Paper submitted by the Trades Union Congress (3 October 1978)

Caption: On 3 October 1978, the British Trades Union Congress sets out its position on the implementation of a European Monetary System (EMS).

Source: Parliament-House of Commons-Expenditure Committee (Ed.). The European Monetary System, First report from the Expenditure Committee, session 1978-79, together with the minutes of the evidence taken before the General Sub-committee in session 1978-79 and appendices. London: Her Majesty's Stationery Office, 1978. 159 p. ISBN 0 10 206079 7.

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The new European Monetary System

Paper submitted by the Trades Union Congress

1. Over the past year political opinion within Europe has swung back in favour of re-establishing some kind of fixed exchange rate system. European governments have become increasingly disillusioned with floating exchange rates. It has been argued that by creating uncertainty floating exchange rates have had a dampening effect upon trade, investment and growth and that floating exchange rates have thus had the effect of deepening the current recession in Europe. With the recent decline of the dollar and the concomitant disruption of foreign exchange markets it has become a matter of urgency that a review of the alternatives to floating exchange rates should be conducted.

2. Events have moved rapidly since April this year when Chancellor Schmidt surprised his fellow EEC Heads of State at the Copenhagen Summit by advocating a return to fixed exchange rates within Europe. Hitherto this cause had been championed almost exclusively by the EEC Commission as the first part of its programme for Economic and Monetary Union. The popularity of Schmidt's idea had spread by the time the EEC Heads of State met at their next Summit in Bremen on 6 and 7 July. At Bremen it was possible to reach agreement in principle on the issue of fixed versus floating exchange rates. A communiqué issued at the end of the Summit referred to a return to fixed exchange rates as "… a highly desirable objective." More importantly, an annex to the communiqué contained French and German proposals for the establishment of a new European Monetary System (EMS) of fixed exchange rates.

3. Throughout the summer economic and financial officials from the EEC member states have met frequently in an attempt to work out the details of such a system and to resolve any associated difficulties — no small task given the imprecision of the wording used in the Bremen proposals. According to the timetable laid down at Bremen, these officials should finish their work by mid-October. There should then be enough time for member states to scrutinise the final proposals in detail before they meet again in December at the Brussels Summit. If all goes as planned and the member states approve the proposals submitted to them, it is expected that the new system will come into force on 1 January 1979.

4. The task of drawing up the detailed EMS proposals is as yet incomplete. Many technical questions and other matters remain to be resolved by negotiation. It is thus impossible at present to give a definitive assessment on the implications of the new system. However, on a subject of this importance, it would be worthwhile if the Committee were to be informed of the main issues involved before the details of the final proposals become known. Fortunately sufficient material has surfaced concerning the state of the negotiations to give a reasonably reliable account of the present position. It is the aim of this document to present such an account of the main issues surrounding the EMS to the Committee. It is also important that the Committee should consider this issue before the next EEC Tripartite Conference takes place on 9 November, the agenda for which is sure to be dominated by the EMS proposals.

The EMS negotiations

5. In any system of fixed exchange rates it must be clear how the central rates for currencies can be defined. In other words, it must be clear against which *base-rates* currencies are fixed. This subject, though technical by nature, holds important implications for the operation of the system and has become a point of contention among the representatives of the member states at the EMS negotiations. Two suggestions concerning base-rates of "numéraires", as they are sometimes called, have been advanced in the course of these negotiations. These are the so-called "parity grid" and "basket" approach.

6. The *parity grid*, supported amongst others by the Germans, has the advantages of being simpler to understand and easier to operate. Under this approach each participating country would be required to fix the value of its currency directly against those of the other participants in a mutually consistent fashion. Thus, say, if £1 equals 4 D-marks and 1 D-mark equals 1,000 lira, then £l must equal 4,000 lira. In all, if each of the nine member states wished to join the parity grid, there would be 36 cross-rates of this kind, which the member states would be required to hold. Each country would be obliged to maintain the value of its

currency within a small margin (2¼ per cent) either side of these central rates in the grid. If the exchange rate between any two grid currencies were to move against or beyond these limits, then the central banks of both countries would need to intervene on the foreign exchange markets to re-establish the grid rate. All currencies in the grid would move together against the currencies of non-grid members. Thus if the D-mark were allowed to appreciate against the dollar, then all grid currencies would need to appreciate against the dollar by a similar amount.

