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No. 138, September 1980

ON THE MEANING AND FUTURE OF THE
EUROPEAN MONETARY SYSTEM

TOM DE VRIES



INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS

PRINCETON UNIVERSITY

Princeton, New Jersey

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On the Meaning and Future of the European Monetary System

The European Monetary System entered into force on March 13, 1979. Active negotiations on its completion are likely to resume in 1981. The time is ripe to attempt an assessment of this important scheme and the ways to complete it, and to consider its possible future contribution to European and worldwide monetary relations as well as to European integration.

In what follows attention is paid to both political and economic factors since the basic purpose of the Common Market is the political goal of bringing about a European federation. None of its activities can be properly understood without keeping this objective in mind. "We are not in business, we are in politics," Walter Hallstein, the first President of the European Commission, used to say. While it is true that with the passing of time the objective has shifted, temporarily at least, to a confederation of nations rather than full federation, the political aspect remains.

In undertaking such a broad task, I must of necessity confine myself to some main issues and avoid comment on the discussions of intricate detail to which the new arrangement has also given rise. Moreover, in the present early and still very fluid state of the EMS, the basic issues are of far greater importance.

I. A Brief Retrospect on European Integration

a. Early Efforts

We often lose sight of the simple fact that all fundamental difficulties with European integration flow from an unfortunate truth: for more than thirty years, European governments have consistently rejected any real transfer of sovereignty to European federal institutions, while claiming at the same time to be pursuing the ultimate objective of European unity. They did this for the first time on the occasion of the U.S. offer of Mar-

An advanced version of this essay was discussed in a seminar at the European University Institute in Florence and benefited from comments by Professors Peter Ludlow and Sir Andrew Shonfield. My appreciation of the way political factors influence economic decisions has been greatly deepened by intensive discussions with my colleagues at the School of Advanced International Studies, and in particular by the seminars of the Johns Hopkins Foreign Policy Institute. Professors David P. Calleo and Simon Serfaty commented on parts of the manuscript. I am also grateful for comments by Sir Joseph Gold, for many years the General Counsel of the International Monetary Fund.

shall Aid in 1947. The recipient organization, the OEEC, remained a classic intergovernmental conference, in spite of efforts on the part of "Europeans" to turn it into a customs union that might evolve in the direction of a European political federation. Such a federation had been called for by Churchill and de Gaulle during and after World War II, by Churchill as early as 1943.¹ The same attitude became apparent once again when France failed to ratify the European Defense Community (EDC) in 1954. This failure also meant the end of the European Political Community (EPC), on which official work had been proceeding since September 1952. In retrospect, the defeat of the EDC stands out as a decisive setback for European federation; up to that time its early realization had seemed a distinct possibility.

The central attributes of a state are its powers in the domains of defense, foreign policy, and money. Hence, integration through a European Defense Community and a European Political Community, covering all three areas, was indeed the logical approach. But this route proved impassable from a very early stage. As a consequence, European federation may have been condemned for many decades to come. I shall deal more fully with the driving forces of the European movement in section 8. Here we need to note only that one of its purposes had been to achieve a more independent role for Western Europe in the collaboration with the United States. But in the absence of timely and effective action to that end, the temporary military division of Europe between East and West at the end of World War II was institutionalized in the early 1950s by the cold war into a new and stable European system. Arrangements were made in all three areas—political, military, and economic—that confirmed the predominance of the Soviet Union and the United States in their respective spheres of influence in Europe. The rearmament of West Germany in the Atlantic framework of NATO rather than in the European setting of the EDC was symptomatic in this respect, and contributed to similar arrangements in other fields. As a result, it has proved more effective to settle most important questions directly within the Atlantic framework, rather than trying to tackle them first in the European setting. The outcome of these forces has been that today the basic political arrangements in the Atlantic system are almost identical to those arrived at by 1955, twenty-five years ago (see DePorte, 1979, pp. ix-x). Even the completion of a European customs union has not led so far to fundamental political change.

After the failure of the EDC and EPC, Europe fell back on what is

¹ For a concise historical survey of the idea of European unity, which can be traced back at least to the fourteenth century and has its origin in the Roman Empire of antiquity, see Hallstein (1962, pp. 1-17).

called in political jargon the “neo-functional” approach to integration. Put plainly, this approach amounts to trying to trick governments into doing in a complicated way what they refuse to do in a straightforward way. According to this strategy, a politically motivated bureaucracy tries to identify sectors which are politically symbolic but sufficiently uncontroversial and technical in nature that the political authorities will leave much of the decision-making to experts. The sectors selected must be related functionally to other areas of economic, social, and ultimately political importance, so that decisions in one area will produce a spillover effect into these other areas. Pressures will then be created for common action in the new sectors, leading to further integration. The functional theory holds that the process of integration will gather its own momentum once it gets started. In the light of experience, the later neo-functional strategy has been formulated based on the conviction that a dedicated and politically motivated secretariat is needed to push the process along.²

b. The Common Market

For twenty years the Common Market relied mainly on this neo-functional strategy. Of necessity, therefore, its method has been one of moving toward integration and the ultimate objective of political unification by small steps. When Dutch Minister J. W. Beyen proposed this route in Messina in 1955, he had the European Coal and Steel Community of Robert Schuman and Konrad Adenauer to build on. But these two men had in mind *both* the direct approach—from coal and steel to defense and on to politics—and the indirect one of bringing about integration first in one sector, then in another. However, with the direct avenue blocked, it was logical to try the alternative, and set up the Common Market and Euratom. This was an imaginative response in 1955, in the aftermath of the failure of the EDC, and it led to a great step forward. As a result of the conference in Messina, the Treaty of Rome, setting up the Common Market, could be signed within less than two years, on March 25, 1957, and enter into force on January 1, 1958.

But the limitations of this approach have since become apparent. As we have seen, there has been no basic change in the fundamental political arrangements affecting Western Europe since 1955. Governments have refused to be tricked into doing what they do not want to do. And although functional relationships do exist among the various fields covered by the Common Market, they have not necessarily resulted in a forward movement as a result of spillover; they have also led to spillback.

² Jean Monnet was, of course, one of the earliest and most persistent proponents of this strategy. For a more detailed analysis see Tsoukalis (1977, pp. 21-30).

When a conflict arose between the demands of the Common Agricultural Policy, based on fixed exchange rates, and the necessity of changes in exchange rates as a result of divergent economic policies, the outcome was not a spillover into greater integration of economic policies but a spillback into a slow disintegration of the Common Agricultural Policy.

Europe must now face the fact that its cozy hope of achieving economic and political unity by imperceptible small steps, as the result of spillover and without any real effort, is in no way supported by the experience of the past twenty years. Insofar as there was any movement in the monetary field in the decade preceding the negotiations leading up to the EMS in 1978, it was backward rather than forward. It has become clear that the present piecemeal approach, while it does produce intensive consultation and cooperation between sovereign states, is not leading in any relevant time frame to European unity and the ultimate goal of European federation. Progress toward these goals will require a deliberate political decision to transfer real powers to European federal institutions. The crisis of Europe lies in the fact that the European nation-states go on withholding consent to such transfers of sovereignty while continuing to attach importance to the original goals. Yet in many fields the inadequacy of national policies confined to the limited geographical area of even the larger European nation-states is becoming ever more evident. The time for rhetoric has passed, and Europe must make up its mind. This is the central message of both the Tindemans and Marjolin reports (1975, p. 4, and pp. 1 and 5 respectively).

The basic trouble is that the European movement lacks a strong motivating purpose, for it has become obvious that even European federation will not restore to Europe what it lost in the years 1914-44, during what might be called its Thirty Years' Civil War:

What was lost to Europe between 1900 and 1950, and above all between 1939 and 1945, was the sense of predestined leadership which had been taken for granted since the days of Plato and Virgil, Charlemagne and the builders of Chartres Cathedral.³

A federation encompassing the whole of Europe, East and West, would have been a credible superpower. But the Western half of Europe alone is less convincing. However, as a "half-Europe" is the only practical choice given the outcome of two world wars and the cold war, it is clear that some new thinking is required on the purpose of European unity and the ways to achieve it. I shall come back to this question in section 8.

For the moment, the best that European unity can promise is a role of some influence for Western Europe between the three superpowers and

³ John Russell, *A Lost Leadership*, quoted in DePorte (1979, p. 229).

the Third World. In the eyes of the "Europeans," this is a goal eminently worth striving for when compared with the alternative, but—at any rate until very recently—it was not really felt to be a pressing objective by the whole of European society. At least, this is the conclusion that must be drawn from the actions of the European countries to date.

While the European countries are contemplating these unpleasant truths, running the risk in the meantime that inaction will allow the tide in favor of European unity to recede further, the choice is between doing nothing, with the chance of disintegration of what *has* after all been achieved, or trying to squeeze an extra mile out of the policy of small steps. The latter is what the European Monetary System is all about.

2. Past Problems with Monetary Union

a. Money versus Foreign Policy and Defense

While reasons can thus be advanced for continuing to make the best of the basically inadequate policy of small steps, it is by no means obvious why these steps should again be taken in the monetary field. If the European movement wants to make the influence of European thought and culture more strongly felt in the world, it requires a common foreign policy. A closely related field is defense. "Can one conceive, over the long term, of a Europe growing together . . . in an increasing number of ways and yet not trying to provide coherently for its own defence?" British Prime Minister Edward Heath already asked a decade ago (Heath, 1970, p. 72). Given the central roles of foreign policy, defense, and money in any political structure Europe may yet build, why not concentrate on foreign policy and defense after the failures in the domain of money?

The answer to this question in the field of defense is, of course, that post-Gaullist France, and to a lesser degree also Britain, are not ready to merge their armed forces in a European Defense Community. But this amounts to saying that they are not ready for European federation or even confederation. What, then, is the point of trying to merge money?

Europe's economic strength has certainly been sufficient for many years to enable it to provide for its own defense in alliance with the United States, including an autonomous nuclear capability of sufficient force to be a credible deterrent. But the fractionalization of the European defense effort has resulted in tremendous waste. While European defense expenditures are considerable (\$35 billion a year),

. . . what is negligible is the amount of power (detering or coercive) that is being purchased by the EEC countries for this price, as they remain subjected to the whims of their ally in the West, their main foe in the East, and

their former colonies in the South. There seems to be hardly any historical precedent of a state, or group of states, with both comparable defense expenditures combined with similar physical and human resources, and such total dependence on external support for security from physical aggression or economic strangulation (Serfaty, 1979, pp. 38-39; see also p. 40).

Obviously, Europe will have to address its defense problem in the coming decade, if not in the next few years.

It is even more difficult to explain why money was chosen again over foreign policy. There were specific reasons, described below in section 3b, for the birth of the EMS. Furthermore, the Treaty of Rome, creating the Common Market, deals with economic policy, not foreign policy. But this is a legal, not a political, explanation. Obviously, a common foreign policy would further Europe's ends in the world more directly than a common monetary policy. And in spite of an impressive increase in foreign-policy cooperation in the past few years, achievements in this sector still lag behind those achieved in the economic field. Moreover, the average citizen is much less directly affected by foreign policy than by economic policy, so that progress in the foreign-policy domain might well be easier.

It might thus have been wiser to select foreign policy and defense rather than money as the next main area for European action.

b. A Plan Born in Confusion

Indeed, the record in the monetary field is hardly encouraging. In 1969 the Heads of State or Government of the Community, known today as the European Council, decided to create an Economic and Monetary Union (EMU) to be completed by 1980. But the Council failed to indicate clearly by what measures this objective was to be achieved. It acted almost as though the solemn decision to establish such a union would suffice to bring it about.

The Marjolin Study Group has stated that this decision was taken without a precise idea of what was involved, an exact description of what occurred. To those unfamiliar with a few plain truths, money is an arcane and highly technical subject. At the same time money is obviously of political importance. This combination makes it an ideal candidate for the neo-functional approach. In monarchies the image of the sovereign appears on the coins. In all countries the government seems to have a great deal to do with money, along with that awesome and mysterious institution, the Central Bank. Thus by unifying the monetary systems of the countries of the Community, something important would obviously be achieved without having to face many troublesome ques-

tions about national sovereignty. Such, at any rate, was the prevailing political opinion at the time.

This confusion was fully compatible with the neo-functional strategy, and money must have seemed a godsend to the Commission and its staff. Indeed, there is good reason to believe that the European Commission was partly deceived by its own strategy. As money was primarily an affair of the central banks, it ought to be possible, according to Commission thinking, to wrest basic powers from those banks by convincing governments that they were taking an important step toward European integration without giving up vital sovereign powers themselves.

If the Council and the Commission did not have "any precise idea of what was being undertaken" (Marjolin, 1975, p. 4), it was not for want of information on the subject. The Werner Committee, whose specific task it was to enlighten them on this very question, was clear enough on the matter. It mentioned the necessity of creating two "Community organs to which powers until then exercised by the national governments will have to be transferred. . . . The *centre of decision for economic policy* will exercise independently . . . a decisive influence over the general economic policy of the Community . . ." and a "Community system for the central banks [possibly] of the type of the U.S. Federal Reserve System" would have to be set up. "The essential features . . . of the public budgets . . . will be decided at the Community level; . . . the creation of liquidity throughout the area and monetary and credit policy will be centralized; monetary policy in relation to the outside world will be within the jurisdiction of the Community . . ." (Werner Report, 1970, pp. 12-13). In short, it was pointed out clearly that an Economic and Monetary Union requires the transfer to Community organs of vital sovereign powers in the budgetary and monetary fields.

The view expressed by the Werner Committee was widely supported by academic analysis. Giving up the freedom to follow independent budgetary and monetary policies and to vary the exchange rate was of the essence of an Economic and Monetary Union, which required that these vital powers of economic management be transferred to Community institutions. But this would directly affect policies concerning employment, wages, prices, and social welfare. Sharing the management of a nation's finances means sharing the management of its economy as a whole. Thus a transfer of sovereignty was involved that would affect the daily life of the citizen in a clear and direct manner. The power of the purse and sovereignty are intimately connected. Or, to put this old adage into modern words, the Minister of Finance is involved in almost all government decisions since practically everything the government decides costs money.

To embark on an Economic and Monetary Union without confronting these fundamental issues was like embarking on an ocean crossing aboard a ship without a rudder. Accordingly, failure of the EMU was widely predicted at the time.⁴

c. The Moral for the Future

In view of these facts it is remarkable—and perhaps an outstanding example of how modern society is now so complicated that it is becoming harder and harder for politicians to lead and for the electorate to understand—that the Community went ahead with its project for an Economic and Monetary Union without any intention of effectuating the transfer of sovereignty indispensable for its success. Instead, the Community seemed to rely on bringing about such a union through the simple act of legislating it into existence.

