

ECONOMIC AND MONETARY INTEGRATION

WITHIN THE EEC

(A REVIEW OF LITERATURE)

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VASUDHA GARDE

GOKHALE INSTITUTE OF POLITICS AND ECONOMICS,
PUNE 411 004

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Chapter I

INTRODUCTION

(Period leading to EMU 1957-69)

1.1 Economic/Trading Blocks - A Post War Development

After the Second World War there was a major change in the organisation of the international economy. The pre-second world war international economy was territorially balanced and integrated. This is manifested in the theoretical work on international economics which has emphasized a Government of "one world model" or an integrated international economy. Despite this preference for a "one world model", the actual international economy was moving in a different direction. In place of a strong unifying economic force, there were a number of regional blocks. The European countries took the lead in organizing a regional free trade area and forming an EEC in the year 1957. About the same time in the Socialist countries of the Eastern Europe a similar block was already formed in 1949. It was called Communist Economic Council (COMECON) or Council of Mutual Economic Aid (CMEA) as described officially in Socialist countries. Similar trends were also seen in the LDC of Latin America which formed their Economic Block called Latin American Free Trade Association (LAFTA).

1.2 Stages of Economic Integration

The theory of integration refers to the commercial policy of deliberately/ discriminatively reducing/ eliminating trade barriers only among the nations joining together. The degree of economic integration ranges from preferential trade arrangements to free trade areas, customs unions, common markets and economic unions.

1.2.1 Preferential Trade Arrangements

These provide lower barriers on trade among participating nations than on trade with non-member nations. This is the loosest form of economic integration, e.g., British Commonwealth Preference Scheme, 1932.

1.2.2 Free Trade Area (F.T.A.)

This is the form of economic integration wherein all barriers are removed on trade among members but each member retains its own barriers on trade with non-members, e.g., EFTA, 1960, UK, Austria, Denmark, Norway, Portugal, Sweden, Switzerland and Finland as an associate member.

1.2.3 Customs Union - allows no tariffs or other barriers on trade among members (FTA) and in addition harmonizes trade policies (common tariff rates) towards the rest of the world, e.g., Six countries of West Europe - France, West Germany, Italy, Belgium, Netherland and Luxembourg - signed the Treaty of Rome in 1957 for the creation between them

a customs union or common market.

1.2.4 Common Market - goes beyond a customs union by also allowing the free movement of labour and capital among member nations (EEC in 1970).

1.2.5 An Economic Union - goes still further by harmonizing or even unifying the monetary, fiscal and tax policies of member states. This is the most advanced type of economic integration, e.g., Benelux in 1960 (now a part of EEC), US. One important aspect of complete economic union is that exchange rates are fixed permanently among member countries of the union.

Fixity of exchange rates can be achieved through three different institutional arrangements -

1.2.5.1 Payments Union - In a payments union countries pool their international reserve assets and provide for the financing of intra-union payments imbalances.

1.2.5.2 Financial Policy Coordination - requires in addition, that countries harmonize their monetary policies and avoid the consequences of large destabilizing capital flows.

1.2.5.3 Under Monetary Integration - countries surrender completely the right to make independent monetary policies, thus permitting the maintenance of permanently fixed exchange rates and the introduction of a common currency.

Thus, Monetary Union has inside its boundaries the total and irreversible convertibility of currencies. (Currency Integration) the elimination of margins of fluctuations in exchange rates and complete liberation of capital movements (financial integration). Whereas Economic Union relates, not only to currencies and to foreign exchange markets, but also to fiscal and monetary policies. Economic Union and monetary integration must occur together. One is impossible without the other.

1.3 Reasons for Economic Integration

Possibility of economies of scale, specialisation of production and an improvement in efficiency through competition. Changes in terms of trade for the union vis-a-vis the rest of the world and changes (improvements) in the rate of growth.

Problems one can pose -

- a) Has the EEC fulfilled any of these expectations regarding trade, growth, concentration, specialisation, money and banking?
- b) Has the EEC become the great market free of obstacles to factor movements? Has the community been an example of trade creation or trade - diversion?

Comments

- a) At the trade level, trade creation has tended to

outweigh trade diversion.

b) There has been a great growth in inter-community trade and in trade between EEC and third parties.

c) A qualified and selective mobility of capital and labour has been achieved.

d) In the field of banking and business absence of European legislation has made it easier for multinationals (American Companies) to implant themselves in the Common Market rather than to encourage inter-state mergers in the Community.

One can observe, in two important areas, an increase in the welfare of the inhabitants of the Common Market, their wealth has increased and their choice of goods has widened. This was followed by a number of moves towards economic and monetary union in the years that followed, a move towards inter-penetration would, it was thought, do much to increase the welfare of the inhabitants of the EEC.

1.4 Economic Integration and the EEC

1.4.1 The Treaty of Rome created a system (EEC) which, for its proper functioning requires some form of monetary organisations. Initially, the Bretton Woods system provided such a framework, however, with the decline of the Bretton Woods system in the late 1960's, the issue of European

Monetary Integration was first raised.

1.4.2 Smithsonian Agreement, 1971, Washington

The countries of the EEC agreed in 1972 to manage their currencies so that their exchange rates moved in relation to one another, and within certain narrow bands, in relation to the dollar. It was considered that the management of the currencies of the community in this way was the necessary first step to monetary union, and eventually to the ideal of a common currency. The fluctuations in the rates of each currency were confined within a margin of +/- 2.25 per cent. In addition, the group as a whole was also managed, in respect to the dollar with fluctuations confined within a range of +/- 4.5 per cent. Initially, the arrangement was referred to as 'the snake in the tunnel'. After 1973, however, the 'snake' was left to float against the dollar, and the 'tunnel' vanished. The countries in the 'snake' were for varying periods of time, Belgium, Denmark, the Netherlands, West Germany, the U.K., Italy, France and outside the EEC itself, Sweden and Norway.

Chapter two discusses the stages of EMU incorporating the snake.

1.4.3 European Monetary System (EMS)

This method of managing European currencies was replaced in 1979 by the European Monetary system.

In 1980-81, the US dollar regained its strength but this could not bring back a system based on the dollar, because many things had changed. The international monetary system (IMS) would thus be based on more than one reserve currency for some years to come.

The EMS could be the optional way to organize the European Pole of the IMS. It would increase the effectiveness of a Euro-American monetary dialogue.

The decision to promote the evolution of the EMS will be an important political decision. It will be affected by deep historical and economic forces - rather than by merely technical requirements. These forces are related to two common problems -

- a) Future of the common market, and
- b) Evolution of international and monetary relationships.

The evolution of the EMS has to be seen in the light of the contribution it can make to a better handling of these problems.

The EEC agreed in 1978 to the setting up of the EMS to replace the existing 'European Currency Snake' procedure for the control of exchange rates. The EMS was introduced in 1979 for an initial phase of two years with the intention to introduce a more comprehensive system

in 1981. The second phase, however, has been postponed. The system is similar to that of the European Currency Snake in that it is designed to keep the member countries' exchange rates within specified bands in relation to each other. Each currency in the system may fluctuate only between ± 2.25 per cent against any other currency. This applies to the West German mark, the French franc, the Belgian franc, the Danish krone, and the Irish pound. The Italian Lira although within the EMS, is exceptionally allowed to fluctuate within a margin of ± 6 per cent. The UK and Greece do not participate in EMS exchange rate arrangements. In addition to the limits set within which currency rates may move one with another, each currency is allowed to diverge from its European Currency Unit (ECU) Central rate by only a given percentage. This percentage differs between currencies according to the weight of the currency which is used in calculating the ECU. (Table 1.1)

Table 1.1 indicates an increase in bilateral stability of ECU component currency exchange rates in recent years. The weighted average of the coefficients of variation of these currencies against the ECU is lower in the more recent period than for the first four years of the EMS. The exchange rates of the ECU's component currencies have also generally been more stable against the ECU than, for example, against the deutsche mark or the SDR, but more stable against the SDR than the US dollar.

Table 1.1 : Coefficients of Variation of ECU Component Currency Exchange Rates in Terms of the ECU, SDR, Deutsche Mark, and US Dollar

Country	1979-82				1983-85			
	ECU	SDR	DM	US \$	ECU	SDR	DM	US \$
1) Belgian/ Luxembourg franc	0.046	0.126	0.074	0.203	0.010	0.057	0.010	0.094
2) Danish kroner	0.048	0.121	0.068	0.195	0.010	0.056	0.010	0.092
3) French franc	0.043	0.125	0.071	0.201	0.015	0.066	0.019	0.102
4) Deutsche mark	0.028	0.065	-	0.136	0.010	0.054	-	0.092
5) Irish pound	0.015	0.095	0.037	0.170	0.014	0.064	0.019	0.100
6) Italian lira	0.060	0.141	0.084	0.216	0.040	0.080	0.044	0.111
7) Netherlands guilder	0.028	0.068	0.009	0.139	0.007	0.058	0.006	0.096
8) Pound sterling	0.072	0.060	0.071	0.121	0.029	0.067	0.032	0.104
9) Greek drachma ¹	(0.097)	(0.168)	(0.116)	(0.240)	0.139	0.181	0.164	0.195
Weighted Average ²	0.060	0.123	0.063	0.218	0.012	0.038	0.012	0.059

1 The Greek drachma has been included in the ECU valuation basket only since September 17, 1984 and is included in the weighted average in this table for the first period.

2 Weighted by average nominal GDP.

Note: The EMS arrangement is designed to narrow fluctuations in exchange rates among participating currencies. To the extent that this objective is met and participating currencies have a heavy weight in the ECU's valuation, this arrangement would tend to stabilize the value of most EC currencies in terms of the ECU.

