

# EUROPEAN PARLIAMENT



*s e s s i o n   d o c u m e n t s*

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## R E P O R T

of the Committee on Economic and Monetary Affairs  
and Industrial Policy

on EMS plus 1992 Programme: Lessons to be drawn  
for the Implementation of the EMU

Rapporteur: Mr João CRAVINHO

PE 205.926/fin.

Or. EN

\* Consultation procedure requiring a single reading  
\*\* Cooperation procedure (first reading)

\*\*I Cooperation procedure (second reading) requiring the votes of a majority of the current Members of Parliament  
\*\*\* Parliamentary assent requiring the votes of a majority of the current Members of Parliament

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By letter of 14 July 1992, the Committee on Economic and Monetary Affairs and Industrial Policy requested authorization to draw up a report on EMS plus 1992 Programme: Lessons to be drawn for the Implementation of the EMU.

At the sitting of 14 October 1992 the President of the European Parliament announced that the committee had been authorized to report on this subject.

At its meeting of 24 November 1992 the committee appointed Mr João CRAVINHO rapporteur.

At its meetings of 27-28 January 1993, 5-6 May 1993, 1 July 1993, 7 September 1993, 20-21 September 1993, 21-23 September 1993, 5-6 October 1993 and 11-13 October 1993 the committee considered the draft report.

At the last meeting it adopted the motion for a resolution unopposed with 1 against and 2 abstentions.

The following were present for the vote: Mr Beumer, chairman; Mr Desmond and Mr Patterson, vice-chairmen; Mr Cravinho, rapporteur; Mr Amaral (for Mr Cox), Mr Barton, Mr Peter Beazley, Mr Bofill Abeilhe, Mr de la Camara, Mr Cassidy (for Mrs Lulling), Mr Crampton (for Mr Fuchs), Mr David (for Mr Colajanni), Delcroix (for Mr Caudron), Mr Donnelly, Mrs Ernst de la Graete, Mr Fitzgerald (for Lataillade), Mr Fourcans, Mr Friedrich, Mr Gasoliba i Böhm, Mr Harrison, Mr Herman, Mr Hoppenstedt, Mr Christopher Jackson, Mr Mattina, Mr Merz, Mr Metten, Mr Peter (for Mr Rogalla), Mr Pierros, Mrs Randzio-Plath, Mrs Read, Mr Riskær Pedersen, Mr Roumeliotis, Mr Siso Cruellas, Mr Speciale, Mrs Tongue (for Mr Seal), Mrs Thyssen, Mr von Wechmar, Mr Wettig and Mr von Wogau.

The report was tabled on 14 October 1993.

The deadline for tabling amendments will appear on the draft agenda for the part-session at which the report is to be considered.

A.

MOTION FOR A RESOLUTION

on EMS plus 1992 Programme: Lessons to be drawn  
for the Implementation of the EMU

The European Parliament,

- having regard to the Committee of Governors' report on 'Implications and lessons to be drawn from the recent Exchange Rate Crisis' and the Monetary Committee's report on 'Lessons to be drawn from the disturbance on the foreign exchange markets';
  - having regard to the Study by the Association for the Monetary Union of Europe (AMUE) on 'The EMS in transition: Lessons learned from the experience of the EMS and the completion of the Internal Market Policy options to prepare stages II and III of EMU';
  - having regard to the decision of the Finance Ministers and Central Bank Governors of the EC to widen the intervention thresholds of the ERM to +/- 15 %;
  - having regard to its resolutions of 14 April 1989<sup>1</sup>, 10 October 1990<sup>2</sup>, 14 June 1991<sup>3</sup>, 24 October 1991<sup>4</sup>, 7 April 1992<sup>5</sup>, and 15 July 1993<sup>6</sup>;
  - having regard to Rule 121 of the Rules of Procedure;
  - having regard to the report of the Committee on Economic and Monetary Affairs and Industrial Policy (A3-0294/93);
- A. Recognizing that the creation of the EMS has had a primary objective to enhance monetary co-ordination aimed at holding together the Trinity of:
- i) semi-fixed exchange rates,
  - ii) free capital movements,
  - iii) independent national monetary policies,

and that during its 15 years experience relative currency stability was achieved via various combinations of the above three factors;

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<sup>1</sup> OJ C 120, 16.5.1989.

