# The development of the European Monetary System

*The **Governor** examines[1] the question of European exchange rate stability in the context of the Community's internal market programme and discussions about European economic and monetary union. He argues that the internal market programme should not be incompatible with the stability of the exchange rate mechanism, but concludes also that it cannot realistically be predicated on complete currency stability. The exchange rate can be an important adjustment mechanism and, until significant inflation differentials between member countries have been eliminated and a much greater degree of economic integration and policy co-ordination achieved, periodic changes in exchange parities will remain necessary. Major political and institutional adjustments would also be needed before economic and monetary union could become a reality, and the **Governor** argues there is little evidence yet of any readiness to accept the fundamental changes involved in the immediate future. He suggests, therefore, that it would be more profitable to concentrate on immediate practical steps towards the long-term goal—promoting the real economic integration of the Community, increasing economic policy co-ordination and taking other measures such as greater use of EMS currencies in intervention within the Community.*

I propose this evening to look at the general question of European exchange rate stability against the background of the various initiatives that make up the Community's internal market programme, and in the context of the discussions now in train—principally but not exclusively in the Committee formed under President Delors—about European economic and monetary union. Speaking here in Luxembourg, I can think of few more appropriate topics; it is only a little over a month since the Delors Committee met here in the Kirchberg Centre to look again at that seminal report on monetary union prepared nearly twenty years ago under the Chairmanship of M Pierre Werner, the former Prime Minister of this country. I am not the only member of the Delors Committee to view Luxembourg as an historic home of European monetary integration: many of you will I imagine have heard President Karl-Otto Pöhl's important address to a conference here a few weeks ago. With much of what President Pöhl said on that occasion I find myself in agreement, and I do not want to repeat tonight positions that he has stated so clearly and vividly. Rather I would like to concentrate now on the practical and evolutionary aspects of achieving greater exchange rate stability. The wider debate about economic and monetary union is fired by a great deal of idealism, perhaps inevitably given the far-reaching and visionary nature of the topic. But such visions cannot easily capture the imagination of practical men; they will look rather for concrete developments that offer unequivocal and tangible benefits. Like I suspect most central bank Governors, I class myself as a pragmatist; and the emphasis in the Delors Committee mandate on *'concrete stages'* is thus very welcome to me.

Exchange rate stability, and monetary union in particular, have come to be on the political agenda partly because of two apparently contradictory propositions about the relationship between the completion of the internal market—'1992' for short—and the exchange rate mechanism of the EMS.

- one, that 1992 will *destroy* exchange rate stability by removing one of the major defences of the ERM—namely exchange controls; and
- the other, that the benefits to be realised from 1992 will be greatly reduced unless there is a much *greater* degree of exchange rate stability within the Community than exists at present.

So is exchange rate stability an impossibility in the single market, or is it essential to the success of 1992? A look at both propositions in a little more detail may suggest what is required if real progress is to be made towards exchange rate stability.

## The liberalisation of capital movements and the ERM

Earlier this year, the Community adopted a directive requiring member states to abolish all remaining exchange controls over the next few years. This is a particularly important element of the 1992 programme; a genuine internal market could not be created without this freedom for capital to be moved throughout the Community. But while the principle of complete liberalisation of capital movements has been unanimously accepted by member states, some are nervous that its implementation will undermine the stability of the Exchange Rate Mechanism. By removing exchange controls, it is said, much larger speculative movements of short-term capital will be able

(1) In a speech at the 1988 Forex Conference of the Forex Club, in Luxembourg, on 15 November.

to take place between currencies, thus disrupting exchange rates. Moreover, it has been argued that until now the protection afforded by exchange controls has allowed some participants in the ERM to exercise a greater degree of independence in setting monetary policy. But in a regime of free capital movements, ERM members may see less scope for such independence: subject to the important qualification that the system provides for the occasional realignment, monetary policy would have to be governed by the exchange rate—and the pursuit of policies which were incompatible with the exchange rate objective would lead to speculative, destabilising short-term capital movements.

