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# THE EUROPEAN MONETARY SYSTEM
# A BALANCE SHEET

by

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## THE EUROPEAN MONETARY SYSTEM - A BALANCE SHEET

The European Monetary System (EMS) celebrated its eighth birthday in March 1987; a rather unexpected event in view of the skepticism, if not sheer cynicism, with which the majority of bankers and professional economists had greeted its birth.

During its eight years of life, the EMS has experienced dramatic changes in the oil market which in turn have had a major impact on the current account balances of EC countries, their inflation rates as well as economic growth and investment. The large increase in oil prices of 1979 was followed by a steady decline which in 1985 and part of 1986 took the form of a landslide. During the same period, the exchange rate of the US dollar, sustained by the economic policy-mix adopted by the Reagan Administration, experienced a meteoric rise with respect to all other major currencies, only to be followed since early 1985 by a continued fall which always runs the risk of ending with a crash-landing. The first years of the EMS also coincided with the longest and deepest economic recession which the EC countries had experienced in the postwar period. Although the general emphasis was on deflationary policies, which were after all largely responsible for the prolonged recession in Western Europe, there were also important exceptions during this period in terms of the policy priorities adopted by different EMS governments. One such exception was the socialist government in France during its first year in office.

Thus, the first eight years have been far from uneventful. In this paper, we shall start by examining the historical background before the setting up of the EMS, which can be considered as the latest step in the process of monetary integration in Europe. We shall then discuss the economic and political motives behind the setting up of the system in March 1979 and its method of operation. Having dealt with the questions of why and how, we shall then proceed to an evaluation of the operation of the EMS during its first eight years of life. In the concluding section, some general points will be raised regarding the creation of a regional currency bloc in the EC and the prospects for the future.

## HISTORICAL BACKGROUND

There is little in the Treaty of Rome about money and even less so of a binding nature. Equilibrium of the overall balance of payments, confidence in the currency, high level of employment, and stability of prices are mentioned as the main objectives in the pursuit of national economic policies. Member states also agree that the exchange rate should be viewed as a problem of common interest, envisage the possibility of mutual aid in case of balance of payments difficulties, and call for the elimination of exchange controls in conjunction with the gradual liberalisation of the movement of goods, services, persons and capital. Provisions are also made for the coordination of national monetary policies which should take place in the context of the Monetary Committee (1).

There was certainly no provision made in the Treaty of Rome for a common policy or for the eventual creation of a regional currency bloc (2). The existence of the Bretton Woods system, dominated by non-EC actors, and intra-Community policy differences permitted only a low common denominator in the monetary field. The emphasis in the Treaty was on the creation of a customs union, and to a lesser extent a common market. Macroeconomic policy only came as an afterthought.

The first decade after the establishment of the European Economic Community (EEC) in 1958 saw a growing interest in montetary integration. The constraints imposed on national economic autonomy through increased trade interdependence, and the increasing instability in the international monetary system, clearly linked with the gradual weakening of the dollar, acted as the main incentives. In a rather contradictory manner, external relations also provided a major stumbling bloc for proposals leading to European monetary integration, as the Six countries proved unable to define a common policy vis-à-vis the United States and the dollar.

The turning point came with the Hague Summit of December 1969 when an agreement in principle was reached on the creation of an Economic and Monetary Union (EMU). General agreements at the highest political level are not always translated into concrete action; and this was the case with EMU. It soon became clear that EMU was based on a temporary convergence of widely different interests. the latter could not provide a sufficiently solid basis for what should be a radical transformation of the economic and political environment in Western Europe. The permanent fixity of exchange rages, together with full convertibility of currencies which were to be achieved by 1980, would not only have serious implications for the monetary and fiscal policy in each member country. It would also have far-reaching institutional and political implications which went to the heart of national sovereignty. It soon became clear that member countries were not prepared to accept the practical consequences of a general agreement subscribed to by their heads of state or government.

There were also some differences as regards the strategy to be adopted during the intermediate period. Those differences in turn reflected mainly the different interests between potential creditor and debtor countries as well as the different ways in which EC currencies were affected by dollar instability. The collapse of the Bretton Woods system and the growing divergences among EC economies, which followed the first oil shock and the economic recession of the 1970s, sounded the death knell to the EMU project.