<sup>2</sup> OJ C 284, 12.11.1990.

<sup>3</sup> OJ C 183, 15.7.1991.

<sup>4</sup> OJ C 305, 25.11.1991.

<sup>5</sup> OJ C 125, 18.5.1992.

<sup>6</sup> PV 23 II.

- B. Admitting that since the early 1980s the phenomena of globalisation of markets of finance, capital and investment and deregulation of markets have put an end to the effective use of capital controls, have aggravated the problem of controlling money supplies, have influenced the determination of the exchange rates and have fed speculation;
- C. Considering that the existing EMS is inevitably prone to crisis since global markets have changed the context of implementing orderly monetary and exchange rate policies within the initial EMS framework;
- D. Noting that the average daily turnover of currencies due to speculation within the OECD area is at present six times greater than the commercial demand for currency and that on certain days the speculative element of the turnover in the foreign exchange markets can be anything up to 95% of the day's business; considering, furthermore, that this sort of turnover has led to a situation in which the OECD countries' currency reserves are occasionally equivalent to no more than a good half of one day's total turnover in the foreign exchange market;
- E. Considering that the recent proposals from the Committee of Governors and the Monetary Committee on the reform of the EMS, maintaining the status quo and hoping that the speculative attacks on European currencies are over, have been clearly disproved in the recent July crisis because the system as initially conceived does not respond to current monetary conditions resulting from the globalisation of financial and capital markets and active institutional investors, and allows private markets dictate economic and monetary policies while inducing disorderly placement of savings;

As Regards the Decision of 2 August and Related Options

1. Believes that the decision of 2 August 1993 by the Finance Ministers and Central Bank Governors of the Community to widen the obligatory marginal interventions thresholds of participants in the ERM to +/- 15 %, amounts to a system of managed floating of exchange rates that would have the following consequences if persistent in the medium term:
  - a) the Community may revert to floating exchange rates;
  - b) competitive devaluations may be induced which may encourage protectionism and severely damage the incomplete and fragile single market;
  - c) economic policy, the CAP and the EC budget would be adversely affected;
  - d) monetary co-ordination would not be possible unless the intrinsic flaws of the EMS are corrected in time.
2. Is of the opinion that the current design of the EMS cannot cope with disequilibria of fundamentals: competitiveness, inflation, wage settlements, current account and budget deficits, while maintaining fixed exchange rates;
3. Stresses the fact that the basic intrinsic flaws of the status quo induce unwarranted speculative attacks leading to unnecessary real costs in

terms of output and employment; these high costs could endanger the whole process of European integration and could break up the Single Market;

4. Expresses its inquietude over the recognition by the official bodies that only interest rates are still effective instruments to counter speculative attacks; recalls the fact that in the presence of global markets, a one policy instrument (i.e. interest rate) is supposed to influence four objectives: boost investment, control inflation, stabilise the exchange rate and increase private savings;
5. Stresses that proposals conceived as the immediate creation of a de facto Monetary Union of a 'core group':
  - a) will not be compatible with the integration process laid down in the Treaty on European Union (TEU),
  - b) will amount to destroying the institutional setting as conceived for the second stage of EMU and will create a two speed Community that could lead to the break up of the Single Market,
  - c) will undermine the system's primary objective to ensure monetary cooperation of all Member States,
  - d) will signal a lack of credibility of the Maastricht Treaty;

