italian proposal for compulsory intervention after the early warning was rejected by a large majority, so that only the degree of looseness of the presumption to act was now the object of discussion; nor were the prospects better for the "involuntary debtor" clause.

Whereas considerable progress had been made towards defining the characteristics of the future EMS (whether one liked the results or not), the chapter of the parallel measures was still completely blank. The only conclusion one could infer from the Report submitted to the Council by the Economic Policy Committee on November 13 was that the matter had received no consideratio at the political level and that, as a result, there was complete disagreement on all the questions concerned - from the analysis of the existing situation to the nature and size of the additional measures. We have seen that some initiative, at least at the technical level, had been displayed on our side in the monetary field. It is an interesting and unanswered question whether anything similar had been done, and by whom, in this other field: the impression is that we had decided to rely on our partners' understanding and good will. Both understanding and good will, however, appeared to be in very scarce supply at the Ecofin meeting of November 21. Our Treasury Minister recited his cahier : increase of the Community budget; Regional Fund; some revisions of CAP; sizeable contributions on interest charges for all available financial sources (EIB, Euratom, ECSC, Ortoli Facility). He was listened to, but his requests were not even debated, with a conspicuous show of lack of interest.

By the time of the Ecofin meeting the English had probabily already decided not to join. Whatever their true reasons, the unsatisfactory development of the exchange rate agreement and the lack of any progress towards structural measures gave them a good excuse and they could not be overly impressed by the Italian argument that any hint that the EMS should not start on January 1st, 1979 would weaken one's bargaining position. Still, on the eve of the meeting between the Italian and English Prime Ministers in London, on November 26 (the last of the series), a valiant effort was made by our experts to find an acceptable reply to all the British objections and to induce them to join: self-interest made them find acceptable answers to criticisms which could have been their own. It was a good show, but not enough to induce the English to change their mind.

3.13 Such then was the situation on the eve of the Brussels Council: we had managed to score some points on the monetary front, of which the more important was the concession of the wider band, but we had been unable to alter the trend which the Germans and the French had set; we had not yet been able to obtain any firm engagement as to structural policies and changes of resources;

we had not succeded in establishing a common front with the English and we could not rely on much support to our requests in Brussels. Altoghether a rather weak position.

Dr. Renato Ruggiero writes that it is a mistake "to treat the dialectics of European construction in the same way as the methods of traditional diplomacy, since the latter is more interested in reconciling contrasts than in orienting a movement of true integration" (1). This may well be, and this was exactly what we tried to do in the monetary field by our (perhaps belated) attempts to build a truly new system. We failed, and we had to realize that traditional diplomacy was the game successfully played by the others. As we went to Brussels, we were aware of it: but traditional diplomacy implies give and take, and by then there was very little left we could give and hence very little we could hope to take.

(1) Ruggiero (b), p.171.

V - Brussels and the Week after.

5.1 It is not easy to provide a precise account and a plausible interpretation on what happened in Brussels - when Mr. Andreotti felt unable to decide Italy's entry into the EMS - and of what happened a week later. We are confronted with several puzzling questions. What, in the first place, made the Italian Prime Minister take a totally unexpected decision on December 5? But then, what induced the Italian Government to agree on entering the EMS on December 12? When was the latter decision taken? And why was some encouragement provided to the supporters of a compromise solution? We tread, here, on very slippery ground: the versions and the interpretations of the events which occurred on that week are far from unanimous.

5.2 As for the first question, some, in view of what happened later, feel inclined to provide a rather cynical answer. The Brussels decision not to join was part of a shrewd design by Mr.Andreotti, of which the final dénouement, with Italy saying yes a week after, was the other part. According to this version, Mr.Andreotti took two facts into consideration: the majority on which his government rested was breaking down on the left, owing to the progressive hardening of the Communist Party line and to its open dissatisfaction with the government, and it would be impossible to put the pieces together again for some time; criticism against him, for opposite reasons, was mounting in his own party, where a vociferous trend to the right could easily be detected. A dramatization of Italy's entry would allow Mr.Andreotti to come out as the man who, in the name of Europe, had resisted left-wing, and above all Communist pressures, and would help him to rally his own party around him and to resume a position of leadership.

It is an ingenuous interpretation; but not a plausible one for two sets of reasons: one resting on internal political considerations, the other on an appraisal of the somewhat unexpected situation which the Italian delegation had to face in Brussels.

Looking at the internal political situation on the eve of the Brussels Council and at its subsequent evolution, one is bound to think that, by his double move, Mr.Andreotti managed, if anything, to maximize his political losses: something one can hardly suspect a man like him to do on purpose. First, there had been a Government decision to join, at the last Council of Ministers before Brussels. Second, everybody - the press, public opinion, the political forces - was quite convinced that we would join and nobody appeared inclined to attribute great importance to the outcome of the bargaining on incomprehensible technicalities, such as the "involuntary debtor" clause, or even on parallel measures, which were often considered as mere ornaments to the façade. Third, Mr.Andreotti must have been well aware, as everybody was, that even the Communist Party, having shot a last salvo with Hon.Barca's article on the Sunday before the Council (an article which some within the party had considered too tough), was quite resigned to a positive decision. The Communists would, as a result, do some barking, but little biting and may even be glad at the prospect of not having to face open isolation on a "European" issue. Further, the Communists had often repeated that, as far as parallel measures were concerned, they were interested in a new approach to the budget, regional and agricultural policies of the Community, but that grants or soft loans would not make them change their view. Nor can it be understood why Mr.Andreotti should go out of his way to antagonize the Communists. By joining immediately, rather than later, Mr.Andreotti would still have gained prestige within his own party, without accelerating the deterioration of his relationships with the left.

This first set of reasons goes towards showing why, on purely internal political grounds, it would have been more convenienient for Mr.Andreotti to decide an immediate entrance. The second set can explain why he did not do so: in a loose summary, it was the bitterness felt at the diplomatic insuccess which Italy met in Brussels.

5.3 The Italian delegation had gone to Brussels hoping that some of the things which had not been obtained during the negotiations could be obtained in the final round. According to the Italian bill-of-fare, the presumption of action, as the early-warning signal flashed, should be strengthened by narrowing down the scope of any escape clause and by introducing the "involuntary debtor" clause. The change of central rates and the possibility of temporary opting out should be made easier and "depoliticized" as much as possible. The short-term support should be increased by more than the medium-term. In the field of parallel measures Italy asked sizeable additional loans with an interest bonus and special amortization conditions and an acceptance by the Council of the increase of the Regional Fund in the Community Budget according to the recent vote of the European Parliament.

If they had decided to stand by what Mr.Pandolfi had said in Parliament on October 10, the Italians should have insisted on all these things, for all, or almost all, of them belonged to Mr.Pandolfi's "minimal requirements" in the three fields of exchange rate agreements, EMF, parallel measures, "which, if not satisfied in one, ...cannot be compensated by concessions in the other two". The mood was however very different now from that prevailing in October, and one can presume that there was readiness to accept a good deal of trade-off. What the Prime Minister did not expect, and must have therefore found hard to accept and almost offensive, was the rejection of all, or almost all, his requests.

The only relatively satisfactory results were obtained in the field of credit facilities, where the Germans accepted the majority's wish to allocate more to the short than to the medium-term support (14 and 11 billion ECU respectively) and where a compromise was reached for the settlement of the very short-term support (45 days). The Bundesbank instead succeded in vetoing the "involuntary debtor" clause (on which the French offered no help). The escape clause was approved in a softer version than that supported by the Italians, as the term "exceptional" was not introduced. But the really bitter surprise came when the Council dealt with the parallel measures.