What was left of the EMU until March 1979 was the "snake" which represented the attempt by a group of European countries to preserve some degree of stability in their bilateral exchange rates. This "zone of monetary stability" in a world of wildly fluctuating currencies was centred on the Deutschmark. In addition to the Federal Republic of Germany, only the Benelux countries remained in the "snake" during the whole period (1972-79). It could hardly be described as a Community arrangement since four out of the nine member countries of the EC had left the "snake" by January 1974, while two outsiders, namely Sweden and Norway, were part of it for some years (3).

## ECONOMIC AND POLITICAL MOTIVES

The "snake" provided the basis for the creation of the EMS, although the latter is substantially different from its predecessor both in terms of membership and of its method of operation. The EMS has been the product of a Franco-German initiative taken at the highest political level by Chancellor Schmidt and President Giscard d'Estaing. It can also be seen as the crowning act of a close cooperation between France and Germany, which clearly marked EC developments in the latter half of the 1970s (4).

The creation of the EMS was seen, first and foremost, as a means of reducing exchange rate instability among EC currencies. There are two important assumptions hidden behind this proposition. The first one is that exchange rate instability, which has been a major feature of the system of fluctuating rates, has deleterious effects on the real economy, and more precisely on trade, growth and investment. Although there is no agreement as yet among professional economists, at least as regards the effects of short-term variability, most political leaders and businesmess in Western Europe attach considerable importance to stable exchange rates. This is usually closely related to the size of the national economy and its openness to international trade. In the case of the EC, stable exchange rates are also seen as a complement to the proper functioning of the common market and the common agricultural policy which is based on a system of common prices.

The second assumption was related to the lack of any serious prospects for monetary reform at the world level. The experience of the last eight years seems to have validated this assumption.

The "zone of monetary stability", which the EMS was intended to create for all EC currencies, was meant to have both an external and an internal dimension. Exchange rate stability should be backed by a growing convergence between EC national economies, with the emphasis being placed clearly on inflation rates. The whole EMS was based on a convergence of policy priorities among EC governments and was also seen as an important instrument in the fight against inflation. Its creation meant an increasing acceptance of the German economic model by the other EC countries.

The EMS was also seen as a European defensive mechanism against American "benign neglect" as regards the dollar, and more generally what was perceived to be a political vacuum in Washington at the time of the Carter Administration. The EMS was not only intended to provide Western Europe with a certain degree of insulation against the vagaries of the dollar and the instability of the post-Bretton Woods international monetary system. It was also a means of strengthening Europe economically and politically, and this was especially important at a time when US leadership was seen as waning. The French in particular had long considered money as a major political instrument in international affairs.

The successful launching of the EMS, after a rather short period of intensive negotiations which took place during 1978, contrasts sharply with the ill-fated attempt to set up an EMU some years earlier. It is true that the EMS was a much less ambitious, and certainly more realistic project than EMU. However, economic and political conditions had also changed substantially during the intervening years. Stripped off from any European rhetoric, the EMS was based on a package deal which could be described in the following terms:

(1) The starting point was the "snake" which at the time consisted of the DM, the Benelux currencies and the Danish krone (the Norwegian krone was forced to leave in December 1978 in anticipation of the transformation of the "snake" into the EMS). The Germans, and Schmidt in particular, were keen on deepening and extending regional monetary cooperation. They feared the effects of prolonged international monetary instability, and also an excessive revaluation of the DM, resulting from the continuous sinking of the dollar in exchange markets. The effect on the DM could be partly avoided by spreading through the EMS the upward pressure on more EC currencies. Money was also seen as a means of strengthening the process of political integration in Western Europe. The Germans seemed prepared to make some concessions in order to achieve those goals. The other members of the old "snake", countries with small and highly open economies, would be only too happy to see an extension of the area in which stable exchange relations applied.