I have presented the argument in somewhat extreme terms. In practice the situation is much less clear-cut. In particular, the Community will not be moving in one step from a regime of extensive exchange controls to a situation of complete freedom of capital movements. Although until very recently only two ERM participants—Germany and the Netherlands—had no exchange controls at all, others have been gradually liberalising. Indeed, with the recent moves by Italy and Denmark and those to take place in Ireland in January next year, relatively few exchange controls will soon be left among ERM participants. Admittedly the process of liberalisation has not always been entirely smooth. Before the January 1987 realignment, for example, the pressure of short-term capital movements against the French franc was considerable; while, in the summer of 1987, Italy had temporarily to re-impose certain controls when the announcement of the plan to abolish all controls in the Community led to speculation against the lira. On the other hand, Italy's latest move towards capital liberalisation has caused no difficulties so far. All of this suggests that exchange controls are not particularly effective in an increasingly integrated financial world.

The ERM has not only survived this liberalisation: it has enjoyed a period of relative stability, without any realignment for nearly two years—a period which has encompassed considerable external turbulence, including substantial speculative movements against the dollar as well as the stockmarket crash. How is it that the ERM has remained apparently so robust? One reason for its strength, perhaps, is that it is not an inflexible system; the margins within which the currencies are allowed to fluctuate around their central rates can absorb some of the pressure of short-term flows. Because of this flexibility, the authorities are able to achieve an acceptable balance between exchange market intervention and adjustment of interest rate differentials in defence of their currencies. These defences are all the more effective to the extent that they, and other aspects of policy, can be co-ordinated. A fair degree of co-ordination already exists; and the willingness of the members of the EMS to strengthen the system as necessary was well illustrated by last year's Basle-Nyborg agreement, when important improvements were made to the financing, intervention and policy co-ordination mechanisms.

This is not by any means to suggest that as the remaining exchange controls are abolished the ERM will be free from all strain. That is unlikely to be the case—there can never be a guarantee against speculative capital movements or against external shocks that may have an uneven impact on ERM participants. But the experience of liberalisation to date suggests that these strains should not be such as to break the mechanism as it now exists. The markets are beginning to accept that co-ordination within the ERM is a reality. The more that members can achieve a closer convergence of economic performance, the less likely it is that speculation will be rewarded.

## Does the single market require exchange rate stability?

These thoughts bring me to the second of the questions that I posed at the outset: is greater exchange rate stability necessary if the benefits of the internal market are to be realised? The short answer, in my judgement, is 'no'. The purpose of the internal market programme is to remove barriers and distortions to trade—in order to reduce costs, to enable economies of scale to be realised, and to ensure that trade takes place at prices that reflect underlying economic realities. In some senses the exchange rate is a price like any other. It is therefore important that it is the right price—that exchange rates are not fundamentally misaligned, for example. And in foreign exchange as in any other market, a fixed price is not necessarily the right price: for a fixed price cannot adjust to changing circumstances. (It is, incidentally, also true that the efficient allocation of resources requires that trade should take place at uniform exchange rates between currencies—something that is not always the case at the moment in the Community with, for instance, agricultural green rates. But to explore that subject would take longer than this occasion will permit!)

At the same time, I would not deny the intellectual attractions of greater exchange rate stability within Europe, and perhaps, ultimately, of a single currency—provided that prevailing conditions made such developments feasible and sensible. The benefits, of course, would lie mainly in the reduction of uncertainty. Although the exchange rate is, as I have said, a price like any other, it is a particularly important price and yet one often subject to significant volatility. The evidence that this volatility deters trade and investment is not clear cut. It is important here to distinguish between nominal and real exchange rate stability: uncertainty about the former can, in many cases, be hedged against; while uncertainty about the latter can often prove more of a deterrent, particularly in the case of longer-term decisions—including, I would suggest, some of the investments needed to reap the benefits of the internal market. Once significant inflation differentials have been eliminated, the conflict between nominal and real stability will, of course, cease to exist. At that point the arguments for nominal exchange rate stability within the single European market will be more convincing.

Because the exchange rate can sometimes be an important if imperfect adjustment mechanism for restoring equilibrium between countries, it would be foolish to move to a single currency before being satisfied that alternatives were available. Adjustment would then depend on flexibility in relative wages and prices between countries, and on the free movement of goods, labour and capital. It is these mechanisms, of course, that already have to be relied upon to bring about adjustment when regional imbalances occur *within* countries. The serious regional problems that still exist in many member states indicate that economic integration is far from complete even at the national level; *between* member states the obstacles are still greater. The internal market programme will help here, of course. But even after 1992 there will still be formidable linguistic, cultural and administrative differences—often far greater than any existing within member states. And although governments can act to remove the more obvious obstacles, there is much they cannot do. The necessary degree of economic integration can only come about by evolution.

