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TEPSA/IEP

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: The Future of the European Monetary System (EMS)
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# Economic Policies and "Finanzausgleich"

## I. Problems of the coordination of economic policies within the EMS

In a monetary system with fixed exchange-rates such as the EMS the coordination of economic policies is of fundamental importance. Whatever the specific provisions for obligatory interventions in the exchange markets may be, the problems relating to economic coordination are the same: The factors determining the development of exchange-rates have to be steered in such a way that the exchange-rate mechanism and the credit mechanism will not be overcharged.

In principle, the need for minimizing differences in the respective national policies refers to all fields of economic policy, i.e. monetary policy, budgetary policy, incomes policy, etc. Above all, however, it means that a sufficient degree as to the coordination of monetary policies must be achieved. Only if one assumes that, in the long run, the further completion of the EMS to a system of truly common monetary policy, decided on the community level by some "nucleus" of a European central bank, were possible, then the need for coordination of national monetary policies would be diminished. But, as for the near future this possibility can certainly be regarded as an illusion, the question of how policies influencing the development of exchange-rates can adequately be coordinated remains essential for the future ot the EMS.

Exchange rates are determined by supply and demand on the foreign exchange markets. The market situation itself is a result of current transactions, of medium- and long-term capital movements, and of short-term financial flows between the countries concerned. Current transactions depend in the long run on international competitiveness and therefore on the differences in inflation rates and productivity. In the short run, they are also influenced by business cycles. These factors are also decisive for medium- and long-term capital movements but here, in addition, the interest rate differences on national and international capital markets have to be taken into consideration. Finally, short-term financial flows are influenced primarily by differing money market interest rates and by exchange-rate expectations. Thus, a great number of factors would have to be controlled.

In the EMS, however, there are only very few and insufficient provisions of that kind. Medium-term coordination of macroeconomic policies does not take place except, to a certain degree, in connection with the medium-term credit support and with the use of community loans for financing oil-price-induced balance-of-payments deficits. On the other hand, as to monetary policy, the Committee of Central Bank Governors and the Monetary Committee provide a forum for regular contacts and the exchange of opinions between monetary policy makers. Moreover, in the EMS some arrangements exist specifically concerning policy coordination when the divergence indicator is reached. Nevertheless, the results as to the coordination of interest rates as well as to the developments of the stocks of money in the different member countries of the EMS are not very encouraging.

Therefore, an EMS at a higher stage - for example of the type described in "Option 5 A" - would require an additional institutional framework to promote the harmonization of national monetary policies. This should entail permanent and serious consultations on different policy levels (for details, cf. the paper on "The Options Ahead"). More important than new instutional arrangements, however, would be the true will to pursue a more stabilization-oriented monetary and budgetary policies in all member countries of the system. Only on this basis an extended EMS can be viable.

II. The EMS as an instrument of an Intra-European "Finanzausgleich"?

In connection with the EMS a number of measures has been introduced which, explicitly or implicitly, entail financial transfers between member countries of the EMS. Apparently, this combination has been regarded as politically necessary in order to make the EMS more attractive for some member countries of the Community. Nevertheless, it must be asked whether the mixing-up of monetary policy with elements of an intra-European "Finanzausgleich" is desirable and appropriate for further monetary integration.

In principle, two theoretical questions have to be answered. First, are there any arguments for intra-community-transfers as a consequence of monetary integration in Europe? More generally speaking, is it justified to provide financial transfers between countries which decide to fix parities between their currencies? Indeed, some economists claim that there is such a necessary interdepence. Their argument is that by fixing parities (or by narrowing the range of flexibility of foreign exchange-rates) some countries have to accept additional economic burdens. The reason for this, they say, is that exchange-rate changes as an instrument to cope with (internal or external) economic problems are no more at the disposal of public authorities. Therefore it is necessary that additional economic problems resulting from this situation should be distributed among all the countries concerned by means of an intra-European "Finanzausgleich". In detail, the argument can be found in two different versions: One assumes differing "Phillips-curves" between different countries. The consequence of this is that monetary integration leads to a harmonization of inflation rates and thus creates different burdens in the process of adjustment to the new combinations on the "Phillips-curve". The other explanation states that differing rates of productivity development cause changes in the location of industries within the area with fixed exchange-rates when an approximation in the developments of real wages is supposed. Both explanations, however, are only acceptable on specific conditions which cannot be taken as granted in the case of the EMS. So, the most that can be said is that there might be a certain plausibility for justifying intra-community financial transfers by arguments of monetary theory but that it is definitely impossible to quantify the amount of those transfers in the case of the EMS. It should be noted that this point must be strictly separated from the general recommendation of an intra-European "Finanzausgleich" as a means of reducing income differences within the community, a recommendation which is based on the theory of intergovernmental fiscal relations and on the distribution aim of public policy, but not on monetary theory.

The second theoretical question is whether monetary policy can be regarded as an instrument appropriate to diminish international or interregional differences in the development of the standard of living. Taken efficiency as the primary criterion for judging the way of realization of such an intra-community "Finanzausgleich", this criterion can be interpreted in the sense of (1) ex-ante quantification and attribution of the costs and benefits of alternative instruments to achieve that aim, and (2) transparence of these costs in public budgets. Both requirements are badly satisfied by monetary policy. In this respect, public finance is the much better instrument.

The EMS, however, implies open, as well as hidden, elements of financial transfers. First, there is the open ressource-transfer, consisting of interest rate subsidies granted in the framework of the so-called Ortoli-facility. Second, there are hidden transfer elements in the credit mechanisms which have been brought into the EMS and which were increased when the EMS was introduced. These mechanisms are the Very Short-Term Financing, the Short-Term Monetary Support and the Medium-Term Financial Assistance. In particular, the Very Short-Term Financing and the Medium-Term Financial Assistance are not given at market conditions but at preference rates. Furthermore, the existence of the credit mechanisms as such entails transfer elements insofar as countries pursuing an inflationary economic policy face less pressure to change this course of policy when such credit facilities are at their disposal. Therefore, the existence of the credit mechanisms and the transfer elements connected with them further the risk of continued or even augmented inflation within the community. Moreover, this risk is increased by the way of refinancing of the credit mechanisms, i.e. by creation of central bank money.