(2) The main question was how to attract the other three big countries into the new exchange rate arrangement. For the French, participation in the EMS was seen as an integral part of the anti-inflation strategy adopted by the Barre government. The same was, to a lesser extent, true of Italy which was also trying to escape from the vicious circle of inflation-devaluation-inflation. However, given the perceived difficulty in bringing the Italian inflation rapidly down to German levels, the Italians entered the exchange rate arrangement with an undervalued currency and a wider margin of fluctuation. The political factors mentioned above, both as regards European unification and relations with the USA, applied to both France and Italy.

(3) Britain was a totally different case. The political factors worked in exactly the opposite direction. Enthusiasm for European union was hard to find in Britain, while the Labour government of the time showed remarkable sensitivity about the EMS being seen as an anti-American weapon. The Labour government also wanted to avoid the excessive deflationary pressures which were seen as arising from Britain's membership of the EMS. Interestingly enough, the Conservative government of Mrs. Thatcher, who succeeded Mr. Callaghan, decided to stay out for totally opposite reasons. Membership of the EMS would have constrained the government in its pursuit of a monetarist policy which actually led to a long overvaluation of the sterling. Although the Thatcher government later rediscovered the exchange rate target, the full participation of sterling in the exchange rate arrangement of the EMS has been continuously postponed.

(4) The only other country outside the "snake" was Ireland. It decided to join the EMS partly because of the side-payments offered in terms of subsidised interest loans and partly as an expression of political independence vis-à-vis Britain which remained by far the largest trading partner of the Republic.

## THE OPERATION OF THE SYSTEM

The EMS is a system of fixed but adjustable exchange rates. One of the novelties of the system is the European Currency Unit (ECU) which is at the centre of the EMS and consists of a basket of fixed amounts of each EC currency. Those amounts can be revised every five years. Even the sterling and the Greek drachma, which do not participate as yet in the exchange rate management, now belong to the ECU basket. In turn, each EC currency has a central rate defined in ECUs. Central rates in ECUs are used to establish a grid of bilateral exchange rates. The margins of fluctuation around those bilateral rates are set at 2.25 per cent, with the exception of the Italian lira which operates within wider margins of 6 per cent. Central bank interventions are copulsory and unlimited, when currencies reach the limit of their margins of fluctuation. Central rates can be changed by common consent, following a procedure in which all the countries participating in the exchange rate mechanism are involved, along with the EC Commission.

Another novelty of the EMS is the so-called divergence indicator. It was introduced in order to provide a certain degree of symmetry in the adjustment burden between appreciating and depreciating currencies and an automatic mechanism for triggering consultations before the intervention limits are reached. There is a so-called "presumption to act" when the divergence threshhold is reached. The divergence indicator is the ratio of a member currency's ECU price, which is based on actual exchange rates and is therefore variable subject to the limits imposed by the margins of fluctuation in bilateral exchange rates, to the fixed ECU price based on central rates. This device makes it possible to locate the position and the movement of an EMS currency relative to the EC average represented by the ECU. The threshold of divergence has been fixed at 75 per cent of the maximum spread of divergence for each currency. (5)

The functions of the ECU are not limited to those directly related to the operation of the exchange rate mechanism, namely as a numeraire for the determination of central rates and as a reference unit for the construction and operation of the divergence indicator. The ECU was also intended to play a central role in the intervention and credit mechanisms of the EMS. Against the deposit of 20 per cent of gold and dollar reserves held by member central banks, which took the form of three-month revolving swaps, the European Monetary Cooperation Fund (better known from its French acronym FECOM) issued ECUs in return. Those ECUs were therefore intended to serve as an official reserve asset, although subject to various restrictions, as a denominator for market interventions arising from the operation of the exchange rate arrangement and also as a means of settlement between the monetary authorities of the EC. This meant a sharing of the exchange risk between creditor and debtor countries. Exactly the same applied to the credit mechanisms of the EMS.