The result is well known. Failure followed upon failure until the project was no longer taken seriously by anybody and the process of spillback set in. Its place was then taken by the hazy idea of creating a “European Union” by 1980, the content of which has never become clear. It is to be hoped that this experience has made two things evident: (1) the problems at hand cannot be solved without institutions adequate to the task, and (2) supranational objectives require the transfer of sovereign powers to Community institutions.

3. Political Forces

In the malaise created by the failures of the European Monetary Union as a result of denying these truths, the December 1978 decision of the European Council to set up a European Monetary System came as a welcome surprise. In spite of what I said in section 2a about choosing the monetary sector once again as a field for action, the decision was welcome because the EMS has been well designed, with a large dose of realism, and because it seems to open new doors to monetary cooperation.

The decisions putting the EMS into operation were taken after initia-

⁴ See Nye, “The Political Context,” and Cooper, “Implications for Integration of the World Economy,” both in Krause and Salant, eds. (1973). These two articles are singled out because they are conveniently grouped in one interesting volume on the subject. But this view was and is widely held; the present author may perhaps be allowed to mention that he unsuccessfully argued a similar position when involved in the preparation of these plans as a member of the Commission’s staff. A clear and basic statement of this position and the reasons for it dates back at least to the mid-1950s; see the reprinting of some of his previous work in Scitovsky (1958, esp. pp. 95-101).

tives by German Chancellor Helmut Schmidt and French President Valéry Giscard d'Estaing at the April and July 1978 meetings of the European Council in Copenhagen and Bremen. The initiatives resulted in a detailed *Resolution of the European Council*, adopted at the December 1978 meeting in Brussels.⁵ This procedure is not in conformity with the Treaty of Rome, which provides for a proposal by the Commission and decisions by the prescribed organs of the Community, which do not include the European Council. Concrete and detailed actions such as this by the European Council are therefore opposed in principle by some members of the Community as a departure from the Treaty and its supranational elements. But in the renewed optimism that the agreement on the EMS brought about in European circles, this point was almost overlooked—and probably rightly so.

a. Germany's Fundamental Turnaround

It is a well-known though neglected historical fact that important initiatives in the domain of monetary relations, which are often regarded as technical, take place only when new political factors are at work. What, then, were the specific political forces that prompted the setting up of the EMS?

All the efforts of General de Gaulle to give Europe an independent monetary personality failed in the end because of the refusal of Germany, with its large reserves, to support a policy that would estrange it from the United States. Yet in 1978, for the first time, the German government thought and acted on semi-Gaullist principles, and began to display political initiatives tending to match its economic ascendancy. The German Chancellor was ready to make proposals that—while not anti-American—would nevertheless make Western Europe more independent of U.S. monetary policy, and to push them through. Two or three years earlier, Bonn would not have dared to embark on anything so independent from American policy as the EMS (cf. Watt, 1979). It should be noted, however, that this German assertiveness was cloaked in a European coat. Since this particular constraint on German policy is likely to persist for a number of years, it provides a unique opportunity that all those interested in promoting European unity cannot afford to miss.

A number of factors played a role in bringing about this fundamental change in the German attitude toward closer European monetary col-

⁵ *Resolution of the European Council of 5 December 1978 on the establishment of the European Monetary System (EMS) and related matters*, reprinted as Annex I to this essay. Two other documents of the European Council related to the EMS are reprinted as Annexes II and III.

laboration.⁶ Although the international monetary system is centered on the dollar, until November 1, 1978, the U.S. authorities insisted that the external value of the dollar was not an object of American policy but had to be determined by market forces. This position struck many Europeans as another example of the abdication of American leadership since the Vietnam War, and it further undermined the confidence of the German Chancellor in the American President and in American foreign policy generally.

In economic terms, this U.S. policy resulted in—or was perceived by Germany as resulting in—a sharp change in the value of the German mark, not only against the dollar but, much more important and often overlooked, against the currencies of most other European countries, which are Germany's main trading partners. In the opinion of the German authorities, this created an unacceptable situation. They would either have to let the mark rise into the stratosphere, with disastrous results for exports, for investment (which depends on exports), and thus for employment, or the Bundesbank would have to buy vast quantities of dollars to keep the exchange rate down, an action that would increase the German money supply and involve serious inflationary dangers. Chancellor Schmidt therefore had strong incentives to look for a system in which changes in the dollar rate would be less disturbing to the stability of exchange rates vis-à-vis Germany's main trading partners.

b. The Collaboration between Schmidt and Giscard

The shift in German policy was made possible by another important development—the strengthening of the political position of President Giscard d'Estaing as a result of the French elections of March 1978. Two main elements have dominated German foreign policy since World War II: close alignment with U.S. foreign policy in all relevant areas and collaboration with France. With one leg of this policy temporarily crippled by the absence of any clear U.S. foreign policy, it was natural for Germany to put more weight on the other leg, collaboration with France (cf. Szász, 1979, p. 80).

Thus, at the same time that the absence of a U.S. international monetary policy created considerable disorder and uncertainty in the monetary field, European political circumstances were favorable to joint action by Germany and France. The need for action by the two most powerful members of the Community coincided with the opportunity. The political leaders of these two countries, personal friends, both former Minis-

⁶ André Szász, Managing Director of the Netherlands Bank, has underlined the importance of this turnaround in German policy, which had always opposed the so-called monetarist approach, in an article entitled "The European Monetary System" (Szász, 1979, pp. 79-80).

ters of Finance, and thus familiar with monetary questions and able to push aside with relevant arguments the objections of their colleagues and civil servants, saw their chance to press ahead with the European structure and took it. A few trusted experts were chosen by the German Chancellor and the French President to work out a concrete plan to deal with the monetary disorders. The alternatives, discussed in section 2a, of action in the fields of foreign policy and defense, never came up.

The personal commitment of Chancellor Schmidt and President Giscard d'Estaing to a new European monetary system played a decisive role. Schmidt, having made up his mind about the desirability of a new monetary initiative, and having found in Giscard and French Prime Minister Raymond Barre trustworthy supporters, went to great lengths to bring matters to a successful conclusion. It has been widely reported that the Chancellor at one point took the unprecedented step of going to Frankfurt to take part in a meeting of the Board of the German Bundesbank in order to overcome its resistance. But two other actions may well have been more important: he initiated discussion on the EMS, and he committed himself politically without prior consultation with the Bundesbank.

The French President had his own reasons for favoring the new plan. Linking the franc to the German mark would reinforce the anti-inflationary discipline that he was trying to impose on the French economy with the strong help of his Prime Minister. His fundamental purpose was and still remains the restructuring of the French economy, a constant preoccupation of post-war French economic policy. In a recent interview Giscard explained that when he became Finance Minister in the early 1960s, the objective of his economic policy was to enable France to overtake Britain. By 1967 this objective had been achieved. What was now needed, he continued, was for France to adopt economic policies broadly comparable to the German ones so that France could become Germany's equal, "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" (quoted in Ludlow, 1979, p. 22).

Moreover, Giscard has been associated with efforts at European monetary unification since 1962. With strong domestic economic reasons to support the new plan and with new political room for maneuver as a result of the March 1978 elections, the French President could be counted on to pursue his old plans and give unreserved support to the German Chancellor's initiative.

The firm commitment of the German and French political leaders and their close collaboration turned out to be of vital importance in the con-

struction of the EMS. From the first discussions in Copenhagen in April, through the meeting of the European Council in Bremen in July, to the decisive meeting in September between Schmidt and Giscard in Aachen (the old capital of Charlemagne), where the Franco-German proposal took its concrete form, the steady collaboration between the political leaders of the two most powerful members of the Community proved to be a strong driving force. Moreover, both political leaders were in favor of a rather strict disciplinary mechanism, Giscard for the reasons just explained. Their attitude was widely misinterpreted and misunderstood at the time by political leaders in other member countries and by some of their own subordinates (cf. Ludlow, 1979, p. 18). But it was never in doubt and had a strong impact on the plan finally agreed upon.⁷

c. The Position of Others

If in Germany and France the monetary authorities were not at all times in tune with the two political leaders who were determining the basic design of the EMS, the situation was similar in almost all other member countries of the Community. Many ministers of finance and most central bank boards, as well as their advisors, tended to take a skeptical view of the scheme. It was the European Council, composed of heads of state or government, that took the decision to press ahead, largely on political grounds. In the British case the roles were reversed: the Bank of England supported the scheme, but Prime Minister Callaghan decided not to join.

On balance, Italy, like France, welcomed the additional discipline expected from the EMS, as well as the prospect of an additional transfer of resources. A number of smaller member countries of the Community greeted the plan as a remedy for the European malaise.

The European Commission welcomed the plan as a step forward and as complementary to two other Community developments: the direct election of the members of the European Parliament (without doubt an important event, although it does not increase the formal powers of that body) and the expected enlargement of the Community by the accession of Greece, Portugal, and Spain. Although the European idea must encompass the whole of democratic Europe, these accessions are likely in the short run to further dilute Community action and render its decision-making process still more difficult. A deepening of the Community by the EMS was therefore a welcome counterweight. The President of the Commission, Roy Jenkins, was the first to revive the idea of a new mone-

⁷ These developments are described in fascinating detail in Ludlow (1979). This most interesting example of writing recent history partly on the basis of extensive interviews with those involved has been expanded into a book version to be published by Butterworth, London.

tary initiative in his Jean Monnet lecture of November 1977, and he seems to have played a vital role as the person with whom Schmidt could privately discuss European monetary matters while the Chancellor's ideas were taking shape in late 1977 and early 1978.

d. The British Position

The British Government, and in particular Prime Minister Callaghan, who handled the negotiations, was skeptical from the beginning. In the first place, there was the anti-European bias of the left wing of the Labour Party. In the middle of an effort to rescue his wage policy, and with elections approaching, the Prime Minister wished to avoid a row with the left wing over Europe.

But there was a wider argument. Throughout the nine months of negotiations, Prime Minister Callaghan took the view that a purely European scheme that ignored the problems of the dollar was too narrow an approach. It could survive only if the dollar rate were stable, and on the difficult question of how to achieve such stability the plan was silent in all the languages of the Community (cf. Watt, 1978, pp. 580-581, and Statler, 1979, pp. 219-220). While it is true that dollar trade is more important for Britain than for other Community members, it is equally true that money fleeing from the dollar will head for the mark (and the Swiss franc) and thus tear apart the European exchange-rate structure. Prime Minister Callaghan did have a valid point, and we shall have to come back to this unresolved problem.

The result was that the efforts by Chancellor Schmidt to involve Britain in the negotiations from the beginning came to nought. A secret high-level negotiating team was set up between the Copenhagen and the Bremen meetings of the European Council, consisting of Schulmann of the Bundeskanzleramt, Clappier, Governor of the Banque de France, and Couzens, Second Permanent Secretary in the British Treasury. But the British were not to be won over to the scheme. The European idea does not yet enjoy a firm basis in the United Kingdom. The consequence is that Britain has not yet found a way to make its full contribution to the European Community. It may well be that a greater internal consensus on the European idea as well as on British domestic social and economic policies is a prerequisite for Britain to play its European role.

There were also economic reasons for staying out. The British inflation rate was one of the highest in the Community, but North Sea oil was coming on stream, strengthening the external position of the pound. Since the decision not to join, a new element of uncertainty has been added by the decision of the Conservative successor government of Prime Minister Margaret Thatcher to abolish British exchange controls

on capital movements, after forty years. It was and still is difficult to determine the effect of these contradictory forces on the exchange rate of the pound against the continental currencies. It may thus have been wiser to wait until the outlook becomes clearer.

Whatever the reasons or their merits, Britain decided not to join the EMS. A British proposal establishing links with the EMS was accepted, however. Sterling is part of the basket that determines the value of the EMS's new reserve asset, and Britain participates in all discussions about the future development of the system even though it has not joined it. That this proposal was accepted is a sign that the leaders of other members of the Community, not least Chancellor Schmidt, would like to see Great Britain join the new system (Ludlow, 1979, p. 46). British participation would widen the area of application of the system, strengthen its resources, and make the EMS a full Community arrangement. The declarations of British cabinet ministers that the United Kingdom will become a full member of the EMS as soon as circumstances permit are therefore welcome. It would be unfortunate to see Great Britain once more in the role of odd man out.

With the exception of Britain, then, European political opinion was favorable to the establishment of the EMS.

e. Astute Small Steps

It is important to remind ourselves that the EMS belongs to the policy of small steps. As we shall presently see, it basically amounts to the creation of an International Monetary Fund on a regional basis. Certainly it will not lead automatically to the unification of Europe. Nor does it constitute a monetary union or even a major step in that direction. Perhaps the lesson of decades has been learned. Former German Chancellor Ludwig Erhart once described the use of monetary schemes to promote economic integration as putting the bridle on the tail of the horse,⁸ and many commentators since have similarly characterized such efforts as putting the cart before the horse. Yet the EMS is quite an imaginative arrangement that exploits to the utmost the possibilities of the existing situation while staying within the bounds of realism. Moreover, it contains some starting points for further constructive progress. It is therefore a welcome step.

4. The Main Features of the EMS

Having described the background of the forces leading to the creation of the EMS, I turn now to the features of the system itself.

⁸ Quoted by Gottfried Haberler in Krause and Salant, eds. (1973, p. 33).

a. Main Features

The EMS consists of two main elements: an agreement about a Community exchange-rate regime, and a decision to create a European Monetary Fund. The EMS has four main functions: (1) the implementation of an exchange-rate arrangement, (2) the granting of monetary credits on a vastly increased scale, (3) the issue of a new reserve asset, and (4) the pooling by members of part of their monetary reserves. Although the convergence of economic developments in member countries is essential if the purposes of the EMS are to be achieved, despite some new efforts no concrete measures to increase convergence have so far been taken, nor has greater convergence been achieved.

The first three functions mentioned, as well as convergence, are well within the field of action of the International Monetary Fund, which supervises a code of monetary behavior, possesses a credit mechanism, and issues a reserve asset. The IMF code of behavior encompasses exchange-rate policy proper and domestic policies of particular relevance to the exchange rate, in addition to other rules in the field of international payments (IMF Articles of Agreement, Art. IV and *passim*). The question whether the IMF shall also assume the fourth function is at present under discussion. It has been proposed that the IMF create a Substitution Account in which countries could deposit dollar reserves, and possibly reserves held in other currencies, in return for the reserve asset of the IMF, SDRs. The pooling of reserves in the EMS takes place in similar fashion by depositing a given percentage of gold and of dollar reserves in return for the reserve asset of the EMS, European Currency Units. This is similar to a Substitution Account. Although its ultimate purpose is different, since it belongs to the neo-functional approach to European unity, one would thus not be far amiss in describing the EMS in its monetary aspects as an IMF on the European scale.