I conclude, therefore, that the internal market programme cannot realistically be predicated upon complete currency stability; and it may not, in the short run, even *promote* currency stability. To the extent that, over time, the 1992 initiative encourages real economic convergence, and improved policy co-ordination between member states, then gradually the conditions for nominal exchange rate stability will emerge. But given the present state of convergence of economic performance between member states, one cannot escape the conclusion that periodic changes in exchange rate parities will still be necessary for the foreseeable future. And within that timescale it is not so much delay in making progress towards monetary union as a premature obsession with that process that is likely to be an impediment to the internal market.

## The implications for monetary union

I do not believe that the United Kingdom is alone in being sceptical about the feasibility of achieving monetary union in the Community in the foreseeable future. I have already spelt out in general terms the *economic* challenges that will have to be faced. It is also worth spelling out what monetary union—a single currency—would involve in *political* terms. It would require a major transfer of decision-making power in the economic field. Monetary union would be incompatible with member states operating different monetary policies, and thus some means of formulating and implementing monetary policy at the Community rather than national level would need to be established. There would also have to be constraints on member states' fiscal policies in order to ensure that they were not incompatible with the agreed Community monetary policy; and although member states would presumably still have considerable freedom in determining the size and composition of government expenditure, there might in practice need to be limits on the size of budget deficits, and, almost certainly, constraints on how those deficits were financed.

And even when the economies of the Community were reasonably integrated, and prices and wages sufficiently flexible, imbalances of some kind would be certain to continue to occur *between* countries, in the same way as today they exist *within* countries, and there would therefore need to be an agreed way of handling such problems. In particular, an appropriate balance would have to be struck between financing such imbalances and adjusting them away by means other than exchange rate changes—means such as structural changes within the economies concerned. Such adjustment is often slow and it is therefore arguable that, while adjustment was taking place, imbalances would need to be partially financed by transfers from surplus to deficit countries. The question would then arise: what sort of transfers? Regional measures of the kind that have been tried and discredited at the national level over the past forty years? Support for industries that are no longer economically viable? Or the financing at Community level of the sort of automatic transfer payments, such as social security benefits, which at present ease imbalances within member states? Such mechanisms are plainly some way off.

All in all, therefore, economic and monetary union would involve major changes in the way that economic policy in the Community is formulated and implemented; major changes in the balance of power between the Community and individual member states; and, following on from this, major changes in the Community institutions needed to carry out the new functions and in the democratic accountability of those institutions. Whatever the commitment of governments and electorates to the long-term aim of economic and monetary union, I see little evidence yet of any readiness to accept such fundamental changes in the immediate future.

## A practical way forward

So for the time being I suggest that it may be more profitable to concentrate not on the final goal—topical though it may be to investigate the details of a European currency or a European central bank—but on the immediate practical steps that may be taken to prepare the ground.

Some would say that the obvious next step would be for sterling, and other EMS currencies that do not now participate in the ERM, to join the mechanism. The United Kingdom's stance towards the ERM is perhaps well enough known to you all, but the arguments that lie behind our position may I think bear repetition. Those who advocate participation sometimes stress only the advantages of exchange rate stability and play down the fact that, as I have just argued, those advantages can only be obtained at a price. While bearing in mind wider obligations to the Community as a whole, ultimately it has to be for each country to decide whether the benefits of greater stability outweigh the costs in terms of loss of flexibility in monetary and exchange rate policy.

The decision is a difficult one. I would not deny that the existing participants have on the whole been happy with their choice; but it has to be said that many small, open economies started from a position of enjoying little effective policy freedom, or saw benefits in the discipline of alignment with the counter-inflationary deutschemark. This latter factor was perhaps particularly important in the early years of the ERM's life, when inflation was high. Now that inflation is less of a problem, one can see emerging, in the debate about the symmetry or otherwise of adjustment under the mechanism, some of the concerns that have influenced the United Kingdom over the years.