The Italians felt on relatively safe ground as, before the Council, the Germans, in last-minute bilateral contacts, had said they would not oppose substantial concessions. What must have been neglected or underestimated by our diplomatic advisers was the evolution of French internal political affairs. Even a French President is not immune from the whims of a composite majority. It so happened that, before the Council and in connection with the vote of the European Parliament, Mr.Chirac had launched a heavy attack against what he thought a far too accomodating approach of the President towards Europe and France's European partners. President Giscard was thus induced to prove that this was not the case and chose to do so, at the expense of Italy, when the issue of parallel measures came to the attention of the council. He said a flat no to the Italian requests and, so that the message would get home, even said it publicly, in rather unpleasant terms, in a press and television conference during a break of the works of the Council. Britain, at that stage, was no longer interested in the business (visibly so, same report); the Germans, though accepting the Italian position, were not ready to go out of their way to support it; and Italy was left a lone loser.

It is therefore quite understandable that Mr.Andreotti, who may be guilty of other sins, but not of being too impulsive and rash, rather than saying a final yes or a final no (with some loss of personal dignity in one case and of internal political credibility on the other) should choose to take time, let the feelings cool down, sund the mood at home and, if possible, try to get some side concessions from his major partners.

THE FUTURE OF THE INTERNATIONAL MONETARY SYSTEM

(6)

by Robert TRIFFIN

[Draft of a paper to be delivered on October 31, 1979, at a Conference of the Global Interdependence Center, in Philadelphia]

I. INTRODUCTION

Let me first confess that I find it increasingly hard to speak about the broad topic which has been assigned to me: "The Future of the International Monetary System".

How could I possibly say something new, that you have not heard before, without leaving out the most essential and crucial points about which I - and many others - have spoken and written so many times already over the last twenty years? The best I can hope to do is to be selectively boring, by touching only upon a few major points which I feel to be most significant at this juncture, and yet most likely to be forgotten because they are too obvious to be mentioned in our learned discussions.

I shall also disappoint you in another way. Most of you are probably most interested in a successful, correct forecast of what lies ahead, no matter how grim the prospects may be. If I yielded to that wish, and projected recent trends into the months or years immediately ahead, I could only tell you that the international monetary system has no future, because our political leaders - and, alas, their economic advisers! - may be unable to muster the lucidity and the courage required to negotiate and implement the radical, agonizing, reforms indispensable to cure the world inflation, recession, balance-of-payments disequilibria, chaotic exchange-rate fluctuations, creeping protectionism etc., to which we seem to be condemned.

I prefer to concentrate on what should be done to reverse the process, even if the chances are that nothing of the kind will be done in the foreseeable future. I would rather run one chance out of ten to help build a better future than nine chances out of ten to predict correctly the disasters that may await us.

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Advice about institutional reforms, however, must be based on a clear understanding of the major shortcomings of the present institutions. Many of my economic colleagues, particularly in the United States and in England, became increasingly convinced, a few years ago, that a major portion of the blame could be placed on the system of fixed, even though adjustable, exchange rates enshrined in the Bretton Woods system. The experience of the last six or eight years has disabused most of us of the illusion that floating rates would lessen inflation rates, unemployment, and balance-of-payments disequilibria. A few may still hold consistently, however, that the growing inflation, unemployment and balance-of-payments disequilibria of the floating rates regime are due to the fact that governments do not let them float freely, under the impact of market supply and demand, but insist on continued interventions and management - or rather mismanagement? - by the official authorities. Others - and I confess to be among them - hold that some amount of concerted international management would be less harmful than either freely floating or nationally managed rates.

My major thesis, however, is that neither stable, nor floating, exchange rates can function satisfactorily in the absence of any international control, and restraints, over the fantastic explosion of international liquidity provided to the market, in recent years, by the monetary authorities and the commercial banking system. In developing this thesis, I shall center on the inflationary aspects of this phenomenon, and neglect - regrettably - the problems of recession and unemployment, which I certainly regard as an even worse ill than inflation, but to which inflation has proved, I think, to be a contributing factor rather than an effective and lasting remedy.

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CORRECTIONS

1. p.5

   paragraph II, sub paragraph (3), last line should read :

   "..reserves with its own IOU's."

2. p.7

   line 6 should read :

   "..profits will, however, be passed on sooner or later to Governments, and are practically .."

3. p.7 bis

   Table I, Sect. B.

   Title should read :

   " Impa ct of Market Price Fluctuations in"

4. p.15

   Paragraph II, last line should read :

   "..exchange markets, if not effected -as suggested below- with the EMF instead."

5. p.25

   Paragraph I, sub paragraph (b), line 1 should read :

   "most of all, the still enormous weight of the United States as an .."

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II. THE MAIN MONETARY SOURCE OF THE WORLD INFLATION

Admittedly, the root causes of the world inflation in which we are now engulfed lie outside the field of monetary policies and institutions, national or international. The unprecedented growth of material production, and consumption, initiated some 200 years ago by the industrial revolution undoubtedly helped meet real needs for food, shelter, health, transportation, etc., and remains essential to the attainment of decent health and living standards in the poorer, less developed countries. It was later sustained and accelerated, however, first by the advertising revolution which created new needs unperceived before, secondly by the Keynesian revolution which warded off in the postwar years the cyclical recessions which previously interrupted or reversed periodically the growth process, and, thirdly, by the fantastic explosion of military expenditures to a level of $ 400 billion to $ 500 billion a year, just about equal to the total G.N.P of China, Bangladesh, and India, double that of the thirty other poorest countries and two thirds of that On which 36 countries grouping 57 %) of the world's population have to live or to starve. These non-monetary factors are the basic roots of the world inflation[1]. They have brought within our horizon increasing scarcities of essential foods and raw materials, and environmental problems, which can be overcome only by huge investments and rising costs of production. These latter are further accelerated by collective bargaining and pressure groups, and spread from the scarce sectors to the others.

It is at this point that monetary policies enter the inflationary process. They may accomodate it by expanding bank credit to the official and private sectors of the economy, thus financing increases in wage, costs, and prices; or they may refuse such financing, but at the risk of slowing down not only inflation, but economic activity itself, at least temporarily.

(1) on less than $260 a year (0,71 U.S cents per day) in 1976, i.e about 2.8% of per capita G.N.P of Switzerland, 3.3% of that of U.S, and 3.7% that of Belgium. These calculations are derived from the estimates of the ~~1978~~ World Bank Atlas.

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The evolution of the national monetary systems and of the international monetary system itself has tended, over the years, to eliminate former constraints on the inflationary proclivities to be expected from both the public and the private sectors of the economy. This, I believe, is the crucial issue in the acceleration of national and international inflation since the first and the second world wars, and particularly at the present juncture. Obvious as it may be, it deserves more emphasis from the economic profession.

Gold was traditionally the major constraint on such proclivities, but its beneficial role in this respect has been vastly exaggerated by the enthusiasts of the gold standard. Credit money - i.e. bank currency and deposits - played an overwhelming part in sustaining feasible rates of economic growth in the century before the first world war. By 1913 already, credit money accounted for about 85 per cent of estimated - or "guesstimated" - world money supply (1), and its widespread use did not prove incompatible with a closer approach to non-inflationary rates of monetary expansion than in the previous gold and silver money regimes, subject to repeated debasements of the coinage. Any country determined to fight inflation would be better advised to try legal, or constitutional, ceilings on money creation (x per cent a year, for instance, <u>à la</u> Milton Friedman) than to tie money creation to gold. I shall abstain from pursuing this suggestion any further, and turn instead to my main topic, <u>i.e.</u> the <u>international</u> monetary system.

The major development here is, without question, the generalization after the first, and particularly after the second, world war of the so-called gold-exchange standard, under which all but one or a few countries accumulated their

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(1) See table 1, p. 62, of my Princeton Study on the <u>Evolution of the International Monetary System: Historical Reappraisal and Future Perspectives</u>, Princeton 1964.

international monetary reserves not only in gold, but more and more in one or a few national, so-called "reserve currencies" - primarily sterling at first, and later the U.S. dollar - legally convertible into gold upon single request by their holders. I pointed out long ago (1) that the inflationary proclivities of such a system made its breakdown inevitable. The gold convertibility of the sterling standard had had to be suspended in 1931, and that of the mightier dollar standard collapsed similarly in 1971.