Source : International Monetary Fund (International Financial Statistics).

The ECU is defined as a weighted average of all EEC currencies (including sterling) the weights used being the share of each country's output in the EEC total. (Table 1.2) The ECU is, therefore, a 'basket' of currencies, similar in principle to SDR's. The previous snake did not include the requirements to contain movements in rates in relation to the ECU.

Chapter 3 covers the EMS, ECU and further developments of EMS.

Table 1.2 : The ECU Valuation Basket

Currency	March 13, 1979 - Sept. 16, 1984 ¹		Sept. 17, 1984 - Present ²	
	Percent- age weight at inception ³	Currency units	Percent- age weight at inception	Currency unit
Belgian Franc	9.3	3.66	8.2	3.71
Danish kroner	3.1	0.217	2.7	0.219
French franc	19.8	1.15	19.0	1.31
Deutsche mark-	33.0	0.828	32.0	0.719
Irish pound	1.1	0.00759	1.2	0.00871
Italian lira	9.5	109	10.2	140
Luxembourg franc	0.4	0.14	0.3	0.14
Netherlands guilder	10.5	0.286	10.1	0.256
Pound sterling	13.3	0.0885	15.0	0.0878
Greek drachma	-	-	1.3	1.15
	----- 100.0		----- 100.0	

N.B. Portugal and Spain joined EEC on Jan. 1, 1986.

- 1 Council Regulation (EEC) No. 3180/78 of Dec. 18, 1978, Commission of the European Communities, (Official Journal of the European Communities), Vol. 21 (Dec. 30, '78)
- 2 Council Regulation (EEC) No. 2626/84 and Declaration of September 15, 1984, Commission of the European Communities (Official Journal of the European Communities), Vol. 27 (Sept. 16, 1984).
- 3 Once the currency amounts are established, the percentage contribution of each currency in the basket to the value of the ECU will vary, depending upon movements in the bilateral exchange rates.

Source : Occasional Papers (51)
The Role of the SDR in the IMS.
IMF, Washington D.C., March 1987.

Chapter II

TOWARDS AN EMU

2.1 The Treaty of Rome (Treaty Establishing the EEC and Connected Documents, 1957)

This movement towards economic and ultimately political integration of the major west European countries has been one of the most important political and economic developments. Since the end of the World War II with major effects on the patterns of world trade and power, the EEC enlarged since its inception by the addition of Britain, Denmark and Ireland, has a population exceeding that of either US or the Soviet Union. The foreign trade of EEC with the rest of the world exceeds that of any other country. Principles developed are applicable to all regional associations. (American Common Market, The Benelux Union, and the New Zealand - Australia free trade association.)

On short-term economic policy article 103 of the treaty states that it should be considered as a matter of common interest and, therefore, it should be subject to mutual consultations.

As regards balance of payments each member state shall pursue the economic policy to ensure the equilibrium of its overall balance of payments and to maintain

confidence in the currency while ensuring a high level of unemployment and the stability of the level of prices,

In the monetary field, co-ordination would be promoted through the creation of a monetary committee. Article 106 states exchange controls should be eliminated to the extent necessary to make possible the movements of goods and services, persons and capital, which would be liberalised as a consequence of the obligation of the Treaty.

On the other hand, the exchange rate which is of common interest, and the possibility of mutual aid in case of serious difficulties in Balance of Payments is envisaged in the Treaty.

2.2 Early Efforts 1960-68

Procedures for consultations and policy co-ordination were organised after the signing of the Treaty of Rome. In addition a number of measures were taken in the early '60s. However, 1964-68 were the years of indifference - no significant action was taken to promote monetary integration. The failure to make any appreciable advance in monetary integration during this period seems to reflect the continuing payments surpluses and mounting reserves of the individual member countries. During this period, however, the Commission continued to stress the need to move

towards monetary solidarity. It argued that, with the growing integration of the Community on other fronts (rapid removal of trade barriers, etc.) one country tended to have greater impact on the economic considerations of the others. As a result, coordinated policy decision became urgent. However, these suggestions met with no response.

2.3 Crises of 1968-69

The period between 1968-69 was characterised by a radical change in the relative positions of the EEC countries within the IMS. From serious shortage of foreign currencies from which they had suffered in the 1950's, the six moved to a long and uninterrupted period of balance of payments surpluses and mounting foreign reserves. Export surpluses served as a major contributing factor for the high rates of growth which the West European economies enjoyed during these years. At the same time there was a gradual weakening of the reserve currencies - the dollar and the pound, which finally led to the collapse of the Bretton Wood's system. If the end of the convertibility of the dollar into gold (officially declared in August 1971) is considered as the end of postwar IMS, then the de-facto end of the convertibility had already taken place in March 1968 with the creation of a two-tier gold market or even before. The various proposals which were put forward during this period leading towards monetary integration in the EEC

were motivated by external preoccupations. Thus the inability of EEC countries to define a common external monetary policy constituted a major stumbling block. Reaching a common policy became difficult by the politicisation of international monetary issue by General de Galls. The short period of EEC unity in International Monetary Reform talks, provided a clear illustration of the bargaining strength of EEC with the French Political crisis of 1968 and the turmoil in the EEC exchange markets which followed it, internal preoccupations became very important.

The EEC went through the worst economic crisis since its inception. As a result, the customs union was shaky, so also the CAP of the EEC. During this period very few achievements were made in the EEC monetary co-operation. An infra-structure of committees was created. In July 1967, M. Raymond Barre, replaced M. Marjolin as the Commissioner responsible for economic and financial affairs. The Commission emphasized on cooperation instead of integration. It also came up with a memorandum containing proposals on the coordination of economic policies and on monetary cooperation (Barre Report, 1969).

This is the first Barre plan as against the plan submitted by the French Commissioner after the Hague Summit (1969)

2.3.1 First Barre Plan

The Commission started by stressing the degree of interdependence already reached between the member countries as a result of the CU and the CAP, and the effects which this had on the effectiveness of national economic policies. It was believed that, unless some steps were taken towards further economic monetary integration regressive steps would become inevitable in future.

2.3.1.1 Main elements of the Barre Plan :

(1) With the experience of the first two medium-term economic policy programmes behind it, the Commission wanted an improvement of the mechanism and a greater convergence and compatibility between national economic objectives.

(2) It called for an improvement of the co-ordination of short-term economic policies. The system of prior consultations should be extended to all economic policy decisions which might have an influence on the economies. Such consultations should be extended to the preparation of the national budget.

(3) It suggests the establishment of a community mechanism of monetary cooperation, which would include both short-term monetary support and medium-term financial aid. For both upper ceilings should be adopted as well as maximum quotas for each individual country.

2.3.2 Together with the first Barre plan there was another important issue which preoccupied the minds of the EEC Finance Ministers and Governors of the Central Banks (Mons meeting 1969). The policy of credit restraint in US, had led to an extensive borrowing by US companies and banks on the Euro-dollar market. This brought an outflow of capital from the EEC countries with a heavy drain in foreign reserves and a subsequent rise in interest rates. The selective measures against capital outflows, which were introduced in Belgium, France and Italy and even in the FRG before the 1969 speculative crises, did not succeed in isolating the EEC capital markets from international pressures. The years 1968 and 1969 marked by a strong rising trend in interest rates at the international level, showed the degree of interdependence reached between national capital markets, with the Euro-dollar market being the main transition belt. They also served to make clear the asymmetrical position the USA and the relative weakness of the EEC countries, with their small capital markets in this interdependent framework. The EEC countries realized that they could no longer use the monetary instrument for purposes of internal balance as long as required policy for the latter did not coincide with the monetary policy of the USA. Among the EEC countries, only FRG was able, at least to some extent, to hold back the rise in

interest rates because of the undervalued position of the mark. The monetary crises of 1968-69 ended with a decision of the new French government to devalue the franc in August 1969, which was followed by a revaluation of the mark in October. The fixing of a new parity for the German currency was preceded by a short period of floating. Any illusions which had been left about the existence of a de-facto monetary union, were therefore shattered. On the other hand, the devaluation and German revaluation were not preceded by consultations within the EEC as decided.

2.4 New Initiatives (1969-71)
(Preparatory Stage upto 1971)

A Summit Conference of the Community heads of State was convened at the Hague on December 1 and 2, 1969 (Werner Report, 1969, Annex, 17).

2.4.1 The Hague Summit
(1969 President (French) Pompidou).

Main themes which dominated discussion during the Hague summit -

(a) 'Completion' - measuring the achievement of objectives in which the Community still lagged behind.

In Practice (especially to the French) completion meant the adoption of a regulation for the financing of the CAP and the creation of the Community's own resources.

(b) 'Deepening', meaning thereby that new initiative would have to be taken to re-launch European integration after the end of the transition period envisaged by the Treaty of Rome.

In practice the issue of deepening of the EEC was dominated by proposals related to the economic and monetary fields.

(c) Finally 'Enlargement' referred to the entry of the four candidate countries, i.e., Britain, Ireland, Denmark and Norway.

2.4.1.1 Plans for an EMU - already in July 1969, the Council had reached an agreement on two main elements of the Barre plan -

- (a) on the system of prior consultations
- (b) on principle of short-term monetary support.

The Commission stressed the need for progress towards EMU.

On the monetary aspect of EMU, two different elements could be distinguished.

- (1) the question of convertibility and thus of freedom of capital movement, and
- (2) the exchange rate system to be applied within the EEC during the transition period.