It is true, during the first 2 1/2 years of the EMS only the Very Short-Term Financing has been used. Nevertheless, the fact that the other two mechanims also contain uncontrollable elements of a "Finanzausgleich" has to be seen as a problem of principle which might soon become virulent.

The consequences of these considerations are threefold. First, all elements of intra-European "Finanzausgleich" connected with the EMS and the respective burdens for public budgets should be made transparent as far as possible. Second, the EMS as an instrument of monetary policy and monetary integration should be made free from all elements of financial transfers between nations or regions. Finally, the Medium-Term Financial Assistance should be financed not be creation of central bank money but by public budgets, either those of the member countries or that of the European Community itself.

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Summary:

## The EMS as an Instrument of an Intra-European "Finanzausgleich"?

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## THE POLITICAL DRIVE TO CREATE THE EUROPEAN MONETARY SYSTEM. DOES IT STILL EXIST ?

Condensed version of a paper by
Jonathan Carr, Financial Times, Bonn.

This paper makes two main claims. First, that the European Monetary System (EMS) emerged when it did mainly because there was a weak U.S. President in the White House. Second, that another external challenge may yet spur the Western Europeans to further integration efforts, although present conditions are not propitious.

Clearly, there are good arguments on economic and financial grounds alone for creating a "zone of monetary stability" in Europe. But it is unlikely that Chancellor Schmidt and President Giscard d'Estaing would have staked their reputations on so risky an enterprise if the U.S. had had a leader pursuing calculable policies and the dollar had been fairly stable. This was manifestly not the case during at least the first years of the Carter era.

The birth of the EMS was not a deliberate challenge to the dollar but a self-defence effort against the vagaries of U.S. policy. But it could easily be interpreted as such a challenge and the then British Prime Minister Mr. Callaghan clearly saw it that way. Britain cited other reasons of a technical nature for not becoming a full member of the EMS from the start - but its basic objection was a political one, stemming from reserve towards European integration and the special relationship with the Americans.

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In November, 1981, the position is as follows:

1.) According to the original agreement, the EMS should have enteredd its second stage in March. It did not do so, mainly because Messrs. Schmidt and Giscard agreed in early 1980 that they did not want the EMS issue with its implications for national sovereignty emerging during their election campaigns - the German one in Autumn, 1980, the French one in Spring, 1981.

2.) M. Giscard lost the election and a new Socialist-Communist administration came to power. While Paris remains dedicated in principle to the EMS, the high French inflation rate forced E devaluation of the Franc this Autumn. French deficit spending policy seems likley to push up inflation further, widen the price differential with West Germany in particular, and bring further Franc devaluation sooner or later.

3.) Britain has become a little more interested in full membership of the EMS,~~xyxBxyxyxyxyx~~ because of the major swings to which the pound sterling has been subject over the last couple of years.

4)) The U.S. has in Ronald Reagan a President more inclined to take a strong policy line. But the combination of high U.S. interest rates, a federal budget deficit bigger than expected, and an attitude of "benign neglect" to dollar intervention seems to pose a challenge to the Europeans little if any less than that existing in Jimmy Carter's time.

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To help counter this threat the French have proposed introduction of a two-tier interest rate system for Europe - which has implications unacceptable to the Germans. And they have talked of building up the ECU as a reserve asset. The latter goes to the heart of the problem - for so long as the D-Mark operates as the world's second reserve currency it will automatically react more sharply to the movement of the dollar than other EMS currencies do.

But how is the ECU to gain a major reserve asset role? That question raises another - about the proposed European Monetary Fund (EMF). Maximalists argue that the EMF would in effect be a European central bank, overseeing the ECU and its development. But who would have the final policy say, the Fund as an independent institution like the Bundesbank, or politicians acting through the Council of Ministers?

The minimalist approach would be to rename the existing European Monetary Cooperation Fund the EMF - and have done with the problem. A compromise suggestion of a half-way house between these two extremes is more ambitious than it looks. Even small steps would prejudice the final shape and role of the Fund - and thus require an initial accord of principle by all participants on just what is being aimed at.

At present there is no such accord. The problem is an eminent political one and it seems unlikely it will be seriously faced unless a pressure from outside Europe dictates otherwise. One such pressure might be a further aggravation of the U.S. fiscal dilemma combined with still greater swings in the dollar rate. Even that might not be enough to overcome European inertia - but life is full of surprises. In late 1977 very few people indeed foresaw the creation of the EMS.

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## EC Enlargement and EMS Participation

Summary of Discussion Paper

for Institut für Europäische Politik, Bonn

by Dr.Rainer Hellmann, Brussels

The enlargement of the European Community by Spain and Portugal risks to lead the European Monetary System (EMS) into a situation comparable to the one existing before Giscard d'Estaing and Helmut Schmidt took the initiative of its launching in 1978. From March 1976 to March 1979 only five of the then nine EC member states had remained members of the European Economic and Monetary Union. By the loss of four participants the snake mechanism of narrowed currency margins had shrunk to a "minisnake".

This situation caused great political discomfort in the Community, as non-members of the snake felt themselves excluded from a central point of integration, though they had left the snake on their own demand. Efforts to bridge the gap like the Tindemans-Report of early 1976 were misinterpreted as if they were trying to make the two tier system permanent.

The formation of two strong groups inside a Community, each of which follows different directions and meets in seperate circles is politically highly undesirable. If Spain and Portugal would join the EC in a period in which Britain and Greece have not yet joined the exchange rate mechanism of the EMS, there would be a group of eight EC members participating and four members not participating in the core of the system. If Britain had then become a full participant still one fourth of member staes would not be participants. In the longer run such a situation must lead to divisions and unacceptable situations. The EMS foresees the participation of all member states of the EC in its steering committees. This could become unacceptable for EMS participants if the group of non-participants became larger.

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Therefore the question of EMS participation should not be deliberately neglected as it was in the negociations with Greece, but settled in the negociations on enlargement with Portugal and Spain. The third enlargement of the EC could well coincide in 1984 or 1985 with the passage to the second stage of the EMS. If the EMS will then be legally founded, the question of participation can no longer be simply eluded, even if not settled in the enlargement negociations. Neither should the new members be tempted to consider their EMS participation as a matter of secondary importance.