Most of the academic and official debates concerning the recent evolution of our international monetary system have unfortunately centered on two secondary issues, rather than on the most crucial one :

(1) The explosion of oil prices, which occurred only in the last months of 1973, and cannot therefore be blamed for the suspension of the dollar convertibility in 1971, nor for the doubling of world reserves over the years 1970 - 1972.

(2) The merits and demerits of floating vs stable (but adjustable) exchange rates. Interesting as it is, this debate obscures the fact that world reserves have grown, under both systems, at a wildly inflationary rate incompatible with the proper functioning of either.

(3) Far more significant is the inflationary proclivity of any reserve-currency standard - convertible as well as inconvertible - enabling the reserve-currency center to finance huge and persistent deficits - internal as well as external - by the flooding of world reserves with its own IOU's.

Not to drown you in an ocean of statistical estimates, let me merely mention the highlights of world reserve creation in the last

(1) In 1957 in my book "Europe and the Money Muddle", and in greater detail in my 1960 "Gold and the Dollar Crisis".

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six years (1973 - 1978) of the floating exchange rates regime under which we live today. Measured in dollars, at current market prices, world reserves have tripled over these six years, increasing by $ 380 billion, from $ 191 billion to $ 571 billion, at an average pace of 20 % per year, multiple of course of any feasible growth in world trade and production in real terms.

What are the sources of this increase ?

(1) World physical monetary gold holdings, measured in SDR's (or in ounces) contributed less than nothing to it. Indeed, they declined slightly as a result of official sales to the private market by the IMF and the United States.

(2) There were no SDR allocations over this period. (Their resumption in 1979 is unlikely to account for more than 3 % of reserve increases this year).

(3) Net IMF credits contributed about 2 %.

(4) The remaining 98 % were derived from the two following sources :

(a) 33 % from Central Banks' accumulation of national currencies (overwhelmingly dollars and Euro-dollars) as international reserves, i.e. to the financing of a few rich countries, primarily the United States;

(b) 65 % (nearly two thirds) from the rise of gold market prices measured in SDR's (34 %) and from the rise of the SDR itself vis-à-vis the U.S. dollar (31 %). (1)

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(1) Soaring gold prices were the major source (82 %) of a further $ 58 billion increase of world reserves in the first five months of 1979. Revaluing the end of May reserves at the October 1st London price of $ 414.75 per ounce would account for 97 % of a total increase of world reserves by $ 218 billion since the end of 1978 to $ 787 billion.

A major portion of these reserve increases valued in dollars undoubtedly reflects bookkeeping profits rather the acquisition costs, - and realized inflationary impact - of reserves accumulated in the past by the monetary authorities, and to which SDR-valued reserve increases of 133 billion provide a closer, although very imperfect, approximation. These bookkeeping profits will, however, be passed on to Governments, and are practically certain to elicit in many countries more expansionist fiscal and monetary policies in the future than would have been the case otherwise.

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TABLE 10

SOURCES OF OFFICIAL RESERVE CREATION

(in billions of SDR's at 35 per ounce, and of U.S. dollars)

	End of			1973–June 1979 Increases		Ratios = June 79/ Dec. 72
	1972	1978	June 1979	in billions of SDR's or $	in % of Total $ Increase	
A. In billions of SDR's	147	279	291	144	32	1.98
I World Gold	41	40	40	-2	–	0.95
II International Credit	105	239	251	146	33	2.38
A. Foreign Exchange	96	221	230	134	30	2.40
B. SDR Allocations	9	9	13	4	1	1.43
C. Net IMF Credit	–	9	8	8	2	9.07
B. Impact of Valuation Changes	44	291	348	304	68	7.87
I Of SDR gold price on gold Valuation	29	159	204	175	39	6.98
II Of $ price of SDR on :	15	133	144	129	29	9.55
A. Gold valuation in $	6	60	71	65	14	11.75
B. International credit in $	9	72	73	64	14	8.07
C. Total (A+B) Reserves in billions of dollars	191	571	639	448	100	3.35
I. World Gold	76	259	315	238	53	4.12
II International Credit	114	312	324	210	47	2.83

Sources and Notes : See Appendix Table 1

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TABLE I

Sources of Official Reserve Creation : 1973 - 1978

(in billions of SDR's and of dollars)

	End of		1973 - 1978 Increases	
	1972	1978	in billions of SDR's or $	as % of Total Increase
A. In billion of SDR's	147	279	133	35 %
I. World Gold	41	40	- 1	-
II. International Credit	105	239	134	35 %
1. Foreign Exchange	96	221	125	33 %
2. SDR Allocations	9	9	-	-
3. Net IMF Credit	-	9	9	2 %
B. Impact of Fluctuations in	44	292	247	65 %
I. The SDR price of gold on the valuation of gold holdings measured in SDR's	29	159	130	34 %
II. The dollar price of SDR on the valuation in $ of	15	133	118	31 %
1. Gold	6	60	54	14 %
2. International Credit	9	73	64	17 %
C. Total Reserves (A + B) in billions of dollars :	191	571	380	100 %
I. World Gold	76	259	183	48 %
II. International Credit	114	312	198	52 %

Sources and Notes : see Appendix Table 1.

Reserve investments in the United States (mostly in Treasury securities and bank deposits) account for the major portion of world foreign exchange reserves, and of their growth. Direct and indirect (through U.S. banks' branches abroad) U.S. liabilities to foreign official holders, as reported in the Federal Reserve Bulletin, total more than two thirds of these reserves, both in 1972 and in 1978, the remainder being accounted in part (about 12 %) by Euro-dollar creation by foreign banks, and in part (about 20 % of the total, according to IMF sample estimates) by other foreign currencies; marks, Swiss francs etc. Few economists are probably aware of the full inflationary impact of this financing upon the rest of the world.

The first - and most widely understood - is that it gave us, under floating as well as under fixed rates, what de Gaulle called the "extravagant privilege" of financing most of our deficits with our own IOU's. Our reported direct and indirect liabilities to foreign official holders totalled $ 194 billion at the end of 1978, i.e. nearly 15 times our total reserve assets of $ 13 billion at the end of 1972. Their increase of $ 124 billion (from $ 70 billion at the end of 1972) was of course the main feeder of huge, persistent and increasing deficits which we would have been unable to sustain if we had had, - like other countries - to finance them from our own reserves (1).

(1) Note, however, that this increased indebtedness to foreign official holders financed the "recycling" role of the dollar, imposed upon us by its reserve-currency use, rather than the current account deficits of the U.S. itself. Our net capital exports over these six years, are reported by the Survey of Current Business (June 1979), totalled $ 135 billion, of which $ 24 billion were financed by our surpluses on goods, services and remittances, and $ 111 billion by our increased liabilities to foreign official holders. See Annex Table ......

TABLE II

Composition of World Foreign Exchange Reserves : 1972 - 1978

(in billions of $, and in per cents of total)

	End of 1972	End of 1978	1973 - 1978 Increases	% of Total 1972	% of Total 1978
I. U.S. Liabilities	70	194	124	67	67
A. Direct	62	162	100	60	56
B. Foreign Branches of U.S. Banks	8	32	24	8	11
II. Other (III - I)	34	94	60	33	33
A. Other currencies	21	58	37	20	20
B. Euro-dollars (other than IB)	13	36	23	13	13
III. Total Foreign Exchange Reserves	104	288	184	100	100

Sources and Notes :

I. U.S. Liabilities : Tables 3.14 and 3.13 of Federal Reserve Bulletin

II.A. Other Currencies : Rough estimates of 20 % of total foreign exchange reserves (line III), based on sample estimates published in IMF Survey, May 28, 1978, p. 155

Lines II and IIB are obtained residually : II = III - I and II B = II - IIA (Line II B Euro-dollar estimate of $ 13 billion in 1972 corresponds closely to the estimate of "identified Eurodollars" reported in the IMF Annual Report 1978, p. 53, converted into dollars, minus I B).

III. Total Foreign Exchange Reserves : International Financial Statistics, August 1979, p. 32 estimates, converted from SDR's into $'s.