As regards the Reform of the EMS

6. Stresses that any proposal for the reform of the EMS can only gain credibility if itself is the result of an affirmation by the European Council concerning:
  - a) the credibility of the TEU, the instruments necessary for and stages of EMU, building up the institutional convergence as required for the implementation of stage three as laid down in the TEU;
  - b) the gradual process of EMU leading to the establishment of a single currency, the ECU, as laid down in Articles 3a and 109l (4) of the TEU;
7. Considers it imperative that any proposal for the reform of the EMS at the beginning of the second stage could be made only in the context of the TEU taking account of the principles laid down in the Maastricht Treaty and developing fully the tasks and responsibilities of the European Monetary Institute (EMI); in this context, proposes, with a view to overcoming the present currency crisis and improving monetary developments and coordination, that the monetary authorities improve their voluntary cooperation over monetary policy in the second stage, as provided in Article 109f of the TEU and the statute of the EMI;
8. Finds it necessary that in implementing the preceding paragraph:
  - a) the seat of the EMI and its President should be agreed on in the forthcoming European Council,
  - b) the process leading to the independence of the national central banks should be concluded as soon as possible,
  - c) the appropriate resources should be made available to the EMI;
  - d) the convergence of economic performance should be pursued consistently;

9. Notes that the defence mechanisms available to the EMS to resist unwarranted speculative assaults on the currencies in the system need to be improved and extended, in order to restore the system's credibility and monetary stability; believes that selective measures need to be taken to make speculation more difficult and more risky without seriously impeding the normal operations of the capital markets; calls on the Commission and the Council to submit appropriate proposals forthwith;
10. Asks the Commission, the Council and the Committee of Governors to examine if, only for the second stage of EMU, broadening the anchor of the monetary system could be based on the ECU and the strongest currency in the main markets, subject to the following rules:
  - a) a stable relationship between the exchange rates of the ECU and of the strongest currency should be maintained,
  - b) realignments would be made only if the stable relationship of the two above exchange rates could not be maintained,
  - c) the system should be managed in a way that it would follow a money supply rule that would not increase liquidity beyond the rate necessary to support real growth;
11. Equally requests the Commission, the Council and the Committee of Governors to examine paragraph 10.a) on the basis that any fall in the value of the ECU against any one or more currencies will be corrected by either freezing the relative weights of each currency within the basket or by increasing, in compensation, the quantity of any currency or currencies within the basket. Accordingly, asks the Commission to examine:
  - a) such a proposal in the light of Article 109G of TEU given the context of Council Regulation (EEC) No. 1971/89 amending Article 1 of Regulation (EEC) No. 3180/78 amending the value of the unit of account used by the European Monetary Cooperation Fund;
  - b) the effects of such a system on the markets in ECU-denominated securities and possible remedies;
12. Proposes for examination a reform of the current asset settlements rule of the EMS obliging national central banks to repay intervention credits with foreign exchange reserves, by settling outstanding debt among national central banks and the EMI in ECUs;
13. Favours the EMI, within its primary tasks conferred upon it by Article 109f, paragraphs 2, 3 and, if necessary, paragraph 7, of the TEU, as the monetary authority fully responsible for issuing and managing the ECU; consequently, it proposes for examination, in conformity with Article 109f (3) of the TUE, to further develop the operational functions of the EMI as stipulated in Article 6.4 of its statute: 'The EMI shall be entitled to hold and manage foreign exchange as an agent for and at the request of national central banks';
14. Points out that great efforts will still be necessary by the Member States in order to fulfil the convergence requirements of the Maastricht Treaty and welcomes the fact that from the beginning of the second stage a procedure will be in place to deal with excessive government deficits.

15. Is convinced that, in preparing the third stage of EMU as called for by Article 109f (3) of the TEU, the EMI should adopt a gradual approach built on safeguard clauses and consensus procedures for carrying out monetary coordination in fulfilment with the necessary procedures for implementing the third state;
16. Requests the Commission, in accordance with Article 103(2) of the TEU, to submit a proposal defining the content, procedure and monitoring of multilateral surveillance reinforcing thus the credibility of the mandate given to the EMI by this resolution;
17. Asks the Council, meanwhile, to underscore the link between monetary cohesion and a genuine single market by publicly making the case for a single EC currency;
18. Requests the Commission and the Committee of Governors to study the above proposal and report to Parliament their findings as soon as possible and thus propose the appropriate legislation for its implementation;
19. Instructs its Present to forward this resolution to the Council, Commission and Committee of Governors.

B.