At the Hague Summit, it had become apparent that the desirability of an EMU as the final objective, shared by both President Pompidou (French) and Chancellor Brandt (German) did not stop the two leaders from having different priorities for the initial stages. While the German Chancellor insisted on the coordination of economic policies as a pre-requisite for any progress towards EMU, the French President seemed to be more interested in immediate measures in the monetary field and in setting-up the foundation for the creation of a regional monetary block (optimum currency area). In concrete terms the difference of views was centred on two issues :

The monetarists advocated the institution of an Exchange Stabilisation Fund and a first reduction of intra-EEC margins of fluctuations during the first stage of EMU. (German, Dutch and Italian members voiced their disagreement.). The main difference seemed to be based on whether or not the Community should move towards an irrevocable fixity of parities and an elimination of margin of fluctuation, before the system of economic coordination had proved to work systematically. The controversy over the narrowing of margins and setting up of an 'Exchange Stabilisation Fund' remained unresolved in June 1970, when the Interim Report of Werner Group was submitted (Werner Report, 1970).

2.4.1.2 By a decision of March 6, 1970, the Council set up a Committee, headed by Werner of Luxembourg, to draw a plan based on the Barre Report of 1969, to establish by stages an EMU in EEC.

In the meantime a debate was developing as to the timing and priority of the various steps towards EMU.

In its final form, the envisaged union was to have the following main features:

(1) A Single Community currency or the rigid fixing of the exchange rates of the member currencies inter-se, with complete elimination of margins of fluctuations and the "total and irreversible" inter-convertibility of such currencies.

(2) complete liberalization of all capital movements within the area;

(3) a common central banking system, organised along the lines of the federal reserve system, involving common management of internal and external monetary policy and pooling of external monetary reserves; and

(4) centralised responsibility in a Community "Centre of decisions for economic policy" politically responsible to a European parliament.

The final goal was to be approached in a series of stages of which only the first was spelled out.

First stage (January 1971 to December 1973) (As per Werner Report, 1970).

(1) A series of measures to reinforce procedures for compulsory prior consultations in matters concerning principally medium-term economic policies, cyclical policy, budgetary and monetary policies.

(2) To further liberalize intra-Community capital movements - Abolition of residual exchange controls and discriminative practices which still restrict movement of capital between member countries, coordination of policies concerning current problems and structural aspects of capital markets - To move towards a European capital market.

(3) To standardize various instruments of economic policy and fiscal standardization, and in particular adoption by all member countries of the value-added tax system with 'assimilation' of national rates; alignment of excise duties sufficient to allow suppression of controls at intra-community frontiers.

Standardization of the instruments of monetary policy: obligatory consultations to be held by the Committee of the Central Bank of Governors which will scrutinize at least twice a year monetary and credit conditions in each member country and will issue guidelines concerning principally, interest rates, bank liquidity and the granting of

credit to the private and public sector.

(4) To narrow margins of exchange rate fluctuations among member countries. The Report recommends that from the start of the first stage, the central banks should limit the fluctuations in the intra-group rates of exchange within bands narrower than those resulting from the application of margins in force for the dollar. Narrowing of the margins would be accompanied by interventions on exchange markets in Community currencies.

During the first stage the mutual credit facilities to which such interventions may give rise should not exceed those laid down for the mechanism of monetary support for short-term.

2.5 The First Stage (January 1971 to December 1973)

2.5.1 Interlude

In March 1971, the governors of EEC central banks decided to reduce the intra-EEC margins of fluctuations from 1.5% to 1.2% on either side of the parity. However, this decision was never applied because it coincided with the worst international monetary crisis and the collapse of the Bretton Woods system. In 1970-71, the US balance of payments' deficit was large and it was combined with an outflows of capital. As a result of a change in domestic monetary policy in the US and lowering of interest rates,

capital started flowing back to the European countries.

2.5.1.1 Crises of 1951

In May 1971 speculation in the exchange markets increased as a result of French pronouncements calling for a revaluation of gold and the proposal made for a deutschemark float. The German currency found itself in the forefront of speculative attack both :

(a) because of an almost complete lack of exchange controls, and

(b) because the deutsche mark was seen by speculators as the safest bet.

In an emergency meeting, the EEC finance minister, Schiller, proposed a joint-float of all EEC currencies with respect to the dollar, and offered German support in an attempt to persuade other countries to accept this proposal (agreed upon Benelux, opposed by France and Italy). Instead France proposed the adoption of capital controls by the EEC countries to ward-off speculative inflows. Failing to reach an agreement, the Council of Ministers decided to allow certain countries to float their currencies (Luxembourg 'agreement to disagree' 1966). The German and the Dutch currencies were floated, while new capital controls were introduced in almost every single EEC country.

The exchange crises which ended in May 1971 faced German policy makers with conflicting forces. On the one hand the Deutsche Bundes bank was forced to accumulate large amounts of dollars in order to support the existing rate leading to strong inflationary pressure on domestic economy. At the same time, the Federal Republic was subject to pressure from the US to revalue the Mark and thus help to correct US payments deficit which was against the interests of exporting industries. This coincided with the long-term interest of a country, largely dependent on foreign trade and relying on export-led growth, in avoiding accumulation of exchange controls at the world level. All these forces combined in favour of revaluation either by fixing a new parity for the mark, or by floating and thus letting the market forces decide on the new exchange rate. Thus a joint-float (EEC Currencies) was an ideal solution. Once this possibility was ruled out, a unilateral float of the mark was chosen as the second best. The EEC countries agreed on the principle of fixed but adjustable parties. It was mentioned that any realignment of exchange rates should include the US dollar. (Smithsonian Agreement, 1971) The EEC countries also called for measures to control capital movements, which would take the form of either:

- (a) a limited widening of margins, or
- (b) direct controls of short term flows.

Thus both French and the Germans were satisfied.

In the EEC, the floating of currencies led to renewed fears about the survival of the customs union and the CAP.

The final agreement (between M. Pimpodou and Mr. Nixon, on the realignment of exchange rates, which would also include a devaluation of the dollar) was reached at the Smithsonian Institute in Washington in December 1971, when the new 'Central rates' as opposed to the official parties declared at the IMF, (Table 2.1) were announced together with a widening of margins of fluctuations to 2.25 per cent on either side of the dollar parity (and President Nixon announced that he would try to devalue the dollar).

Table 2.1 : Realignment of Currencies, 5 May - 18 Dec. 1971

	Currency	Change against Gold	Change against the US Dollar
1.	D. Mark	+ 4.6	+ 13.6
2.	Belgium Frank	+ 2.8	+ 11.6
3.	Guilder	+ 2.8	+ 11.6
4.	French Frank	-	+ 8.6
5.	Lira	- 1.0	+ 7.5
6.	Pound	-	+ 8.6
7.	Dollar	- 7.9	-

EEC failed to adopt a joint stand, in 1971 (May) there were 2 possibilities for joint action open to them:

- (a) They could either float their currencies together with respect to the dollar, or
- (b) They could introduce controls to ward-off speculative inflows.

Both were tried by the EEC at a late stage but failed to provide a permanent solution. As the crisis continued the choice open to the EEC countries became one between : (a) greater exchange rate flexibility (following a realignment of parities), and (b) more exchange controls, (usually presented in the form of a two-tier market system).

Germany, Italy and the Netherlands favoured greater exchange rate flexibility although no country was in favour of generalized system of floating. On the other hand, France, Belgium and Luxembourg opted for an EEC system of floating a two-tier market.

2.5.1.2 Illogicality in the position of France and the US

On the one hand, the price of gold had not reached the heights which it later attained and a return to the gold standard was still the official objective of French Diplomacy. On the other hand, the collapse of the dollar in the years which followed and the unwillingness of Central

banks to hold dollar balances may be used as evidence that the French and the US positions at the time were not completely illogical. France was one country in contrast with the F.R.G. which incurred a serious loss in its reserves with the devaluation of the dollar.

Another important reason which helps to explain the disparate measures adopted by the EEC countries was the fact that these countries were faced with different economic conditions. Clearly a joint float between a strong Mark and a weak Lira could not be sustained for long unless it was preceded by a realignment of parities and it were recognized that exchange rates could be changed more frequently than in the past. Both France and Italy were afraid that their currencies would be pulled upwards by the Mark. The German offer of foreign exchange support would not be sufficient to persuade them to join because of the prospect of incurring big debts to the Deutsche Bundesbank. Thus, trade/monetary negotiations were linked with wider political issues.

Although reactions of different EEC countries cannot be understood unless they are placed within a broader political context, different degrees of vulnerability to US pressure can at least partly explain the divergence of responses.

2.5.2 Pre-Smithsonian Period

Until May 1971 the official parities of all EEC currencies were fixed in terms of gold. In practice, the US dollar was used as a standard of reference, which amounted to the same thing, since the price relationship between gold and the dollar had not been changed during the whole post-war period and the latter was still convertible into gold.

According to the IMF Articles of Agreements each currency was allowed to fluctuate within 1% on each side of its dollar parity. Following the European Monetary Agreement, which came to replace the European Payments Union in 1958, the margins of fluctuation of all the European currencies participating in this agreement were limited to about 0.75% on either side. Since there existed no particular monetary arrangement for the EEC currencies exactly the same thing applied to the latter.

The American currency was also used as a means of intervention in the hands of national monetary authorities which served to keep each currency within the margins allowed. This has one important consequence, namely, that the reciprocal margins of fluctuation between any two currencies other than the dollar were double, those applicable to the relation between any currency and the dollar. Illustration : AA and BB.