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What is less understood is that the combination of floating exchange rates with the flooding of world reserves by paper claims on a few reserve centers has also suppressed a major restraint on domestic inflationary policies by all countries alike. As long as world reserve increases remained moderate - i.e. until the end of the 1960's - domestic inflationary policies were sanctioned by balance-of-payments deficits and reserve losses, entailing fairly rapidly the inability of the more inflationary countries to avoid a devaluation, or depreciation, of their currency. This was a traumatic experience, especially under a legal system of fixed rates, since it involved an obvious failure of official policies, exposing responsible officials to the danger of not being retained, reappointed or reelected to their job. Daily floating rates have greatly weakened this trauma and its consequent political deterrent to persistent inflationary policies. Floating rates speed up the readjustment of exchange-rates to competitive levels by the more inflationary countries, but tend also to facilitate the continued pursuit of inflationary policies by them.

Concern about the domestic and external impacts of inflationary policies has not vanished. It has indeed increased with the acceleration of inflation, but the most effective - because unavoidable - barrier to them has practically disappeared. The United States was not restrained by gross reserve losses, because the acceptance of its own currency - which it can produce without limit - by other countries enabled it to finance enormous deficits, before and even after the dollar became inconvertible. What is less perceived so far in most of our economic debates is that the size and persistence of these deficits, together with floating exchange rates, have practically eliminated any substantial losses of reserves, even by the most inflationary countries. Significant reserve losses were experienced by about a dozen countries only in the first years following the explosion of oil prices, but gross reserves, even expressed in SDR's rather than in dollars, and with gold valued throughout at 35 SDR's per ounce, more than doubled on the average, for countries other than the United States and the oil-exporting countries over the three years 1970-1972, and have nearly doubled again (a 75 per cent increase) since 1972. Even the non-oil exporting less developed countries increased their reserves by 65 per cent from 1969 through 1972,

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and by 168 per cent in the following six years. Reserve declines of more than 50 million SDR's are reported by International Financial Statistics (in its annual 1979 issue) for only two countries other than the United States from 1969 through 1972 (1) and nine countries over the following six years (2).

This does not mean, of course that all other countries were in surplus on current account, but merely that the current account deficits of even the most inflationary ones could be financed - and indeed overfinanced - by international borrowing.

The flooding of world reserves by dollar and Euro-dollar creation has added new dimensions to this financing. It has increased the cash reserves of commercial banks, enabling them to expand their own foreign lending at a pace which they could not have sustained otherwise. I shall come back to this problem in the concluding pages of this paper, but must first explain why I still retain some hope of reviving the drive for world monetary reform, more indispensable than ever, but which harassed officials practically abdicated in Jamaica and the Second IMF Amendment. "I am not optimistic", Jean Monnet used to say, "I am persistent".

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(1) Zambia and, curiously, South Africa, with losses of SDR 200 million each.

(2) Losses of SDR 3,800 million are reported for Australia, 2,065 million for Canada, 685 million for Portugal, 523 million for Turkey, 521 million for South Africa, 420 million for New Zealand, 107 million for Zambia, 106 million for Jamaica, and 51 million for Greece.

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TABLE III

Geographical Distribution of World Reserves : 1969 - 1972

	end of year, in SDR billions			Ratios		
	1969	1972	1978	1972/1969	1978/1972	1978/1969
World	79	147	278	1.86	1.91	3.55
United States	17	12	15	0.71	1.24	0.88
Other countries	62	134	264	2.[illegible]	1.97	4.29
OPEC	4	10	46	2.45	4.62	11.27
Other Countries	58	124	218	2.16	1.75	3.79
Developed	46	105	165	2.30	1.58	3.62
Less developed	12	20	53	1.65	2.68	4.42

Source : International Financial Statistics, Annual 1979 (pp. 45 and 47)

III. Resuming the Aborted Drive toward Indispensable Reforms

1. The EMS Breakthrough

The most hopeful sign of possible progress toward reform, since the breakdown of the Bretton Woods System, is the breakthrough finally achieved in March of this year with the initiation of the European Monetary System (EMS for short).

I shall not dwell here on this topic, limiting myself to a few observations necessary to dispel widespread misunderstandings about the aims and mechanics of the EMS.(1)

The scepticism - and often downright opposition - of many American economists to this new and crucial development is primarily inspired by the conviction that commitments to exchange-rate stability are premature, harmful, and bound to fail, as long as the participating countries do not succeed in reducing the wide divergences still prevalent today between their national rates of inflation. What they fail to understand is that this conviction is fully shared by the EMS negotiators themselves and that the new system aims indeed to accelerate, rather than prevent, the exchange-rate readjustments still expected to be inevitable in the years immediately ahead. Full monetary union - and even irrevocable commitments to exchange-rate stability - is only a hope, still relegated to the future and conditional upon the harmonization - hopefully downward - of inflation rates and the consolidation of this harmonization through ambitious reforms - not yet fully agreed or even formulated - transferring adequate jurisdiction from national to Community authorities and institutions.

Let me mention briefly three crucial features of the system most attractive to its promoters.

(1) The system restores for the participating currencies, a common denominator - or numéraire - sadly lacking in the reformed IMF Agreement. This common denominator is the ECU, defined as a weighted basket of the participating currencies. Unsatisfactory as this definition may be, it is a more

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(1) For further details, see my "Suggestions for an American Response to EMF" in a forthcoming volume of the Brookings Institution, from which I have extracted here a few relevant passages.

realistic benchmark for exchange-rate calculations, readjustments, and progress toward stability than a widely fluctuating dollar, since trade, services, and capital transactions among the countries of the European Community and others - in Western Europe, the Middle East and Africa - likely to gravitate around the ECU encompass two-thirds to three-fourths of their total external transactions, i.e. close to ten times their transactions with the United States (see Annex Table).*

(2) One of the first consequences of this definition is to give, for the first time, an operational significance to the principle formulated in Article 107 of the Rome Treaty: "Each Member State shall treat its policy with regard to rates of exchange as a matter of common concern". Since each country's official rate is defined in terms of the ECU, and since the ECU itself is defined as a weighted average of member currencies, it is impossible for any one currency to revalue upward - or downward - in terms of this average without a compensatory depreciation - or appreciation - of all the other participating currencies. Any readjustment of mutually agreed exchange rates can thus be effected only by mutual consent.(1)

(3) Two other exchange-rate commitments are also central to the EMS agreement.

The first is taken from the former "snake" agreement: the monetary authorities of each country are committed to intervene in the exchange market - through sales or purchases of their own currency - in order to limit bilateral exchange fluctuations between their currency and any other participating currency. to a 2.25% margin (temporarily enlarged to 6% for Italy).

The second, and totally novel one, is to calculate for each currency a so-called "divergence indicator" reflecting its market fluctuations in terms of its officially agreed central ECU rate. When these fluctuations reach a certain percentage of the maximum divergence possible under the bilateral margins system, the monetary authorities

*One may argue that the somewhat larger shares of total trade contractually denominated in $ are more relevant, but the choice of the $ denomination in transactions with countries other than the U.S is itself an illogical residue of past habits no longer justified today.

(1) As demonstrated by the first readjustment of this sort - and certainly not the last - on September 24, 1979. Note, however, that readjustments were first calculated on a bilateral basis, as before (an upvaluation of the D.M. by 5% against the Danish Krone and 2! against each of the other six participating currencies, with no change in the bilateral rates between the latter), and the implied rates vis-á-vis the ECU derived afterwards and entailing an upvaluation of the DM by 10%, a devaluation of the Krone by 3.8% and a uniform devaluation of the other six currencies. (The fictitious central rate of British Pound vis-á-vis the ECU was readjusted also on this occasion by +2.07 %).

of the issuing country are automatically presumed to take appropriate action (market interventions, internal monetary policy measures and/or other economic policy measures, and/or readjustment of its central rate vis-à-vis the ECU), or, if they fail to take action, to explain and discuss with their partners the ways in which the situation should be corrected. Thus, in total contrast with Bretton Woods and all other traditional monetary "sovereignty" rules, consultations on desirable exchange-rate readjustments may be forced upon a reluctant country, rather than left exclusively to its own initiative.