7. The parity grid system is exactly the same as that which obtains among members of the European "Snake". At present the Snake is restricted to five countries, Germany, Benelux and Denmark, a group that in fact represents a D-mark zone. France, Italy and the UK were for a short time members of the Snake in its earlier days. But these countries found that they either could not or did not wish to hold the value of their currencies against the strong D-mark and so they left. On past evidence it appears that Snake-type arrangements have been too rigid and inflexible, tending principally to benefit those participating countries with stronger currencies.

8. Because of these and other drawbacks attributed to the parity grid system, the "basket" alternative has been put forward. The main advocate of the basket is at present the UK though at the time of the Bremen meeting it also had the support of France. Under the basket system each country would be required to maintain the value of its currency relative to the European Currency Unit (ECU), a new unit of account equal to the weighted average of all participating currencies. It is argued that this approach would provide additional flexibility to the EMS. For as the value of a basket currency varies on the exchange markets, so will the value of the ECU also vary in proportion to the weight of that currency in the basket. Thus, when a basket currency comes under pressure, the need for market intervention would be less than in other fixed rate systems because, to a greater or lesser extent, the value of the ECU would also move in the same direction as the currency in question. The Germans are worried that nominal exchange rates would be too flexible in such a system, thus defeating the purpose of the whole exercise. They have argued that if the basket approach were to be adopted, the value of basket currencies against the ECU should be kept within a narrower margin (say 1 per cent) either side of the central rates.

9. Advocates of the basket system have stressed that their system affects strong and weak currencies alike and produces a "symmetry" of obligation among its members. In more conventional fixed rate systems, like the parity grid, pressure is more heavily placed on the weaker currencies. It has often been the case that the weaker currencies have to deal with the problems created by the stronger currencies. Under the basket arrangements, if a strong currency like the D-mark were to appreciate against the ECU, and, by dint of that, against other European currencies, then the responsibility for restoring the basket-rates would fall on the German authorities to a much greater extent than it would fall on the other countries in the system.

10. It now seems more likely that the parity grid system will be adopted in preference to the basket approach. At their recent meeting in Aachen, Chancellor Schmidt and President Giscard d'Estaing appeared to accept a Belgian "compromise" proposal, which, on closer examination, has been seen to favour heavily the parity grid approach. The Belgian proposal puts forward the idea that exchange rates should be expressed in ECUs but that, more importantly, the intervention system should be based on the parity grid approach. The UK is continuing to advocate the basket approach in the face of opposition from the other member states. The parity grid seems to have won the day because it will be simpler to operate and, though more onerous on the weaker members, it will maintain fixed exchange rates more rigidly. As a concession to those countries with weaker currencies, it is anticipated that these countries will not be required to join the parity grid in its full form when it comes into operation. It is thought that these countries would benefit if during a transitional or lead-in period their currencies were permitted to vary by a larger percentage from the central rates.

11. If the parity grid is taken as the basis of the EMS, then the whole question of an *adjustment mechanism* for the system will assume greater significance. Whereas each country entering the system will try to ensure that the value of its currency is pitched at a realistic and tenable level, this does not mean that these initial parities must remain fixed for all time. Adjustments must periodically take place to take account of differences among EMS members in their inflation rates, industrial performances and competitive positions.

If the EMS does not allow for such adjustments in parities, it is inevitable that the whole system will come under unbearable pressure and will crumble as other fixed rate systems have crumbled in the past. The question is what kind of adjustment mechanism should be adopted. It remains to be decided under what conditions and with reference to which procedure devaluations and revaluations can be allowed to take place. The Bremen communiqué merely notes that such changes in parity "… will be subject to mutual consent."

12. Fixed rate systems are vulnerable to speculation. The markets are aware that fixed parities cannot be maintained indefinitely. As British experience all too clearly demonstrates, speculative movements of international capital can undermine the position of countries faced with balance of payments difficulties. It is important that currency adjustments should not be dictated to member states by speculative movements on foreign exchange markets. To withstand such movements, large foreign exchange reserves are required. It is for this reason that the EMS negotiations have spent much of their time in determining how countries participating in the system can help one another maintain the value of their currencies on foreign exchange markets.