Very short-term credit facilities, in amounts that are in principle unlimited, are granted to each other by participating central banks, through the FECOM, in order to permit intervention in EC currencies. The duration of this type of financing is 45 days from the end of the intervention month. There are also other credit facilities which have existed prior to the setting up of the EMS. The short-term monetary support is intended to deal with financing needs arising from temporary balance of payments deficits. There are creditor and debtor quotas which are periodically revised. The duration of such loans is three months, twice renewable. The medium-term financial assistance provides credits for a period of 2-5 years on a conditional basis. There is also the

Community loan mechanism through which the EC can borrow and on-lend to member countries amounts of up to 8,000 million ECUs.

In principle as a means of fostering economic convergence among EC countries and in practice as a carrot to lure the economically weaker countries into participating in the EMS, provision was made for the granting of 3 per cent interest rate subsidies on loans given to member states by EC institutions and the European Investment Bank (6).

## AN EVALUATION

The most important achievement of the EMS has so far been a significant reduction in exchange rate variability among participating currencies. This is true both when the experience of EMS currencies is compared with that of other currencies, such as the US dollar, the yen and sterling, during the same period and also when it is compared with the experience of the participating currencies prior to the setting up of the system. Furthermore, the reduction in exchange rate variability during the period of the EMS applies to both nominal and real rates (7).

Having gradually gained credibility in the exchange markets, the EMS has helped to curb overshooting and thus to avoid big, short-term fluctuations of currencies which have characterised the period of floating. Even more important, the EMS currencies appear to have avoided long periods of misalignment which has been another important feature of the system of floating in recent years (eg. US dollar and sterling) and which has been the result of the dominant role of capital movements in the determination of exchange rates.

The fact that the reduction in exchange rate variability applies to nominal and real rates also suggests that there has been at the same time a convergence in cost and price developments. The EMS had been originally conceived as a means of bringing about a greater economic convergence among participating countries and more precisely as an additional weapon in the fight against inflation, with West Germany providing the standard of reference and the anchor for the system. And this is, to a large extent, what happened. After an early period characterised by a widening of inflation differentials, which followed the second large increase in oil prices in 1979, inflation rates in EMS countries have been dropping steadily while the gap between the fastest and the slowest inflating countries has also been slowly reduced (8).

Admittedly, inflation rates have been declining virtually everywhere else in the industrialised world, and it is possible to isolate the EMS effect on participating countries. However, it seems plausible to argue that the determination of countries such as France and Italy to pursue an anti-inflation policy has been very much strengthened by their participation in the system.

Exchange rate stability would not be interpreted as rigidity. During its first eight years of life, the EMS experienced eleven realignments. Six of the total of eleven realignments until now can be considered as major ones, involving most EMS currencies. There are two significant features of those realignments. The first one is that changes in exchange rates, and the size of those changes, have genuinely become a matter of collective decision, which was not true of some of the early ones. This is almost a revolutionary development touching at the very heart of monetary sovereignty. The other is that some recent realignments have been accompanied by important changes in the domestic economic policy of the countries concerned. The most prominent example is the sixth realignment in June 1982, when the devaluation of the franc marked a reversal of the previous policy pursued by the French Socialist government and the adoption of a package of stabilisation measures (9).

Timely realignments, coupled with a growing convergence in terms of inflation rates, have been the two main pillars on which the success of the EMS has rested until now. Member countries have also resorted to other instruments, such as interest rate differentials and foreign exchange interventions, in order to convince markets that they meant business. This has worked remarkably well. Although the variability of both long- and short-term real interest rates has declined sharply, interest rates have been used in times of tension, together with market interventions, as a means of resisting speculation. On the other hand, it can be argued that the non-participation of sterling has implied, among other things, a higher risk premium incorporated in UK interest rates.

The experience with the intervention and financing mechanisms of the EMS has been relatively satisfactory, although significantly different from the way in which it had been originally conceived. About two thirds of total interventions have been made in US dollars, even though a substantial share of these were undertaken to stabilise currencies within the EMS band. A second main feature has been that only a relatively small percentage of total interventions has been carried out at the compulsory intervention limits. Interventions have been increasingly intra-marginal as a means of preventing the buildup of speculative pressures. Third, a substantial and growing share of intra-marginal interventions has been carried out in EC currencies, and this has also led to an increase in the share of official reserves held in EC currencies (10).