EXPLANATORY STATEMENT

I. Introduction

The creation of the Bretton Woods system in 1944 and of the European Monetary System (EMS) in 1979 has had a single objective: solve the problem of the Inconsistent Trinity. [1] The inconsistent trinity is a well established theorem which stipulates that it is almost impossible to hold together:

- a) fixed exchange rates,
- b) free capital movements, and
- c) independent national monetary policies.

Experience has shown that countries may have any of the two but not the three at the same time. If a country chooses to have fixed exchange rates and free capital movements, it can not have an independent monetary policy because the latter will have to pursue a policy geared to restraining capital flows. If a country chooses to have an independent monetary policy and no capital restrictions, it will be forced to have a flexible exchange rate because only then can it control its money supply and thus manipulate its interest rate to sterilize capital flows. If a country chooses to have an independent monetary policy and fixed exchange rates, it will have to restrict capital flows for otherwise it may not control its money supply.

On the other hand, fixed exchange rates and perfect capital mobility mean that the dominant central bank, whose currency acts as the anchor, will determine the currency area in which only one rate of interest will prevail. This has been the preferred option of the Bundesbank.

What differentiates the Bretton Woods system from the EMS is the degree of integration of the international economy. During the period of the Bretton Woods (1944-77), finance and capital markets were regulated by the IMF's Section 3 which stated that 'Members may exercise such controls as were necessary to regulate international capital movements'. Yet the feature of the 1980s is the globalisation of markets in trade, direct investment, capital and finance. [2]

Global markets have meant:

- i) an end to the applicability of IMF's section 3 on capital control,
- ii) aggravation of the redundancy problem in controlling the money supply,
- iii) loss of power to influence the determination of the exchange rate.

Effects i) to iii) can be summarized in a single idea. Globalisation has rendered traditional instruments and methods redundant. We are left with one policy instrument: interest rates, which is supposed to influence four objectives: a) boost investment, b) control inflation, c) stabilise the exchange rate and d) increase private savings. These four objectives are conflicting and thus constitute the conflicting quarter of globalisation.

This is this context that defines the parameters of the reform of the EMS. The options available are four. The first has to do with the official view expressed by the two reports submitted to the Copenhagen ECOFIN Council by the Committee of Governors and the Monetary Committee. It amounts to a single proposal: change nothing of the EMS but use its mechanisms in an intelligent way.

The official view has resulted in the decision of the ECOFIN and of Central Bank of Governors of 2 August 1993 to allow Member States to fluctuate their exchange rates by +/- 15%. It implies an end to monetary cooperation as experienced during the EMS period and effectively means the break down of the EMS since the first condition of the Inconsistent Trinity does not hold. Hence the official view should be rejected for the reason stated in the resolution and in the subsequent sections.

The second option is purely political. Move to stage III of EMU today and not tomorrow. It means that stage II of EMU will only be of a short-term duration.

The third option has to do with the recommendations of the AMUE study.[3] It proposes the formation of a monetary union by five Member States who fulfil the nominal convergence criteria of the Treaty on European Union (TEU). These five Member States will 'serve as a stable anchor for those countries where further adjustment to convergence is still required'.

The fourth option is of the rapporteur, which builds on previous resolutions of Parliament.[4] It can be summarized 'allow the European Monetary Institute (EMI) to fully develop its primary and secondary tasks conferred upon it by the TEU and thus establish a dual-anchor for the second phase of EMU'.

## II. AMUE Proposal

The essence of the recommendation made by the AMUE is stated in its paragraph 485: 'a stability zone forming a broadened anchor for the rest of the countries could at the beginning comprise Germany, France, Belgium, Luxembourg, Holland and Denmark'. The choice of these countries is made on two main criteria: 'price stability' and 'exchange rate stability', and a secondary criterion 'interest rate convergence'.

The stability zone of these five countries will be endowed with 'an additional unlimited long-term finance facility (extra-facility for short) for foreign exchange market interventions. The asset settlement mechanism for these facilities is indefinitely suspended. Central bank interventions drawing on the facility are not sterilized. Access to the facility is limited, but not automatic, and subject to a number of conditions' (§ 510).