As Spain and Portugal will probably not be able to participate fully in the EMS from their EC membership, transitional regulations and transitional periods for full EMS participation could be negociated. A longer transitional period than five years should not be excluded and it should be considered as a period of serious preparation for effective full participation. Eventually the new members could prevail themselves after the transitional period for some other years of the larger 6 percent margin conceded now to Italy. A differential in the margins seems a lesser evil than a two tier system of membership in the EC. The statute granted to the United Kingdom should remain an exception and should disappear as early as possible and not later than with the passage to the second stage of EMS.

The composition of the Ecu basket should be revised with the enlargement. An Ecu composed of 12 currencies can hardly compete and become a more used currency unit in comparison with the SDR composed of only five currencies. A new Ecu could eventually be composed of a basket of the seven currencies of members with an 8 or 10 percent share in the GNP of the enlarged Community (France, Italy, Germany, United Kingdom, Spain, Netherlands, Belgium). Even a more restrictive basket could be considered.

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Norbert Kleinheyer

Bonn, November 1981

Discussion-Paper

## Options of Further Development of the EMS: The System of Credit- and Stand-by-facilities

1. The credit-mechanism is a central instrument of the European Monetary System (EMS); it consists of different elements: The Very Short-Term, the Short-Term and the Medium-Term Credit Facilities. This instrument is derived from the Deutschmark-dominated "snake" but it has been expanded considerably.

2. Originally it was planned to consolidate the credit-mechanism in the hand of the European Monetary Fund (EMF) two years after establishing the EMS at the very latest. (See No. 4.1 and 1.4. of the European Councils Resolution Establishing the EMS).
Implementing this promise is overdue by since more than seven months, and the resoluteness of the chiefs of the EMS governments to promote the evolution has become less trustworthy.

3. Any consolidation of the credit-mechanism in the EMS without intervention into the structure of competence, without rearrangement of the criteria for credit-placing and without readjustment of the volumes of the facilities would be purely cosmetic (pretended competence of a central institution), but it would complicate the decision-making in the EMF.

4. The consolidation of the credit-mechanism has to take into account the various objectives of the different credit facilities. The Very Short-Term Facility is an instrument for compensating the balances of preceding interventions which is handled by the FECOM in cooperation with the central banks. The Short-Term Facility is an instrument for settling temporary balance-of-payment difficulties provided by the Committee of Governors of the EEC central-banks. The Medium-Term Credits are an instrument of balance-of-payment settlements between the countries in order to resolve structural problems.

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5. Consolidating the stand-by mechanism of the EMS raises the question of competences: monetary competences are distributed in different ways in the EMS countries. It follows that it is impossible to delegate the competences to the Fund corresponding to the scheme of competences in each country. It would be necessary to assign functions of national central banks to international "government institutions" and vice versa. This raises the question of the position of the national institutions. For instance the Deutsche Bundesbank may not be authorized to delegate competences to an international organization, including national governments, without jeopardizing its autonomy.

6. When establishing the first common institution with monetary competence on EEC level it is indispensable to choose an appropriate key which is qualified to warrant a balance-of-power in the EEC between governmental and monetary institutions. One solution of this problem could be to transfer only real central-bank functions to the EMF. That would allow the realization of to realize an institutional independence on the European level vis-à-vis both the European Council and the Commission analoguous to the autonomy of national central-banks.

7. There are several alternatives how to transfer the facilities to the funds; the following schedule shows five of them:

| variant | credit facility | | | participation in decisions of EMF | |
|---|---|---|---|---|---|
| | very short-term | short-term | medium term | governm. | centr.-b. |
| 1 | F | F | F | Yes | Yes |
| 2 | C | F | F | Yes | Yes |
| 3 | F | F | G | No | Yes |
| 4 | F | C | G | No | Yes |
| 5 | F/C | C | F | Yes | Yes/No |

F = competence of the fund

C = competence of the central bank

G = competence of the government, the fund is participated in financing

8. Essentially there are five models for the organisation of the EMF: the "minimal solution" means to do nothing but renominating the FECOM; the "management solution" means to transfer the competence of the short-term credit facility to the EMF; the "regional fund solution" refers exclusively to the competence of the medium-term facility; the "central-bank solution" includes only the very short-term and the short-term facilities; and the "sui generis solution" takes all facilities together.

9. The previous discussions have shown a preference of the central-banks for the "central-bank solution", while the governments seem to favour the "sui generis solution". Only the last one would materialize the intended complete consolidation.

1o. The consolidation of the credit facilities creates technical problems: the system of creditor-quotas and debtor-quotas has to be replaced by a general credit limitation for the EMF.

11. The consolidation should be an occasion to examine the quantitative equipment of the credit facilities. Neither the experiences in the "snake" nor those in the EMS give reasons for enlarging the credit-mechanism. The total volume has to be reduced.

12. We must not seperate the stand-by mechanism in the EMS from the other credit-sources of the EMS members. The countries can dispose of the IMF facilities and the euromarket facilities,too. If the growing credit volume of a country means an increasing "conditionallity", it should be proportioned to the cumulative debt of the country. Otherwise there is an incentive to avoid disagreeable consultations and obligatory conditions by drawing on other credit-sources.

13. Granting credit facilities must be covered by compulsory obligations. Only these measures can warrant a well-timed and sufficient adaptation of economic and monetary policy in the countries in question. Therefore it is necessary to overcome the firm linkage between political mandate and the monetary authorization in the different countries. The willingness of governments to impose the burden of restrictive stabilization policy on the constituency varies in accordance with the cycles of parlamentary elections. Only an extremely independent

institution on Community level will be able to guarantee that the adjustment process will continue and, at the same time, it will provide for a successful stabilization policy in the EEC. Such an institution has to be both sufficiently independent from national governments and central-banks on the one hand and permanently in touch with the national institutions on the other hand for being able to stimulate the national policies and to support the international efforts.