The use of the EMS financing mechanism has been limited. Recourse to the very short-term credit facility, arising from interventions at the compulsory limits, has been declining steadily because of the increasing recourse to intra-marginal interventions. The short-term monetary support and the medium-term financing facility have never been used. In times of difficulty, EC countries have preferred to borrow from Eurocurrency markets. Recourse has been made only once to another medium-term financing facility. This involved EC borrowing in capital markets on behalf of an EMS country, namely France. The same facility was also used in 1985 for the benefit of Greece. Last but not least, the use of the ECU as an official asset for the settlement of debts arising from EMS operations has been very modest indeed.

One lesson which can be drawn from the above experience is that the EC countries have made only very slow progress in terms of reducing their dependence on the dollar. This was one of the main unspoken objectives associated with the setting up of the EMS. They still rely heavily on the dollar even for intra-EMS interventions, and they have done little in promoting the development of the ECU as an alternative currency.

It is extremely interesting that this very job was taken over by the markets. While the official ECU remained underdeveloped and underutilised, the combined amount of outstanding bonds and bank assets denominated in ECUs grew rapidly from zero in 1980 to the equivalent of 40,000 million dollars in 1985. The private ECU market has flourished despite the ban imposed on ECU-denominated assets in the biggest EC economy, namely the German one. The ECU has also been increasingly used in the foreign trade of individual EC countries, and especially the fastest inflating ones such as Italy and France (11).

In its early stages, the EMS has come under strong criticism by various members of the economics profession and the banking community (12). A system of stable and periodically adjustable exchange rates was seen as making little sense in an economic environment characterised by independent national monetary policies and a wide divergence of inflation rates. The system was, therefore, expected either to break down as a result of those internal contradictions, or alternatively to be sustained at a heavy price. This price would involve costly interventions, high instability in money supply and/or interest rates, trade distortions arising from the variability of real exchange rates as well as trade and capital restrictions. The market was considered as a better judge of the "correct" exchange rate of a currency than goverments and central banks.

As inflation rates have been converging downwards (even if this convergence can be considered by some as rather slow), together with nominal and real interest rates, the grounds for criticism have weakened. People can still point to the changes in real effective exchange rates, which have resulted from the progressive overvaluation of the fastest inflating currencies such as the Italian lira, the French franc and the Irish punt. However, this overvaluation has been to a large extent deliberate, being used as a means of breaking the vicious circle. Furthermore, the EMS experience in this respect has been undoubtedly much better than that of any of the other major currencies such as the dollar and sterling which have suffered from long periods of misalignment of their exchange rates.

Critics oten also point to the existence of capital controls which have been used, in both France and Italy, as an important policy instrument in times of speculative pressure. This is not the place to try and answer the hotly debatable question regarding the desirability of liberalising international capital movements. It should, however, be pointed out that the operation of the EMS has coincided with moves towards further liberalisation, and that the EC Commission has come up with proposals for the complete elimination of all capital controls by 1992, which in turn raises the question of the need for a closer coordination of monetary policies in the future (13).

The divergence indicator, one of the original elements of the EMS, had been criticised as technically flawed, inoperational and possibly also inflationary, since it might force countries with appreciating currencies to adopt more lax monetary policies. Although it is virtually impossible to isolate the effect, if any, of the divergence indicator on economic policies, the experience until now seems to suggest that its influence has been very limited. Possibly one explanation is the heavy reliance on intra-marginal interventions, which meant that the threshold was not often reached in order to allow the mechanism to come into operation. Moreover, the "presumption to act" may be a very difficult concept to translate into concrete policy measures in an intergovernmental context.

Apart from the pure floaters, who will be against any form of intervention, because markets are supposed always to know better than governments, there are also some EMS critis who would still argue that the whole operation has hardly been worth the effort (14). What has been the effect, they would ask, of more stable exchange rates on real economic variables such as international trade, growth and investment? In terms of the latter, the experience of the EMS countries during the first half of the 1980s does not compare well with that of non-EMS countries such as the USA, Japan or even the UK. But what about other factors which may have influenced those real economic variables? Were deflationary policies the result of an inherent bias of the system or a deliberate choice made by national authorities? And what about the long-term effects of misalignment in terms of the allocation of resources? It is obviously impossible to isolate the EMS effect on the real economy, at least in a rigorous fashion. But this does not mean that stable exchange rates are irrelevant.