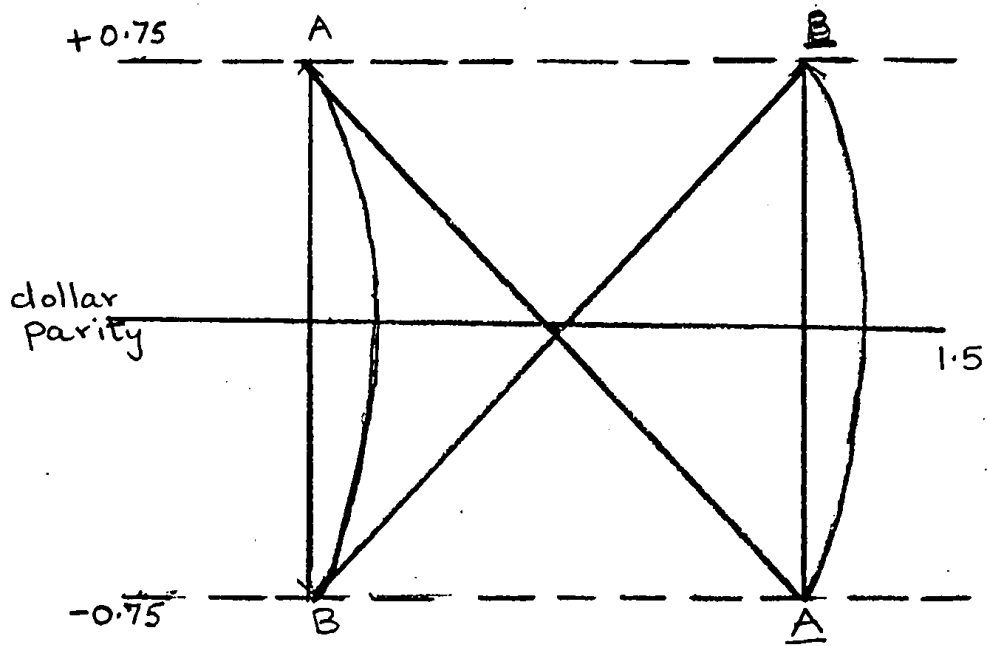


Figure 1

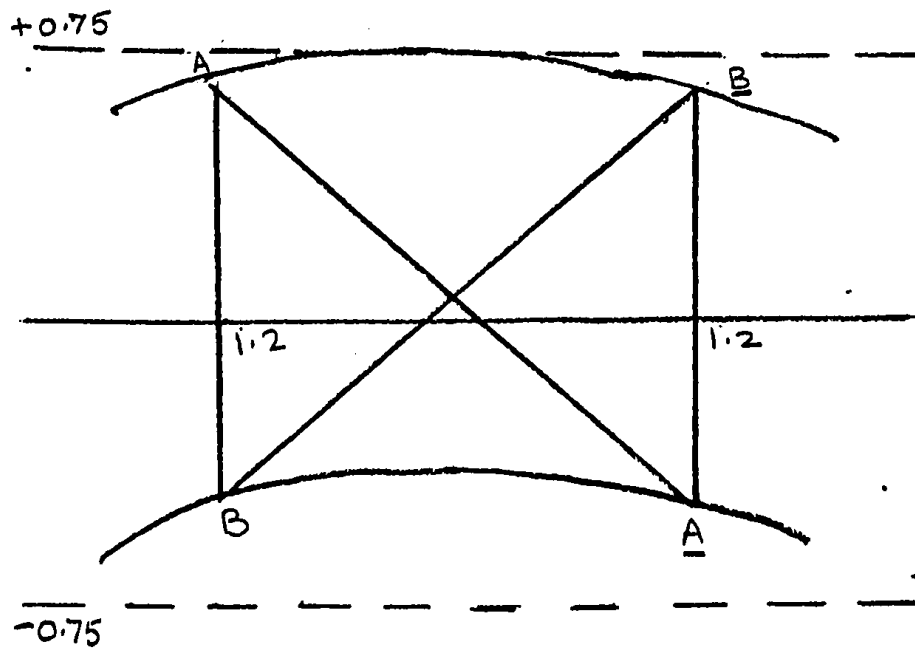


Figure 2

At any point of time, one EEC currency would find itself at the upper end (limit) of its dollar parity (A) while another (B) could in the same way reach the floor of its permitted margin of fluctuation with respect to the dollar. This would imply that, at the time, the reciprocal rate between two currencies would diverge by 1.5% from both the rates which would result if both currencies were quoted at the official parity. (Figure 1).

The idea of narrowing the intra-EEC margin meant that, while the margins of fluctuation applicable to the dollar rate would remain fixed at 0.75% each side of the parity, the reciprocal margins between any two EEC currencies would be reduced something less than 1.5%. Thus the EEC currencies would fluctuate in common, keeping the margins applicable to their reciprocal rates narrower than those permitted by a full use of their dollar margins (figure² above shows the case in which the EEC margins would be limited to 1.2% as it was decided by the EEC Central banks, March 1971). This fluctuation could be compared with the movement of a snake in a tunnel hence the name given to this particular arrangement.

2.5.2.1 Consequences of such a differentiation of the intra-EEC margins

To begin with, we consider the effects of the latter on the role of the dollar in the International monetary

system (IMS) and particularly in relation to the EEC central banks. In the postwar period, the dollar assumed the role of an intervention and reserve currency in the hands of central banks, as well as the role of a means of transaction for private use. The reason why preference is given to the dollar by commercial banks and private companies in their international transactions was the fact that the exchange risk involved in holding dollar balances has been less than in holding any other national currency. This was attributed to the difference between the margins of fluctuation applicable to the dollar rate of any currency and those applicable to the rate between any two currencies other than the dollar. If the intra-EEC rates were reduced, then the privilege enjoyed by the dollar would be partially or totally eliminated. This might then lead to a replacement of the dollar by the EEC currencies for intra-Community trade.

As regards the intervention and reserve roles of the dollar, the narrowing of the intra-EEC margins, would become directly relevant only if it were coupled by the use of community currencies instead of, or in conjunction with, the dollar for intervention in the exchange markets. This would also lead to some holding of EEC currencies as reserves by the EEC central banks. Eventually the central banks of third countries might also hold these currencies

among their foreign reserves. The increased sensitivity which a narrowing of margins of fluctuations would bring to difference in interest rates is rather important. This would lead to a reduction in the scope of independent monetary policies open to national authorities.

2.5.3 Smithsonian Agreement

The immediate cause of the collapse of Bretton Woods system was the expectation in late 1970 and early 1971, in the face of huge balance of payments deficits, that the US would soon be forced to devalue the dollar. This led to a massive flight of liquid capital from the US.

In December 1971, representatives of the 'group of ten' nations met at the Smithsonian Institution in Washington and agreed to increase the dollar price of gold from \$ 35 to \$ 38 an ounce. This meant a devaluation of the dollar of about 9 per cent. At the same time, the German mark was revalued by about 17 per cent and the Japanese yen by about 14 per cent with respect to the dollar, and other currencies by smaller amounts. In addition, the band of fluctuation was increased from 1 per cent to 2.25 per cent on either side of the new central rates and the US removed its 10 per cent import surcharge since the dollar remained inconvertible into gold, the world was now essentially on a dollar standard.

In 1973, the US was forced to devalue the dollar this time by about 10 per cent (by increasing the official price of gold to \$ 42.22 an ounce), at the same time, the dollar remained inconvertible into gold. In March 1972 the original six member nations of the European Common Market decided to let their currencies float jointly against the dollar with a total band of fluctuation of only 2.25 per cent, instead of 4.5 per cent agreed in December 1971. This was named the European 'Snake' or the 'Snake in the tunnel' and lasted until March 1973.

European Snake : The decision of the six members of the European common market in March 1972 to allow their currencies to float jointly against the dollar but to limit the total band of fluctuation to only 2.25 per cent. The composition of the European snake changed over time.

2.5.4 The Re-launching of EMU - The Paris Summit

The Smithsonian Agreement was seen as a solution to the monetary crisis and seemed to satisfy all major participants. The realignment of parities was expected to restore confidence in the dollar and to lead to the correction of the US deficit in the balance of payments. France which had insisted on a reform to the international system as a first priority, now seemed satisfied and thus turned its attention to a re-activation of EMU in the European Community. The foundations of a new agreement at the EEC level were laid during the February 1972 meeting

between Herr Braudt and M. Pompidou.

The new compromise which emerged was based on three elements :

1. France secured a narrowing of infra-EEC margins of fluctuation and obtained a commitment from Germany that instruments of capital control would be introduced in the face of a new monetary crisis.

2. The FRG was more interested in the coordination of economic policies. It obtained French acceptance for the creation of the Steering Committee within the EEC which would be responsible for the coordination of economic policies. This Committee was intended to improve and guarantee the continuity of the consultation procedures.

3. A system of permanent presidency was also directed towards this objectives.

4. Italy succeeded in adding another element, i.e., regional policy.

The decision taken at the Smithsonian Institution in December 1971 to widen the margins of fluctuation of each currency with respect to the dollar to 2.25 per cent meant that the margins applicable to the reciprocal rates between any two EEC currencies would from then on 4.5 per cent.

Table 2.2 : Snake in the Tunnel

Remarks	Pre-Smithsonian		Post-Smithsonian	
	Before any EEC agreement	Apr. '71 decision (never applied)	Before any EEC agreement	March 1972 decision
	Per cent	Per cent	Per cent	Per cent
Margins of fluctuation applicable to the dollar rate of any EEC currency on either side of the parity	0.75	0.75	2.25	2.25
Margins of fluctuation applicable to the reciprocal rate between any two EEC currencies on either side of the parity	1.5	1.2	4.5	2.25

If EEC exchange rates could vary within a 4.5 per cent band, this meant that apart from any thing else, the principle of common prices on which the CAP was based would be jeopardised.

This constituted a major factor in not making full use of the new margins. However, as a result of the Nixon measures of August 1971, the collapse of the Bretton Woods system and the loss of confidence in the dollar, all European central banks were now keen to avoid an accumulation

of dollar balances and to strengthen regional solidarity.