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Hans R. Krämer

## The Development of the European Monetary System - Legal Considerations

1. The further fate of the EMS may depend on economic or political considerations. However, legal questions are involved if it comes to put the preferred option into practice. Even the option to dismantle the existing system must be tested with a view to its legal implications. Rules and procedures agreed upon (such as the rules for the preparatory stage of the EMS) can - normally - be put out of action only by mutual consent. De Gaulle's practice of keeping the French chair empty, for instance, was considered illegal at that time. By agreement between the member states, however, the first stage of the EMS can be ended at any time. (On March 31st, 1983, the closing date of the "test run", it will be ended automatically).

2. So much for the options to end the EMS. The options to develop the system appear to be legally more complicated. For all of them the following basic considerations should be borne in mind: The easiest way to develop the system beyond the actual preliminary stage is to do it within the framework of the EEC-Treaty. If that is possible, only the institutions of the Community have to take action. If the Rome Treaty must be amended, however, or if a new treaty on the EMS is to be concluded, this can only be done by unanimous consent of the member states and upon ratification by all (ten) parliaments.

3. Within the framework of the EEC-Treaty the following procedure, in that order, is to be followed:

- If special rules of the Treaty are pertinent, they should be applied. One can even doubt whether the member states are free to conclude an agreement outside the available and applicable framework (for political reasons), but, probably, they may do so unanimously, as "masters of the treaty".
- If the EEC-Treaty has no such special rules, the general clause of Art. 235 should be considered, which empowers the council to "take the appropriate measures" if action by the Community should prove necessary "to attain one of its objectives".
- If Art. 235 cannot be applied, the Treaty may be amended appropriately, according to the procedure laid down in Art. 236.

Instead of amending the EEC-Treaty, the member states may also agree upon a separate treaty to introduce the final stage of the EMS.

4. The application of these rules to the different options to develop the EMS rises the following main questions:

a. Which of the measures considered are covered by special rules of the EEC-Treaty?

b. Which of the remaining measures are "necessary" for the functioning of the Common Market according to Art. 235? Further: Are there limits to the application of the clause?

c. Which measures are considered essential for the development of the EMS but are neither covered by special rules of the EEC-Treaty nor by Art. 235? Such measures can only be put into practice by means of an amendment within the framework of Art. 236 or by a new treaty concluded apart from that framework.

ad a) - The Treaty of Rome - apart from treating "economic policy" in general (art. 104) - deals explicitly with such matters as the "policy with regard to rates of exchange" (art. 107) or the "conjunctural policies" (art. 103) or the situation where a member state is in "difficulties as regards its balance of payments" (art.108). Since such situations and these policies are also subjects of the EMS, at least some of the measures contemplated can be based on special rules of the Treaty. One of them could be the regulation of mutual assistance, another the narrowing of the exchange rate margins or the coordination of monetary policy.

ad b) - Apparently, there is no ready-made answer to the question, whether one or another measure in the monetary field is necessary for the functioning of the Common Market. It can only be answered with the help of economic, perhaps political, criteria. However, it seems rather probable that methods considered in connection with the development of the EMS normally also fulfil the condition of being necessary for the development of the Common Market.

If that is granted for the sake of argument, it remains to be asked whether there are limits to the application of Art. 235.The text mentions no limits. Nevertheless, in the legal discussion of the clause some limitations appear to be generally recognized: (i) No new independent organ may be created, (ii) the character of the EEC must not be changed, and (iii) no subject, which is not already covered by the treaty, may be introduced by way of Art. 235. From the observation of these barriers follows ad c) - An independent EC Central Bank/European Monetary Fund (EMF) must no be created by using art. 235, because of limitation (i). On the other hand, an EMF which essentially carried out the decisions of the Council would have practically no monetary authority (and could, of course, not be classified as a central bank), but also a system of such kind cannot be based on art. 235. In this case limitation (ii) is relevant, for to abolish the decision making power of the Central Banks and to transfer the competence in this field completely to the Council would change the character of the Community.

That certainly places every version of Economic and Monetary Union (option 1) outside the field of application of art. 235. Moreover, it is at least very doubtful whether other measures which lead irrevocably to an Economic and Monetary Union, can be realized by means of art. 235, e.g. totally fixed exchange rates.

If this view is accepted, essential parts of option 2 fail to meet the test of art. 235, and that leaves only option 3. This option could be put into practice within the framework of the EEC-Treaty.

5. If the Treaty of Rome must be changed or a separate treaty on the EMS concluded, this must be done according to the law of the member states. In Germany the basic rules can be found in the Constitution, the Grundgesetz. Like the parliaments of other member states the Bundestag has to approve international treaties on matters which touch its law making authority. Monetary sovereignty is among these as is indicated, inter alia, by the Bundesbankgesetz (law).

6. It can be argued that a transfer of German monetary sovereignty to the Community, in order to form an Economic and Monetary Union, means a change of the Constitution. Normally, a change of the Constitution would require a parlamentary majority of two thirds. In case of a transfer of sovereign powers to an international organisation, however, a simple majority is sufficient. This is stated by art. 24 Grundgesetz. Similar rules to facilitate the membership in international organisations - especially to facilitate European unification - can be found in the constitutions of other member states (see e.g. art. 67 of the Dutch, 11 of the Italian, and 20 of the Danish Constitution).

7. So, at least as far as the Federal Republic of Germany is concerned, option 1 can only be brought about by the majority of the Bundestag, but a simple majority is enough.

8. It should be noted that among the German legal profession some doubts have been raised as to whether a complete transfer of monetary sovereignty to the organs of an Economic and Monetary Union may really be managed by means of art. 24 Grundgesetz, because of its grave consequences for essential parts of national policy (economic and otherwise). However, similar steps have already been taken with the transfer of vast economic powers to the European Economic Community. Moreover, the transfer of military sovereignty to the (illfated) European Defence Community was also based on art. 24. So, it can be assumed, that the German Constitutional Court would interpret the article in a way which covers the transfer of monetary sovereignty to the Economic and Monetary Union.

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## The non-monetary role of the ECU

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1. Central banks in the member countries of the European Monetary System use the ECU frequently. The non-monetary use of the ECU, however, has remained limited. This paper, first, describes the areas outside the central banking system in which the ECU is already used as a unit of account, second, examines which legal, economic and technical problems restrict the wider use of the ECU, and, finally, mentions some of the preconditions for a larger role of the ECU in Europe.