In order to maintain a code of conduct among the five, the EMI will 'survey and monitor each central bank's adherence to the agreement'. The agreement will be something similar agreed upon by the founding central banks of the EMS, on how to implement the core group's monetary union. Hence the EMI, without power of decision, will be made 'an independent arbitrator'.

Certain conditions are attached to the would-be agreement:

- a) a non-devaluation option, conditional on using the extra-finance-facility.
- b) a consistency rule for monetary policy geared to targeting monetary aggregates, interest rates and nominal income. 'Money supply is then to grow in proportion to a commonly agreed nominal (or unavailable) rate of inflation plus the expected growth rate of potential output' (see § 525).
- c) a 'no sterilization of reserve flows' clause aided mainly by the extra-finance-facility.

It is recognised by the AMUE study that its kind of 'Monetary Union of the Five' presupposes autonomous and politically independent central banks as well as additional measures. These additional measures are about 'the voluntary acceptance of a productivity oriented wage rule' (§ 473). This wage rule will form the base of a European approach to an incomes policy.

A second element necessary for the 'MU of the Five' is to form 'an independent group of economic advisers, consisting of economic experts respected across Europe, to draw up an annual 'Report on Economic and Monetary Convergence in the EC'' (§ 475). The task of the economic experts will be to act as impartial assessors of what is needed for the formulation of guidelines of the economic policies of the Member States so that economic policies of Member States become coherent and consistent with stability oriented growth.

#### IV. Comments on the AMUE proposal

The AMUE study neither states the assumptions under which its 'MU of the Five' will be possible, nor is it explicit on who gains and who bears the costs. It implicitly assumes that if the 'MU of the Five' succeeds, it will be good for the Community and this will be an external economy to the rest (see AMUE § 482). If one adds to it that the study associates the formation of the 'MU of the Five' with economic growth and price stability, then the economic logic rests with the welfare gains shared by the rest.

The AMUE study recognizes that its 'MU of the Five' essentially establishes a two-speed-Community and adds: 'The Maastricht Treaty leaves little room for an institutional two-speed approach to EMU, at least after 1996' (§ 481). Yet it justifies its choice on welfare considerations.

The innovation introduced by the AMUE resides with its proposal to reform the present asset settlement rule of the EMS (the latter obliges national central banks to repay all interventions credits with foreign exchange reserves) by suspending the asset settlement rule via the introduction of the extra-finance-facility (EFF).

This reform presupposes:

- a) independent monetary policies among the five of the 'core group',
- b) high substitutability of the assets included in the definition of M3,
- c) full control of money supplies by each central bank of the 'core group',
- d) equal partners within the 'core group',
- e) an exogenously given supply of money for each of the five,

- f) the EFF acts as a common pool of reserves to which only the five have access but subject to the conditions stated earlier, and
- g) the anchor currency is not endogenous to the system.

The above seven conditions lack realism. They could be applicable if two of the conditions of the inconsistent trinity hold. In the presence of global markets in trade, banking, finance, direct investment and capital, assumptions: a), c) and e) do not hold.

Assumptions d) and g) cannot be made because among the 'group of the five' the dominant central bank is the Bundesbank and the anchor-currency to the five is the D-Mark.

The unrealistic nature of the b) assumption is shown by recalling the broader definition of the money supply, M3:

M3 = currency in circulation + sight deposits with banks  
+ savings deposits + claims on monetary institutions  
+ placements as deposits at statutory notice or with contractual maturity over one year.

For one country only, Germany, in February 1991, M3 was 719 839 mio ECU of which M1 accounted for 261 235 mio ECU and M2 for 471 522 mio ECU.

The wage-setting rule is based on the idea that money wage increases will be linked to productivity. In this way, the study believes, the cost-push inflation will be dealt with and inflationary expectations will wither away; uncertainty will then be manageable. However, this wage-setting rule does not necessarily conform to the varied practices in the twelve Member States. Theoretically, if the service sector accounts for a substantial part of GDP, the measurement of productivity becomes difficult, almost impossible.