By a happy coincidence, and one which illustrates the ingenuity with which the EMS has been put together, the acronym of the English expression European Currency Unit spells the name of an old French coin, the écu. I shall use the term "écu" in the rest of this essay.

While the exchange-rate regime agreed upon could be implemented right away, future decisions will be required for the creation of the European Monetary Fund (EMF), and provisional arrangements were necessary to implement its main features as far as possible without delay. The reason is that both Community and national legislation is required for the implementation of some features of the EMF, including institutional arrangements and the permanent transfer to the fund of part of the monetary reserves now held by central banks. Under the provisional arrangements, credit facilities are increased about two and a half times,

some of the envisioned operations of the EMF are carried out by the already existing European Monetary Cooperation Fund (often called FECOM from its French initials), and the EMS is governed by existing Community institutions, such as the Council of Ministers of Finance, the Committee of Central Bank Governors, and the Monetary Committee.

b. The Exchange-Rate Regime: What It Is Not

One objective of the EMS is to create "a zone of monetary stability in Europe" (*Resolution*, Art. 1.1). This phrase has led to the mistaken notion that the EMS exchange-rate regime constitutes a kind of Bretton Woods par-value system on a European scale.

In fact, a more flexible regime is intended (Commission, 1979, pp. 72, 78-79, 80; Szász, 1979, p. 80; Triffin, 1980, p. 38). "Success must not be confused with an absence of changes in central rates," warns the Commission (1979, p. 78). Bitter experience has made it evident to all that fixity of exchange rates cannot be brought about by legislation. The near-identification of fixed exchange rates with monetary integration in Europe in the late 1960s and a considerable part of the 1970s has been counterproductive. Inflation rates depend on the power and militancy of trade unions and the resulting wage increases; on the political power of the government; on its policy preferences regarding social objectives, government expenditures, and price stability; on the level of dissatisfaction with the existing income distribution; and on national trends in productivity, to name but a few factors. These differ among countries, and so do inflation rates. It is an illusion to think that coordination of economic policies can bring about quick and meaningful progress in overcoming these fundamental differences; the social and political obstacles and structural economic differences are too deep-seated (cf. Tsoukalis, 1977, p. 172). Moreover, governments have to face domestic electorates, not coordinated electorates, a political obstacle of the first order to effective coordination.

Even the transfer of important policy-making powers to federal organs would not suffice to ensure exchange-rate stability. Also required would be the Europeanization of many groups in the member countries' pluralistic societies, such as labor unions, employer organizations, pressure groups, and political parties, as well as the thinking of ordinary citizens. Some of this is taking place through the tireless efforts of the Community authorities in Brussels and the efforts of member governments to harmonize their legislation. But the constant growth of government involvement in almost all facets of daily life in Western industrial democracies works in the opposite direction. The national state gets steadily more involved in the lives of its citizens through the constant adoption

of new national laws and regulations. More is lost daily than is won in Brussels through efforts at harmonization, because of the separation of national societies that these national measures bring about. The fact that the economic impact of such measures differs from country to country constitutes an additional obstacle to the maintenance of fixed exchange rates. The actions of national labor unions and the resulting decisions on wages are only the most obvious example.

The phrase "a zone of monetary stability in Europe" has led to a second mistaken notion, namely that the EMS would somehow protect the European exchange-rate structure from the pressures produced by volatile movements in the dollar exchange rate. Downward movements in the dollar rate lead to conversions of dollars into marks and Swiss francs, the two strongest European currencies. They therefore push up the exchange rate of the mark and the franc, not only against the dollar but also against the other European currencies. There is little in the EMS that will prevent these unfortunate events from repeating themselves without progress toward almost complete convergence, which at best will take a number of years. We encounter again Prime Minister Callaghan's point about the vulnerability of the EMS to the problems of the dollar.

c. The Exchange-Rate Regime: What It Might Be

It is impossible to predict precisely how the EMS exchange-rate regime will develop in practice, just as it was impossible to foresee in 1946 how the IMF exchange-rate provisions would operate in fact. But the working of the European Exchange Rate Arrangement (the joint-currency float known as the "snake") among Germany, the Benelux countries, Norway, and Sweden provides a convenient starting point. Three essential elements can be identified: (1) the arrangement was operated in a manner resembling the "crawling peg," (2) there was a willingness to use monetary and interest-rate policy in full support of the scheme, and (3) exchange controls on capital movements were sufficiently effective, or money and capital markets were sufficiently imperfect, to help the functioning of the arrangement.

It is by now well known that a Bretton Woods type of "adjustable peg" exchange-rate system, in which exchange rates are changed infrequently and by a rather substantial percentage, is incompatible with freedom of capital movements because of the opportunities it creates for almost riskless speculation. For this reason, effective controls on capital movements, although combined with freedom for current transactions, formed an integral part of the original Bretton Woods system. This basic design was gradually but radically altered during the 1950s and 1960s, leading

to the breakdown of the par-value system in the early 1970s (see de Vries, forthcoming). In today's circumstances of essentially free capital movements, pegged exchange rates can work only if there are, or are thought to be, clear and small limits to the magnitude of changes in pegs that the authorities will bring about. Incentives to speculate can then be countered by a tight monetary policy in deficit countries to limit the funds available for speculation and create appropriate interest-rate differentials. The combination of these elements largely eliminates the riskless opportunities for gain through portfolio adjustments among currencies.

These elements were, in fact, present in the operation of the snake. First, changes in central exchange rates (the "peg") were moderate, amounting to a few percentage points only. It was uncertain when they would take place and even whether they would take place at all. When necessary, however, there was a willingness to carry them out before payments disequilibria assumed serious proportions. Of the ten central-rate adjustments between 1972 and 1978, five occurred at half-yearly intervals during the last two and a half years of the operation of the snake.

Second, countries remaining in the snake were willing to make effective use of monetary and interest-rate policy to offset possible exchange-rate movements. André Szász, Managing Director of the Netherlands Bank, has often emphasized this point. He recently analyzed the experience both of "countries which compensated the monetary effect [of an outflow of funds]" and had to leave the snake, and of "countries which allowed the monetary effects of their deficits to [be] felt in the money market" (Szász, 1978, pp. 21-24). The working of a zone of monetary stability will similarly require that at times its members attune their short-term monetary policy to the needs of the exchange market at the expense of "orderly monetary markets."

Third, capital movements were impeded to a certain extent, and this was of some help to the functioning of the system, although it is contrary to the principle of monetary integration. The German authorities at times took measures to reduce the interest nonresidents could obtain on temporary liquid mark holdings. Countries like Denmark or Sweden had controls on capital outflows. Moreover, foreigners could not easily borrow money in these countries for conversion into stronger currencies.

This combination of small exchange-rate changes with uncertain timing, the use of monetary policy to create offsetting interest-rate differentials and a shortage of funds available for speculation, and some impediments to the movement of capital allowed the system to operate.

Even under these conditions, however, substantial movements of funds took place for short periods.

Will the EMS exchange-rate system be able to work successfully as a quasi crawling peg like that developed under the snake? No good reasons can be adduced why it should not, although the snake was a simpler system. The two main periods of monetary stability since the introduction of paper money were characterized by the dominance of a single country that combined satisfactory internal growth, price stability, and political leadership: Great Britain steering what was called the gold standard and the United States steering what was called the Bretton Woods system. The snake, too, was dominated by a single country whose performance other members wanted to emulate: Germany. But the larger European countries fitted less well into that system. As Oort (1979b, p. 195) has pointed out, "Every time the relation between the major currencies of the community had to be adjusted, the weaker partner dropped out." There is no clearly dominant country in the Community, and the process of integration is thereby unavoidably complicated.

The present intention of the German authorities is clear. Behind closed doors, in public statements, and in Parliament, they have emphasized that EMS credit facilities will not be allowed to endanger the German policy aimed at internal stability. Count Lambsdorff, the Minister of Economic Affairs, has declared in the German Parliament: "Intervention [on the exchange markets] is a matter for decision by the Bundesbank, including the possibility of suspending such intervention when the Bank is of the opinion that it would conflict with the realization of monetary targets and similar objectives."⁹ In other words, if EMS credit threatens to have inflationary consequences endangering German internal stability, the exchange rate of the mark against other EMS currencies will be realigned by one technique or another in order to stop the granting of further credit. Let us note in passing that in the two largest Western economies, the United States and Germany, internal concerns thus predominate!

This German attitude reduces the likelihood of excessive exchange-rate rigidity between the currencies of the larger EMS members. No matter how big the EMS credit facilities, Germany will eventually call a halt to further credit through exchange-rate action.

The attitude of one other large Community member, France, is also of vital importance. (Italy has adopted margins of 6 per cent and the United Kingdom does not participate.) After the experience of the past

⁹ *Information Bulletin of the Federal Government*, Dec. 8, 1978, quoted in Szász (1979, p. 84) (translation provided).

decade and a half, it seems unlikely that a country would be willing to go deeply into debt to maintain an unrealistic exchange rate. The French authorities and public have shown a persistent attachment to fixed exchange rates—but not necessarily to a particular parity. Yet the danger threatening the EMS exchange-rate system is that central-rate adjustments will be deferred too long, creating the necessity of largish central-rate changes that would reintroduce disturbing portfolio adjustments and render the system inoperable.

From this point of view EMS exchange-rate policy in 1979 was rather reassuring, but it should be continued in 1980 and beyond. In 1979, two exchange-rate realignments of moderate size took place. As a result of the realignment of September 23, 1979, the mark was valued upward by 2 per cent against the other EMS currencies, and the Danish krone downward by 3 per cent. On November 30, 1979, the central rate of the krone was lowered by a further 5 per cent against all other EMS currencies as part of a Danish package of policy measures.

Three comments on these developments are in order. First, Germany initiated the realignment action of September 1979 for the reason announced at the start of the EMS, namely that intervention became so large as to severely threaten German domestic monetary targets. The change in central rates put an end to that intervention.

Second, unrest on the exchange markets was set off by a fall in the dollar rate. Thus it was shown once again that weakness of the dollar does produce stress on the EMS exchange-rate structure because dollars are converted into the strongest EMS currency, the mark. Until the U.S. authorities succeed in their current efforts to bring dollar liquidity under control there will be the constant threat that excessive dollar balances will play havoc with the European exchange-rate structure.

Third, it must be noted that the exchange-rate realignments have so far been limited to an upward movement of the mark and downward movements of the krone, with the exchange-rate structure among the other EMS currencies remaining unchanged. While this policy may have been appropriate in 1979, it would be a mistake to rule out exchange-rate realignments among other EMS currencies because the authorities of some of the countries concerned are unwilling to admit that their external position might have weakened in relation to the others. The EMS can succeed only if exchange-rate relationships are kept in harmony with underlying conditions. There is no room for false pride in this area.

Thus, the EMS exchange-rate system appears to have begun as a *de facto* crawling peg. It is very different from the Werner Plan, which was aimed at locking exchange rates more and more firmly to one another until irreversible stability and monetary union had come about.

Nor is it a free-for-all, with exchange-rate flexibility compensating for the shortcomings of internal policy, as was the hope in the mid-1970s. Instead, the EMS is a new synthesis of those two opposing earlier views, with emphasis on order and on the responsibility of the authorities for exchange-rate developments.

It is in this way that a system of reasonably frequent adjustments of central rates differs significantly from a system of floating rates, and that an EMS exchange-rate regime would make a difference even if central rates were changed rather frequently in the beginning. The authorities clearly assume responsibility for exchange-rate developments, and they publicly commit themselves to a view about the appropriate rate, two things that the U.S. authorities still refuse to do, despite occasional action to support the dollar's exchange rate. The hope and expectation are that the EMS system will be managed well enough to forestall portfolio shifts between Community currencies, increase exchange-rate stability, and thus reduce the uncertainty that has had such a restraining effect on investment in the open economies of Western Europe.

The EMS exchange-rate regime is likely to undergo modification with experience, but two things seem certain. First, an attempt to impose exchange-rate rigidity would reproduce the same tensions that led to the collapse of the Bretton Woods par-value system. (As noted, the intention is to operate the system more flexibly.) Second, there is a limit to the number of central-rate changes that the EMS exchange-rate regime can withstand within a given period without losing its meaning.

In this last respect the so-called "divergence indicator" (*Resolution*, Arts. 3.5 and 3.6) deserves attention. The indicator starts to give off warning signals when the exchange rate of a currency vis-à-vis the écu (not vis-à-vis its intervention points) reaches a certain figure.¹⁰ One may wonder whether exchange-rate movements within the narrow margins (2½ per cent) of the EMS are all that meaningful. Nevertheless, it is significant that the EMS is the first scheme in operation that incorporates a presumptive indicator as a trigger for policy discussion and co-ordination. When a currency crosses its "threshold of divergence," consultations result, as well as a presumption that the authorities concerned will correct the situation by diversified intervention, measures of domestic monetary policy, changes in central rates, or other measures (*Resolution*, Art. 3.6). If the flashing of a divergence indicator does in practice lead to meaningful policy discussions, important progress will have been made. So far, however, the EMS has started to function without much concrete attention to the question of convergence.

¹⁰ For a technical description, see Commission (1979, pp. 85-91).

d. Conclusions on the Exchange-Rate Regime

Two obvious dangers threaten the EMS exchange-rate system apart from its vulnerability to the problems of the dollar. First, the larger countries could continue, as in the past, to show a reluctance to adjust exchange rates promptly and adequately under a regime of stable but adjustable central rates. The result of this attitude heretofore has been that they dropped out of the system altogether. As General Moshe Dayan has said, in a battle the question is not who is right but who is left.

Second, the EMS exchange-rate system might continue as a quasi crawling peg, as under the snake, but become so loose as to raise questions about its basic purpose. In spite of the trend toward increased government involvement with the economy, the past ten years have been characterized by a decrease in effective governmental control over economic developments in Europe as well as in North America. This loss in control cannot but hinder the efforts to bring about greater convergence and will necessitate relatively frequent adjustments in central rates. A zone of monetary stability in Europe requires more effective control over the economy and mastery of the problem of inflation—in both Europe and the United States.