2. The use of the ECU within the banking system has already been promoted by the fact that the budget of the European Community (EC) is expressed and settled in European Units of Account (EUA), the value of which is identical with the value of the ECU. Roughly 10 per cent of the expenditures of the EC, or about 50 million ECU each month, are transferred through ECU-accounts which the Commission keeps with individual commercial banks and savings institutions in most member countries. The Commission has demand as well as time deposits in ECU. Interest rates for time deposits in ECU with maturities of 1, 2, 3 and 6 months are published regularly by the Commission. The unit of account of the European Investment Bank is also the ECU.

   Private non-banks have made use of the ECU by denominating loans, bonds and securities in ECU. The first EC-institution that issued ECU-bonds was the European Investment Bank in June 1981.

3. Despite some examples, the non-monetary use of ECU has remained negligible. Legal, economic and technical prob-

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lems limit the wider use of the ECU. The legal difficulties which inhibit the use of the ECU even in its limited role as a unit of account vary from country to country but include for example exchange controls, monetary and credit controls, limitations with regard to banks' open foreign currency positions and national laws prohibiting indexing clauses.

In addition, the economic incentives for the non-monetary use of the ECU are limited: The exchange risk is not necessarily reduced by using ECU instead of national currencies; both, lenders who wish to diversify the currency composition of their assets and borrowers who want to minimize their exchange risk by incurring liabilities in a number of currencies, will find it more attractive to put together their own baskets of currencies instead of relying on a fixed basket, such as the ECU; even speculators will find it more attractive to speculate against a certain currency instead of a basket of currencies.

Finally, technical problems restrict the wider use of the ECU: The structure of the ECU and the necessary calculations are difficult; bank-transactions in ECU are complex and therefore expensive; the computation of ECU-interest rates is complicated; and the general possibility of changing the composition and the weights of the ECU-baskets creates additional risks in denominating long-term assets and liabilities in ECU.

4. As a precondition for an increased role of the ECU outside the central banking system goverments have to lift the legal restrictions that limit the ECU-use in their respective countries. In addition, EC-institutions should intensify their use of the ECU and open more ECU-

accounts in member countries; salaries of the EC-staff, for instance, could be paid in ECU. Commercial banks could offer ECU-traveller cheques. And central banks could accept ECU-denominated papers for discounting.

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The future role of the ECU

(Monetary aspects)

Conclusions from the contribution submitted by Peter-W. Schlüter to the Expert meeting of the Trans European Policy Studies Association (TEPSA) in the Bundesbank, Frankfurt, November 20 and 21, 1981.

Conclusions

The political prospects envisaged in connection with the establishment of the EMS and the previous discussions on its further design implied that the basket ECU is eminently capable of development and that one day a kind of European parallel currency might evolve from it. The present study has come to conclusions which do not justify such expectations. The study indicates that the possibilities of development of the basket ECU must be regarded as very limited. An ECU parallel currency is only likely to come into being if it is issued and controlled by the Community on its own responsibility.

The example of the basket ECU made it quite plain that the expansion of the role of the ECU should be guided by the qualitative characteristics of conventional international reserve assets. Above all, an adequate guarantee of convertibility is necessary in order to make creditors more willing to hold ECUs on a voluntary basis. While convertibility is safeguarded institutionally (by the Fund) at first and enhanced by further rules as to use, in the course of time it should be supplemented by market convertibility. At the same time, it should be ensured through suitable control of ECU creation that the ECU remains scarce and does not undermine the need to adjust economic policies. As long as the ECU is unable to compete with conventional reserve assets, its yield would also have to be institutionally safeguarded. This would require, inter alia, the definitive provision of the Fund with monetary reserves.

The limits to the further development of the basket ECU become apparent when the use of the ECU is extended beyond the Community central bank sphere to the private sector. The character of the ECU as the average of various currencies turns out to be dubious in so far as it makes stability policy more difficult. The basket ECU is unsuitable for use as a private means of settlement and reserve asset, also in third countries. Only a currency which is put into circulation and independently controlled by an autonomous Community monetary authority can have such properties. This control cannot be replaced by the monetary influence exercised by the member countries through the basket ECU. Hence the only ECU that could act as a parallel currency which is a full Community means of settlement and reserve asset is one whose value can develop freely in the market and which is subject to Community monetary sovereignty.

Considerations of this nature go far beyond the foreseeable further development of the ECU. The state's monopoly of money is one of the most important aspects of national sovereignty. The EEC countries will only agree to a partial and perhaps progressive transfer of this monopoly to an institution of the Community if economic and monetary integration makes headway. If the ECU were to be given the properties traditionally characteristic of national money, this might prove to be both the effect and the cause of such integration. In the end, the criterion for judging the future role of the ECU would be its contribution to the achievement of convergence on the basis of monetary stability, as the most important precondition for integration in the Community.

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The European Monetary Fund

Conclusions from the contribution submitted by Peter-W. Schlüter to the Expert meeting of the Trans European Policy Studies Association (TEPSA) in the Bundesbank, Frankfurt, November 20 and 21, 1981.

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## Conclusions

The European Monetary Fund is generally considered to be the body in which rules agreed upon with respect to integrating monetary policy as well as responsibilities transferred to the European Community are to be institutionalised. However, the actual tasks and organisational structure of the Fund are still open questions. They neither derive automatically from the present European Fund for Monetary Cooperation, on which no major decision-making powers have yet been conferred, nor do they derive from resolutions or plans of political bodies, and in particular from the decisions on the EMS taken by the European Council. This means that the tasks carried out by the EMF as well as its structure will depend first and foremost on the way the EMS is designed in its final stage and on the role to be played by the Fund in that system.

The EMF is intended to be an instrument for achieving the objectives of the EMS. At present, these aims are to stabilise exchange rates between the participants in a system containing constraints that are conducive to the coordination of economic and monetary policy. The EMS will function successfully only if its members achieve as high a degree of domestic and external monetary stability as possible. In the long run the objectives of the EMS could also include improving the basis for a single currency area in the context of a monetary union. This implies that the Fund should always be capable of further evolutions; however, in line with the "subsidiary principle", sovereign rights would be transferred to the Community in as cautious a way as possible.