The Council of Economic Advisors is similar to what it exists in the USA or in Germany. This body will be completely independent of Member States or of Community institutions and will have a task: 'offer independent opinions on all aspects of economic policies and make recommendations to all Member States'. All recommendations will be made public in order to induce Moral Persuasion on Member States to follow consistently the wage/productivity rule or adjustment policy programme. It should be recalled here that the Martin-Herman (A3-0123/92) and Roumeliotis (A3-0043/93) reports have requested an interinstitutional agreement in the economic field of EMU.

In the AMUE study, it is believed that speculation originates in a situation characterised by complete capital liberalisation and integrated finance and capital markets while labour markets are segmented and labour mobility is low. Hence if the labour market is made flexible by a wage-productivity rule, speculations will be constrained. The Group of Ten Study has found that global markets account for a large part of speculation.

If the AMUE scheme of the credit mechanism is accepted, the existing intervention mechanism of the EMS will be dispensed with. The objective will be to regain control of the money supplies of the 'core group' so that the stability of money supplies will be enhanced. The logical conclusion to draw from such a scheme will be to say that inflation will be controlled because the joint money supplies are controlled.

Yet the EFF may dispense with the existing repurchase-clause provided that a high degree of substitutability between assets denominated in various currencies exists. This could be shown to exist if interest rates have converged.

The more serious problem of the AMUE study is that it feeds speculation and encourages competitive devaluations by the countries that are not members of the "MU of the Five". If both phenomena gain momentum, they may lead to the break up of the Single Market.

The AMUE study slightly reforms the EMS; it effectively means reinforcing the dominant position of the Bundesbank whose currency has lost its capacity to internalise money externalities.[5] By forming the 'MU of the Five', it maintains the D-Mark at the centre of phase II of EMU, which will thus continue to internalise confidence externalities and capture seigniorage externalities.[6] In fact, the proposal for a 'MU of the Five' was first made by the former President of the Bundesbank, Dr. Pöehl, appearing before the Economic Committee in April 1991, who recently restated the same proposal.[7]

#### V. Parliament's Resolutions: A Proposal for phase II of EMU

The gold standard (1894-1914) had the 'pound sterling' as its dominant currency in making international payments and foreign transactions and in holding currency reserves. The Bretton Woods agreement (1944-1973) was a 'dollar system'; it had a hegemonical currency convertible into gold and assumed the role for a reserve currency and of a world medium of exchange.

The EMS was conceived in 1978 as having the ECU at the centre of or as the anchor to the system. The financial and capital markets have established the Mark as the anchor to the EMS. For the reasons cited in the AMUE study (see §§ 333-345), the DM cannot bear the full burden of an anchor and, thus, cannot continue being at the centre of the second phase of EMU.

Given the comments on the AMUE scheme, the rapporteur's alternative proposal seeks to build on Parliament's earlier resolutions in the context of the institutional structure of phase II of EMU. Hence the reform of the EMS resides in the idea of a system having a dual-anchor.

The proposal seeks to develop for stage II of EMU the neglected aspect of the Resolution of the European Council of 5 December 1978 establishing the EMS, namely, the full utilization of the ECU as a reserve asset and means of settlement (§ 1.4). In other words, the ECU will not become a transactions currency but merely the means of settlement for official and private financial institutions. This could be done in the context of the tasks of the EMI conferred by Article 109f of the TEU and by the protocol on the EMI annexed to the TEU. Thus the official and private ECU circuits will be integrated.

A monetary system based on a dual-anchor needs a stable relationship between the exchange rates of the two currencies involved. In the scheme proposed, the ECU and the D-Mark are chosen to serve as the dual anchor. The D-Mark is chosen for obvious reasons; it has already been established as the anchor to the EMS and is supported by the largest economy of the Community.

The ECU is chosen because:

- a) it is the officially recognized currency to be at the centre of the EMS (EMS Resolution, § 2.1),
- b) it is the currency designated by the TUE to be fully developed in phase II of EMU (Articles 109f and 109g),
- c) it is the currency that will replace national currencies in phase III of EMU (Articles 3a and 109l).