I have to say that it is still not obvious that the conditions are yet right for United Kingdom participation in the ERM. As you well know, our domestic monetary policy is at present responding to the excessive growth of domestic demand during the course of this year, and to the inflationary pressures that accompanied it. The main objective of policy is to exert steady downward pressure on inflation. Interest rates play an important part in this process and while we recognise the general value of stability, it cannot be the overriding objective of our policy. For the present, that remains the reduction of inflation.

From the viewpoint of the ERM itself I think it still also true to say that the involvement of sterling in the mechanism at this stage would introduce a new element of complexity into its operation.

What then are the practical steps open to us? I suggest that we should concentrate first on promoting the real economic integration of the Community. The success of the single market programme will be important, of course, but even after 1992 we must expect to see further steps towards integration, and the markets will need time to take full advantage of the opportunities created. In many if not all member states there are instances of structural imperfections and rigidities which make markets work less than perfectly and which can hinder adjustment to changing circumstances; this tends to be true of labour markets in particular. If the Community is to work smoothly as a single market, such structural problems will need to be dealt with.

Second, more might be done to increase economic policy co-ordination between member states. Much is already being done in this area; and last year's Basle-Nyborg agreement, with its provision for joint monitoring of economic and monetary developments and policies and for concerted action within the ERM, is an example of a development that has in practice proved to be a real and valuable contribution to economic policy co-ordination in the Community. If the will was there, more could be done in the area of policy co-ordination without the need for institutional change: the necessary bodies, namely, the Council of Ministers, the Committee of EC Governors and the Monetary Committee, already exist.

There are a number of further practical steps that could be considered. For example, there might be greater use of EMS currencies in intervention within the Community. The ECU might have a useful role to play here, as markets in it develop; the impact of a country's intervention in ECUs upon relative exchange rates in the rest of the EMS will be muted by the wide spread of currencies in the ECU basket. But such issues can be controversial, and it cannot be denied that, even now, there are differences between ERM participants on the appropriate course of monetary and exchange rate policies. These are genuinely held differences which will not easily be resolved. One should perhaps not be too surprised that it is proving difficult to agree the precise terms of a common policy in regard to the ERM; and it underlines the difficulties that we are likely to encounter in attempting at this stage to reach agreement on the much wider range of issues involved with monetary union.

## Conclusion: the EMS and the wider international monetary system

I have been speaking tonight about the task of improving exchange rate stability within the European Monetary System. But of all people, this audience of foreign exchange market experts needs no reminder that Europe does not exist in a vacuum, but as part of a wider global system of currency and financial markets. What happens out there can all too easily become an 'exogenous shock' for the ERM, just as developments in Europe can have far-reaching implications for those living and working in Wichita or Osaka. In this wider world too, striving for greater exchange rate stability has become a major preoccupation after more than a decade of free floating. The process began with the Plaza agreement some three years ago and has been continued at summit meetings and meetings of Finance Ministers and Governors of the G7 countries since. With a new Administration being formed in the United States let us hope the process will be carried forward with renewed vigour.

Tonight is not the occasion to speculate where the Plaza-Louvre process of policy co-ordination and exchange rate management is leading. Some siren voices regard it as wholly misconceived. Others hanker after a return to a Bretton Woods type system, and are encouraged by the successes of the ERM to hope that this is no longer so fanciful an idea as it may have seemed only a few years ago. Still others believe we are heading for a tripolar currency system based on a US dollar zone, a Japanese yen zone and the EMS.

What is clear is that all observe and study the operation and development of the EMS to see what lessons, or warnings, it may have for the prosecution of exchange rate stability on a global scale. As my concluding thought tonight, I should like to suggest that three lessons stand out very clearly.

- The first is that in establishing new arrangements relative to policy co-ordination and exchange rate management, patience is necessary; patience and flexibility. It has taken time for the ERM to establish credibility in the markets, when at its outset sceptics were encouraged by the frequency of realignments to think it could be as short-lived as the snake had been. But its stability through the past two turbulent years has shown that patience has been rewarded, even if the EMS we now have is somewhat different from the aspirations of Bremen.

- The second lesson is that intervention alone, unless accompanied by appropriate policy stances, can only defend desired exchange rate parities in the very short term.