Starting from the relatively restricted mandate of the European Council for the institutional design of the final stage of the EMS, the Fund would primarily be charged with the consolidation of the existing credit mechanisms as well as issuing ECUs, which are to be freely usable as a reserve asset and as an instrument for settling balances. In consolidating the Community's financial support mechanisms in the EMF the very short-term financing facility, which can have a great impact on monetary policy at the national level, should not be included. On the other hand, the pooling of the short and medium-term support mechanisms will probably depend very much on the role accorded to the Fund in decisions on economic and monetary policy at the Community and member state level.

In addition, the EMF should contribute to domestic monetary stability within the Community by keeping ECUs in sufficiently short supply. Since they do not come into being by an autonomous act of money creation, the supply of ECUs can be best kept under control by continuing to base them on the deposit of traditional monetary reserves with the Fund and limiting the size of credits extended by it. This would counteract the danger of the Fund providing so much liquidity in the form of ECUs that the pressure on member states to restore equilibrium in their payments balances would be weakened. In contrast to the rules and regulations governing the transitional stage of the EMS, limits should accordingly be set both on the total volume of ECUs to be issued and with respect to their sources (dollar substitution, mobilising gold holdings, creating ECUs via credit). The impact of fluctuations in the <u>price</u> of gold on the amount of ECUs that are created could perhaps be avoided by adjusting the <u>level</u> of gold holdings (varying the amounts of gold deposited with the Fund).

The <u>total</u> financial resources of the EMF should correspond to the equivalent of 20 per cent of the dollar and gold reserves of all central banks within the Community when the transition to the final stage of the EMS is effected. The share of reserves transferred by <u>individual</u> countries, however, should be determined by their quotas in the short-term monetary support mechanism, reflecting as they do the relative economic strength of the member countries better than the present method. This would also help bring about consistent rules and regulations governing quotas and voting power within the Fund.

Over the longer term, the ECU, being based on the transfer of national monetary reserves to the Fund, is just as restricted in its development as through its basket structure linking it to national currencies. It will not be able to assume the role of a fully fledged means of payment and reserve asset until it is issued by the Fund autonomously and the circulation of ECUs is managed by monetary and credit policy at the Community level. It is improbable that the economic and political conditions for transferring the appropriate powers to the Fund for this purpose will come about in the foreseeable future. This is equally true of the Fund's right to intervene freely in the foreign exchange markets, to set up guidelines for national monetary and credit policy, etc. However, the road should be kept open for developments of this kind in the direction of a Community central bank system.

The tasks of the Fund, its financial resources and its institutional design are all closely interdependent. It is therefore possible to study them in isolation only if the Fund's structure matches the tasks entrusted to it, i. e. not giving the Fund powers that because of its institutional framework it is incapable of exercising. Of the various types of Fund conceivable there are three ideal types, namely an "administrative Fund", a "central bank Fund" and an "economic and monetary Fund", each of which would assume certain specific tasks. The basic idea proven by history of the need to separate decisions on the creation of money and on the way it is employed would favour an independent EMF of the central bank type. Its primary task would be to contribute towards safeguarding domestic monetary stability in the Community. In pursuing its mandate the Fund should support the economic policies of the member countries as well as of the Community bodies responsible for economic and financial affairs.

It is almost certain that such an EMF independent of Community institutions responsible for shaping economic policy is the only model able to evolve towards a Community central bank system. Such a Fund, being the most suitable body for achieving a zone of monetary stability - and this will not be possible on a durable basis without ensuring domestic monetary stability - would simultaneously best foster further progress towards European monetary integration. Of course,achieving this objective requires not only a maximum degree of convergence of economic development and economic policies in the member states; it also presupposes that the institutional framework of the Community be redesigned in such a way that shaping policy and taking decisions correspond to the needs of an economic and monetary union.

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Short Review

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The European Monetary System has been put into force for the pilot-periode on the basis of a recommendation, a legally not binding act. However, it has been decided that for the final period the System should be incorporated in the legal order of the Community by being based on a formal legal act. In this context several questions arise depending on how the System will be shaped in details; especially the question arises wether the Monetary System could be put into force by an act of the legislatur of the Community, i.e. the Council or whether there is a necessity for amending the Treaty of Rome according to the procedure provided for in article 236 of the Treaty of Rome which amounts to a ratification of the necessary legal act by 10 national Parliaments. But there also ist the question whether the Monetary System as it is shaped now is suitable for a legal act; the question arises since there are certain stipulations the potential legally binding characters of which might be regarded as questionable.

From the viewpoint of the basic separation of powers and competences between the Community and the Member States as described within the Treaty of Rome the monetary policy falls within the competences of the Member States. The monetary policy is a substantial part of the economic policy which, in general, is a responsibility of the Member States and for which the Treaty of Rome only provides a procedure of simple coordination by the organs of the Community. But resulting from several provisions of the Treaty there are some - mostly indirect - limitations and restrictions to the Member States' competences in the field of the monetary policy.

If the Treaty of Rome is not to be amended the European Monetary System can only be incorperated in the Community law on the basis of the general competence laid down in article 235. Whether the pre-conditions for a legislative act on the basis of article 235 are fulfilled, highly depends on how the Monetary System will be structured in details; but even as it stands now the applicability of article 235 of the Treaty of Rome might be regarded as doubtful.

A monetary system obliging the Member States for intervention on the exchange markets for the purpose of stabilizing the exchange rates and, furthermore, obliging the partners of the system to settle the current balances by means of a European Currency Unit (ECU) as being provided for does not surpass the scope of the competence given to the Community according to article 235 of the Treaty of Rome. But the discretion of the Community's legislator is bound by the fact that the Community whenever legislating has to preserve stability of prizes and to omit any measure which might harm their basic aim of the Community's task. Therefore, the system of intervention has to be stipulated in a way that the obligation of convergence and of adapting rests with those Member States the currencies of which have the higher inflationary rates. If there is no effectiv obligation to assure a policy aiming at stabilisation and lowering the inflationary rates the act of the legislator can be regarded as being doubtful and might be struck down in the case that the European Court is involved.