(4) Beyond its "numéraire" and "divergence indicator" functions, the ECU also serves not only as a unit-of-account for an increasing number of Community operations, but also as a real money of settlement and reserve accumulation.

Central bank stabilization interventions in the exchange market should be conducted, as far as possible, in member currencies rather than in dollars. Since, however, central banks do not in principle accumulate member currencies as reserves, such interventions require mutual credit operations between the two central banks concerned, the issuing bank of the strong currency accumulating claims against the issuing bank of the weak currency. Central banks grant each other through the EMCF (European Monetary Cooperation Fund) unlimited very short-term financing for their interventions and short-term monetary support, which can be supplemented further by medium-term financial assistance, granted by the Council under appropriate conditions.

These short and medium-term arrangements now entail lending commitments totalling in theory 38.7 billions of ECU, but not all of which could in fact be simultaneously utilized.

The borrower can exercise one of several options, or combination of options, when the reimbursement falls due. In case he wishes to settle in ECU's, he cannot force reluctant creditor ECU settlements exceeding 50% of the amount due. For any portion not settled in ECU's, the general rule - in the absence of any other agreement between the two parties- is to settle in reserve componentsin the same proportions as as those in which the debtor central bank holds its reserves, gold, however, being excluded. In practice, therefore, the option is primarily between ECU or $ repayments.

But how do central banks acquire such ECU's? They are credited in ECU accounts on the books of the EMCF against equivalent transfers[1] of gold and dollar reserves for amounts equal to 20% of each country's gold and dollar assets. The conversion of these gold and dollar transfers into ECU's takes place at current or (for gold) average market prices over the preceding six months. They totalled initially, last June, about 26 billions of ECU's, i.e. about $ 35 billions, and ECU 29 billion, equivalent to nearly $ 40 billion at the end of September.

The EMS baby is only six months old, but is deemed by its parents to be reasonably healthy. Its growth to adulthood, however, will require additional and crucial agreements calling for a high degree of political vision and responsibility. I wish I could review here, in particular, the steps necessary to transform the EMCF into a European Monetary Fund and, later on, into the Federal Reserve System of a full-fledged Monetary Union. This, however, deserves another paper, which I shall spare you today.

You may be more interested, indeed, in the external - rather than internal - problems confronting the EMS, in the immediate and longer-run future.

2. The ECU and the Dollar

One of the first and most urgent problems confronting non-member countries as well as member countries is the insertion of the EMS into the world monetary system, and particularly the uneasy relationship between the ECU and the dollar in international settlements.

An important feature of the EMS in this respect is highly welcome by our monetary authorities. This is the replacement - in principle at least - of the dollar by Community currencies in intra-Community interventions on the exchange market and by the ECU in the settlement of mutual credits. We have often, and justifiably, complained of the dominant use of the dollar in both of these respects, as it could exercise strong - even though unintended - upward or downward pressures on dollar exchange-rates, irrespective of any development in the dollar competitiveness in world trade, whenever Community countries' surpluses or deficits switch from eager to reluctant dollar holders, or vice-versa.

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(1) These "transfers", however, are still for the moment reflected in renewable three months' swaps, leaving the exchange risks on gold and dollars to the depositing central bank rather than sharing them through the EMCF.

The first months of functioning of the EMS have been somewhat disappointing in this respect, dollar interventionshaving remained far larger so far than was intended. New measures are now under discussion to make possible a further reduction in the use of the dollar in market interventions and settlements. If successful, these measures should eliminate unnecessary pressures - upward or downward - on the dollar rate, and restore the disciplines whose excessive relaxation has proved - as discussed above - the major engine of world inflation and continued balance-of-payments disequilibria for other countries as well as for the United States.

The use of the ECU outside the Community itself might, at first view, be more worrisome. As mentioned already, the ECU is likely to provide a powerful pole of attraction for other European, Middle East and African countries for which trade with the Community accounts for a major portion of their total trade. Some of these countries are already looking in fact to the ECU as a potential benchmark for their exchange-rate policies, and stabilization endeavors. Switches from dollars to ECU's in private and official settlements and reserve accumulation might become very tempting, if made possible by the EMS authorities, or by the imaginative Euro-currency and Euro-bond sectors of the world economy. Such switches might depress dollar rates unduly on the exchange markets.

A close, two-way, cooperation between the EMS and the U.S. authorities will be necessary, in any case, to prevent a further weakening of an already undervalued, overcompetitive dollar. If this trend were allowed to proceed much further, it would inevitably trigger protectionist reactions abroad against so-called "foreign exchange dumping" by the U.S., and possibly panicky reactions in the United States itself.

The fear of such a disastrous course of events is a powerful stimulus to cooperation between the U.S. and Europe, and the EMS provides new and unprecedented instruments to make such cooperation more feasible and effective than in the past.

The first requirement in this respect will be the correction of our huge and growing deficits of recent years, and indeed the restoration of healthy surpluses in our balance of payments on current account. This, in turn, will require an even more determined and successful fight to reduce our profligate oil consumption and imports and a rate of domestic inflation double or triple that of Germany, Japan, Belgium, the Netherlands, or Austria, to say nothing of Switzerland. The clear affirmation of these prior policy objectives by the Congress as well as by the Administration, and their early implementation by concrete restraints on fiscal overspending, excessive money creation, price and wage increases, oil consumption and imports, etc. should help restore confidence in the dollar, and reverse bearish speculation against it by Americans and by foreigners.

Yet a total and lasting correction of our deficits cannot be expected overnight. Corrective policies - including past readjustments of our exchange rates - produce their effects only slowly. The avoidance of an excessive depreciation of the dollar will still require considerable financing of our tapering-off foreign deficits for some time to come.

We can, first of all, draw for this purpose on our own international reserves, estimated at $ 21 billion at the end of June, but which would approximate in fact to more than $ 90 billion if our gold holdings were revalued at the current price of gold on the market. This latter estimate would, of course, be excessive since gold prices would collapse in the event of massive sales from our reserves. It is relevant, however, as one of the many reassurances to prospective creditors about our solvency, and as an indication of our ability to transfer gold at - or close to - market prices to foreign monetary authorities in settlement of their dollar claims.

Far more important, of course, is the willingness, amply demonstrated already, of foreign countries to participate in a joint defense of agreed dollar rates, including, of course, the readjustments - upward as well as downward - that might be deemed appropriate, or unavoidable, before any stabilization of the dollar vis-à-vis the other major currencies can be realistically envisaged, even as a presumptive goal rather than a legally binding commitment. The radical policy changes announced and put into operation since November of last year - and reinforced on October 6 of this year - are essential in this respect.

We have, first of all, accepted to intervene massively in the exchange market, rather than leave such interventions nearly exclusively to others. We have, secondly, agreed to reduce the inflationary impact of our borrowings abroad by borrowing in the financial market, rather than nearly exclusively from central banks. Thirdly, we are now ready to denominate our foreign borrowings in the creditors' currencies as well as in our own, in order to make them more attractive and acceptable to prospective lenders deterred by the risk of exchange losses on a depreciating dollar. Fourthly, we are now willing to explore actively with our IMF partners the opening of so-called "substitution accounts" in SDR's as a way to mop up some of the dollar overhang accumulated in the past.(1)

The EMS opens up new opportunities in all of these respects.

First of all, the adoption of the ECU as a parallel currency may soon enable us to denominate some of our foreign borrowings in ECU's. Financially, this would expose us to smaller risks of exchange losses than alternative denominations in national currencies such as the mark or the Swiss franc. Politically, it would be a concrete and spectacular demonstration of our will to support the new European Monetary System, and be far more acceptable than borrowings in any national currency other than the dollar, opening us to the accusation, for instance, of making the dollar a satellite of the mark.