In February 1972 the Council of Ministers decided to limit intra-EEC margin to 2.25 per cent by July of the year. Following a German proposal, it was also agreed that intervention in the exchange markets would be made only in Community currencies, while the use of dollars would be allowed only when the snake reached the ceiling or the floor of the tunnel. Settlements of debts which would arise from the use of each others currencies for the operation of the snake would be effected at the end of the following month and in proportion to the composition of reserves of the debtor country. This method of intervention and of settlement of debts satisfied the economic interests of likely creditors, like Germany, who wanted to avoid as much as possible an accumulation of additional dollar balance. At the same time, it coincided with French interest in reducing the role of the dollar as an intervention and reserve currency.

In February 1972 the Council also adopted a Directive on the control of financial flows and the neutralisation of the effects of these flows on domestic liquidity. With the directive, the member states undertook the responsibility to create the necessary instruments in order to achieve an effective control of investments in the monetary market.

In order to sustain fixed exchange rates and the narrow intra-EEC margins, the countries of the Community decided to go backwards even in terms of the only two directives on the liberalisation of capital movements adopted by 1960 and 1962. Thus, in March 1972, a new attempt was made to launch EMU. It was based on a clear package deal designed to satisfy the different interests of the member countries. In broad terms, it was along the same lines as the compromise reached in March 1971. The aim was again to keep fixed exchange rates within narrow margins of fluctuation, i.e., the snake in the tunnel acquired more practical significance than before, both because of the difference between the width of the tunnel and the size of the snake and because of the method of intervention and settlements of doubts adopted.

The British authorities renounced their obligation to keep the pound not only within the snake but even within the tunnel. Thus it was not the narrowing of EEC margins which was at stake but rather the whole system of pegged exchange rates. The same remark applies to the floating of EEC currencies during 1971, as well as, to what happened later with the lira and the French franc. The only exception was the Danish Krone, when in response to the British float, the Danish monetary authorities decided to make full use of their dollar margins. But this lasted for

only a limited period. The Krone again joined the snake a few days before the Paris Summit of October 1972.

Fixed exchange rates were not the only monetary issue with which the EEC countries were faced before the Paris Summit, ^{there was} the problem of international monetary reform. The Bretton Woods system had officially ended in August 1971 and the Smithsonian Agreement was seen as providing only a temporary solution. The group of 20 was created by the IMF in July 1972 in order to replace the group of 10 as the main forum for discussion.

An important question was therefore, whether the EEC countries, (the old six together with the new members) could adopt a common policy during the negotiation which were to follow. During the Second half of 1972, the question of a revaluation of gold had already become an important issue within the EEC. Italy had joined France in pressing for a rise in the price of gold (This followed President Pompidou's visit to Italy in July 1972, also see 'La Figaro' 2 August 1972) which was opposed by Germany and Netherlands. (The Dutch position could be explained better in political terms because the Dutch Central Bank was not opposed to a revaluation of gold) both (i) because of a fear that this might be considered as a first move towards a gold standard, and (ii) because these two countries would accept a revaluation of gold only if it were the result

of an international agreements (unlikely). The question of the price of gold also had a direct effect on the operation of the EEC snake and particularly on the settlement of debts arising from it. The settlement of debts was made on the basis of the composition of reserves of the debtor country. But no country was willing to pay part of its debt in gold, evaluated at the official price, which was much below the price ruling in the private market. Another issue of concern among EEC countries was over the creation of a European Monetary Fund (EMF).

In July 1972, the finance ministers of the six and the prospective new members met in London and agreed on the general principles of international monetary reforms. They reiterated their attachment to fixed but adjustable parities, the need for controlling short-term capital movements and the reduction of the role of reserve currencies. Finally, one month before the Summit the EEC finance ministers decided to set up a European Monetary Cooperation Fund (EMCF) which, at least in its initial stage, would be limited to technical functions. It was only the question of the revaluation of gold which was still left unresolved.

In the monetary field, the Paris Summit of October 1972 served as a platform for a declaration of intentions which mainly endorsed agreements already reached within the community.

The heads of the government called for taking of the necessary decisions which would enable a transition to the second stage of EMU in January 1974. The Commission was asked to submit two reports - one on the adjustment of the short-term monetary support mechanism and another on the progressive pooling of reserves.

Even though EEC countries have been faced with quick and drastic change in the external environment there has been a large difference between the intentions expressed at the Paris Summit and the measures as well as the attitudes adopted by the same governments a few months later.

The Summit served to establish EMU as a question of first priority for the Community. This was the principle objective of the French Government. The German appeared to be willing to cover a large part of the way towards satisfying the French objective, at least by signing a letter of intent and some general and vague agreements. The British and the Italians were willing to make some concessions in order to obtain an agreement on the Regional Fund. As far as the British Government was concerned, the concessions did not take a very concrete form, since British had already abandoned in the previous June, the snake which was the main expression of EEC monetary cooperation. It was still hard to believe that the British Government felt ready to subscribe to the objective of a complete EMU to be

achieved in eight years. The smaller partners of the Community had much less chance to veto any agreement reached by the big countries. On the other hand, except for the Netherlands, no other country showed any particular interest in doing so. Belgium and Luxembourg had been following the French 'monetarist' policy. Ireland was mainly concerned with regional policy and Denmark with the survival of fixed exchange rates. It was only the Dutch prime-minister who fought a lost battle on the question of institutions.

2.5.4 The Snake Leaves the Tunnel

In 1972 interest rates were rising faster in West Europe than in the US. Moreover, there were no signs of the US payments deficit being eliminated; and a new speculative run on the dollar was triggered off by the decision to introduce a two-tier market in Italy and the floating of the Swiss-franc in January 1973. Italy enjoyed a surplus on current account, however, its balance of payments suffered from big capital outflows which reflected the low degree of confidence of the Italian business community in the wealth of the economy and in the stability of the political status quo. At the time, the capital outflow was aggravated by the deflationary policy followed in the FRG and the high interest rates which prevailed there. Therefore, in January 1973, the Italian Monetary authorities decided to

introduce a two-tier market system in an effort to defend the parity of the lira.

A new US policy of 'unbenign' rather than 'benign neglect' started; this meant that the US authorities were not only unwilling to support the dollar in the exchange markets-except for a brief spell in July 1972 - but they also encouraged speculation which could lead to a new devaluation of the dollar. The introduction of new capital controls in the FRG did not prove sufficient to stop speculative inflow of capital.

Following the second devaluation of the dollar in February 1973 Mr. Schultz, the Secretary of the US Treasury, announced that the US authorities would no longer intervene to support the dollar while they also undertook to abolish all capital controls by the end of 1974. ('Agence Europe', 1973).

In March 1973 the Commission put forward a package deal (Agence Europe - 1973), which would include the return of the pound and the lira to the snake and a joint float of all EEC currencies with respect to the dollar. In order to facilitate the participation of Britain, Ireland and Italy in the EEC monetary arrangement, the Commission argued that greater internal flexibility within the snake should be ensured. By internal flexibility was meant that when faced with serious strains within the snake the EEC countries would

be able to adjust the exchange rate of their currency with respect to other currencies of the snake.

However, Commission's proposals did not succeed in bringing about an EEC agreement (conditional by UK, Italy). M. Giscard d'Estaing argued that instead of a joint EEC float the Community countries should insist on the USA contributing to the support of the exchange rates which had been agreed less than a month before. The other EEC countries exerted pressure on both Britain and Italy to accept the Commissions' proposals on the amount of credits and pooling of reserves. Because of the impossibility of reaching a common solution for all nine countries of the Community and given the refusal to support the existing structure of exchange rates, the six EEC countries decided to float their currencies in common on 12 March 1973. This followed a revaluation of the mark by 3 per cent. The joint float marked a marriage of convenience between the old economists and monetarists. In 1970 fixed exchange rates were taken for granted. In 1973 the problem had been transformed into one of avoiding further devaluations of the dollar and in putting pressure on the USA to support its currency. The desire to achieve stable exchange relations between EEC countries in a world of almost generalised floating united the six EEC countries. This objective was seen both as an end in itself and as an important

element in the survival of the CAP.

But even after the snake had left the tunnel, intra-EEC stability of exchange rates, even excluding the independent floating of the pound and the lira remained more of an illusion rather than a reality. Following the 3 per cent revaluation of the mark in March, two more exchange rate changes took place during the remaining months of 1973.

Believing that floating against the dollar would allow rather free scope for an independent monetary policy, the German authorities raised the official discount rate. (BIS (1974), p.28). As a result the mark was revalued again by 5.5 per cent in June. This was followed by a 5 per cent revaluation of the guilder in September 1973. The final blow to the EEC snake came with the independent floating of the French franc in January 1974. This was to protect French foreign reserves against strains on the balance of payment and to put the French industry on, as strong a competitive position, as possible in the aftermath of the jump in oil prices. The decision to float the French franc and the statements which followed in both France and Germany demonstrate the extent to which government reactions are determined by short-term economic considerations. As late as December 1973, France was refusing to accept the transition to the second stage of

EMU unless the pound and lira rejoined the snake, just one month later the franc was floated. (Meeting of Chatham House, London, 1974). German officials stated that the five EEC countries had remained in the snake in order to keep something of EMU alive, which others might join later, hoping that, by keeping intra-EEC margins within a narrow band, the Community would arrive at a closer coordination of economic policies. Thus, in 1974 the main 'economist' countries, namely, Germany and the Netherlands remained in the EEC snake while the leader of the 'monetarist' group France floated its currency independently.