The conclusion is that the acceptance of greater order and governmental responsibility for exchange rates constitutes important progress, but that the authorities will encounter deep-seated social and political forces that will make their task difficult. The prospect is for *de facto* modification in the EMS exchange-rate system in the light of experience, and for slow progress toward convergence, mastery of inflation, and real exchange-rate stability, given the reduced governability of the Western industrial democracies.

Fortunately, the European Monetary Fund and the écu show more promise as tools for promoting European unity.

5. Credits and Ecu's: Temporary Arrangements

As noted, enlarged Community credit arrangements became effective at the entry into force of the EMS, and écu's were created under provisional arrangements. Mutual credit arrangements among member countries were augmented 2½ times and now amount to about écu 25 billion.¹¹ The credit facilities consist of short-term monetary support, granted by the central banks to one another without conditions, and of medium-term financial assistance, subject to economic-policy conditions laid down by the Community Council of Ministers of Finance. In preparing the

¹¹ On April 1, 1980, one écu equaled SDR 1.03 and \$1.28.

conditions and monitoring the performance of a debtor country, the Committee of Central Bank Governors, the Monetary Committee, and the European Commission all have a role to play, although the final decision is taken by the Ministers. However, the economic-policy conditions on which the credit was given have so far not been enforced in the few cases that have occurred, which obviously has diminished their effectiveness (see Szász, 1978, p. 28, and 1979, p. 85).

The short-term credits available are summarized in Table 1 and the medium-term financial assistance in Table 2. Each member country of the Community has committed itself to provide medium-term credit in an amount that exceeds its IMF quota, while its entitlement to conditional credit is still considerably larger than its lending commitment;

TABLE 1
SHORT-TERM MONETARY SUPPORT
(in millions of *écu's*)

	<i>Former</i> ^a	<i>Present</i>	<i>Per Cent of Total</i>
Debtor quotas:			
France	720	1,740	22.03
Germany	720	1,740	22.03
United Kingdom	720	1,740	22.03
Italy	480	1,160	14.67
Belgium-Luxembourg	240	580	7.34
Netherlands	240	580	7.34
Denmark	108	260	3.29
Ireland	42	100	1.27
Subtotal	3,270	7,900	100.00
“Rallonge”	3,600	8,800	
Total	6,870	16,700	
Creditor quotas:			
France	1,460	3,480	22.03
Germany	1,460	3,480	22.03
United Kingdom	1,460	3,480	22.03
Italy	960	2,320	14.67
Belgium-Luxembourg	480	1,160	7.34
Netherlands	480	1,160	7.34
Denmark	216	520	3.29
Ireland	84	200	1.27
Subtotal	6,600	15,800	100.00
“Rallonge”	3,600	8,800	
Total	10,200	24,600	

^a The factor used in this table for conversion of European Monetary Units of Account (EMUAs) into *écu's* is approximately 1.2.

SOURCE: Commission (1979) and IMF Staff.

TABLE 2
MEDIUM-TERM FINANCIAL ASSISTANCE

	<i>(in millions of écu's)</i>			<i>(in millions of SDRs)</i>	
	<i>Former Creditor Ceilings</i>	<i>Present Creditor Ceilings</i>	<i>Per Cent of Total</i>	<i>Present Creditor Ceilings</i>	<i>IMF Quotas</i>
France	1,200	3,105	22.03	3,249	1,919
Germany	1,200	3,105	22.03	3,249	2,156
United Kingdom	1,200	3,105	22.03	3,249	2,925
Italy	800	2,070	14.67	2,166	1,240
Belgium-Luxembourg	400	1,035	7.34	1,083	921
Netherlands	400	1,035	7.34	1,083	948
Denmark	180	465	3.29	487	310
Ireland	70	180	1.27	188	155
Total	5,450	14,100	100.00	14,755	10,574

SOURCE: Commission (1979) and IMF Staff.

there are no debtor ceilings. These quantitative relationships show the importance of the new credit facilities.

Écu's have been created on a temporary basis by swapping with the FECOM 20 per cent of a member's gold reserves and 20 per cent of its dollar reserves against écu's. These temporary écu's can be used to settle debts resulting from recourse to the short-term credit facilities. A debtor is entitled to settle half of such debts in écu's. Settlement of the remainder in écu's is not excluded in principle, but it must be repaid in other reserve assets if the creditor country so desires. Medium-term credit is to be repaid in the assets in which it is granted; such credits might be granted in écu's.

It might appear that an actual transfer of gold could take place between central banks as a concomitant of settlements in écu's. This is not the case, however, because at the end of the interim period the swaps will be reversed. If a debtor has been unable in the meantime to reacquire its original allocation of écu's as the result of a subsequent payments surplus, it must buy them back with SDRs and dollars, i.e. without using gold, in proportion to the composition of its reserves. As a result, at the end of the transitional period each central bank gets back exactly the same quantity of gold it put in.

Thus the écu's created and used during the interim period have only a temporary existence, like fairies that disappear at daybreak. At the end of the transitional period the whole system will be unwound, final settlements will take place in SDRs and dollars, and the present system is to be replaced by the new European Monetary Fund. No concrete

details concerning the EMF are laid down in the *Resolution of the European Council*; it will operate and create écu's in accordance with decisions that still have to be taken. While discussions on these matters have begun, in mid-1980 they are still in a very early stage, with nothing yet agreed.

One immediate consequence of the interim system is that gold has been made usable again as a reserve asset through a technique that is similar to the use of gold as collateral. In the swaps, which are renewed every three months during the transitional period, gold is valued at the average market price of the previous six months or the average market price of the penultimate working day, whichever is lower, to avoid valuation above the market price as much as possible. As the market price changes, the amount of écu's supplied to the participating countries is adjusted every three months, up or down as the case may be, to restore this relationship. In the latter part of 1979 this arrangement led to a substantial creation of écu's, part of which disappeared in the first half of 1980.

6. The Future European Monetary Fund

So far I have described measures actually taken pending the creation of the future European Monetary Fund at the end of the transitional phase. Article 1.4 of the *Resolution of the European Council* states: "We remain firmly resolved to consolidate, not later than two years after the start of the scheme, into a final system the provisions and procedures thus created. This system will entail the creation of the European Monetary Fund. . . ."

At certain points the *Resolution* gives some vague hints as to what the EMF should look like, but the main negotiations on its shape and functions have yet to take place. Only half of the EMS, the exchange-rate regime, has been put into place so far. The other half, the EMF, must still be created. Thus, in the following paragraphs I will attempt to set out some main principles that seem important to any future European Monetary Fund.

The decisions to be taken are fundamental and of great importance. In setting up the EMF the Community countries have the power to make the most forward-looking changes. Exchange-rate stability depends on factors that are partly, if not largely, beyond the control of the authorities, but it is fully within their power, if they so wish, to transfer reserves to a common institution and to endow it with the right to grant credit and issue a reserve asset. Thus the decisions the member countries take on these matters will be a measure of their resolve to advance the process

of integration, although the outcome will also be influenced by what happens to the dollar and to international monetary relations.

a. Conditionality and Its Institutional Implications

Article 4.1 of the *Resolution of the European Council* states: "The existing credit mechanisms . . . will be consolidated into a single fund in the final phase of the EMS." This is an important and constructive point of departure.

The intended consolidation will make possible a reorganization of the various balance-of-payments credit mechanisms of the Community. Much more important, however, in view of the necessity to increase economic convergence, is the fact that such consolidation offers the opportunity to overhaul and greatly strengthen the economic-policy conditions to which a deficit country must conform if it is to receive assistance. Effective conditionality is a vital means to promote convergence. Although policy coordination among creditor and debtor countries is necessary, part of the effort at adjustment in an inflationary world must be made by deficit countries. I will consider the question of "Convergence to what norm?" in section 8a.

The conditionality of credits within the European Community is in need of fundamental reinforcement. The IMF, which has as one of its main tasks the granting of credits linked to conditions concerning economic policy, has developed a number of techniques for carrying out this task. Credits are given only on the basis of an economic program that offers a realistic prospect of eliminating short-term financial imbalances. The program contains quantified objectives, called "performance criteria," concerning, for example, the public-sector deficit, domestic credit expansion, the external-payments position, and exchange-rate policy, and these must be complied with. The actual credits are phased and made available in quarterly or half-yearly tranches that can be drawn only when the performance criteria, reflecting the general thrust of the total program, have been met during the previous months. If one of these performance criteria is not met, the right of access to further credit tranches lapses automatically. After the disbursement of the credit has been completed, the IMF maintains close contact with the member concerned, monitoring economic policies so as to obtain repayment within three to five years.

For such methods to work, a capable and specialized staff is indispensable, along with the constant attention of a policy-making organ. Basic rules for the granting of credit have to be determined, and they must be adapted to the particular circumstances of a member country. Furthermore, flexibility is needed to adjust the conditions agreed initially,

in the light of unforeseen developments, and without watering down the original intent of the program. Such adjustment therefore requires a new decision by the Executive Board.

Neither the Committee of Governors nor the Council of Ministers of the Community meets frequently enough or has the time necessary to give the guidance required for the implementation of effective working methods such as these. The European Monetary Fund will therefore need a Managing Board like that of the European Payments Union of the 1950s, and this Board must be supported by a capable, independent, and objective staff.

As Polak (1979, p. 6) has pointed out, the extension of conditional credit by a multilateral agency entails many difficulties. The granting of conditional credit must be firmly based on an accepted theory of adjustment and on guidelines for their application if it is not to be castigated as arbitrary. It must also take into account and respect the social and political circumstances of the borrowing countries if it is not to be castigated as imposing a rigid doctrine. Clearly, navigation between these two rocks is not simple. A minimum requirement for success is a staff with experience, knowledge of member countries, a sound theoretical approach, and the courage of its convictions. Moreover, this staff needs the backing of a strong management and of an autonomous policy-making organ to shield it from undue political influence and to enable it to implement the principles in individual cases without detailed political supervision. The IMF has worked to develop these principles and to assemble a staff with a strong *esprit de corps* that is able to administer a policy of conditional credit, and it has learned from experience how difficult it is to be successful in these endeavors. Ample time, as well as the willingness of member countries to let an autonomous Managing Board and staff develop these capabilities without much political interference, will be necessary if the EMF is to become effective in granting conditional credit so as to promote the indispensable convergence.

One way to achieve this objective might be to extend the tasks of the European Commission and its staff, but this does not appear to be a promising road. Somewhat paradoxically, the very supranational ambitions of the Commission and its staff have diminished its authority. We have here a result of the neo-functional approach described earlier. Thus Oort (1979a), drawing on his experience as Treasurer-General of the Netherlands, a position that brought him into close contact with various international economic organizations including the European Community, which he served as Chairman of its Monetary Committee, writes:

In certain respects the Community has, in spite of its supranational setup, a weaker administrative structure than, for instance, the International Mone-

tary Fund. In its composition the day-to-day Executive of the Community, the European Commission, already contains the element of political compromise. According to my personal judgment, its staff is, as a result of the excessive influence of the member states concerning appointments, much less a secretariat acting and feeling internationally than is the case with the OECD or the IMF. The reports of the EC are in general of a rather political inspiration and technically of an inferior quality, for instance compared with the consultation reports of the IMF. The result is that in financial-economic circles the authority of the Commission and its staff, as an international secretariat, is clearly inferior to that of the Secretary-General of the OECD or the Managing Director of the IMF and their staffs (p. 22, translated).

And he goes on to complain about the "frustration occasioned by endless meetings of Ministers, committees, working groups and . . . the repetition of discussions on the same subjects on so many levels. . . . A change in this mentality is obviously essential" (p. 23).

One is struck by the contrast between the results achieved by a politically inspired staff, working in neo-functional fashion, and the original expectations. It is a sad but telling commentary on the effectiveness of this experiment to compare Oort's judgment with Walter Hallstein's enthusiasm and high hopes in an early phase:

The courage of the ministers should not be underrated—nor, indeed, their endurance. Forty-five separate meetings, 7 of them at night; a total of 137 hours of discussion, with 214 hours in subcommittee; 582,000 pages of documents; 3 heart attacks—the record is staggering. . . . Of course, this is only a beginning (1962, p. 55).

But unfortunately there is no room for doubt about the outcome. Commenting on the essential matter of consultations among Community members about economic and financial policies, Szász (1978) writes:

At present, such discussions are the exception rather than the rule within the EEC. It is seen as less than good manners to criticize policies of other member states. Even though policy conditions may be agreed upon with a deficit country when a Community credit is granted, no one is prepared to take that country to task when the conditions are not complied with (p. 28).

Such discussions might make it painfully clear that the Community is not on the road to economic and monetary union, something a politically motivated Commission and staff are not supposed to bring into the open.

Beyond these difficulties resulting from the historical development of Community institutions, there is a more fundamental reason for creating a strong autonomous body to govern the EMS, and in particular the EMF. The European Fund will be a monetary institution, and hence capable of creating liquidity. It should also be an embryonic European central bank. The logic of the Treaty of Rome suggests that the European

Commission should in time be transformed into a European federal government. Meanwhile, the political power of the member countries of the Community finds expression in the decisions of the Council.

Given the strong pressures on government to increase spending for many worthwhile purposes, the necessity of a separation between the government and the money-creating power of the central bank has been generally accepted since time immemorial. Nowhere does the government have direct access to the printing of banknotes, and nowhere is the central bank a mere division of the Treasury, although government influence over the central bank is growing in many countries. Similarly, a clear separation must be brought about between the monetary authority of the Community, the EMF, and the political powers within that Community, i.e. the national governments, the Council, and the European Commission. The development of appropriate European monetary arrangements therefore demands an autonomous institutional structure for the EMF, including a Managing Board of considerable independence supported by a capable, objective, nonpolitical staff.

b. The Role of the Ecu

I have begun examining the tasks of a future EMF by analyzing the implications of effective conditionality, all of which point to the need for autonomous management of the EMF. Other tasks appropriate to the future EMF point in the same direction, and to these I now turn, starting with the future role of the écu.

The *Resolution of the European Council* states that the écu shall become "a reserve asset and a means of settlement," and "will be at the centre of the EMF" (Arts. 1.4 and 2.1). The logical implication of these intentions, and of having credits granted by the EMF rather than by member countries bilaterally so as to reinforce conditionality, is that the EMF grant such credits in écu's. Thus the EMF would have the power to create liquidity, an outcome that is inevitable in any case when a monetary institution is established. Liquidity creation by the EMF would take the place of the liquidity creation that occurs at present when bilateral credits are financed by national central banks.