- And the third lesson is simply that, although the co-ordination of policy stances between sovereign governments is much easier to talk about than put into practice, meaningful progress can be made when those involved see it in their own self-interest that it should be, and have the political will to bring it about.

*In a subsequent speech,[1] on the development of the ECU and its possible role in European economic and monetary union, the **Governor** again stresses the need for a pragmatic approach, suggesting a number of ways in which the growth of the private ECU might be encouraged.*

We have heard a lot this year about European integration; and the projected completion of the internal market—the 1992 initiative—does indeed present great opportunities to European governments and businesses. If we can thoroughly dismantle the economic barriers that exist between us, and create a truly open European market, then we should see great improvements in efficiency and competitiveness, with benefits to consumers and industry alike.

What role has the ECU to play in all this? As a composite unit, the ECU should in my view continue to present a commercially attractive option for European business; and as trade benefits from the 1992 initiative, then so too, I hope, will the ECU markets.

## ECU and EMU

But there are those who would give the ECU a rather grander role in all this, and who consider the ECU to be in some way the key to moving rapidly to full economic and monetary union in Europe. This is surely a case of misjudged enthusiasm. The ECU may symbolise a European monetary identity; and it may be regarded, to a limited extent, as tangible evidence of closer monetary co-operation. But it is in no way a realistic short cut to further economic and monetary integration in the Community; and I believe that if we tried to use it as such, the short-cut would soon turn into a dead end. As I said in Luxembourg recently, Europe cannot achieve economic and monetary union, and possess a single currency, until the political and economic circumstances are right. Developing the ECU now as a putative common currency would do nothing to create those circumstances.

In any case, to speculate on the identity of a future single currency is to put the cart before the horse. It is certainly not to be excluded that, for political or presentational reasons, the ECU might be chosen in preference to one of its component national currencies or to an entirely new unit; but that decision will plainly be one to take at the time.

The initials 'ECU' stand, of course, for European Currency Unit, and the acronym recalls the old French 'ecu', or crown; but the original meaning of 'ecu', as I am sure we all know, was an heraldic shield or emblem. In other words the commercial and practical nature of the ECU sits alongside a rather more symbolic quality. I do not in any sense wish to detract from the latter; but I strongly feel that any discussion of the future evolution of the ECU should be firmly grounded on its commercial and practical attractions. The financial and commercial markets, where the ECU has been so successful and must continue to establish itself, have little time for icons.

## Growth of the ECU

So what lies in store for the real ECU—for the basket currency, that is, rather than the symbol? (And perhaps I should emphasise that I propose to deal today only with the development of the private ECU; for the official ECU, used solely between central banks in the EMS, raises quite separate issues.)

The ECU is now well established in world financial markets: the sixth most widely used currency in international cross-border lending; and seventh in international primary eurobond markets. While growth has levelled off a bit since 1985, the ECU share of the bond market has remained stable at around 4%. And success in these areas is largely, and encouragingly, a result of the enthusiasm of the private sector.

I see no reason why use of the private ECU should not increase further—especially if commercial demand is encouraged by the completion of the internal market. But that is not to say that there are no obstacles; and on occasions there may be a role for governments, and the markets, or both together, in ensuring that the development of the ECU is not needlessly handicapped.

## ECU Treasury bills

While ECU bond markets, assisted by competitive yields, have thrived, shorter-term paper markets have been underdeveloped by comparison; and if the private ECU is to continue its progress, these markets will need to become deeper and more liquid, and to provide a wider range of trading instruments.

(1) At the Extraordinary General Assembly of the ECU Banking Association, on 6 December.

An important milestone in this respect is the United Kingdom's ECU Treasury bill programme. By supplying a new short-term instrument, this programme fills a gap in the ECU market, and the involvement of twenty-nine market makers, mostly from within the Community, should help provide liquidity to the market. Ours is of course not the first government to issue short-term instruments denominated in ECUs. The Italian government in particular has issued ECU paper with maturities of just over one year since October 1987, and these now total nearly ECU6 billion. The Irish government has also issued a small amount of short-term ECU paper. But our initiative is nonetheless the first full short-term ECU Treasury bill programme and will, I hope, allow London to make a further contribution to the development of the ECU. It also serves as an example of the kind of pragmatic assistance that the authorities can provide to the private ECU market.