If the system does not leave the power to adjust the pivot exchange rates to the Member States and if it instead of this provides for binding decisions of the Council or the Monetary fonds, taken unanimously or with a majority vote, the Monetary System comprises a transfer of powers to the Community to an extent that the scope of article 235 may be regarded as being surpassed.

The restructuration of the short and medium term financial assistance system as provided for lies within the scope of the Treaty of Rome; here too, the power and discretion fo the legislatur is bound to the overriding stability aim of the Treaty

The prescription entitling Member States to stay apart from the System raises for basic reasons the question whether the Monetary System as it stands now can be incorporated in the legal order at all. The same is due to the provision which without fixed conditions allows Member States to take leave from the System. It would be incompatible with the Community law if the possibility to stay apart and the right to take leave would be connected with a loss of the membership status. Since it is a basic principle of the constitution of the Community that all Member States take part in any decision and activity of the community, there is no possibility to exclude Member States from the communitarian power nor is there a possibility to abstain from taking part in the Community's action. There are doubts whether and in how far special situations Member States being faced with can be taken into consideration and there are especially great doubts whether it be possible to entitle Member States to get rid of/the legal obligationsof a Community system if there is no fixation of the conditions no control and no time limit.
The European Monetary Fonds regarded as nucleus of a later central bank system of the Community and being endowed with stearing and decision making power cannot be institutionalized than by/amending the Treaty of Rome according to the procedure provided for in the Treaty. This is especially neccesary in the case that the Fonds should have the status of an constitutional organ and an independent stand vis à vis the Council and the Commission.On the basis of Article 235 the organ structure as created by the Treaty of Rome can only be altered in a very limited manner namely in creating organs and instances under control and influence of the original organs; and even these alterations are not possible if they harm the institutional balance within the Community. The creation of a new independent organ with constitutional status on the basis of a restructuration of the monetary policy responsibilities within the Community is to be regarded as an

act tantamounting to a complete restructuration of the institutional structure of the Community; such a basic restructuration of the Community is not left to its legislator but to the Member States and requires a formal amendment of the Treaty and the consent of the national Parliaments.

The Future of the European Monetary System (EMS)
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## The EMS, the Dollar and the International Monetary System

One main argument in the early decision for the EMS in July 1978 (as well as in the preceding proposals for European monetary unification) was the desirability of establishing a European monetary area of greater independence from the fluctuations of the dollar-rate. That was when the dollar was depreciating rapidly as a result of a U.S. monetary policy of benign or even malign neglect. During the following months and years, however, the EMS was mostly preoccupied with the task of its internal and institutional construction. Meanwhile the Carter Administration introduced measures to stabilize the dollar in November 1978 and again in October 1979, which were partly unterstood as an U.S. reaction to the EMS-decision. As long as the dollar remained relatively stable, the question of a common policy towards the dollar seemed to be less urgent.

But,when the dollar-rate climbed up in 1980/81 to levels well above what could be explained by economic fundamentals and when the EMS-countries were forced to keep up with high U.S. interest rates notwithstanding recession, the argument for a common policy towards the dollar regained momentum, mainly to support an independent European reduction in interest rates. As long as national inflation rates within the EMS are diverging heavily, however, a strong argument against a common dollar policy can be made on the grounds that this would only lead to massive official interventions against the market. On the other hand, if economic fundamentals within the EMS were converging the dollar-exchange rate of the different EMS-currencies would more or less automatically move in the same direction, thus limiting a common policy towards the dollar to actions of "leaning against the wind" and "keeping orderly market conditions". This in turn might cause the U.S. to participate in a closer monetary cooperation with the EMS.

The future position of the EMS within the international monetary system and in relation to the dollar largely depends on whether the progress the EMS will achieve in terms of

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economic and monetary stability and institutional machinery will permit the ECU to be transformed from the existing basket currency into an internationally convertible currency.

If the EMS succeeds in this effort it might exert a certain attraction on third countries either by setting a precedent for further monetary regionalization or by offering a real alternative to the dollar as an international currency. Such a competition between the ECU and the dollar might again lead the U.S. to pay more attention to monetary stability, but could also cause conflicting views on both sides on what kind of monetary cooperation should be pursued.

The EMS was established as a regional monetary system fully compatible with the rules of the IMF. The assurance of IMF-compatibility was essential with regard to U.S. approval of the EMS. In addition, the strictly regional limitation of the EMS accords with the objective of European integration and reflects the need for internal consolidation of the EMS as a precondition for any further step towards a more active role in international monetary relations.

As members of the IMF the EMS member-states are committed to cooperate closely within the IMF-system, e.g., to support the distribution of the SDR as a main international reserve asset. While this obligation does not seem to cause any conflict at this stage of development one may nevertheless argue whether a future evolution of the ECU as an international reserve currency would not conflict with the principles of IMF-compatibility.

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The Future of the European Monetary System (EMS)
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The Requirements for a European Monetary System under the Conditions of the 1980s

- Summary -

1. Experience with the EMS does not indicate convergence of inflation rates or of monetary policies, regardless of how the money demand functions are estimated.

2. The fact that, nevertheless, exchange rates have been relatively stable in the EMS is due to unusual real exchange rate changes. These real exchange rate changes are not associated with differences in current account changes or in monetary expansion minus real growth rates but with differential changes in inflation expectations and exchange rate expectations. There is no reason to expect that these unusual real exchange rate changes will continue in the 1980s; they are even likely to be reversed.

3. The member countries which have experienced unusual real appreciations vis-à-vis the EC average (Ireland, Italy and, to a much smaller extent, France) are not likely to adopt considerably more restrictive monetary policies in the future. Thus, if the real appreciation of their currencies fails to continue, the need for devaluations of their currencies is likely to increase.

4. Doubts about the continuation of recent real exchange rate changes and about the willingness of Ireland, Italy and France to accept fast monetary deceleration indicate that the EMS has to be reformed so as to permit a maximum of

exchange rate flexibility and to increase the incentives for price level stabilisation.

5. If parities are not abandoned, parity changes must be facilitated:
   - The power to alter the parity should rest with the central bank, not with the government (at least in Germany).
   - Parity changes should not require the assent of other member countries.
   - Foreseeable exchange rate changes should be gradual and preannounced (crawling peg).
   - In the case of discretionary parity adjustments, the new parity should be within the previous band.