13. To this end it has been proposed that a *European Monetary Fund* (EMF) should be set up in which each participating country should deposit 20 per cent of its gold and dollar reserves. In addition, each country would be required to deposit a similar quantity of its own currency at the EMF. Each country would be credited with the equivalent amount of ECUs against these deposits. These ECUs would then be used to settle debts among EEC central banks. In total, reserves equal to 50 billion dollars would be made available to the EMF in this fashion. It is intended that the EMF would become fully operational two years after the inception of the EMS, that is, by 1 January 1981. As the major contributor to the Fund, Germany regards this aspect of the proposals as its main contribution to the EMS, in exchange for which it feels it should receive concessions on other issues. What remains to be decided among the EEC member states is how this EMF should be constituted and who should control it. Sensitive issues of national sovereignty are at stake here. To what extent credits from the EMF should be unconditional or issued with strings attached also remains an open question of great importance. If EMF loans are to be conditional, issued discretionally by the EMF, then the potential benefits gained by pooling reserves would be much diminished in the eyes of those countries most likely to need them.

14. At the time of the Bremen Summit it was recognised that a return to fixed rates would pose greater difficulties for the weaker members of the Community. There would be more strain on these countries to hold their currencies against the stronger currencies for any prolonged length of time. In order to assist the weaker economies in meeting these difficulties it has been argued, most notably by the UK, that a *transfer of resources* should take place within the Community from the stronger to the weaker members. In some quarters the EMS proposals are seen as the first step on the road to Economic and Monetary Union (EMU). If this is the real intention behind the EMS proposals, then the question of resource transfer takes on greater importance. For it is considered that there is little chance that EMU can be made to work effectively until a greater degree of convergence among the EEC economies is achieved. And to achieve this convergence, resource transfer is needed. A whole array of issues is involved with resource transfer including the reform of CAP, the enlargement of the Regional and Social Funds and the revision of national contributions to the Community Budget. The opinion was expressed among the Heads of State at Bremen that the time was right to tackle all these issues together. By doing so, all the main problems confronting the EEC would be dealt with at once. However, the optimism of Bremen has since evaporated somewhat and some member states are questioning the wisdom of connecting the EMS with the re-examination of these other issues.

Issues arising

15. The principal reason for re-instituting fixed exchange rates within Europe lies in the belief that they will create a better climate for growth both inside and outside the Community. It is obviously beneficial that order should be restored to the international monetary system after so many years of disarray. Ever since 1971, the international monetary system has been in a constant state of crisis. In as much as a return to fixed exchange rates in Europe could create some degree of stability in the system, then the EMS proposals must be welcomed. The prospects for growth must become brighter as instability and uncertainty in the system of

international payments diminish.

16. However, the order which is re-established within Europe must be lasting and must be equally beneficial to all members of the Community. For if the EMS were to fall apart as its predecessors had done, then the world monetary system would be thrown into a deeper crisis. Fixed exchange rate systems can be durable only if they do not place too many demands upon their members and if they are seen to be fair to all. In the past weaker currencies have dropped out of these systems because they have felt that a disproportionate share of the burden inherent in operating these systems had fallen upon their shoulders, and as a result had retarded their growth. This aspect of the EMS is of particular interest to the UK. Despite the prospect of a surplus in the UK balance of trade in the forthcoming period, it is probable that, relative to the D-mark, sterling will still be classified as a weak currency. Sterling will come under severe pressure if, for instance, UK inflation rates rise above the European average.

17. There are grounds to believe that the EMS would operate in a fashion which would inhibit the growth of some of its members, especially its weaker members. In order to stay in the system member states would need to exercise self-discipline in the management of their economies, which could have a deflationary impact on economic activity. In some quarters this “discipline” is welcomed. Certain commentators contend that the British economy would benefit as a result. According to their reasoning Britain would be forced to tackle the fundamental problems facing the country, namely, poor economic and industrial performance. Because changes in exchange rates would be ruled out, Britain would be forced to improve its industrial performance and bring down its inflation rate yet further in order to compete on level terms with other European countries in a fixed rate system. It is left unsaid in this argument, however, what would happen to Britain, or to any other country in a similar position, if this turnaround took a long time to achieve. With a rigid EMS there is a danger that the UK would then be forced to maintain an overvalued currency. As a consequence, UK exports would fall and the UK Government, possibly prompted by the EMF, would be forced to pursue deflationary policies for balance of payments reasons. It has been suggested that countries facing difficulties in holding the value of their currencies in the EMS could solve their problems by raising their interest rates above the European average. Yet such an approach could not be held for long without reducing the level of investment in those countries with overvalued currencies. The conclusion cannot be avoided that in an open economy an overvalued currency restrains growth and in a rigidly applied EMS the pound may become overvalued.