I am glad to say that the programme has attracted considerable interest. Both tenders so far have been heavily oversubscribed—on each occasion by almost four times the amounts on offer. The details of the third tender on 13 December are to be announced today and with this continuing series of monthly tenders we shall aim to build on the very encouraging start that our programme has made. I would like to take this opportunity to thank those among you—and there are many—who have helped to make this programme a success.

## ECU clearing system

There are, of course, other important steps which have already been taken towards meeting the specific needs of the ECU market. A good example is the ECU clearing system set up in 1986 by this Association, with the BIS acting as its clearing agent. An efficient and prudently managed clearing is perhaps particularly important for a composite unit like the ECU, which has no domestic market of its own, and establishment of the ECU clearing has been extremely helpful to the ECU markets. It is also, incidentally, an indication of what market practitioners can achieve with only minimal assistance from the authorities. As so often, the most beneficial developments are those which arise from market pressure and which are provided by the market.

## The prospect

How else may the use of the private ECU be encouraged? It is perhaps worth pausing at this point to consider what exactly makes the ECU useful and attractive to both financial and commercial interests. Recent business surveys have suggested that the ECU, by virtue of its stability and composite nature, is in theory an attractive means of reducing the exchange rate risks inherent in cross-border trade; a useful hedging instrument, in other words, enhanced by an attractive yield. But demand remains more latent than realised. The developments that I have been describing should make people more aware of the opportunities, and perhaps stimulate the use of the ECU.

In general, commercial initiatives in this field should prove to be self-reinforcing. As use of the ECU increases, stimulated by the potential private demand that surveys have already revealed, so there will be a need for more sophisticated financial ECU instruments which will in turn inspire greater commercial activity.

On that score, I would welcome other issues of ECU debt, and in particular short-term sovereign paper from other Community countries, where such issues made commercial sense. A similar pragmatic development would be the increased use, again only where appropriate, of private ECU in intervention by Community central banks. I also welcome the progress being made to improve and enhance the infrastructure of the ECU market—for example, the development of repurchase and financing facilities on the basis of our own Treasury bill; the possibility of an ECU futures contract; and the consideration being given to streamlining settlement arrangements for ECU instruments.

## ECU reweighting

Finally, I should like to say something about reweighting. The special composite nature of the ECU is, of course, the source of its commercial attraction, but this quality can also be seen as an unwelcome cause of uncertainty. The composition of the ECU is next due for revision in September 1989. The last review was in 1984, but much has changed since then, especially in the ECU markets. This time around, there is more potential for uncertainty among financial institutions over the likely outcome of the reweighting and the possible inclusion of additional currencies.

The regulations that govern the composition of the ECU as an official unit of account in the Community are quite clear, and the private ECU follows their definition. They say that any revision of the ECU must not change its external value at the time of reweighting, and that any changes to the weights of the component currencies should take underlying economic criteria into account. The possible inclusion of the peseta and escudo is important for two reasons. First, the banks whose ECU assets exceed their liabilities, and who hedge the difference in the national markets of the currencies which make up the ECU, will rapidly have to adjust their hedging strategy. Second, the inclusion of these two currently high yielding currencies would add to the impact that reweighting is in any case likely to have on ECU yields and therefore on ECU asset prices.

I certainly do not want to offer a view today on how these uncertainties should be dealt with. But I do feel strongly that anything that governments can do ahead of September to leave market participants with a clearer idea of the outcome of the next reweighting can only assist the further development of the ECU markets. Delaying a decision, leaving market participants in the dark, will do nothing to enhance the progress of the ECU.

## Conclusion

I make no apology for concluding on that rather technical note, for it reinforces a theme of my remarks today, which is that the private ECU will stand or fall on its commercial attractions. Let us by all means look to the future—but with the vision of level-headed practitioners.

Perhaps one day 'ECU' will be the name of a single European currency; but in the meantime, even if the ECU we use today may to some extent represent the first symbolic step along that road, its development should surely remain in the hands of the private sector. Its growth should be a pragmatic self-generating process that needs encouragement, without intrusion, from official quarters. In this perspective I applaud and wholeheartedly support the activities of your Association, and wish you well for the future.