Nevertheless, such an innovation would have important implications. While it would establish the écu more firmly, it would also give rise to some difficult problems. At present, creditor limits determine the maximum amount of credit a member country is committed to provide. One way to maintain creditor limits and still have the EMF grant credit would be to let the EMF purchase debtor currencies and sell creditor currencies in IMF fashion. Creditor limits would be maintained because the EMF could not sell more creditor currency than had been transferred

to it. Under this technique, however, credits would continue to be granted in national currencies, not in écu's. Moreover, it is a clumsy system and was opposed at Bretton Woods by Lord Keynes. The other way to maintain creditor limits would be to establish acceptance limits for écu's for each member country, similar to the acceptance limits for SDRs in the IMF's Special Drawing Rights Department. But this technique limits the usability of the écu and diminishes its character as a full-fledged reserve asset.

The fundamental solution to these problems lies in limiting the accumulation of écu's by a particular country through the maintenance of realistic exchange rates and firm control over the total issue of écu's, in part by exercising strict conditionality over credits. The question is, of course, whether member countries will have sufficient confidence in the strength of the system and its executive organs to give up the protection provided by the basically unsatisfactory monetary techniques sketched above. It seems unlikely that they will be so inclined, at least in the beginning.

A second question relates to the écu's role in private transactions. In the early stages of the operations of the future EMF, member countries are likely to want to limit the role of the écu to that of a reserve asset and a means of official settlement between monetary authorities. The EMF can, of course, limit the holding and use of the écu's that it issues (and that appear in its books) to those official entities it wishes to admit. But the authorities cannot prevent private financial institutions from creating their own écu's by accepting deposits and making loans denominated in écu's, just as the private sector is already creating deposits in SDRs (and, indeed, in national currencies). We touch here upon the question of parallel currencies, about which much has been written in the past few years. Parallel currencies do exist already. A striking example is the Swiss franc, a currency whose international importance depends not on its role as legal tender in the small Swiss economy but rather on its role as a parallel currency.

It is far from certain, however, that the private sector would prefer the écu over a specific national currency. For anyone wanting to cover a currency risk, a basket of currencies corresponding to his liabilities is more useful. For anyone out to make profits by switching currencies, a particular currency will be more attractive at any particular moment than a basket of currencies, which always contains both strong and weak currencies. In the long run, however, a basket of currencies by definition provides greater stability than one particular currency alone. The interest to be paid on écu holdings is also a factor.

The development of the écu into a genuine European currency, used for both official and private transactions within the territory of the Com-

munity, is an important long-term objective. But it should be clear from the discussion in section 2b that widespread use of the *écu* in this way would take the Community well along the road to monetary union, requiring the transfer of important powers from the national authorities to a federal institution. Until such a transfer has taken place and so long as national governments remain responsible for economic developments, they would be well advised to take effective measures to prevent the widespread use of the *écu* in ways that would erode their power to carry out their responsibilities.

Another important question is whether the role of the *écu* as a reserve asset for the monetary authorities of nonmember countries should be promoted. Opinions differ on this question, but on balance the weight of argument seems to be against such action from both a worldwide and a Community standpoint.

The reserve-currency system based on the dollar and the pound sterling has proved to be highly unstable. It is hard to see why a dollar/*écu* system should be more stable. And it is no easier to understand why the EMS members should pursue collectively a reserve-currency role for the *écu* that they have discouraged individually for their national currencies. Specifically, what would be the point of the EMF attracting dollars not only from its members but also from nonmembers? (See Polak, 1979, p. 11.) To be sure, the early phase of the reserve-currency cycle offers some advantages: beyond the economic advantages, the influence and prestige might be particularly helpful to the EMS in its present early stage of development. But, as the experience of the pound and the dollar has shown, a high price must be paid in succeeding phases of the reserve-currency cycle.

c. Pooling Reserves

Reserves are already partially pooled in the EMS as presently constituted; 20 per cent of gold and 20 per cent of dollar reserves have been exchanged against *écu*'s, although in a temporary way.

This pooling of reserves against the issue of *écu*'s shows strong similarities to the creation of a Substitution Account on a worldwide scale that is under consideration in the IMF. But there are also some differences. First, the transfer of assets has been temporary so far, and the EMS has thus been able to avoid solving two crucial problems, namely where to lodge the exchange risk, and how to generate enough income to pay an adequate interest rate on *écu*'s (Polak, 1979, p. 4). Second, the issuing country of one of the main reserve assets for which *écu*'s are substituted, the United States, is not a member of the EMS and so has only a very indirect influence on any of its decisions, including the decision on investment of the dollar balances deposited. In contrast, American views

are a major factor in the deliberations of the IMF. We encounter here yet another consequence of the absence of any coherent and forward-looking U.S. international monetary policy between about 1974, when the inconclusive discussions on international monetary reform slowly came to an end, and the last two months of 1978. A third difference is that écu's are created against gold as well as dollars, while no Substitution Account for gold is under consideration in the IMF.

As in the case of a Substitution Account in the IMF, which would issue SDR-type claims in exchange for dollars, in principle the pooling of reserves in the EMS does not create liquidity; a new reserve asset is substituted for an existing one. The words "in principle" have to be added because gold is remonetized and remobilized. At the very least, gold is used as collateral for intra-Community settlements, whereas before the EMS it was hardly used any longer in monetary transactions.

It will be of interest to see whether, in the final regime, central banks, under the ultimate responsibility of their governments, will effectively engage in an irreversible sale of some of their gold in exchange for a paper claim, while renouncing the right to the increase (or decrease) in the value of the gold pooled in the EMF. It appears more likely that a special regime for gold will be established. In such a regime member countries could contribute some gold as capital for the EMF. They would thus obtain an equity interest in the EMF because there would be no outright sale of gold. It would nevertheless be possible to issue écu's as a counterpart of the capital provided by member countries. It would also be possible to continue the mobilization of member countries' gold reserves by allowing them to borrow écu's against the deposit of gold as collateral. Such a procedure might enable EMS members to use (and lose) gold reserves.

Other reserve assets, such as reserves held in dollars or in SDRs, would be transferred permanently to the EMF by way of a final sale against écu's. Part of the claims held by EMS members on a possible future Substitution Account in the IMF should be transferred in the same way. (Alternatively, the EMF itself could substitute SDR claims on such an Account for part of its dollar holdings.) The *Resolution* mentions a figure of 20 per cent for the pooling of reserves; that percentage ought to be increased with the passing of time. As the member countries increase the share of their nongold reserve assets that they sell to the EMF, it may become necessary to make provision, under certain well-defined conditions, for the convertibility of écu's into a means of payment that is usable on a worldwide scale, i.e. into dollars. For quite some time, EMS members are likely to intervene in dollars to balance their non-EMS payments.

d. An Intervention Policy for the EMF

It will be impossible to pool an ever-increasing part of members' dollar reserves in the EMF without resolving the question of whether the EMF will be able to buy and sell dollars against écu's on the foreign-exchange markets. More fundamental, it will be impossible for an EMS exchange-rate system to provide protection against fluctuations in the dollar rate without developing an EMS strategy vis-à-vis that dollar rate.

Under the snake arrangement a division of labor developed spontaneously. The smaller countries maintained their parity against the mark, and the dominant country, Germany, developed a dollar policy. With the accession of the larger Community members to the EMS, that procedure is no longer workable, since there is no clearly dominant country within the full Community. In a fully developed phase of the EMF and the écu—which may be further away than the end of the transitional phase and the creation of the EMF—a logical outcome would be an arrangement whereby the écu assumes the role played by the mark in the snake. Under such an arrangement the EMS countries would agree on a strategy concerning the écu/dollar exchange rate. With that strategy determined, it would be the task of the national authorities to pursue monetary and exchange-market policies to keep the rate of their national currencies against the écu within the required limits. The EMS Managing Board would exercise surveillance over the development of both the écu/dollar exchange rate and the exchange-rate policies of the national authorities against the écu. If the situation so required, the Managing Board, or perhaps its Chairman, would initiate confidential consultations to determine whether another small adjustment of central rates was called for. Decisions concerning central rates would continue to be taken, as at present, as a result of negotiations between the Ministers of Finance and central bank Governors of all member countries.

Through market intervention the Managing Board would implement the exchange-rate strategy agreed for the écu against the dollar, using the reserve assets sold to it against écu's. If there were some moderate private circulation of écu's, intervention would take the form of the EMF buying or selling dollars against écu's (or SDRs against écu's if the EMF had exchanged part of its dollar holdings against SDRs in an IMF Substitution Account). If there were no private circulation of écu's, other technical arrangements would be required.

However, the difficulty is not only one of reaching agreement among the EMS countries on an écu/dollar strategy; no dollar policy can be successful without the agreement of the U.S. authorities. Given the difference of opinion on exchange-rate policies on the two sides of the Atlantic,

it is perhaps unrealistic in the near future to hope for more than agreement *at certain moments* (such as occurred around November 1, 1978, or in October 1979) that the movement in the EMS/dollar exchange rate has been excessive or, on the contrary, that movement should take place but has not. The need to resolve this issue may provide an opportunity not only to work out the principles of a dollar policy among the European authorities but also to reach more agreement between the European and American authorities.

The importance of this question can hardly be overrated. "The durability of the EMS and its international implications require coordination of exchange rate policies *vis-à-vis* third countries and, as far as possible, a concertation with the monetary authorities of those countries," declares Article 5.1 of the *Resolution of the European Council*. The implementation of this important and evident principle will not be easy.

e. Institutional Arrangements

At the end of the transitional phase, and especially after the system has evolved over a number of years, the EMS will need governing organs able to make decisions concerning many matters on a regular basis. Among the subjects that the EMS will have to deal with are exchange-rate policies both *vis-à-vis* the dollar and among EMS members, Community surveillance over exchange-rate policies of both types, market intervention to implement the exchange-rate strategy *vis-à-vis* the dollar and surveillance over intervention by the authorities of member countries in order to keep their currencies within prescribed limits, the granting of credits of various durations, and the management of reserve assets sold to the EMF. Also to be faced, although not mentioned so far, are questions like control over the total volume of écus issued and the composition of the écu basket.

In order to carry out these tasks the EMS may well need two governing bodies: a Board of Governors and a Managing Board. In the Board of Governors there is likely to be more emphasis on the national element, and this Board might well consist of Ministers of Finance and Governors of central banks. In accordance with its traditions, which differ substantially from country to country, each member country would make its own arrangements as to the respective roles of the Minister of Finance and the Governor of the central bank in arriving at the views it wanted to express. Each country would also be free to determine whether these views would be presented by the Minister or the Governor. There would be no point in trying to regulate such matters uniformly at the Community level. The differences in traditions demand flexible arrangements. In accordance with this approach, it would not be necessary for

all meetings to be attended by both the Minister and the Governor, nor would it be desirable to have meetings of only Ministers or only Governors. Rather, it would be left to the discretion of individual member countries, given the agenda of a particular meeting and the country's national tradition, to determine whether the Minister or the Governor or both would attend.

In the Managing Board, on the other hand, the accent would be on autonomy. Its members would exercise no functions in their countries of origin. Like the Executive Directors of the IMF, they would have to balance, as they saw fit, the interests of the countries that had appointed them and the interests of the EMS as a Community institution.

The distribution of responsibilities between the Board of Governors and the Managing Board would have to be flexible and might change as the system evolved. One way to achieve such flexibility would be to have the constitutive legal instrument confer only a limited number of powers directly on either the Board of Governors or the Managing Board. The legal instrument would take no final position on the question of the organ that would exercise the other powers. Instead, these powers would be vested in the Board of Governors, but this organ would have the authority to delegate them to the Managing Board. As the system evolved, more and more powers might be delegated by the Board of Governors to the Managing Board. After the system had been in operation for some time, there might be little reason for the Board of Governors to refrain from delegating any powers not directly conferred on it, which might be limited to questions concerning changes in central rates and the admission or suspension of members. Analogous to the IMF system, which has served as something of a model for the arrangements outlined above, the Board of Governors would have the authority to withdraw or modify the delegation of a power to the Managing Board or to override decisions by the Managing Board in those cases in which it had delegated its powers.

Another question would be whether any powers should be directly conferred on the Chairman of the Managing Board. Taking the IMF once more as a starting point, the power to make certain proposals, for instance on exchange-rate policy vis-à-vis the dollar or on the issue of écu's, might be conferred on him. Moreover, he might be empowered to propose the agenda of the Managing Board as well as to organize, appoint, and dismiss the staff and determine its program of work under the general supervision of the Managing Board. In practice this amounts to giving the Chairman a major influence in the selection of projects to which attention should be devoted, as well as the power to initiate such projects.

An important question, worthy of special mention here, is whether the granting of medium-term credits (for a period of two to five years) ought to be decided by the Board of Governors or the Managing Board. At present, final decisions on this subject are taken by the Council of Ministers of Finance, but it is doubtful whether this is the most appropriate arrangement. First, national Ministers of Finance cannot be expected to be sufficiently familiar with the economies of other member countries to be able to judge the details of their programs for economic adjustment. Second, the "senatorial principle" comes into play when Ministers of Finance meet. They are likely to be lenient toward their colleague in need of credit because they themselves may have to ask for a credit in the future. The drawbacks of this system have led in the past to a situation in which countries in need of credits first approached the IMF to negotiate the economic-policy conditions to be attached to any credit, after which the Community Council of Ministers granted an additional credit on the same conditions. It is evident from this procedure that the Community has so far lacked the sophisticated machinery necessary to carry out the difficult task of granting credits under its own policies of conditionality. Together with the need to observe the principle of separation between governments and the access to monetary credit, this state of affairs necessitates a change in present procedures and delegation to a future Managing Board of the responsibility for granting medium-term credits.

f. An Independent Managing Board

Under the institutional arrangements just proposed, important responsibilities would fall on an autonomous Managing Board. In making arrangements for such a Board, the experience obtained with the working of the Executive Board of the IMF ought not to be overlooked. This experience has been well described elsewhere (Gold, 1972, especially pp. 197-201 and 211-216), but a few main points deserve to be made briefly. They should in no way be taken as implying a choice as to whether the EMF should be a "central bank," a "regional IMF," or a "*sui generis*" type of institution. These terms are current in Community circles at the moment, but final solutions will have to be more specific.