On the negative side of the balance sheet, we can refer to the failure of the EMS to expand in terms of membership or to enter the institutional phase which was supposed to happen two years after its launch in March 1979. Pound sterling still remains outside the system, although the question now appears to be more one of time than of principle. With the two successive enlargements of the Community in 1981 and 1986, the Greek drachma, the Spanish peseta and the Portuguese escudo have joined sterling in the group of EC currencies outside the EMS. As long as inflation rates in the three Southern European countries remain considerably above the EC average, participation in the exchange rate arrangement would make little sense. In this respect, the prospects for the peseta are much better than those for the other two currencies.

In institutional terms, the management of the EMS has remained in the hands of national central banks and monetary authorities. The Council of Economic and Finance Ministers (ECOFIN), meeting at least once a month, is the highest political body in which all economic and financial matters are discussed and in which decisions on periodic EMS realignments are taken. Needless to say that economic and financial issues also regularly appear on the agenda of meetings of the European Council (the regular EC summits). Important initiatives have been taken at such summits, including the one which led to the launching of the EMS. However, under normal circumstances, ECOFIN can be considered as the most important decision-making body pertaining to economic policy coordination and the general operation of the EMS.

Day-to-day management is left to the central banks of individual member countries, which keep a close and regular contact with each other. There are also two important EC committees which have played a significant role in laying the foundations for European monetary cooperation and later managing the "snake" and the EMS. The Monetary Committee consists of senior officials from the finance ministries and central banks and meets monthly in Brussels, while the Committee of Governors of Central Banks meets monthly in Basle.

Once a political agreement exists on general policy guidelines, financial affairs can easily become the reserved domain of a small number of experts. Senior officials in finance ministries and central banks do not change very frequently. Thus, the members of those EC committees have the opportunity to know each other well and build a solid basis for close cooperation. In practice, there has emerged a small monetary elite at the European level consisting of people who have for years played a very influential role in intra-EC as well as international monetary negotiations.

FECOM is still nothing more than a brass plate on a door in Luxembourg. The Bank for International Settlements (BIS) acts as its agent regarding all operations arising from the credit and monetary mechanisms. In fact, this amounts to nothing more than an accounting task. According to the agreement reached at the European Council in Brussels in December 1978, the EMS was due to enter its institutional phase at the latest in March 1981. The consolidation of the EMS into a permanent structure would have involved the transformation of FECOM into a European Monetary Fund as well as "the full utilization of the ECU as a reserve asset and a means of settlement". But this consolidation has not happened as yet, and FECOM's role can therefore only be measured in terms of potential.

The role of the EC Commission has been essentially supportive. Although it was a President of the Commission, Mr. Roy Jenkins, who acted as a pioneer in the relaunching of European monetary integration back in 1977, the negotiations leading to the setting up of the EMS were purely of an intergovernmental nature. The Commission is represented in all Council meetings, and participates in the work of specialised committees. It also provides some of the administrative and analytical backup. However, its input in the everyday management of the EMS is marginal, and its influence in the field of coordination of macroeconomic policies very limited indeed. The Commission's proposals for an extension of the EMS have so far been ignored. Similarly, its annual economic report, containing an extensive analysis of the macroeconomic situation in the Community as well as policy guidelines, has had little influence on the actual policies pursued by member countries. In this area, the Community "interest" or "policy" is still defined mainly through intergovernmental procedures at best or as the simple sum of national interests or policies at worst (15).

## CONCLUSIONS

Following a more limited experiment in the form of the "snake", the creation of the EMS has led to the emergence of a fully fledged regional currency bloc in Western Europe. There is certainly large scope in terms of extending and deepening cooperation among participating countries, and also strengthening the EC "monetary personality" in the international system. However, despite its many limitations, the EMS has been a considerable success in at least four main areas: i) it has reduced short-term fluctuations and medium-term misalignment in exchange rates (both important for highly interdependent economies), ii) it has created a system of collective decision-making for exchange rate changes; iii) it has provided an additional weapon in the fight against inflation; and iv) it has laid the foundations for the development of a truly European currency.