Secondly, a reinforced EMCF - and later European Monetary Fund - should facilitate the effective concertation of joint intervention and management of European exchange rates vis-à-vis the dollar. It should also provide an additional mechanism for the "substitution accounts" envisaged above. Reluctant dollar holders could exchange them for ECU's, if they wished, as well as for SDR's.

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(1) Agreement on this technique, however, is likely to require a parallel agreement of some sort on the complementary proposal of the IMF Executive Directors and the Committee of Twenty on "asset settlements". See the remarks of M. Szasz, and others, on this topic in EMS : the Emerging European Monetary System, published by IRES, Louvain-la-Neuve, Belgium, 1979.

The *quid pro quo* of the ECU exchange guarantee granted by the U.S. to the EMCF would be a substantial lowering of interest rates on our obligations, and their consolidation into longer term maturities. This consolidation vis-à-vis the EMCF would leave intact the "liquid" character of the ECU claims held on it by the national Central Banks in exchange for their dollars, insofar as intra-EMS balance-of-payments disequilibria could be settled by mere book-keeping transfers of ECU balances from one member country to another. This liquid character would also be preserved for the financing of European deficits toward the United States - and other dollar-area countries - if our obligations toward the EMCF were expressed in the most appropriate form, *i.e.* in the form of *"consols"* without any imperative repayment date. "Consol" bonds paying interest to their holders, but repayable only at the initiative of the debtor - mostly through open market operations - used to be a most traditional and prestigious means of borrowing for the British Government, and - under the name of "rentes perpétuelles" - for the French Government. They could be made similarly familiar and attractive today, especially if coupled with a "contingent" repayment obligation in the event that present balance-of-payments disequilibria were reversed and our creditors were again to encur substantial deficits toward the United States.

It would, moreover, express operationally an obvious and unescapable truth, *i.e.* that "real" repayment of international credits can only be effected through the recovery of a surplus position by the debtor. All that financial arrangements can do, otherwise, is to reshuffle among the creditors the claims on a deficit country, but it is equally true that these creditors can only receive "real" repayment for their claims by running deficits. I feel that the suggestions above would help dispel the financial fog clouding these transactions - and often misleading the transactors themselves into unfortunate and ineffective policy decisions - and adjust international lending practices to the facts of life.

Note also that the "consols" accumulated by the EMCF - or a reformed IMF - should be negotiable in the market, under agreed conditions, whenever advisable to mop up excessive, inflationary, levels of liquidity.

3. Progress toward Worldwide Reforms

Some people still view regional monetary cooperation as the antithesis of worldwide monetary cooperation. I took the opposite view when I helped plan and negotiate the European Payments Union, which provided in the 1950's a most spectacular demonstration of the complementarity of these two approaches. The EPU did much more, indeed, than the IMF in those years to restore convertibility between the participating currencies and the dollar, as well as among themselves.

I am convinced that the success of the EMS experiment toward its basic objectives, and of the indispensable cooperation between the EMS and U.S. authorities, might at long last break the deadlock which has paralyzed, since Jamaica, the previous determination to restore a workable world monetary order. I hope I am not entirely a "loner" and a dreamer in feeling that floating rates and the Second Amendment to the IMF Articles of Agreement should not relegate to the garbage can all the previous proposals for IMF reform, ironed out over ten years of continuous, intensive negotiations. May I refer those of you who are open to argument in this respect to my inaugural McCloy lecture of last November published in the Princeton Essays in International Finance under the title "Gold and the Dollar Crisis : Yesterday and Tomorrow" (particularly pp. 11 and 12). The revolutionary developments of recent years certainly require a modification of previous proposals for reform, but to enlarge them - particularly to deal with the fantastic explosion of private international credits - rather than to emasculate them.

(1) First and foremost, of course, should be the actual implementation of the often reiterated pious wish to substitute a reformed SDR for the dollar as well as for gold in international reserves and settlements. The latest IFS estimates show how far we are from that goal: SDR's and Reserve Positions in the Fund accounted each, last May, for less than 3% of world reserves, as against 44% for gold (valued at market prices) and 51% for foreign exchange holdings.

Let us hope that the IMF Belgrade meeting resolution regarding SDR "substitution accounts" will prove a first step on the long road still ahead. The mopping up of outstanding gold and dollar holdings through "substitution accounts", however, would be useless - and difficult to negotiate - if it were not complemented by the radical reforms to which it should be a mere prelude, i.e. those that will: (i) limit the future expansion of the world reserve system to what is needed to make it an engine of world stability rather than of world inflation; and (ii) attempt to earmark this growth for the financing of high-priority economic and social objectives commonly agreed, rather than for the haphazard financing of U.S. or other reserve centers' deficits.

I would plead again, as a way to meet the first of these objectives, for a simple but only presumptive rule à la Milton Friedman: the IMF should be directed to expand its total lending and investment portfolio at a rate of 4 to 6 per cent a year, consistent with the reserve requirements of non-inflationary growth of world trade and production. Weighted voting of 2/3, 3/4, or even more, should be required to authorize substantial departures from this presumptive target. For it to have the desired effect, moreover, the monetary authorities should invest all of their future surpluses in SDR's - rebaptized, of course, and made more attractive to members - and eschew any purchase of gold and foreign exchange, except for minimum working balances in foreign currencies still needed for interventions in the market until SDR's are made available - as they should be - to commercial banks, and even other holders.(1)

Particularly encouraging in this respect are the forward-looking "Thoughts on an International Monetary Fund based fully on the SDR" of the Economic Counsellor and Director of the Research Department of the International Monetary Fund: J.J. Polak.(2)

As for the second objective, it would flow automatically from the fact that all reserve growth would become the result of agreed Fund decisions. These should include the type of operations financed in the past by the Fund - including those covered by the "General Agreements to Borrow" - but add to them those now made possible by the substitution of SDR's

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(1) To the extent that more substantial dollar accumulation were deemed necessary in a transition period, it should be deducted from the authorized Fund lending and investment operations.

(2) Recently published by the Fund as No. 28 in its Pamphlet Series.

for gold and foreign exchange reserves, and not necessarily limited - as brilliantly explained by Professor Machlup[1] - to short-term lending. An expansion of IMF operations consistent with the first objective above should leave room for such operations. They might take the form of IMF investments in long-term bonds, or even consols, issued by various agencies such as the World Bank, its affiliates, other Regional Development Banks, and even by other international agencies such as the World Health Organization, etc.

(2) Two further aspects of this reshaping of the international monetary system deserve a few comments.

The first is the need to take into consideration the incredible mushrooming of international credit financed by private sectors, particularly through Euro-currency credits and Euro-bond issues. The rough and incomplete estimates reported by the BIS [2] show a net increase of about $ 330 billion in these private lending operations over the last three years ($ 535 billion gross), i.e. more than 2 1/2 times the reported increase of $ 127 billion in the foreign exchange investments of central banks, and 60 times that of SDR allocations and IMF lending.[3]

Some distinguished economists - from Academia as well as from the U.S. Treasury - have been arguing on this basis that the reforms previously advocated as necessary to arrest the inflationary explosion of reserve creation have not only been made unnecessary by the generalization of floating rates, but have also become irrelevant anyway in view of the ease with which countries can now finance continuing deficits through their borrowings from the private market, rather than through reserve losses or borrowings from the IMF. I would draw from the same facts the opposite conclusions, i.e. that any meaningful attempt to reduce persistent world inflation and balance-of-payments disequilibria must deal with both of their two major sources in recent years:

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(1) Particularly in "The Cloakroom Rule of International Reserves : Reserve Creation and Resources Transfers", Quarterly Journal of Economics, August 1965.

(2) In its June 1979 Annual Report, p. 104.

(3) See accompanying Table IV . Note, however, that a significant portion of these reported increases, valued in dollars, reflect the impact of the dollar depreciation over these years (from 0.85422 to 0.76758 SDR's per dollar) rather than new lending.