Several principles can be distilled from the IMF experience. A first principle is that such a Managing Board should arrive at its decisions by weighted voting. A second principle is that operational decisions, such as a decision to grant a particular credit and the determination of the precise economic-policy conditions to be attached, should be taken by a simple majority of the weighted votes cast. This second principle should be softened by a third principle, that in practice the Board should

strive to reach its decisions by widespread concurrence rather than by narrow majorities, but without watering down the decisions until they are meaningless. These principles can be carried out only if three further conditions are met: (1) the Board must be in continuous or near-continuous session, (2) the personal authority of its Chairman must be generally recognized, and (3) the Board must be assisted by a highly qualified staff.

Particularly in its general policy decisions, the Executive Board of the IMF has sought to arrive at widely acceptable compromises that most members regard as useful. In this process, the Chairman, the members of the Board, and the staff each have specific roles to play.

The main task of the staff is to bring forward new proposals in which conflicting aims and interests find recognition but are synthesized in a practical and workable scheme.¹² The members of the Executive Board must be ready to compromise. Such readiness is stimulated by the knowledge that Board policy discussions generally end in policy decisions, not in the endless postponement of a decision. In the negotiating process the influence of an individual Executive Director is perhaps weighted about equally by his voting strength and by the logic and persuasiveness of his position.¹³ The task of the Chairman is, of course, to move the process along, using his authority and great influence to best advantage and setting the broad targets to be achieved.

In setting up a Managing Board for the EMF, the distribution of voting strength among its members will be a difficult question. Still, the countries of the Community have been able to decide upon their relative voting strength within the IMF and on regular modifications of it, as well as on the relationship of their collective voting strength to that of other IMF members. More directly relevant, they have been able to agree on the distribution of creditor ceilings and their modification in the short- and medium-term credit facilities of the Community (see Tables 1 and 2). They should therefore be able to settle the distribution of their voting strength in the EMF.

It has been the experience of the IMF that some influential countries like to hide behind the Executive Board and its Chairman. They will strongly support particular actions by the Board or its Chairman that they would hesitate to carry out themselves. The imposition of policy conditions in connection with a credit is a recurring example. One would

¹² The tendency to compromise rather than synthesize was a main shortcoming of the "Bureau" of the Committee of Twenty on Monetary Reform (see de Vries, 1976, pp. 585-588).

¹³ Gold (1972, p. 199) perhaps goes slightly farther when he states that "the weight of the contribution of individual executive directors has no necessary relationship to voting strength."

expect this experience to be repeated in the EMF, once it is governed by an autonomous Managing Board. A strong autonomous institutional structure of the EMF might thus provide a counterforce against the present practice in the Community of basing decisions on economic policy almost exclusively on political considerations.

g. Conclusions Concerning the EMF

A major conclusion from these considerations is that the European Monetary Fund offers greater opportunities for promoting European unity than the EMS exchange-rate arrangement. Exchange rates will be affected by many factors over which the member governments have little if any control. But it is fully within their power to pool their reserves in a European Fund, to authorize this fund to issue a reserve asset (which might also be held by the private sector within certain limits), and to intervene in the foreign-exchange markets. Such developments would have far-reaching consequences.

A second major conclusion is that the EMF should therefore be given meaningful tasks. If its activities were to be limited to routine matters—like bookkeeping, the investment of dollar balances sold to it, or the granting of automatic 45-day credit—all in the name of preserving the independence of a future European central bank, the shadow of what matters would be confused with the substance, and no meaningful autonomous European monetary institution would be created. It would be difficult to defend such a course of action for many reasons, and it would be particularly hard to explain why certain powers that have been exercised by the Executive Board of the IMF for many years could not be conferred on a Managing Board of the EMF.

An important case in point is the consolidation of the existing credit mechanisms, including medium-term credits. In order to promote convergence, the conditionality of these medium-term credits must be given real content. The experience gained with the Executive Board of the IMF provides good reasons to believe that an independent Managing Board would be able to enforce conditionality far more effectively than the individual member states themselves. As Szász has noted, conditionality imposed by member states has been a failure. In contrast, the conditionality of IMF credits is a reality borne out by the intensive criticism to which Fund conditionality is sometimes subjected.

A third major conclusion is that in order to perform tasks such as I have envisioned for the EMF, a strong institutional structure will be necessary. The EMF must become an autonomous monetary institution of the Community, led by a Board of Governors and a Managing Board of considerable independence, and supported by its own highly qualified

staff that in the performance of its functions reports exclusively to the organization. Such institutional arrangements are necessary not only to enforce conditionality but also to carry out other tasks that will face the EMS, such as the necessity to develop a common European strategy vis-à-vis the dollar and a corresponding intervention strategy on the foreign-exchange markets. Last but not least, it would be the duty of such a Managing Board to search continuously for practical ways to promote both convergence and the monetary integration of the member countries of the Community.

Of course, the realization of these objectives cannot be guaranteed by appropriate institutional arrangements. Indeed, it would be unrealistic to count on their early realization under any circumstances. A proper institutional structure will only create a framework that allows continuous efforts toward the realization of these objectives to proceed. It would be naive to expect the new organization to come forth fully developed. Instead, it has to evolve and grow over time as the result of much hard work. The best guarantee for ultimate success lies in the high quality and objectivity of that work.

7. The International Implications of the EMS

a. The Dollar

The EMS has been created *inter alia* to protect European currencies against volatile fluctuations in the dollar exchange rate and the influence of such fluctuations on their mutual exchange rates. But the EMS does not possess instruments adequate to influence the dollar rate or to isolate the EMS currencies from the effects of fluctuations in that rate. The dollar rate is basically determined by the American external position, in which—at least at the present time—capital transactions are a dominant factor.

Together with the extraordinary increase in oil prices, a main cause of the present instability of the international monetary system is U.S. domestic inflation. Elimination of that inflation would be a vital step in bringing about more stability in international monetary relations. Given the relative quantitative magnitudes, moreover, the dollar rate is determined to an important extent by U.S. monetary policy, with its influence on international capital movements. It is therefore important not to lose sight of the fact that U.S. monetary policy has always been determined primarily by domestic considerations. Recommendation 17 of the Joint Economic Committee of March 22, 1979, is indicative:

The Committee has consistently opposed diversion of monetary policy from domestic goals to secure international objectives other than in truly excep-

tional circumstances, and we reaffirm that position now. Monetary policy should be based primarily on the needs of the domestic economy (pp. 41-42).

This point of view is widely supported in the United States. Thus it is essential not to be misled by current policies. At the moment, the fight against inflation and external considerations point in the same direction for U.S. monetary policy. But when they do not, the requirements of the domestic U.S. economy can be expected to prevail. It is an open question whether the world, and the EMS, can work out procedures to live in a tolerable fashion with this reality. In the light of American support for European integration in general and for the EMS in particular, and given the importance of movements in the dollar rate for the internal stability of the EMS system, mutual and effective consultation on domestic monetary policies with a view to promoting greater exchange-rate stability between the dollar and the *écu* would obviously be of great importance.

A more fundamental way to alleviate this problem would be to reduce the role of the dollar as an international reserve asset. The U.S. authorities have drawn a similar conclusion and are no longer opposed to a less central international role for the dollar, perhaps by means of a Substitution Account. Given the disturbances on exchange markets that would flow from the diversification of dollar balances into other currencies, such an Account would not only be of worldwide importance but would also contribute significantly to the success of the EMS.

b. The IMF and the International Monetary System

The creation of the EMS, with tasks similar to those of the IMF, cannot fail to affect the IMF, especially if the EMS is successful. In this connection, the EMS will at some time have to make a fundamental decision on its international policy. It can be inward-looking, concentrate on Community member states and the surrounding and associated countries, and try to become a quasi-autarkic entity in the world. Alternatively, it can use its increased influence to promote a better international monetary system, thus taking over part of the task carried out at present by the United States, in close cooperation with that country. Given the interdependence of economies and nations in the present world, the second policy stance is the only realistic one in the absence of far-reaching and costly changes in international economic arrangements and, indeed, in the political relationships of the Atlantic world.

An outward-looking attitude would be in harmony with the worldwide responsibilities of the larger European countries and the international outlook on which the smaller member countries have always prided

themselves. Surely, the effectiveness of the international monetary system as a whole, and of the IMF as the guardian of that system, is a matter of prime interest to the members of the Community. Their quotas in the IMF amount to 28 per cent, nearly half the total for the industrial countries (as against 22 per cent for the United States), and they have six seats on the IMF's Executive Board (Polak, 1979, p. 2). Thus, the members of the Community clearly have a major responsibility for the future of the IMF. For similar reasons they should give adequate attention to worldwide considerations in defining the policies of the EMS and shaping its future development.

In any case, appropriate and effective coordination must be instituted between the IMF and the EMS. The need to harmonize the conditionality of credits to a country applying to both institutions is but one example that springs to mind. But as long as the institutional structure of the EMS remains flimsy, and particularly as long as the European Monetary Fund does not yet exist, it is not easy to give practical reality to this objective. It is hard to establish meaningful contacts between the IMF and Community organs consisting of national officials who—after their monthly meeting—disperse to their various capitals and resume their national duties. Collaboration between IMF and EMS will clearly be made easier by a well-defined institutional structure of the type outlined in section 6.

From a worldwide point of view, the EMS will nevertheless remain a complicating factor in international monetary relations. Yet if its purposes are pursued vigorously, promoting effective European integration, I would not hesitate to welcome and support it. A united Europe is important, both as an end in itself and because the present partial European structure constitutes an obstacle to worldwide cooperation and decision-making in the economic as well as the political and military domains. But if the purposes of the EMS are pursued in a faltering fashion, only its negative international aspects will remain.

The future role of the *écu* is obviously of great importance to international monetary relations. I have already expressed doubts about the desirability of a future international monetary-reserve system based on the dollar and the *écu*, since such a system is unlikely to be any more stable than the previous system based on the dollar and the pound sterling. The experience of many centuries with national monetary systems built on both gold and silver has shown that a system based on more than one monetary asset is inherently unstable and inefficient, and economic analysis has provided convincing explanations of why this should be so. Moreover, the EMS does not establish a monetary union, and in times of uncertainty it will be more attractive to move assets into one of its stronger constituent national currencies than into the *écu*. Only if

the management of the worldwide system continues to fail seriously—as seems to be the case at present for reasons that would require a separate essay to explain—and the world continues to drift toward a multicurrency system despite the high cost involved should a reserve-currency role for the *écu* be envisaged.

Rather than promote such a course, it would be in the interest of the EMS countries, dependent as they are on worldwide trade, to reinforce the international monetary system and integrate the EMS into that system. Such a policy would imply supporting the efforts to improve the system by centering it more firmly on the SDR. Attempts are being made now to prevent the disintegration of the system into a multicurrency-reserve arrangement and to address the role of the various reserve assets in the future international monetary system by moving it toward a single-asset system based on the SDR. These endeavors are likely to be active issues over the next decade. The regional character of the EMS and its specific role in promoting European integration, as well as the European interest in a well-functioning worldwide monetary system, could all find expression in a decision to have the EMF exchange part of its dollar holdings for SDRs in a Substitution Account. Such a step would reinforce the international monetary system and help define the role of the EMS in that system in accordance with the important worldwide responsibilities of the EMS and its members.

c. The Third World

The countries of the Community, with their open economies, play an important role in international trade and finance. Western Europe is more dependent on the import of raw materials from Third World countries than is the United States, and its trade with these countries is of mutual significance. Hence, the decisions the Community makes are of great weight to Third World countries, so that it is increasingly important to maintain and improve cooperation between the Common Market and the countries of the Third World.

These relationships have found concrete expression in the Lomé convention, which improves the access of associated developing countries to the important markets of the member countries of the Community and provides financial assistance for their development efforts. On the other hand, it must be admitted that the countries of the Community, like other industrial countries, have been slow to admit without hindrance the export products of the new industries of the developing countries that their own development assistance has helped to create. Many developing countries are also adversely affected by the Common Agricultural Policy of the Community. However, the drawbacks of that policy for the Com-

munity itself are increasingly recognized, and some important modification of it seems inevitable in the next few years. But if the developing countries are dependent on the Community, the Community's member countries, in their turn, are vulnerable to developments in the Third World, given their critical dependence on the import of raw materials, particularly oil. This mutual dependence is likely to result in new joint arrangements in the years to come.

The EMS has been received with some ambivalence in Third World countries. Insofar as the EMS is successful in its efforts to establish a "zone of monetary stability in Europe," there will also be benefits for the developing countries in today's uncertain world. However, these countries are afraid that exchange-rate stability might be bought at the price of economic stagnation, at least in some Community countries. They fear that the EMS will lead to unduly restrictive economic policies.

Of course, stagnation would be even more harmful to the Community countries, and it is the hope and expectation—indeed the very reason for setting up the EMS—that greater monetary stability will lead to increased real growth. The experience of the 1970s suggests that growth is hampered not only by exchange-rate instability but even more by domestic monetary instability. It has become widely accepted that both growth and employment are harmed by present inflation rates. Thus, although it is difficult to predict the success of the EMS in establishing stability, it is evident that in this respect the interests of the Community countries and the Third World countries run parallel.

8. Prospects for the EMS

Prospects for the EMS depend to a considerable extent on political developments, since European integration is a political enterprise. Its success will also depend on whether the EMS is managed with the same realism and acumen with which it was put together. Finally, there is the question of the meaning of a successful EMS, both for the European structure and for international financial relations. These three questions will be examined in turn in this final section.

a. The Politics of European Integration

The establishment of the EMS was mainly political in nature and part of a wider pattern of developments. Direct election of the members of the European Parliament, a new Lomé agreement, accession of new members to the Community, an economic agreement with Yugoslavia, a common political stand on the Middle East and on Soviet intervention in Afghanistan, all form part of the same picture. Does this mean that

there are fundamental political factors at work pushing anew toward integration after the stagnation of the years 1971-78?

Two fundamental conceptions of the European idea may be singled out among the many choices that Europe has to face (cf. Serfaty, 1979, pp. 104-109). They may be called "Classical Europe" and "Independent Europe" (cf. Cleveland, 1966, pp. 124-146).¹⁴

Classical Europe took federation and supranationality for granted. It was the conception of the Founding Fathers, of the "Europeans," of Jean Monnet and his supporters. Classical Europe was designed to deal with four main problems.

The first problem was to meet the perceived postwar military threat from the Soviet Union. It was assumed on both sides of the Atlantic that neither Americans nor Europeans would be willing to rely on the prolonged presence of large American forces to provide for Europe's security, and that European unity was the only way in which Europe could assemble the required conventional military forces to meet the threat. The decisive importance of nuclear weapons was at first no more clearly foreseen in the European context than it was on a global scale. For about two decades after 1947 the United States was engaged in building a position of strength from which to negotiate with the Soviet Union, whereas in fact its overwhelming comparative strength steadily eroded as the Soviets whittled away first at America's nuclear monopoly and then at its nuclear superiority.