Whereas the DM has the Bundesbank as the monetary authority responsible for its management, the ECU will only have the European Central Bank as the monetary authority assuming responsibility of its management in stage III of EMU, which is likely to start not earlier than 1 January 1999. In the interim period (1994-1999), the EMI (see TUE, Art. 109f, §§ 2 and 3)) shall:

- i) facilitate the use of the ECU and oversee its development,
- ii) oversee the smooth functioning of the ECU clearing system,
- iii) promote the efficiency of cross-border payments,
- iv) supervise the technical preparation of ECU banknotes.

In order that a stable relationship between the ECU and the DM is maintained, three requirements are necessary. First, Article 109g of the TEU, which fixes the currency composition of the ECU basket, should be interpreted within the meaning of Article 1 of Council Regulation (EEC) n° 1971/89, which has amended Regulation (EEC) N° 3180/78. Article 1 of Regulation (EEC) N°1971 states that 'the composition of the ecu...will be determined by firstly the weights, ... secondly, the rates for the ecu derived by the Commission from the rates of the dollar...'. The legal interpretation of 109g referring to freezing the currency composition is open if the above Regulation is accepted as the base for it.

Second, the ratio of the values of the ECU and the DM should be maintained stable. This can be done by endowing the EMI with the task of holding and managing foreign exchange reserves. The two monetary authorities: Bundesbank and EMI, will have to work out operational and technical rules for joint interventions.

Third, the value of the ECU vis-à-vis its component currencies should be maintained stable by adopting the formula of the German government or the Spanish government proposal on the hardened ECU. The objective is to redefine the ECU every time a realignment occurs so that the ECU exchange rate remains stable with respect to the DM. This can be done either by decreasing the basket amount of the currencies which had appreciated most vis-à-vis the DM or by increasing the currency components of the devalued currencies.

The test to the system will come if the DM appreciates vis-à-vis all the rest. Two options are open. Either the Bundesbank will have to intervene and try to reestablish the stable relationship of the DM/ECU rate or all the rest central banks intervene to support their respective currencies. The first option entails symmetrical effects, the second asymmetrical because it is an option forced on them by the monetary policy of the Bundesbank. There is a third option; both the Bundesbank and the EMI intervene to reestablish the original DM/ECU parity; appropriate conditions should be attached to this option.

For the dual-anchor system to work symmetrically, the EMI would have to work out operational rules for all national central banks as called for in Article 109f (2) of the TEU concerned with monetary cooperation. Certain principles may be offered.

The first principle concerns the relationship of the individual currencies of the ECU basket and the ECU. A repurchasing clause will be necessary so that a national central bank that chooses to be deviant from the guidelines set out by the EMI Council will be forced to repurchase its currency against its ECU reserves.

For this principle to be applied symmetrically and fairly, the rapporteur had proposed, but the Economic Committee decided not to include it in the resolution, an Interest Rate Indicator. This Indicator should act as a guide for the EMI responsible for monitoring the monetary policies of the Member States with the aim of ensuring price stability.

A second principle is needed for determining total liquidity. The total sum of DM's M3 and ECU's M3 will broadly define the European money supply. The national money supplies (N-1) define the 'grande totale' of M3. However, total liquidity will be determined by the EMI Council.

A third principle, which the Committee decided not to include in the resolution but had been proposed by the rapporteur, would have to determine the intervention instruments. It is proposed that the German Repo system be adapted to the ECU repurchase clause. The scheme will work as the current system in Germany functions with a difference; the EMI in concert with the individual national central bank concerned will have to intervene in the market in order to maintain a satisfactory relationship between the 'grande totale of M3' and the 'European M3'. It is a relationship between money stocks and not between monetary base (as incorrectly some assert). In order that the ECU repurchase clause could be manageable, all new government debt should be denominated in ECUs.

The protocol on the statute of the EMI states that the tasks of the European Monetary Cooperation Fund (EMCF) and the management of the Very Short-Term Financing mechanism (VSTF) will be taken over by the EMI. Hence the EMS Agreement laying down the operating procedures for the EMS will have to be revised or cease to apply since all settlements will be made by means of ECU.