Faced with a collapse of the post-war monetary order, the EEC countries tried to preserve the main elements of the Bretton Wood system on a regional (European) basis. But the EEC snake was both left without a tunnel and was also heavily mutilated. In January 1974, only five out of the nine EEC currencies remained in it. (This too was achieved only due to periodic changes of the intra-EEC exchange rates). On the other hand the five currencies which remained in the snake formed a Deutschemark zone because of the strong dependence of the Benelux countries and Denmark on the German economy. One reason why stable exchange relationships had become increasingly untenable in practice was the fact that different countries experienced divergent rates of inflation. But the fact that both the Danish

kroner and the guilder remained in the snake - the guilder having even been revalued - while the lira was floated downwards, although the former two currencies occupied higher positions in the inflation league, indicates that divergent inflation rates cannot be a sufficient explanation. The failure to coordinate economic policies and particularly the insistence of some countries to use monetary policy for domestic stabilisation purposes provides part of the answer. German policy before the 1971 exchange crisis and during 1973 is a good illustration.

Faced with internal disequilibrium the EEC governments showed that they were not prepared to sacrifice internal economic objectives for balance of payment considerations, thus another reason was the meteoric rise in the balances which would be transferred from one financial centre to the other and thus provoke a big speculative crisis.

The US policy of 'Benign' or 'Unbenign' neglect contributed to the instability of the market.

2.5.6 Towards Inconvertible Currencies

Full convertibility of currencies constitutes an essential part of a monetary union. During the three years which elapsed from 1970 until the end of the first stage of EMU in 1973, the stability of exchange rates was continuously threatened with massive capital outflow from one

country to another resulting either from differences in the interest rates or from expected change in the exchange rates. Gradually one after the other the EEC countries resorted to exchange controls in an effort to safeguard the stability of their exchange rates. Faced with the dilemma between freedom of capital movements and stable exchange rates, the EEC countries opted for the latter. During this period, a progressive extension of exchange controls in all EEC countries can be observed whenever an exchange crisis was in the offing new controls were introduced, (withdrawn, reintroduced). Three such periods can be distinguished coinciding with big monetary crises in the Community - (i) May - December 1971, (ii) the Summer of 1972, and (iii) the first three months of 1973 culminating in the joint float.

In the end, exchange controls failed completely to achieve the objective for which they were set, i.e., the stability of the exchange rates. Thus at the end of the first stage of EMU, virtually all capital transactions within the EEC were either prohibited or subject to a strict system of controls. Even so, this neither led to a common system of controls adopted by all EEC countries nor helped these countries to maintain the stability of their exchange rates. The joint float of six EEC currencies in March 1973 together with the independent float of the remaining three currencies,

marked the final failure of capital controls.

2.5.7 Coordination of Economic Policies

Divergent inflation rates and lack of effective coordination of economic policies have been among the many causes of the failure of the EEC governments to maintain stable exchange rates among their currencies. It was primarily on the effective coordination and progressive harmonisation of economic policies that the Werner Group relied to achieve a complete monetary union. During the first stage, coordination of policies was based on the institutional infra-structure, which had already been created during the 1960's (only the Steering Committee was added in 1972) and on the resolution and two decisions of March 1971 together with the resolution on March 1972. The main objective of the coordination of economic policies was to safeguard the stability of the exchange rates. However, the frequency of exchange rate changes during the first stage of EMU as well as the abandonment of the snake by four EEC currencies do not point to a particularly brilliant success.

Judging from Table 2.3, coordination of policies did not lead to a convergence of national price trends, on the contrary the gap between different inflation rates appears to have widened in comparison to that which existed during 1960's (Table 2.4). It must, however, be admitted that the

Table 2.3 : Index No. of Consumer Prices in the EEC countries
(1970 = 100)

Year	Belgian	Denmark	France	Germany	Ireland	Italy	Luxemburg	Netherlands	UK
1970	100	100	100	100	100	100	100	100	100
1971	104.3	106	105.5	105.3	108.9	105	104.7	107.6	104.4
1972	110	113	111.7	111.1	118.4	110.9	110.1	116	117.2
1973	117.7	123	119.8	118.8	131.8	122.4	116.8	125.2	128

Source : OECD, Main Economic Indicators, November 1974.

Table 2.4 : Evolution of Consumer Prices (1963-70)
(1963 = 100)

Year	Germany	Luxemburg	Italy	Belgium	France	Netherlands	UK	Ireland	Denmark
1963	100	100	100	100	100	100	100	100	100
1964	102.3	103.1	105.9	104.2	103.4	<u>105.7</u>	103.3	106.7	<u>104</u>
1965	105.8	106.5	110.7	108.4	106	111	108.2	112.1	111
1966	109.5	110.1	<u>113.3</u>	<u>=112.9=</u>	108.9	117.4	112.4	115.4	<u>118</u>
1967	<u>111.1</u>	112.5	116.9	116.2	111.8	<u>=121.4=</u>	115.2	119.1	126
1968	113.1	115.4	118.5	119.3	116.9	125.9	120.6	<u>124.7</u>	137
1969	116.1	118.1	121.6	123.8	<u>124.4</u>	135.3	127.2	133.9	143
1970	120.5	123.5	<u>=127.6=</u>	128.6	131.2	141.3	135.3	145	151

Source : OECD, Main Economic Indicators - Historical Statistics
1955-1971

———— (underlined) indicates break in homogeneity of series
= indicates link.

economic situation which prevailed in the early '70s was much worse than any other in the recent past. In any case, fixed exchange rates could not be expected to endure within a group of countries which in a period of three years experienced cumulative rates of inflation from 31.8 to 16.8 per cent. The co-ordination of economic policies was not very effective during the first stage of EMU. The weakness lay in the technical, as well as, the political and economic fields.

2.5.8 The European Monetary Cooperation Fund (EMCF)

The EMCF was required to facilitate coordination between central banks to keep an account of all transactions resulting from the operation of the snake and to collect all necessary information for its smooth running; so also for the multilateralisation of the debt settlements which took place as a consequence of keeping the EEC currencies within the snake, i.e., transformation of bilateral credits and debts into credits and debts with the Fund, the Fund would thus play the role of a clearing house. If multi-lateralisation were extended, it would help to link, or even merge, the very short-term credit mechanism, which formed a part of the snake arrangement and the system of short-term monetary support.

After the creation of the Fund in April 1973, the BIS was entrusted to act as the agent for it. A step towards

a major qualitative change in its role would be to endow the fund with its own reserves, by pooling of reserve held by central banks, this would also facilitate creation of additional credit facilities and the simplification of the procedures prior to the granting of credit which was necessary for the snake arrangement. A pooling of foreign reserves would also lead to a simplification of the method of debt settlements which were made in proportion to the composition of reserves of the debtor country. The main problem arose because of the difference in the official price of gold and the price which ruled in the private market. The Fund would receive dollars and issue in return credits in EEC units of account. A pooling of reserves could be seen as a first step towards the final objective of placing all interventions in the exchange markets under Community responsibility. The same could apply to the creation of an EEC unit of account which would ultimately lead to a fully-fledged European currency managed by a European Federal Reserve System. The type of reserves to be pooled would also make a difference. If this was limited to dollar balances then the chances of its acceptability would be higher than otherwise. At a time of loss of confidence in the dollar and with the fear of further dollar devaluations, EEC central banks would be more willing to pool the risks involved in holding dollar balances. On the

other hand, if gold were included in the pooling of reserves, then many additional complications would arise because of the difference between the official price and the price ruling in private markets.

From the discussions within the group of experts appointed and those which took place with the Monetary Committee, serious differences of opinion were brought out in the open. The Council of Ministers finally reached an agreement in principle in its Rome meeting in September 1972. This agreement was confirmed at the Paris Summit, where it was also decided that the Fund would be established by 1 April 1978.

The first attempt to expand the role of the Fund was made in March 1973. The Commission put forward a package deal which included pooling of reserves, an extension of credit facilities and the responsibility to be taken by the Fund for interventions in the exchange markets; however, this deal did not materialize. The Fund was set up in April 1973, and its functions were limited to those of facilitating coordination between central banks, multi-lateralising the positions resulting from interventions in Community currencies and intra-Community settlements and administering the systems of short-term financing and monetary support. In June 1973, the Commission (Monetary Organisation of the Community, 1973) produced a

joint report on the adjustment of short-term monetary support mechanism and on the pooling of reserves. It was argued that an adjustment of the credit mechanism, which was almost assumed to be accepted by all, would not be sufficient unless it were accompanied by some pooling of reserves. Otherwise it was argued, no true multilateralisation could be achieved; and dollar interventions would have to be excluded from the Community mechanism. The Commission proposed a transfer to the Fund of all reserves newly acquired resulting from interventions in both dollars and Community currencies, as well as, a progressive transfer of all foreign reserves accumulated in the past. The transfer of foreign reserves would be made according to a fixed time-table; starting with 20% of the reserves held by each central bank of the Community (Table 2.5). The Fund would also be endowed with a fixed capital of 500 million units of account, thus the total reserve of the Fund would be about 12,000 million units of account to start with. The short-term credit ceilings would be fixed at six times the quotas granted to member countries under the previous arrangement made in February 1970 (Table 2.6).