TABLE IV

Main Sources of International Lending : 1976-78

	In billions of dollars			% shares of 1976-78 increases
	At the end of 1975	1978	1976-78 increases	
...ation of Monetary Reserves:	178.8	311.8	133.0	29%
Central Banks' foreign exchange claims	160.3	287.7	127.4	27%
SDR allocations	10.9	12.1	1.2	-
Net IMF credit	7.6	11.9	4.3	1%
...ivate Market (Net)			330.5	71%
Commercial Banks' foreign claims	285.0	540.0	255.0	55%
Flotation of International Bonds			75.5	16%
...tal (I + II)			463.5	100%

...urces:

. International Financial Statistics (August 1979), converting SDR estimates into U.S. dollars. Net IMF Credit (line I C) is "Use of Fund Credit" minus undistributed IMF surplus.

. Bank for International Settlement, Annual Report (June 1979), p. 104.

...ief Comments:

...e 84% growth of international reserve investments and commercial banks' foreign ...change claims alone (lines I and II A) over the last three years is primarily due ... the latter, the foreign lending and investment operations of commercial banks ...ing about double those of central banks, and 46 times those of the IMF.

a) The disordinate financing of reserve-centre borrowings, which floating rates have failed to reduce significantly; and

b) The disordinate growth of private financing, which could not have reached such proportions, anyway, if the U.S. dollar had not acquired unwittingly the privilege - and burden! - of being accepted by central banks as well as by commercial banks and their customers as a "parallel world currency".

My second, and final, observation is that the reform path outlined above should - and undoubtedly will - modify fundamentally the distribution of functions and responsibilities between the IMF, the EMF, and other regional monetary groups already in existence and likely to emerge in the future. The financial, economic, and most of all political, scope for monetary cooperation and mutual commitments is obviously much broader among highly interdependent countries - keenly conscious of this interdependence - than that conceivable at this stage on a worldwide scale between more heterogeneous groups of countries less interdependent from one another.

A few figures illustrate the point. Exports to other Community countries account for 52% of total exports for the Community as a whole, ranging from a near-high of 72% for Belgium to a low 38% for the United Kingdom. This is certainly part of the explanation of the greater degree of enthusiasm shown in Belgium than in the United Kingdom for economic and monetary union, particularly if one considers also the greater dependence of GNP on exports for Belgium (50%) than for the United Kingdom (30%). Merchandise exports to the Community account for 33% of Belgium's GDP as against 9% for Britain (see Table V).

Yet exports to the Community are for all its members a multiple of their exports to their main outside customer: the United States. They are about 4 times as large for Britain, at the low end of the spectrum, and as much as 17 times for Belgium. The crucial importance of the United States - and of the dollar - in Community policies and institutional arrangements derives primarily from other reasons, such as:

TABLE V

Economic Dependence on Intra-Community Exports (in 1978)

	in billions of ECU's			in % of exports to the world		
	Community Total	Belgium-Luxembourg	United Kingdom	Community Total	Belgium-Luxembourg	United Kingdom
I. Exports to Europe:	252	28.5	31.2	70	81	56
1. to Community countries	186	25.2	21.2	52	72	38
2. to other Western Europe	53	2.7	8.6	14	8	15
3. to Eastern Europe	13	0.7	1.5	4	2	3
II. Exports to the United States	23	1.5	5.2	6	4	9
III. Exports to the Rest of the World	84	5.1	19.6	24	15	35
IV. World Total	360	35.1	56.1	100	100	100
1977 % Share in GDP of:						
I. Total exports of goods and services				28	50	30
II. Merchandise exports to the Community				12	33	9

Sources: European Communities : Eurostat

(1) for merchandise trade: Monthly External Trade Bulletin, Special Number 1958-1978, pp. 21-22; and EC Trade by Community Classes and Main Countries, June 1979, pp. 4-5.

(2) for GDP and exports of goods and services: National Accounts ESA, Aggregates, 1960-1977, pp. 95, 115 and 123.

a) The difficulty of changing deeply imbedded psychological attitudes, market habits and bureaucratic routines inherited from the past; and

b) most of all, the enormous weight of the United States as an economic, political, and military power in the rest of the world, as well as in Europe.

Similar observations could be made - and documented - for other areas of the world. A more decentralized structure of monetary cooperation than that of Bretton Woods is long overdue. It would have, to my mind, a triple advantage.

1) To permit a fuller exploitation of the wider potential for realistic cooperation that can be elicited on a regional rather than a world scale;

2) To relieve the IMF of unnecessary responsibilities, and enable it to concentrate its time and attention on those which cannot be discharged as, or more, efficiently on the regional scale.

3) To make wholehearted participation in the IMF more attractive and feasible to disaffected countries, such as many less developed countries, and particularly to make it possible for the Communist countries, unable to adjust their mutual relations to rules and norms derived from the market - less centrally planned - economies of the capitalistic world, but that would not always make sense for their own economies.

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It is now high time for me to leave the floor to others. I hope to have provided enough fuel for a hot debate, to which I invite you all to bring your contributions.

Thank you !

ANNEX TABLES

1. Size, Sources, and Distribution of World Monetary Reserves : 1913 - 1978
2. Size, Sources, and Distribution of Reserve Increases : 1949 - 1978.
3. The U.S. Balance-of-Payments : 1960 - 1978.
4. Regional Pattern of World Exports in 1978.

Table 1

SIZE, SOURCES, AND DISTRIBUTION OF WORLD MONETARY RESERVES : 1913 - 1978
(in billions of $ or SDR's)

End of	1913	1937	1949	1959	1969	1972	1975	1978
CES								
I. World gold in billions of SDR's at 35 SDR's per ounce throughout	4.1	25.3	34.4	39.9	40.8	41.2	41.1	40.1
II. Credit, in billions of SDR's	0.7	2.4	11.1	17.0	37.9	105.3	152.7	239.3
A. Foreign exchange	0.7	2.4	11.0	16.1	33.0	95.9	136.9	220.8
B. SDR allocations and IMF credit	-	-	0.2	0.9	4.8	9.4	15.8	18.5
1. SDR Allocations			-	-	-	9.3	9.[illegible]	9.3
2. IMF credit			0.2	0.9	4.8	0.1	5.5	9.2
II. Impact of Gold-$ Fluctuations			-0.3	0.1	0.2	44.2	149.6	291.5
A. On gold valuation			-0.3	0.1	0.2	35.2	123.6	219.0
1. Gold-SDR rate			-0.3	0.1	0.2	29.2	99.6	158.8
2. SDR-$ rate			-	-	-	6.0	24.0	60.2
B. On credit valuation (SDR-$ rate only)			-	-	-	9.0	26.1	72.5
cial reserves, in billions of $	4.8	27.7	45.2	57.0	78.9	190.7	343.4	570.9
DISTRIBUTION								
Total Reserves, in billions of SDR's	4.8	27.7	45.5	57.0	78.7	146.6	193.8	279.4
I. United State	1.3	12.8	26.0	21.5	17.0	12.1	13.6	15.0
II. Other countries	3.5	14.9	19.5	35.5	61.7	134.4	180.2	264.4
A. OPEC			1.2	2.5	4.1	10.0	48.3	46.2
B. Other countries			18.3	32.9	57.6	124.4	131.9	218.2
1. Developed			11.0	26.3	45.7	104.7	105.9	165.4
2. Less developed			7.3	6.6	12.0	19.7	26.1	52.8

Notes

1. For 1913 and 1937 estimates, see footnotes to Table 8, pp. 66-67 of my Princeton Study in International Finance (n° 12, June 1964) : The Evolution of the International Monetary System : Historical Reappraisal and Future Perspectives. Gold holdings in 1913 are valued at $ 20,67 per ounce. Its revaluation to $ 35 per ounce in 1934 accounts for $ 11,4 billion of the $ 25,3 billion 1937 world gold estimate.

2. All other estimates are calculated from the international reserve tables of the annual issue of International Financial Statistics 1979. Note that IFS tables show the composition of countries' reserves, rather than the origin, or sources of reserves. They include therefore under "Reserve Positions in the Fund" the impact of gold and SDR transfers by countries to the Fund, attributed here to world gold and to total SDR allocations. My estimates for IMF credit, as a source of reserves, include only the "Use of Fund Credit" plus IMF gold deposits and investments in U.S. Government obligations (only from March 1956 through January 1972) and minus a slight discrepancy (rising to about $ 1 billion in 1972-78) arising mostly from the Fund's undistributed surplus.
Slight discrepancies in the IFS total for reserve distribution in 1949 and 1959 have been ascribed to the "Less Developed" Group of countries.