The second problem was how to deal with the German question. Classical Europe was to provide an honorable, nonnationalistic outlet for the reviving German strength. It was also seen as a means of reconciling Germany and France by engaging them in a common endeavor.

The third problem was to restore Europe's economic health. For this purpose it was rightly considered essential to create a single market in which goods, capital, and people could move unhampered, but it was wrongly assumed that the establishment of a Common Market, basically a customs union, required a vast transfer of sovereignty.

The fourth problem was to ensure internal political stability, especially in France and Italy. The restoration of economic health was seen as a way to accomplish this goal, but European political institutions would also play an important role.

At the time of its conception, the analysis and goals of Classical Europe

¹⁴ That I here denote as "Classical" the particular version of the European federal ideal that became embodied in the Community institutions should not obscure the facts that there were many other versions in the early post-war years and that the federal ideal constituted a sharp break with the traditional form of political organization: the nation-state (see Calleo, 1965, Chaps. II and III).

had an undeniable logic. What is more, they stimulated Europe to undertake a vast array of concrete actions to deal with the fact that the traditional nation-state is too small to confront the political, military, and economic problems that arise in modern industrial societies. But as time went by, the specific problems that had provided the basis for the idea of Classical Europe were solved one by one in a framework that transcended Europe. The Soviet military threat was met by Western Europe's reliance on an American nuclear guarantee for its security. The German problem receded into the background as a result of the partition of the country for an indefinite period. Moreover, West Germany accepted partition as part of the arrangements for its rearmament in view of its dependence on the United States for its security. As for economic health, it turned out that the European customs union established in the 1960s ensured both economic health and vigorous economic growth, but without any real transfer of sovereignty to a European supranational entity and only as part of a wider Atlantic economic and monetary system.

Let us note in passing that these security arrangements had a particular advantage for the smaller European countries. An integrated European defense would have resulted in the hegemony of their powerful neighbors. The smaller countries, which must follow the lead of a dominant country in any event, preferred the leadership of an ally 3,000 miles away, with deeply rooted democratic institutions and a tradition of using its power with restraint (cf. Kissinger, 1965, p. 241).

It became apparent only gradually that the arrangements thus established were having a stultifying effect not only on Europe's attitude and actions in the international political and economic field, but also on its attitude toward European unity. As a result of the U.S. security guarantee, decision-making in foreign policy and military strategy passed ever more completely into American hands. Coming after a period of decolonization during which the European countries had been obliged to give up many of their global interests, and especially after the Suez defeat of 1956, U.S. predominance meant that Europe slipped into an easy attitude of dependence on its American military protector for its security. This dependence has now existed for more than a generation. Continued reliance on outside protection, even after its political and economic justification had decreased considerably, has given rise to general attitudes and to an approach toward world affairs that—if they were to remain unchanged—would put Europe increasingly in danger of being regarded by the rest of the world as having retired on social security.

A somewhat similar development took place in international monetary affairs, even though Europe's potential in this field was greater than in defense. The international monetary system became ever more completely

based on the dollar in spite of increasing European economic strength. To be sure, Europe protested against this state of affairs, but since the protest was not accompanied by effective action, it achieved few results at best. One reason was that, in return for providing military protection, the United States insisted that its guidance on key decisions in Atlantic monetary affairs be heeded. From time to time, the American Ambassador in Bonn gently reminded the German government of this basic understanding.

A third reason for the lack of real progress toward European unity was the method chosen by the European Community to achieve integration, which has been called the "Monnet Method" even though it may not fully represent Jean Monnet's ideas on functional integration. This method deals with the how and not with the what. It does not provide an answer to the question, "Where do we want to go?"; it dismisses it. Instead it says, "It does not matter where we go as long as we go somewhere together." It is concerned with keeping everyone in the boat rather than with charting a particular course for it. As J.-F. Deniau, a former member of the European Commission, put it, the result is that Europe, when it speaks with one voice, has little to say (cf. Hoffmann, 1979, pp. 2-3, and 1964, pp. 1274-1275).

Concentrating attention on procedures and institutions rather than on substance has meant in practice that the European nation-states have maintained their individuality and, as a result, pursue different if not conflicting aims. This has put a brake on further steps toward integration. In the long run, one cannot solve political problems with technical expedients in the absence of a policy consensus. The issue has not really come to a head until recently, because of Europe's ability to rely on its American protector. As a result, the European countries have not had to face the hard choices that would have forced them to resolve their disagreements over policy objectives.

Thus the conclusion is that the Soviet military threat and the consequent American predominance in the international political and economic systems of the West have until recently caused a paralysis of European action and a strong inhibition of further movement toward European unity. All the important problems that European unity was supposed to help solve in political, military, and monetary affairs were in fact dealt with under the guidance of and along lines desired by Europe's American protector and in the Atlantic framework.

Reaction against this state of affairs has led to the concept of Independent Europe. First forcefully expressed by General de Gaulle, this idea has gained more and more adherents since 1977-78. Its basic rationale, quite different from that of Classical Europe, is that Europe should

take its own destiny in hand, regain a sense of mission, and play a significant and independent role in the world, while being able to defend its own interests. European independence is the end and European unity simply the means.

The difficulty that General de Gaulle met was Europe's insufficiently strong will to be independent, at least outside France, and its inability to agree on its role in the world. This absence of European political will was at the root of his seemingly contradictory policy of promoting an independent Europe while rejecting any merging of sovereignty. Thus the first attempt to establish Independent Europe failed, because General de Gaulle's policy—and the way it was expressed—led to fears of French hegemony in Europe. But, given his judgment of Europe's mood at the time, the General could not have acted otherwise. A supranational politico-military community would have submerged France, the only nation actively seeking European independence, in a European majority ready to accept the American protectorate, bringing about precisely the opposite from the end he was pursuing. However, a Europe of nation-states was unable to withstand American influence, and, when forced to choose between American and French leadership, the other European countries unhesitatingly chose the United States, with its stable political institutions and its ability to provide a credible defense against the Soviet threat and reassurance concerning lingering fears about Germany. General de Gaulle did find an early follower in Edward Heath after he himself had left the scene, but Heath was even less able to change Europe's mood (cf. Kissinger, 1979, pp. 937-938 and 964-965).

Hence, the stalemate in the construction of Europe. Classical Europe could not provide the necessary motivation because the problems it had been designed to meet were being solved in other ways, while Independent Europe, because it was for a long time identified with Gaullist policy and the particular Gaullist style, was still less attractive. Raymond Aron concluded at the time that Western Europe "prefers provisionally security in impotence to the anxiety and perils of a refound autonomy" (quoted in Cleveland, 1966, p. 146).

Developments during the last few years, however, may lead to greater support for Independent Europe, and perhaps even to some reconciliation between the ideals of Classical and Independent Europe. A number of solutions reached within the Atlantic framework look less solid than they used to. First there is security. As the Soviet Union attains nuclear parity with the United States and superiority in worldwide conventional military capabilities, the realization is slowly spreading that the American nuclear umbrella has become less and less waterproof. At the very same time, the United States is building a defense capability in the Indian

Ocean that must of necessity weaken the strength of its conventional forces available for the defense of Europe. A more independent and better-integrated European defense capability may therefore come to appeal to a wider European audience.¹⁵

Second, there is the need to find more meaningful outlets for increasing German strength. The possibility, if not the inevitability, of a less absolute dependence on U.S. military protection, the likelihood of increased divergence of interests between Europe and America, and the perceived drift of American policy in general have resulted in a German propensity toward more decisive action. A notable example has been the important German role in the conception of and negotiations leading up to the creation of the EMS described in section 3a. At the same time, the internal political situation in France allows a more flexible and forceful French foreign policy. Thus conditions are favorable for constructive Franco-German European initiatives, and so far these have been the basis of all progress toward European unity. A weak spot in this picture is that Britain has not yet found an appropriate place in the European structure or in its further expansion. A more active European defense policy might provide Britain with an opportunity to improve its position.

Last but not least, there is the lack of decisiveness in American foreign policy in both the political and the economic domains. Internal constraints have reduced America's capacity to act and negotiate. The authority of the presidency has decreased and cohesion in Congress has diminished. A vital element is the disappearance of the foreign-policy consensus that had existed since the early 1940s in both the political and economic fields. As a result, negotiated international agreements are not passed by Congress, and the President's authority is further reduced. This vicious circle tends to lead to an absence of policy that in turn has made European leaders speculate for the first time on the possibility of a partial breakdown in U.S. foreign-policy-making.

Similar uncertainties prevail in the economic domain. Although American predominance has diminished, U.S. international economic power remains formidable; witness, for example, its power to change the rules of the international monetary system to fit its needs. The crucial point is that no overall concept or design shapes U.S. international economic policy. A case in point was the curious notion that the U.S. authorities could pursue with impunity a policy with regard to the external value of the dollar—the world's international money for both private and official transactions and at the center of the world's financial system—that no longer took responsibility for the dollar's exchange rate but considered

¹⁵ For additional arguments, see the brilliant but disturbing article by Howard (1979).

it wise to let that rate be determined by the whims and speculations of market operators. Not only did this policy of "benign neglect" (in fact, an absence of policy) damage the world economy and the U.S. domestic economy, but the disruptions it created were a direct cause of the creation of the EMS as a protective device in an economic hurricane.

Since European unity was designed originally to provide answers to some of these same questions, a new impulse toward European unity may well emerge as the Atlantic answers become more uncertain. The need for European unity may appear particularly urgent first to face an increased threat to military and economic security, second as a means of finding an appropriate framework for a Germany that is less firmly embedded in the Atlantic Alliance and gaining in strength and initiative, and third as a means of facing a world where competition and strife are once again more prevalent.

Will a more Independent Europe find structures to give expression to its policies, whether or not along the lines of Classical Europe? If so, there will have to be a much larger measure of agreement on the substance and ends of these policies. Whether the new pressures will bring about that agreement is a fascinating question that may be answered in the next few years. Whatever institutional solutions evolve, it is likely that the next step forward by the ever-closer coalition of European states will take place in the fields of foreign policy and defense. There may have been good tactical reasons in 1977 and 1978 for Chancellor Schmidt and Commission President Jenkins to take initiatives in the monetary field, but in the early 1980s such tactical opportunities are more likely to emerge outside the realm of the Treaties of Rome. In fact, cooperation in foreign policy has been advancing steadily since the French elections of March 1978 reinforced the position of President Giscard d'Estaing. The outcome of that election may have been a turning point in the construction of Europe, this time for the better.

b. Will the EMS Succeed?

That political developments such as those sketched in the previous section will set the framework within which the EMS will operate should cause no surprise; all European initiatives have had a political origin. Moreover, European action in the fields of foreign policy and defense would greatly strengthen the chances of success of the EMS as well as the likelihood of the creation of a strong European Monetary Fund. On the technical level, the ultimate success of the EMS will depend to a significant degree on realizing as much economic convergence as political and sociological circumstances permit. The application by an independent Managing Board of real conditionality in connection with credits from the EMF is vital in this respect. But by itself the concept of convergence

is a typical expression of the Monnet Method, that it does not matter where we go as long as we go somewhere together. Instead, the members of the European Community will have to reach agreement on specific economic-policy goals toward which they should converge, or convergence will fail as a result of diverging policy ends.

In the meantime, wise and flexible management of the exchange-rate regime will be important. Dogmatism must be avoided on the part of "fixers" and "floaters" alike. This may not be easy, but it is essential. Policy should always be in conformity with reality. The EMU tried to move beyond the degree of integration that was in fact possible. The EMS tries to conform to the existing situation, while aiming for an increase in convergence over time. This is the main difference between the EMU and the EMS, and the reason to believe that the latter may succeed where the former failed.

Dangers remain. If policy on adjusting exchange rates becomes excessively rigid again, or if the members of the EMS have recourse to an overdose of credit, the system will be put in jeopardy just as surely as the health of a person with a heart condition who refuses appropriate exercise and declines to stick to a diet of moderation. Yet with appropriate exchange-rate adjustments and moderation in the use of credit, there is no reason to expect the EMS to crumble, as is feared or predicted by many political analysts and economists. In the absence of unforeseeable external shocks, the more realistic construction and more modest goals of the EMS do not warrant such pessimism.

The success of the EMS will also depend on the further restoration of confidence in the dollar as a result of firm American domestic economic policies. It is of vital importance not to lose sight of James Callaghan's observation that a European monetary system that ignores the problems of the dollar will not endure. New volatility in the dollar's exchange rate could wreck the EMS. Yet Europe cannot solve the problems of the dollar. These are first and foremost American problems and can be dealt with only by eliminating America's inflation and excessive dependence on energy imports from a small and distant geographical area of dubious political stability. Purely monetary contributions to a solution of the dollar's international problems must likewise be found in a wider framework than the EMS. Among them might be the creation of a Substitution Account in the IMF through which part of the reserve role of the dollar would be taken over by the SDR. The member countries of the EMS will have to evolve common positions on questions such as these, as well as on an exchange-rate policy for the écu against the dollar. In this respect, a Managing Board of the EMF could play an important role.

c. Does the EMF Matter?

The European Community apparently needs some monetary mechanism; in spite of all failures, the idea keeps coming back. The EMS has been put together with a great deal of economic and political realism and imagination. It does not involve a major transfer of sovereignty, its exchange-rate arrangements are in accordance with economic reality, and the European Monetary Fund has important potential. While it would be unwarranted to hail it as a major step toward European unity, it would also be unwise to underestimate its importance. Those closely involved with it are apt to underrate its psychological impact both on unrelated sectors, such as European foreign policy and defense, and on economic circles outside Europe.

The answer to the question whether in the end the EMS really matters also depends on the determination and imagination with which it is managed and, above all, completed. The European Monetary Fund does not yet exist, and almost all important decisions concerning it have yet to be taken. If the fund is set up in a way that permits it to grow in time into a European central bank, the EMS will certainly matter. But if the EMS is completed in a vacillating way, it will be useless, and even harmful from a worldwide point of view. Thus the EMS is at present in the same state as the effort to bring about European unity: the glass is still half empty, but the glass is also half full. Conclusions about the achievements of the European movement depend very much on whether today's situation is compared with the historical reality of the past or the European dream for the future. More has already been achieved by the members of the Community in the way of both integration and cooperation among a coalition of states than has ever been achieved before. It would be unwise to ignore this reality.