These proposals formed a part of another package deal, linked with the transition to the second stage of EMU, which was put forward by the Commission in November 1973 (Agence Europe - 12-13 November 1973). Three countries

Table 2.5 : Breakdown by Country and Reserve Asset of a contribution of 11,300 million units of account made to the Fund in accordance with the identical percentage method (20 per cent)

Country	Total Contribution (m. u. a.)	Contribution in Gold or in assets linked to gold (M. U. A.)	Contribution in foreign exchange (m. u. a.)
Belgium/ Luxembourg	807	502	305
Denmark	178	40	138
Germany	5,251	1,207	4,044
France	1,854	912	942
Ireland	173	18	155
Italy	1,037	711	326
Netherlands	999	619	380
United Kingdom	1,101	294	707
Composition of Fund's holdings	11,300	4,303	6,997

Source : Commission, Monetary Organisation of the Community, page 14

Table 2.6 : Credit Ceilings for Each Country (Commission's Proposals)

Belgium Luxembourg	Den- mark	Ger- many	France	Ire- land	Italy	Nether- lands	UK
500	270	1,800	1,800	105	1,200	600	1,800

Source : Commission, Monetary Organisation of the Community, p. 15.

were strongly opposed to any pooling of reserves at that time, (FRG, France and the Netherlands) whereas the British Government was in favour of the proposals, (together with the remaining EEC countries). The Commission adopted only the first part of the proposal and lowered the percentage of reserves to be pooled to 10 per cent, but this could not influence the three countries which opposed the scheme. Finally, the link between the adjustment of the short-term monetary support mechanism and the pooling of reserve was broken. The Council of Ministers agreed on an extension of credit facilities, by quadrupling the creditor quota of each country (Table 2.7), while the decision on pooling of reserves was postponed.

Table 2.7 : Adjustment of the Short-term monetary support mechanism

		(million units of account)
Debtor Quota		Creditor Quota
600	Germany, France, UK	1,200
400	Italy	800
200	Belgium/Luxembourg, Netherlands	400
90	Denmark	180
35	Ireland	70

Source : Official Journal, C 20 (5 March 1974)

In the November 1973 proposals, the quota method was replaced by a method based on the percentage of reserves held by each country. As per Table 2.8, Germany was expected to contribute almost half of the total reserves, then came France and the Netherlands, followed by Belgium. Thus, but for Belgium, it was the countries which were to contribute most that opposed the scheme.

The submission of the Commission's proposal in November 1973 fell at a much worse time for the European Community than those put forward in March 1973. There was no longer any question of a joint-float, no solution to the price of golds had been reached and at the same time, the middle-east war and the energy crisis had left the Community in disarray. It was the worst moment to try and persuade large reserve holders to give up part of their reserves without receiving any return. On the other hand, it is understandable that Britain, Italy, Ireland and Denmark, with balance of payments' deficits and small reserve holdings were keen to obtain additional credits without too many strings attached to them.

2.6 'A' Second Stage

2.6.1 Transition to 'a' second stage :

The first stage of EMU ended in December 1973 and was far from successful.

Table 2.8 : Level and Composition of the official reserves of the Countries of EEC
(March 1973)

Country	Total reserves		Holdings in gold or in assets linked to gold			Holdings in Foreign Exchange		
	*(m.u.a.)	As a %	(m.u.a.)	As a % of the		(m.u.a.)	As a % of the	
	Amount	of EEC reserves	Amount	The Country	The EEC	Amount	The Country	The EEC
Belgium/Luxembourg	4,034	7.1	2,512	62.3	11.7	1,522	37.7	4.4
Denmark	892	1.6	200	22.5	0.9	692	77.5	2.0
Germany	26,255	46.5	6,034	23.0	28.1	20,221	77.0	57.8
France	9,269	16.4	4,558	49.2	21.2	4,711	50.8	13.5
Ireland	867	1.5	91	10.5	0.4	766	89.5	2.2
Italy	5,182	9.2	3,554	68.6	16.5	1,628	31.4	4.7
Netherlands	4,995	8.8	3,093	61.9	14.4	1,902	38.1	5.4
United Kingdom	5,003	8.9	1,467	29.3	6.8	3,536	70.7	10.1
EEC - 9	56,497	100	21,509	38.1	100	34,988	61.9	100

* 1 unit of account = 0.888671 gm. of fine gold

Source : Monetary organization of the Community, p. 17.

One month after the end of the first stage with five EEC currencies floating jointly and the remaining four floating independently, stable exchange relations were the good things of the past. The European Monetary Cooperation Fund when it came at last into life after long and controversial debates, was just a plate on the door in Luxembourg. As far as capital movements were concerned, regressive steps had been taken, if compared with, the degree of liberalisation achieved in the 1960's. Nevertheless, at the end of 1973, no national government was prepared to admit in public that the creation of an EMU by 1980 was not a feasible objective and transition to the second stage was controversial. Discussions dragged on, with the policy of each country being determined by short-term considerations. The discussions started with the Report (Attainment of the EMU, April 1973) on the first stage of EMU and the measure to be adopted in future. The Commission proposed a continuation of status quo.

There are two inter-related questions which can be posed -

- (a) What did the Commission expect from the continuation of a strategy along the Werner lines and the compromise reached in the Council of Ministers in March 1971?
- (b) Why was the Commission so cautious about its proposals?

Answers : It did not expect any serious progress to be made before the end of the second stage and it did not

think it is politically feasible to make any radical proposals.

The conclusion reached was that the Community should work on a minimum programme and safeguard what little had been achieved and then hope that by the end of 1975, when the Report on the 'European Union' was expected, the internal as well as the external environment would be more favourable for major political decisions, i.e., the Commission proposed to postpone for another two years the real discussion on EMU. In order to break the deadlock, Belgium proposed a compromise plan in which the transition to the second stage would be combined with a series of concrete measures to be taken during 1974. In reality there were two controversial issues linked to the transition to the second stage of EMU which almost entirely determined the attitude of different member countries on the subject -

- (a) powers of the Monetary Fund and pooling of reserves, and
- (b) setting up of a Regional Fund.

The linkage between the latter and the second stage of EMU had been established at the Paris Summit of October 1972 (Agence Europe, 29 June 1973; The Economist, 21 July 1972, 'Le Monde', 5-6 December 1973; Agence Europe, 10 October 1973). Once some form of agreement was reached

on these two subjects, the task of coming to a decision on the question to transition was made much more easier. In October, the Council of Ministers agreed to set up a Regional Fund by the end of 1973 (it was actually created in March 1975) and in the following month, a decision was taken to extend Community credit facilities without any pooling of reserves. This led to an agreement that the Community would pass, from January 1974, to 'a' second stage of EMU as opposed to 'the' second stage.

The contents of 'a' second stage of EMU were not concrete.

(a) The decision on the attainment of a higher degree of convergence of economic policies replaced all previous ones.

(b) It did not contain any new elements except for

(i) providing monthly meetings of the EEC finance ministers.

(ii) making prior consultations obligatory on change of parity, central rates or intervention points of any EEC currency (latter was the result of the guilder revaluation in September 1973, when the Dutch Government did not initiate any prior consultations on the EEC level).

(c) In the Directive on 'Stability, growth and full employment' member countries were asked to introduce

certain instruments, where they still did not exist in order to increase the flexibility of their economic policy.

(d) The Council of Ministers agreed to set up an Economic Policy Committee which would replace the three committees on Short-term, Medium term, (Economic policy) and Budgetary policy.

(e) Additional credit facilities were created.

2.6.2 A Holding Operation

The economic crisis which has spread in the recent years in the whole of the industrialised west and the radical changes which have taken place within the international economic system have reduced, even more, the feasibility of EMU in the near future. Given the type of problems faced it could be argued that EMU has been turned into a non-issue. The advanced capitalist countries have been faced with a combination of high rates of inflation and unemployment (which was contrary to the main theories of orthodox economic analysis). In addition they had to live with a prolonged state of economic stagnation and big current account deficits (due to inflation in oil prices). All this took place at a time when Bretton Woods System had completely collapsed and no new monetary order had yet been set up. Since 1975, the EEC has resembled a holding operation in which the main

objective was to leave all major initiatives for the time when the economic crisis will have been overcome. Stress has been put on the practical measures which will help the EEC to survive the economic crisis.

1) The issue of Community loans, which would be used to finance the balance of payments deficits of the worse hit countries of EEC has been given first priority.

2) Another objective has been to avoid competitive devaluations of the EEC currencies and the introduction of trade restrictions.

3) Economic coordination has been mainly seen as a means of persuading surplus countries like the FRG to inflate their economies in order to help in correcting the deficit of the other countries.

4) Long discussions have taken place on the subject of 'Price of gold'. The abandonment of the official price and the freeing of gold transactions between central banks at a price close to the one ruling in the private market would facilitate the financing of deficits (e.g., Italy).

How far was the Community successful in adopting short-term practical measures intended to overcome the crisis and avoid a process of economic disintegration?

1) The short-term monetary support mechanism was activated for the first time in favour of Italy in March

1974. The loan was rolled over twice and was later transformed into medium-term financial aid.

2) Actually in a system of floating currencies there is no question of competitive devaluations, if one assumes that 'Neutral' market forces determine the relative price of currencies. In reality, governments can and do 'push' market forces in the right direction. It is true that the existence of the snake has prevented competitive downward floating of the EEC currencies participating in it, as well as the French franc, whenever it formed part of this arrangement. On the contrary, both the lira and the pound have undergone big devaluations in terms of other currencies.

3) Trade restrictions have not been avoided.

4) No significant progress was made in the field of coordination of monetary policies. Divergencies of economic interests and policy preferences have been all too obvious.

5) On the issue of gold revaluation the EEC agreement reached in Zeist in April 1974 precipitated an international agreement to abandon the official price and to free gold transactions between monetary authorities.

During this period, three other issues related to economic and monetary cooperation in the EEC were discussed

in the council of Ministers.

- 1) Proposals leading to some modification of the EEC exchange rate system;
- 2) Setting up of the Regional Fund, and
- 3) Definition of a new EEC unit of account.

Despite the abandonment of the snake by the French franc in January 1974, there was, very quickly, a renewed French interest in a coordinated EEC action in the exchange markets. In 1974 the objective was to make the snake arrangement more flexible so that it should incorporate all EEC currencies including the franc, pound and lira.