TABLE 2

SIZE, SOURCES AND DISTRIBUTION OF RESERVE INCREASES 1969 - 1978.

	From Adam and Eve through 1949	10 Year increases		3 Year increases			9 year increases	6 year increase
		49–59	59–69	69–72	72–75	75–78	69–78	72–78
SIZE								
1. in billions of $	45	12	22	112	153	227	492	380
2. in billions of SDR's	46	11	22	68	47	86	201	133
RATES OF GROWTH								
Over period								
1. of $ estimates		26	35	142	80	66	623	199
2. of SDR estimates		25	38	86	32	44	255	91
Annual growth rates								
1. of $ estimates		2	3	34	22	18	25	20
2. of SDR estimates		2	3	23	10	13	15	11
SOURCES (for $ estimates)								
In billions								
I. Gold	34	6	1	–	–	–	–	-1
II. Credit	11	6	21	67	47	87	201	134
A. For exchange	11	5	17	63	41	84	188	125
B. SDR allocat. & IMF cred.	–	1	4	5	6	2	14	9
III. Impact of gold-$ Fluctuations:	–	–	–	44	105	142	291	247
A. gold-SDR rate	–	–	–	29	70	59	159	130
B. SDR-$ rate	–	–	–	15	35	83	133	118
In % of total :								
I. Gold	76	47	4	–	–	–	–	–
II. Credit	24	50	95	60	31	38	41	35
A. For exchange	24	43	77	56	27	37	38	33
B. SDR allocat. & IMF cred.	1	6	18	4	4	1	3	2
III. Impact of gold-$ Fluctuations:	-1	3	–	39	69	62	59	65
A. gold-SDR rate	-1	3	–	26	46	26	32	34
B. SDR-$ rate	–	–	–	13	23	36	27	31
DISTRIBUTION (for SDR estimates)								
In billions :								
I. United States	26.0	-4.5	-4.5	-4.9	1.5	1.4	-2.0	2.9
II. Other countries	19.5	16.0	26.2	72.7	45.8	84.2	202.7	130.0
A. OPEC	1.2	1.3	1.5	5.9	38.3	-2.1	42.1	36.2
B. Other countr.	18.3	14.6	24.7	66.8	7.5	86.3	160.6	93.8
1. Developed	11.0	15.3	19.4	59.0	1.2	59.5	119.7	60.7
2. Less devel.	7.3	-0.7	5.4	7.7	6.4	26.7	40.8	33.1
In % of world total								
I. United States	57	-39	-21	-7	3	2	-1	2
II. Other countr.	43	139	121	107	97	98	101	98
A. OPEC	3	11	7	9	81	-2	21	27
B. Other countr.	40	127	114	98	16	101	80	71
1. Developed	24	133	89	87	3	70	60	46
2. Less devel.	16	-6	25	11	14	31	20	25

Sources and notes : see table 1

Table 3

The U.S. Balance of Payments: 1960-1978
(in billions of dollars)

	Total	Yearly Average			Year	% Share in Total Financing	
	1960-78	1960-69	1970-72	1973-78	1978	1960-69	1973-7
I. Recorded Debt Increase (-) of	-320	-5	-18	-36	-64	113	91
A. Treasury and Banks to:	-243	-3	-13	-29	-53	69	73
1. Official Institutions	-166	-1	-16	-19	-34	18	46
2. Other (mostly Banks)	-78	-2	3	-11	-19	50	27
B. Other	-77	-2	-5	-7	-11	44	18
II. Statistical Disrepancy	-5	1	4	-4	-11	-13	9
III. Total (I&II), financing:	-325	-4	-14	-40	-75	100	100
A. Current U.S. Deficit (-) (no sign = surplus)	76	5	--	4	-11	-121	-10
1. Net Earnings on Past investments	167	5	7	16	22	-114	-40
2. Other	-91	--	-7	-12	-32	-6	30
B. Capital Exports (-): (Recycling)	-401	-9	-14	-44	-64	222	110
1. Monetary Reserves	5	--	2	-1	1	-11	2
2. Bank Claims	-120	-1	-2	-17	-33	18	43
3. Foreign Aid	-83	-3	-4	-6	-8	81	16
4. Other	-203	-6	-10	-20	-24	133	49

End of Period Average Depreciation (-) or Appreciation of the $, in %, since May 1970, vis-à-vis:	1972	1978	Dec. 1978
1. Twenty Major Currencies	-10	-21	-24
2. Swiss Franc	-13	-59	-62
3. German Mark	-13	-45	-49
4. Japanese Yen	-16	-42	-45
5. Pound Sterling	-4	+25	+21

TABLE 4

GEOGRAPHICAL PATTERN OF WORLD EXPORTS IN 1978
(in % of exports to the world)

EXPORTS TO → / FROM ↓	I	II	III	WESTERN EUROPE			OTHER EUROPE-ORIENTED AREAS			WEST. HEMISP.		ASIA (1)	
	Eur. Orien. Areas	Western Hemisph.	Asia (1)	Total	European Community	Other W. Europ.	Midd. East & Afr. (1)	Communist Countries	Australia N. Zealand S. Africa	USA	Other	Japan	Other
I Eur.-Oriented Areas	75	14	9	59	45	14	11	4	2	9	5	5	4
A. West. Europe	85	10	4	66	50	15	13	5	2	6	3	1	3
Europ. Commun.	85	10	4	66	51	15	13	4	2	6	3	1	3
Oth. Wes. Eurp.	86	10	4	62	45	16	12	12	1	6	3	2	2
B. Mid. East & Africa	48	30	21	41	33	8	5	1	1	19	11	14	7
Oil-Exp. Count.	43	33	24	38	31	8	3	-	1	21	13	16	8
Oth. Midd. East	70	10	13	38	30	9	20	10	2	9	1	6	7
Oth. Africa (2)	74	18	7	57	49	8	12	4	1	12	6	4	3
C. Communist Countries (3)	77	6	17	65	35	30	11	(3) ..	1	3	3	9	9
D. Aust. N. Zeal. S. Afr	40	16	31	26	22	4	6	4	4	13	3	19	12
II West. Hemisphere	41	44	14	25	20	5	11	3	2	20	23	7	6
A. United States	49	32	18	28	22	6	15	3	3	x	32	9	9
B. Canada	18	70	8	10	9	1	4	3	1	68	3	6	2
C. Latin America	42	50	6	31	24	7	6	5	-	33	16	5	2
III Other Asia	41	31	27	18	14	4	15	5	4	25	6	7	20
A. Japan	43	33	22	16	11	4	17	7	3	26	7	x	22
B. Other countries	38	28	34	21	17	3	12	3	2	25	3	16	18
IV World	64	22	13	46	36	11	11	4	2	14	9	6	7

Source : Direction of Trade Yearbook 1979 (International Monetary Fund)

NOTES :

(1) Other than oil-exporting countries.

(2) Other than South Africa.

(3) Incomplete estimates excluding most of intra-trade.

See Source for other explanations and qualifications. Exports to unspecified areas (slight, except for "Other Middle East" and "Australia, New Zealand and South Africa") account for differences between horizontal totals and 100 %

BRIEFS COMMENTS :

1. Intra-trade is much larger for Western Europe, and even the European Community alone, than for other geographical areas. It is also very significant within the Western Hemisphere, especially between Canada and the United States.

2. The share of Western Europe in the export trade of the "Oil-exporting countries" and of "Australia, New Zealand and South Africa" would not orient these areas as decisively as the others toward a European Area. Yet, their main ties would be in that direction rather than toward either the Western Hemisphere or Asia, especially if account is taken of their geographical location and import trade for the first group; and of their financial and political links with Britain for the latter.