However, the more important aspect of the rapporteur's scheme concerns Article 6.4 of the EMI Statute. It states that 'the EMI shall be entitled to hold and manage foreign exchange reserves as an agent for and at the request of national central banks'. In order to develop this operational function of the EMI, the rapporteur proposes that the Member States' contributions of 20 % of their gold holdings and of 20 % of their dollar reserves (already transferred to the EMCF as swaps) will be definitely transferred to the EMI and become the EMI's foreign exchange reserves.

#### IV. Advantages of Parliament's Proposal

The alternative proposal solves partially the inconsistent trinity via a three-fold way. First, the fixity of exchange rates is ensured by the dual-

anchor and its relationship with the individual currencies. The irrevocable fixity becomes a stable relationship.

Second, the independence of monetary policies is transformed into a forced monetary cooperation and not a voluntary one as the EMS or the AMUE proposal recommends. All Member States participate and a monetary discipline is imposed on all.

Third, the 'conflicting quarter of globalisation' objectives is partly dealt with by the institutionalised monetary cooperation. Such cooperation via the pooling of means will seek to control inflation and stabilise the exchange rate.

Fourth, the basic flaws of the present form of the EMS stem from:

- its uncoordinated fiscal-monetary mix,
- its method of realignment of exchange rates,
- its liquidity creation,
- its asymmetric effects,
- its deflationary bias,
- its pretence of a closed economy,
- its anchor currency that cannot maintain the lowest inflation, lowest short-term interest rate and stable exchange rate.

These basic flaws are in large measure taken care of by the rapporteur's proposal for the reform of the EMS. Consequently, speculation which has inflicted a serious damage on the underlying philosophy of the EMS is partly curbed. An effective reply to speculation will be given if the phenomenon of globalisation of finance, capital, direct investment, banking and trade is tackled at a global level.

Fifth, Parliament's alternative proposal is flexible because:

- a) it can accommodate the Independent Economic Council;
- b) it rejects the de facto creation of a two-speed Europe;
- c) the ECU is developed as the TEU calls for during stage II of EMU;
- d) the Exchange Rate Mechanism does not entail the asymmetries that are currently generated by a dominant currency that cannot bear the burden of an anchor since the home country has lost its traditional fiscal soundness;
- e) the intervention mechanism does not impose unnecessary deflation on all ;
- f) total liquidity is kept manageable;
- g) the defence of currencies becomes a cooperative game.

## Notes

- [1] See H.C. Wallich, The Monetary Crisis of 1971 - The Lessons to Be Learned, Washington, DC: The Per Jacobsson Foundation, 1972, for a lucid statement on the 'inconsistent trinity' and discussion on the crisis of the Bretton Woods system. The implications for monetary and fiscal policy were treated by R.A. Mundell, "The Appropriate Use of Monetary and Fiscal Policy under Fixed Exchange Rates", IMF Staff Papers, March 1972. The meaning of monetary cooperation is analyzed by K. Hamada "A Strategic Analysis on Monetary Interdependence", Journal of Political Economy, August 1976.
- [2] The meaning of global finance and capital markets and their implications for macroeconomic policies and the exchange rate policy are treated in the Group of Ten Study on International Capital Movements and Foreign Exchange Markets, Washington: Mimeo, April 1993.
- [3] The AMUE study on "The EMS in transition: Lessons learned from the experience of the EMS and the completion of the Internal Market. Policy options to prepare stages II and III of EMU" was commissioned by the EP.
- [4] See Resolution of 7 April 1992 based on the Martin-Herman Report (A3-0123/92); of 30 October 1992 based on the Oral Question with Debate on the EMS; of 17 December 1992 based on the Randzio-Plath report (A3-0392/92) and of 15 July 1993 based on the Patterson report (A3-0213/93).
- [5] A money external economy (or diseconomy) is defined as an event realised in the market that confers an appreciable benefit (or inflicts an appreciable damage) on some person(s), transactor, institution who (which) were not fully consenting party(ies) or active participant(s) in reaching the decision(s) which led directly or indirectly to the event in question.
- [6] Five categories of money externalities are identified: Transaction costs externalities, Price level externalities, Confidence externalities, Learning and Technological externalities and Seigniorage externalities.
- [7] See article by Karl Otto Pöehl, "How to Save the European Monetary System", The Wall Street Journal, 1 February 1993.

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