With more than eight years of life behind it, marked by major changes in the international economic and political environment, the EMS can be said to have already reached a certain degree of maturity. It certainly can no longer be considered as simply the product of peculiar historical circumstances, and therefore easily reversible once those circumstances change.

International monetary instability has been and continues to be an important factor behind the establishment of a reigonal currency bloc in Western Europe. It is true that interest in international monetary reform has grown in recent years, especially on the US side as the negative effects of the long overvaluation of the dollar have become evident and the fears of an excessive depreciation of the currency and imported inflation have grown. However, the time does not appear to be as yet ripe for the adoption of target zones for the exchange rates between the major international currencies. Countries are not ready to accept the implications, in terms of coordinatin of economic policies, which the adoption of target rates would imply (16). Even such a development would fall short of the needs for stability in intra-EC exchange relations. Therefore, the interest in preserving a European "zone of monetary stability" is likely to remain strong in the foreseeable future.

The Europeans will also continue to have an interest in reducing their dependence on the dollar and on US macroeconomic policies. But this would necessitate the development of a fully fledged European reserve asset and a much closer policy interdependence among the EC countries. The political will for such a development does not seem to exist as yet.

The role of West Germany will be absolutely crucial in determining the future development of the EMS. There is clearly a fundamental asymmetry in the system, which places the Federal Republic in a key position. This asymmetry arises from two main factors. One is the German low propensity to inflation. Combined with the economic weight of the country and the priority attached until now in the other EC partners to the fight against inflation, this has turned the DM into the anchor of the system. The other factor is the international role of the DM, which is substantially different from that of other EMS currencies. This has also meant that dollar fluctuations can have a destabilising effect inside the EMS by influencing the bilateral rates between the DM and the other currencies.

The combination of the above two factors has had a number of implications. EMS currencies have been de facto tied to the DM. While German monetary authorities have been mainly preoccupied with the DM-$ relationship, thus also dragging the whole EMS along with them, the monetary authorities of the other EMS countries have concentrated their efforts on keeping the bilateral rate between their currency and the DM within the permitted margins of fluctuation. This has meant an implicit division of labour in terms of exchange rate interventions between the different central banks. Furthermore, the Germans have been able to set the pace in terms of economic policy. As long as inflation rates were still relatively high, the other EMS countries perhaps did not mind much the deflationary bias in German policy and the progressive undervaluation of the DM against their currencies, resulting from the fact that EMS realignments have so far only partly compensated for cumulative inflation differentials.

As the battle against inflation is progressively won, many EC countries may come to adopt a less benign view of the kind of economic leadership exercised by the Germans until now. Signs of such a development were already clear at the time of the eleventh realignment of exchange rates in January 1987. Gradually, the definition of convergence will need to be extended beyond inflation rates, and thus include some of the real economic variables. This could create new tensions in the system.

Without trying to minimise the economic and political implictions of a further development of the ECU and the creation of a European Monetary Fund for all EMS countries, it could be argued that such a development would turn an essentially German-led system into one which would be more collectively run. Hence, Germany's decisive role in the future evolution of the system.

There are a number of issues which are likely to feature on the EMS agenda in the near future. One will be sterling's participation in the exchange rate arrangement. Although this would further strengthen the EMS in terms of membership and international credibility, it would also constitute a new challenge for the system. The participation of sterling would introduce another international currency. It would therefore increase the centrifugal tendencies inside the system, arising from external developments. This would have important repercussions for the management of the EMS. Another issue will be the reduction in the permitted margins of fluctuation for the Italian lira, and the possible inclusion of the Spanish peseta in the exchange rate arrangement.