18. It is evident from the above that far from encouraging recovery an ill-devised EMS could produce the opposite effect. Employment and growth in the UK could be adversely affected. It is for this reason that much of the discussion on the EMS has centred on the issue of rigidity versus flexibility. As far as the Germans are concerned, rigidity would be preferable because the value of the mark would be held down, an outcome which would benefit German exports and assist in controlling their money supply. From the viewpoint of countries with weaker currencies, flexibility is desirable. It is in this light that the discussions about the parity grid, the basket and the adjustment mechanism must be viewed.

19. As an inducement to support the proposals for a more rigid EMS, Germany has been willing to pool part of its foreign exchange reserves with the other members through the EMF. For this and other reasons, the British proposals favouring flexibility are likely to be rejected by other members of the EEC. Anticipating this to be the final outcome, most member states are determined to ensure that their currencies are valued at an advantageous and tenable level before entering the EMS. Several parity changes among European currencies can therefore be anticipated in the forthcoming months.

20. There is little point in entering an exchange system which contributes to monetary stability in Europe if it produces the exact opposite outside the EEC. If the dollar were to be adversely affected and the IMF undermined by the creation of the EMF, world trade would decline and European recovery would suffer. It is important to ensure that the EMS does not produce these counter-productive side-effects. However, there is another way of looking at the relationship between the dollar and the EMS proposals. If the dollar crisis is destined to deepen and to lead the world further into monetary disarray, then a Europe united by fixed rates and supported by pooled reserves will be better placed to ride out the resultant disorders.

21. The establishment of fixed exchange rates in Europe does not necessarily lead to Economic and Monetary Union. It is important to distinguish between the EMS and EMU. The two are linked in as much as fixed exchange rates are a necessary prerequisite for EMU. Nevertheless, much more is required before EMU becomes a reality, not least of which is the political will within Europe. Despite their enthusiasm for the EMS, it must be doubted whether the Germans possess this wider commitment to EMU. Furthermore, it must be stressed that the ECU is an accounting device to be used in settlement among central banks; there is no reason to suppose that it will necessarily become the single European currency envisaged by the supporters of EMU.

22. However, the EMS proposals, by advocating the establishment of an EEC Central Bank and fixed exchange rates, do make the prospects of EMU less remote. It is probable that the supporters of EMU will try to make political capital out of the EMS proposals and renew their attempts to further the cause of EMU. In line with the General Council statement on “EEC Economic Objectives and Monetary Arrangements” of June this year, the Committee must be firm in their opposition to those who try to use the EMS proposals as a platform for EMU. The General Council have argued that EMU would aggravate rather than reduce the current tensions and difficulties facing the Community by placing greater emphasis on Brussels-based policies rather than on national policies and by exacerbating the existing structural problems within Europe.

Conclusion

23. It is clear that many problems still need to be resolved before the EMS comes into being. However, it is equally clear that enough political momentum has built up behind the idea of fixed exchange rates in Europe to ensure that some type of scheme will be presented to the EEC Heads of State at their next summit in Brussels on 4 and 5 December. Moreover, it is probable that at least partial agreement will be reached at Brussels and that some form of fixed rate system will come into force at the beginning of 1979.

24. Undoubtedly there are advantages to be gained by a return to fixed exchange rates. Equally there are many drawbacks, not least to the weaker and more vulnerable members of the Community. The issues at stake are very important and hold fundamental implications for growth and employment both in the UK and in Europe at large. For these reasons the General Council, in their June statement, made known their wish to be consulted about any plans for establishing closer relationship between European currencies. If the EMS is to survive longer than previous fixed-rate systems, then it must take into account the interests of these weaker countries. The prospect of Community enlargement serves to underline the importance of this point. Taken in this context the issue of resource transfer may take on greater significance.

3 October 1978