6. To increase the incentive for price level stabilisation the following reforms are required:
   - The EC credit facilities should be abolished or reduced.
   - Remaining credits should only be available at market interest rates.
   - Credits should not be denominated in the debtor country's currency, neither totally nor partly (e.g. as part of the ECU). Debtor countries must not be able to reduce the purchasing power of their debt through devaluation and inflation.
   - All short-term and medium-term credits should be subject to policy conditions.
   - Member countries should not be permitted to apply for IMF credits unless their EC credit has been exhausted.
   - The divergence thresholds should only apply to weak currencies. Alternatively, member countries which incur debts as a result of threshold interventions by other member countries must be obliged to settle these debts even if they are unwilling debtors.

7. To ensure that threshold interventions bring about convergence rather than divergence the intervening country should be obliged to intervene in the currency (or currencies)

nearest to the opposite threshold.

8. It is a perversion of the idea of a common market to increase exchange rate stability at the expense of the freedom of capital movements.

9. It is a perversion of the idea of monetary stability to increase exchange rate stability at the expense of price level stability.

10. A transition process towards currency union (one currency) which minimizes the risk of inflation, exchange controls and exchange rate distortions is the creation of a competitive European Parallel Currency. The ECU might be able to play this role if the weaker currencies successively lose their weight in the basket as they are displaced by the ECU. Economically preferable and more competitive, however, would be a European Parallel Currency of guaranteed constant purchasing power.

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## The European Monetary System and Political Integration

## "Voie royale" or "trade off"?

1. Though the Rome Treaty gave monetary policies only a minor role within the integration process, at the end of the sixties monetary integration was seen as the major avenue to more political integration. Pompidou ("voie royale"), Tindemans, European Federalists and the European Parliament stressed the monetary factor as the major instrument for proceeding toward the European Union or - for some - to a European federation."Money"was seen as the major and final core element of national sovereignity.

For some, the over-all goal of political integration was and is of such an overriding importance that economic as well as political risks and costs are either neglected or taken as necessary but temporary burdens of the transition.

Experts of monetary policy, on the other hand, either forget or even exclude overall political integration goals as political "propaganda" which is a nuisance to "good" monetary policy.

The political decision-making process of the seventies indicates trade-offs between integration criteria (like involvement of all member states) and "rational" economic criteria (like effective stabilization zone ).

Also, the one-way relationship between monetary integration as an independent instrument and political integration as dependent goal was put into question. As the failure of the Werner report demonstrated, there were and there are major political prerequisites for any monetary integration. Our experiences of the seventies thus teach us a close mutual, but not sufficiently analysed, interdependance of both dimensions.

2. At the beginning of the eighties major impulses to proceed with European integration have been caused by the international political environment and by institutional changes. In the wake of Afghanistan, new attempts to strengthen political co-operation (e.g. Carrington and the report of London) as well as to give foreign policy and the security dimension a priority (e.g. the Genscher initiative on the European Union) have become more important than in the seventies. With its first direct election, the European Parliament seeks a new institutional balance (i.e. the ad-hoc committee) and finally the mandate of 30th of May 1980 stresses the reform of Community policies and the budget. In all these activities, monetary policies and especially the EMS are either out of sight or given an ambigous role (the exception to this might be the foreword to the 5th economic programme).

3. Yet this shift of priorities as compared with the early seventies or the EMS "boom" of 77/78 might be of major importance for the future development of the EMS. As shown in the list of options, the optimal model(s) for the next phase needs a political, institutional and legal "saut qualitativ" into a new Community system. According to this assumption the general debate might have two advantages:
   a) The political impetus for the next phase of the EMS might be founded on broader principles. The awareness of more global strategy might also drive monetary integration.
   b) for any "saut qualitativ" in the Community history, package deals between divergent interests and different models have proved to be necessary. Though not yet clear, the different elements of the present debate might lead to a constructive package deal as well as including major improvements for the EMS.

4. For the next phase of the EMS we are aware that there are two one-sided lines of argumentation which both disregard certain potential risks on the "trade-off" curve between integration and monetary policies:

a) stressing the integration aspect and neglecting the goal of monetary stability ("we need Community instruments and actions; the efficiency of these instruments to achieve monetary stability is of secondary importance") is short-sighted. The "success" of pursuing common policies or common approaches will be counterbalanced by economic disequilibria leading to more restrictive national measures. Even less serious is the "catastrophe" strategy of purposely creating "revolutionary" instabilities to "force" governments and national parliaments to resign for the sake of the European Federation. Economic efficiency needs to be carefully watched.

b) Forgetting about the Community by merely looking for an optimal currency area (if one can speculate on something like this at all) is also short-sighted. All member countries (perhaps the Federal Republic more than others) need the Community as a general problem-solving framework and as an international coalition. A major prerequisite for these functions would require a certain solidarity within the Community and a framework of general reliability. A "Europe à la carte" (Dahrendorf) which seeks seperate solutions for each policy area is in the medium-term not stable and thus counterproductive.

5. To find the right approach we need to promote certain principles. As the economic principles are stated in the other papers, I list some principles from integration perspectives which should be observed for realizing the EMS:

a) the legal forms and methods of the Rome treaties should be respected and employed. There is ample room for different kinds of instrumentalization. The EMS should stay within the legal framework of the Community.

b) The membership of the EMS should be identical with that of the Community. Forms of accepted multi-tier approaches should guarantee the necessary flexiblilty on one side and the Community character on the other.

c) The substance of the EMS must be consistent with Community goals and with other Community policies (e.g. CAP, industrial policy). The respective effects of different Community policies should be mutually reinforcing and not contradictory.

d) The community institutions should be adequately involved. Further fragmentation and incoherence of the decision-making process must be prevented. The European Monetary Fund should be a core part in the process of reinforcing and reforming the institutional system of the Community.

e) The EMS should not induce political and economic imbalances between countries and regions within the Community.

f) The EMS should increase the capacity of the Community to act in the international system.

If there seem to be any trade-offs now in the long run ("if we are not dead") both goals converge. We cannot have monetary stability without a set of instruments and policies on the Community level. And we cannot have a Community without monetary stability.