The continued liberalisation of capital movements will inevitably strenghten the need for closer coordination of national monetary policies. There should also be attempts to devise new rules regarding intramarginal interventions, in view of the increasing importance of the latter in the management of the exchange rate arrangement. The role of the ECU, both as an official and a private asset, will continue to be at the centre of all discussions about the future of the EMS? A first, albeit modest, step towards the strengthening of the regional currency will be the eliimination of controls on the opening of ECU accounts iin the Federal Republic. However, new initiatives regarding the operation of the system are likely to fall short of anything requiring major institutiional reforms for which some of the important members of the EMS are not as yet politically ready (17).

NOTES

1) Articles 103-109 of the Treaty of Rome.

2) This lacuna hs now been filled with the amendments introduced through the Single European Act signed in 1986

3) For a more extensive analysis of the historical background, see also Loukas Tsoukalis, The Politics and Economics of European Monetary Integration, London, Allen & Unwin, 1977.

4) See also Peter Ludlow, The Making of the European Monetary System, London, Butterworths, 1982.

5) For the background to the adoption of the EMS rules and the differences in French and German approaches, see R. Massera & S. Rossi, "The European Monetary System and European Monetary Integration", in K. El-Din Haseeb & S. Makdisi (eds.), Arab Monetary Integration, London, Croom Helm.

6) For a detailed analysis of the operation of the EMS, see Jacques van Ypersele & Jean-Claude Koeune, The European Monetary System, Brussels, Commission of the European Communities, European Perspectives, 1984; "The European Monetary System", European Economy, July 1979; and "Documents relating to the European Monetary System", European Economy, July 1982.

7) See Horst Ungerer et al, The European Monetary Syste: recent Developments, Occasional Paper No. 48, Washington D.C. International Monetary Fund, December 1986, especially tables 16-30; J. van Ypersele & J.C. Loeune, op. cit. pp 74-87; George Zis, "The European Monetary System 1979-84: An Assessment", Journal of Common Market Studies, September 1984, pp. 61-5; and Massimo Russo, Why the Time Is Ripe, Lecture delivered to the Bow Group, House of Commons, London, 19 May 1986.

8) See H. Ungerer et al. op. cit. Tables 31-36

9) See also J. van Ypersele & J. C. Koeune, op. cit., pp. 80-6

10) See also Stefano Micossi, "The Intervention and financing mechanisms of the EMS and the role of the ECU", Banca Nazionale del Lavoro, December 1985.

11) There has been a rapidly growing literature on the ECU. Two representative examples are: Robert Triffin, The Future of the EMS and the ECU, Brussels, CEPS, 1984; and Thierry Lefevre, L'ECU: Un nouveau marché, Paris, Presses Universitaires de France, 1985; Rainer Masera, "An increasing role for the ECU: a character in search for a script", unpublished paper, Rome, April 1986, and Norbert Kloten, "The ECU: prospects for monetary integration in Europe", The World Today, 1985

12) See for example the chapters by M. Fratianni and R. Vaubel in K. Brunner and A. Meltzer (eds.), Monetary Institutions and the Policy Process, Carnegie-Rochester Conference Series on Public Finance, Vol. 13, 1980.

13) See Commission of the European Communitiies, Efficiiency, Stability and Equity, (Padoa-Schioppa report), Brussels, April 1987

14) See Paul de Grauwe, The European Monetary System During 1979-84: An Evaluation, Universiteit Leuven, International Economics Research Paper No. 47, June 1985; and P. de Grauwe, M. Fratianni and M. Nabli, Exchange Rates, Money and Output: The European Experience, London, MacMillan, 1985.

15) On the subject of coordination, see also Alfred Steinherr, "Convergence and coordination of macroeconomic policies: the basic issues", European Economy, March 1985.

16) See also Loukas Tsoukalis, "The new international monetary 'system' and prospects for reform" in L. Tsoukalis, The Political Economy of International Money: in Search of a New Order, London-Beverly Hills, Sage/RIIA, 1985.

17) As there is a serious possibility of a cooperation agreement to be signed between the European Community and the Gulf Cooperation Council, it may not be altogether idle to speculate about the nature of a financial cooperation between the two blocs, especially if there are further steps in the near future towards regional integration on both sides.