So important are the decisions still to be taken that a new political initiative will be necessary to implement the final phase of the EMS and to set up a strong European Monetary Fund. The EMS initiative was of Franco-German origin, as have been almost all important and successful European initiatives since 1950. Hence Schmidt and Giscard must finish the job they have begun. But both face elections. And so strong is the allergy to supranationality in some circles that even the modest EMS created a political storm in France that delayed its entry into force. As a result, completion of the building now started will have to await the French Presidential elections of 1981, and much can happen in between. We are up against an outmoded but still powerful opposition to real European unity.

If completed, however, the EMS would matter. It would restore order

and responsibility to exchange markets and perhaps yield new pragmatic ways of dealing with them. It would create a European means of settlement, the *écu*, which might in time become a European currency. It should lead to the establishment of a Managing Board of considerable standing and independence, which would have the task of promoting economic convergence and would consequently have to formulate domestic European economic-policy goals. The Board would also have to define and enhance Europe's international role, both in the international monetary system and in its special relationship with the Third World.

I said earlier that the EMS is part of the policy of small steps toward European unity, and I do not want to retract this analytical conclusion. But there is a logic of the mind and a logic of the facts of the real world and its dynamism. Europe must be built in a pragmatic way. With wisdom and luck the EMS may prove to be a significant advance toward European unity.

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ANNEX I

Resolution of the European Council of 5 December 1978 on the establishment of the European Monetary System (EMS) and related matters

A. The European Monetary System

1. INTRODUCTION

1.1 In Bremen we discussed a 'scheme for the creation of closer monetary co-operation leading to a zone of monetary stability in Europe.' We regarded such a zone 'as a highly desirable objective' and envisaged 'a durable and effective scheme.'

1.2 Today, after careful examination of the preparatory work done by the Council and other Community bodies, we are agreed as follows:

A European Monetary System (EMS) will be set up on 1 January 1979.

1.3 We are firmly resolved to ensure the lasting success of the EMS by policies conducive to greater stability at home and abroad for both deficit and surplus countries.

1.4 The following chapters deal primarily with the initial phase of the EMS. We remain firmly resolved to consolidate, not later than two years after the start of the scheme, into a final system the provisions and procedures thus created. This system will entail the creation of the European Monetary Fund as announced in the conclusions of the European Council meeting at Bremen on 6 and 7 July 1978, as well as the full utilization of the ECU as a reserve asset and a means of settlement. It will be based on adequate legislation at the Community as well as the national level.

2. THE ECU AND ITS FUNCTIONS

2.1 A European Currency Unit (ECU) will be at the centre of the EMS. The value and the composition of the ECU will be identical with the value of the EUA at the outset of the system.

2.2 The ECU will be used:

- (a) as the denominator (numeraire) for the exchange rate mechanism;
- (b) as the basis for a divergence indicator;
- (c) as the denominator for operations in both the intervention and the credit mechanisms;
- (d) as a means of settlement between monetary authorities of the European Community.

2.3 The weights of currencies in the ECU will be re-examined and if necessary revised within six months of the entry into force of the system and thereafter every five years or, on request, if the weight of any currency has changed by 25%.

Revisions have to be mutually accepted; they will, by themselves, not modify the external value of the ECU. They will be made in line with underlying economic criteria.

3. THE EXCHANGE RATE AND INTERVENTION MECHANISMS

3.1 Each currency will have an ECU-related central rate. These central rates will be used to establish a grid of bilateral exchange rates.

Around these exchange rates fluctuation margins of $\pm 2.25\%$ will be established. EEC countries with presently floating currencies may opt for wider margins up to $\pm 6\%$ at the outset of the EMS; these margins should be gradually reduced as soon as economic conditions permit.

A Member State which does not participate in the exchange rate mechanism at the outset may participate at a later date.

3.2 Adjustments of central rates will be subject to mutual agreement by a common procedure which will comprise all countries participating in the exchange rate mechanism and the Commission. There will be reciprocal consultation in the Community framework about important decisions concerning exchange rate policy between countries participating and any country not participating in the system.

3.3 In principle, interventions will be made in participating currencies.

3.4 Intervention in participating currencies is compulsory when the intervention points defined by the fluctuation margins are reached.

3.5 An ECU basket formula will be used as an indicator to detect divergences between Community currencies. A 'threshold of divergence' will be fixed at 75% of the maximum spread of divergence for each currency. It will be calculated in such a way as to eliminate the influence of weight on the probability of reaching the threshold.

3.6 When a currency crosses its 'threshold of divergence,' this results in a presumption that the authorities concerned will correct this situation by adequate measures, namely:

- (a) diversified intervention;
- (b) measures of domestic monetary policy;
- (c) changes in central rates;
- (d) other measures of economic policy.

In case such measures, on account of special circumstances, are not taken, the reasons for this shall be given to the other authorities, especially in the 'concertation between central banks.'

Consultations will, if necessary, then take place in the appropriate Community bodies, including the Council of Ministers.

After six months these provisions shall be reviewed in the light of experience. At that date the questions regarding imbalances accumulated by divergent creditor or debtor countries will be studied as well.

3.7 A Very Short-Term Facility of an unlimited amount will be established. Settlements will be made 45 days after the end of the month of intervention

with the possibility of prolongation for another three months for amounts limited to the size of debtor quotas in the Short-Term Monetary Support.

3.8 To serve as a means of settlement, an initial supply of ECUs will be provided by the EMCF against the deposit of 20% of gold and 20% of dollar reserves currently held by central banks.

This operation will take the form of specified, revolving swap arrangements. By periodical review and by an appropriate procedure it will be ensured that each central bank will maintain a deposit of at least 20% of these reserves with the EMCF. A Member State not participating in the exchange rate mechanism may participate in this initial operation on the basis described above.

4. THE CREDIT MECHANISMS

4.1 The existing credit mechanisms with their present rules of application will be maintained for the initial phase of the EMS. They will be consolidated into a single fund in the final phase of the EMS.

4.2 The credit mechanisms will be extended to an amount of ECU 25 billion of effectively available credit. The distribution of this amount will be as follows:

Short-Term Monetary Support = ECU 14 billion;

Medium-Term Financial Assistance = ECU 11 billion.

4.3 The duration of the Short-Term Monetary Support will be extended for another three months on the same conditions as the first extension.

4.4 The increase of the Medium-Term Financial Assistance will be completed by 30 June 1979. In the meantime, countries which still need national legislation are expected to make their extended medium-term quotas available by an interim financing agreement of the central banks concerned.

5. THIRD COUNTRIES AND INTERNATIONAL ORGANIZATIONS

5.1 The durability of the EMS and its international implications require co-ordination of exchange rate policies *vis-à-vis* third countries and, as far as possible, a concertation with the monetary authorities of those countries.

5.2 European countries with particularly close economic and financial ties with the European Communities may participate in the exchange rate and intervention mechanisms.

Participation will be based upon agreements between central banks; these agreements will be communicated to the Council and the Commission of the European Communities.

5.3 The EMS is and will remain fully compatible with the relevant articles of the IMF Agreement.

6. FURTHER PROCEDURE

6.1 To implement the decisions taken under A., the European Council requests the Council to consider and to take a decision on 18 December 1978 on the following proposals of the Commission;

- (a) Council Regulation modifying the unit of account used by the EMCF, which introduces the ECU in the operations of the EMCF and defines its composition;
- (b) Council Regulation permitting the EMCF to receive monetary reserves and to issue ECUs to the monetary authorities of the Member States which may use them as a means of settlement;
- (c) Council Regulation on the impact of the European Monetary System on the common agricultural policy. The European Council considers that the introduction of the EMS should not of itself result in any change in the situation obtaining prior to 1 January 1979 regarding the expression in national currencies of agricultural prices, monetary compensatory amounts and all other amounts fixed for the purposes of the common agricultural policy.

The European Council stresses the importance of henceforth avoiding the creation of permanent MCAs and progressively reducing present MCAs in order to reestablish the unity of prices of the common agricultural policy, giving also due consideration to price policy.

6.2 It requests the Commission to submit in good time a proposal to amend the Council Decision of 22 March 1971 on setting up machinery for medium-term financial assistance to enable the Council (Economics and Finance Ministers) to take a decision on such a proposal at their session of 18 December 1978.

6.3 It requests the central banks of Member States to modify their Agreement of 10 April 1972 on the narrowing of margins of fluctuation between the currencies of Member States in accordance with the rules set forth above (see Section 3).

6.4 It requests the central banks of Member States to modify as follows the rules on Short-Term Monetary Support by 1 January 1979 at the latest:

- (a) The total of debtor quotas available for drawings by the central banks of Member States shall be increased to an aggregate amount of ECU 7.9 billion.
- (b) The total of creditor quotas made available by the central banks of Member States for financing the debtor quotas shall be increased to an aggregate amount of ECU 15.8 billion.
- (c) The total of the additional creditor amounts as well as the total of the additional debtor amounts may not exceed ECU 8.8 billion.
- (d) The duration of credit under the extended Short-Term Monetary Support may be prolonged *twice* for a period of three months.

B. Measures designed to strengthen the economies of the less prosperous Member States of the European Monetary System

1. We stress that, within the context of a broadly based strategy aimed at improving the prospects of economic development and based on symmetrical rights and obligations of all participants, the most important concern should be to

enhance the convergence of economic policies towards greater stability. We request the Council (Economics and Finance Ministers) to strengthen its procedures for cooperation in order to improve that convergence.

2. We are aware that the convergence of economic policies and of economic performance will not be easy to achieve. Therefore, steps must be taken to strengthen the economic potential of the less prosperous countries of the Community. This is primarily the responsibility of the Member States concerned. Community measures can and should serve a supporting role.

3. The European Council agrees that in the context of the European Monetary System, the following measures in favour of less prosperous Member States effectively and fully participating in the exchange rate and intervention mechanisms will be taken.

3.1 The European Council requests the Community Institutions by the utilization of the new financial instrument and the European Investment Bank to make available for a period of five years loans of up to EUA 1 billion per year to these countries on special conditions.

3.2 The European Council requests the Commission to submit a proposal to provide interest rate subsidies of 3% for these loans, with the following element: the total cost of this measure, divided into annual tranches of EUA 200 million each over a period of five years, shall not exceed EUA 1 billion.

3.3 Any less prosperous member country which subsequently effectively and fully participates in the mechanisms would have the right of access to this facility within the financial limits mentioned above. Member States not participating effectively and fully in the mechanisms will not contribute to the financing of the scheme.

3.4 The funds thus provided are to be concentrated on the financing of selected infrastructure projects and programmes, on the understanding that any direct or indirect distortion of the competitive position of specific industries within Member States will have to be avoided.

3.5 The European Council requests the Council (Economics and Finance Ministers) to take a decision on the above mentioned proposals in time so that the relevant measures can become effective on 1 April 1979 at the latest. There should be a review at the end of the initial phase of the EMS.

4. The European Council requests the Commission to study the relationship between greater convergence in economic performance of the Member States and the utilization of Community instruments, in particular the funds which aim at reducing structural imbalances. The results of these studies will be discussed at the next European Council meeting.

ANNEX II

Extract from the conclusions of the Presidency of the European Council of 4 and 5 December 1978 in Brussels

European Monetary System

The European Council agreed, on the basis of the preparatory work of the Council (Economics and Finance Ministers) and of the Monetary Committee and the Committee of the Governors of the Central Banks to set up a European Monetary System as from 1 January 1979.

The purpose of the European Monetary System is to establish a greater measure of monetary stability in the Community. It should be seen as a fundamental component of a more comprehensive strategy aimed at lasting growth with stability, a progressive return to full employment, the harmonization of living standards and the lessening of regional disparities in the Community. The European Monetary System will facilitate the convergence of economic development and give fresh impetus to the process of European Union. The Council expects the European Monetary System to have a stabilizing effect on international economic and monetary relations. It will therefore certainly be in the interests of the industrialized and the developing countries alike. (...)

ANNEX III

Extract from the conclusions of the Presidency of the European Council of 6 and 7 July 1978 in Bremen and Annex

2. Monetary Policy

Following the discussion at Copenhagen on 7 April the European Council has discussed the attached scheme for the creation of a closer monetary cooperation (European Monetary System) leading to a zone of monetary stability in Europe, which has been introduced by members of the European Council. The European Council regards such a zone as a highly desirable objective. The European Council envisages a durable and effective scheme. It agreed to instruct the Finance Ministers at their meeting on 24 July to formulate the necessary guidelines for the competent Community bodies to elaborate by 31 October the provisions necessary for the functioning of such a scheme—if necessary by amendment. There will be concurrent studies of the action needed to be taken to strengthen the economies of the less prosperous member countries in the context of such a scheme; such measures will be essential if the zone of monetary stability is to succeed. Decisions can then be taken and commitments made at the European Council meeting on 4 and 5 December.

The Heads of Government of Belgium, Denmark, the Federal Republic of Germany, Luxembourg and the Netherlands state that the 'snake' has not been and is not under discussion. They confirm that it will remain fully intact.

ANNEX

1. In terms of exchange rate management the European Monetary System (EMS) will be at least as strict as the 'snake.' In the initial stages of its operation and for a limited period of time member countries currently not participating in the snake may opt for somewhat wider margins around central rates. In principle, interventions will be in the currencies of participating countries. Changes in central rates will be subject to mutual consent. Non-member countries with particularly strong economic and financial ties with the Community may become associate members of the system. The European Currency Unit (ECU) will be at the centre of the system; in particular, it will be used as a means of settlement between EEC monetary authorities.

2. An initial supply of ECUs (for use among Community central banks) will be created against deposit of U.S. dollars and gold on the one hand (e.g., 20% of the stock currently held by member central banks) and member currencies on the other hand in an amount of a comparable order of magnitude.

The use of ECUs created against member currencies will be subject to conditions varying with the amount and the maturity; due account will be given to the need for substantial short-term facilities (up to 1 year).

3. Participating countries will coordinate their exchange rate policies *vis-à-vis* third countries. To this end they will intensify the consultations in the appropriate bodies and between central banks participating in the scheme. Ways to coordinate dollar interventions should be sought which avoid simultaneous reverse interventions. Central banks buying dollars will deposit a fraction (say 20%) and receive ECUs in return; likewise, central banks selling dollars will receive a fraction (say 20%) against ECUs.

4. Not later than two years after the start of the scheme, the existing arrangements and institutions will be consolidated in a European Monetary Fund.

5. A system of closer monetary cooperation will only be successful if participating countries pursue policies conducive to greater stability at home and abroad; this applies to the deficit and surplus countries alike.

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