Following suggestions made by M. Giscard d'Estaing, a plan was submitted by M. Fourcade.

- 1) This called for a 'concerted' float of all EEC currencies, which would establish a close coordination between five currencies participating in the snake and the remaining four which floated independently.

- 2) It called for joint EEC intervention in the exchange market in order to maintain a 'Community level' of the dollar.

- 3) It asked for more flexibility in intra-EEC exchange rate adjustments, and

- 4) Proposed an extension of Community credit facilities.

- 5) Proposals for the issue of Community loan,
- 6) Definition of a new unit of account, and
- 7) Coordinated action in the Euro-dollar market.

Similar suggestions, also including the proposals, that responsibility for intervention should not fall only on the central bank, the currency of which found itself at the lowest limit of intra-EEC margins, were made again by M. Fourcade in May 1975, in anticipation of the franc rejoining the snake. But these were not welcomed by the other five countries in the snake.

2.6.3 New Proposals

The realisation that the failure to make any real progress towards EMU during the first stage has been, at least partly, due to the fact that the wrong strategy was followed, has led to some new thinking on the subject and a number of new proposals which could help the Community to break the deadlock already reached. Various study groups were formed which examined alternative approaches.

Four proposals included in -

- 1) Reports on 'European Union' submitted by Mr. Tindemans, and
- 2) The Commission

- 3) The All Saints' day manifesto, and
- 4) The Report of the study group chaired by M. Marjolin.

2.6.3.1 Tindeman's Report

In the chapter on economic and social policies, there are two main elements which characterise the Tindeman's Report (Leo Tindemans, 'European Union', 1976).

- a) the adoption of the idea of a two-tier Community originally put forward by Herr Brandt in November 1974,
- b) emphasis on the snake which would serve as the motor for further monetary and economic integration.

In a sense, Mr. Tindemans proposes the institutionalisation of the defacto existence of two groups of countries in the Community. On the one hand, there is the division between the five countries participating in the snake, together with the non-Community countries, i.e., Sweden and Norway, and the remaining four members of the EEC. On the other hand, there is the division between the privileged members of the group of five including the US and Japan and others. The growing importance of this group in recent years is an indication of the degree of socialisation of EEC countries to the 'Community idea'.

Tindemans' considers the 'snake' as the main focus of attention. It is seen as the means of bringing about a convergence of economic and monetary stability in an

unstable world. In fact, the criticism of Mr. Tindemans' proposals on EMU is that they are too snake-oriented; and the governments are not willing to sacrifice their internal economic objectives for the sake of fixed exchange rates.

2.6.3.2 Report on European Union

In its Report on 'European Union' submitted in June 1975, the Commission mentioned for the first time the creation of a new common currency (Report on European Union, 1975, pp. 14-21).

In its Report the Commission drew some conclusions about the limitations shown in practice of the old Werner approach based on a progressive narrowing of margin of fluctuation and a coordination of national economic policies. The European strategy was mentioned as an alternative approach but emphasis was laid on its role as a reserve currency. At least, in the initial stages, its use would be limited to official transactions between the European Bank and national control banks. Its use as an intervention currency which implies that it would also have to be held and traded by market institutions would come much later.

2.6.3.3 All Saints' Day Manifests

In November 1975 nine prominent economists issued a manifesto in which they also called for an early

introduction of a parallel European Currency which would circulate alongside the national ones. The difference is that All Saints' Day manifesto instead of laying emphasis on the role of the Europa as a reserve currency at least in the initial stages of its introduction, the nine economists stressed its use as a private asset. It was argued that the main advantages of a monetary union are related to the use of a common currency as opposed to fixed exchange rates between existing national currencies. The new common currency, the Europa, would have stability of purchasing power. This would be guaranteed by keeping the price level of a representative commodity basket constant in terms of Europas. The basket would be defined as the weighted sum of national commodity baskets used to calculate consumer price indices in each country. In the period within which national currencies and the Europa would coexist, the spread of the latter would be determined by market forces.

While the Werner approach relied on coordination of policies, which is of a non-automatic nature and dependent on political discretion, the new approach would have the advantage of being gradual and based on the 'free interplay of market forces'.

Assumption : The reasoning used fits very well with the new monetarist theory in which it is argued that product and factor markets have become so well integrated that differences in national inflation rates are only due to unwarranted divergences in rates of credit expansion.

In the long run monetary policy can only influence the rate of inflation but not the level of unemployment. The costs of monetary unification would only be of a transitional nature while each country would adjust its inflation rate to that of the union.

The first task of the new monetarists would be to persuade all national governments that monetary policy has become an ineffective instrument in the pursuit of domestic economic objectives.

Although the Europa approach does not necessitate an irrevocable fixity of exchange rates. It has already been argued that the use of a parallel currency as a private asset would gradually render exchange rate changes ineffective. Thus governments would also have to be persuaded that structural and institutional factors have nothing to do with the rate of inflation and that a common monetary policy would be sufficient to harmonise national rates of inflation. Since the political future of the governments in power depends on their economic performance,

it is very unlikely that they would willingly cede policy instruments even when they have become increasingly ineffective.

2.6.3.4 Marjolin Report

In March 1975, the study group, set up by the Commission, under the chairmanship of M. Robert Marjolin produced a rather pessimistic - or otherwise realistic - report on EMU, the experience gained from the first stage and the prospects for the future. It reached the conclusion that in 1975, the Community was no nearer to EMU than in 1969. (In fact if there has been any movement it has been backward!) It was argued that neither the economic nor the political conditions existed for the attainment of EMU in the near future and therefore the group decided to concentrate its attention on some concrete, short-term measures rather than present yet another long-term plan.

On the Community level, the proposals put forward by the Marjolin group can be divided into two broad categories, one pertaining to measures in the monetary field, and the other to sectoral policies.

In the former, apart from the usual call for increased monetary cooperation, the group insisted on the issue of Community loans and the setting up of an Exchange Stabilization Fund.

The creation of an unemployment fund received much attention. Since the creation of new Community funds would involve a transfer of resources from the rich to the poor countries, the main question which arises is whether a country like the Federal Republic would be prepared to accept the financial implications and under what circumstances.

2.7 Conclusions

1. Precise time-tables have been abandoned, as well as, plans which would try to depict in some detail the path to be followed up to the final objective.
2. The creation of a complete EMU will be a long and rough operation and that simple, technical arrangements cannot make its attainment easier.
3. Progress towards EMU would necessitate big structural changes in national economies and a complete transformation of the EEC as a political and economic entity.
4. In the monetary field, agreement on the rejection of a strategy based on fixed exchange rates and the narrowing of infra-EEC margins of fluctuations.

The desirability of a system of fixed, but subject to small and periodic adjustments, intra-EEC exchange rates and a joint floating with respect to their currencies seems to be widely accepted. A strong emphasis is laid on

the need for decisions on parity changes to be taken by joint agreement.

5. Contrary to the emphasis on a Community monetary policy, it is now accepted that responsibility for fiscal policy should remain at the national level. Fiscal policy should be available to movements for stabilisation purposes at both the national and the regional level.

6. Emphasis is laid on the question of common institutions like the EMCF. The monetary Fund would start with some pooling of foreign reserves and would develop over time into a fully fledged Community Central Bank where a common monetary policy would be decided.

7. Transfer of resources and the role which a bigger Community budget can play in it - received attention.

Progress towards EMU would be impossible unless something is done to remove the economic disparities between areas of the Community; especially since the creation of EMU would be likely to accentuate these disparities.

8. Europa approach has been presented as an alternative to the Werner approach for the attainment of EMU. Although the idea of the Europa serving as a reserve currency, closely linked to the pooling of reserves and the expanded role of the Monetary Fund, seems to acquire growing

acceptance, its use as a private asset is still debatable. On the other hand, official reaction so far have been reserved.

N.B. : Two qualifications :

- (a) Tindemans' Report - smacks too much of 1970 'monetarist' ideas, and
- (b) Extreme versions of the Europa approach are too simplistic to be convincing.

CHAPTER III

THE EUROPEAN MONETARY SYSTEM (EMS)

3.1 Introduction

Since 1973 March, the world has operated under a managed float. This was recognised in the Jamaica Accords (which took effect in April 1978 and recognised the managed float and abolished official price of gold). In January 1975, US citizens were again allowed to own gold. In March 1979, the EMS was established as part of its aim towards greater monetary integration among the nine full members of the EEC, including the ultimate goal of creating a common currency. The main features of the EMS are :

- 1) the creation of a ECU (European Currency Unit) defined as the weighted average of the nine EEC currencies to be used for accounting purposes among member nations (similar to SDR's).
- 2) defining the central rate or par value of each EEC currency in terms of ECU's and allowing central rates to fluctuate by a maximum of 2.25 per cent with respect to other EEC currencies (Italy was allowed a band of fluctuation of 6 per cent and the UK has refused so far to join).
- 3) the establishment of EMF (European Monetary Fund) to provide short and medium term balance of payments assistance to EEC members.

Thus, the EMS serves two main purposes :

(a) It provides an organisation which reduces the scope for exchange rate manipulation and prevents the currencies of member countries from fluctuating excessively in relation to each other.

(b) It inculcates monetary stability in the sense of allowing countries to pursue their stabilization policies in a way which can be drawn from exchange rate policies.

But the EMS has a political ambition too and is looked at as a stage towards full European Monetary Union rather than a practical arrangement for helping stabilize European currencies.

3.2 The EMF (European Monetary Fund)

An institution set up to bring about an efficient working of the EMS.

3.2.1 The Functional Aspects of EMF

Its functional aspect includes maintaining proper balance between the three pillars of EMS :

- (1) Credit Mechanism
- (2) Exchange rate arrangements
- (3) The ECU.

The credit mechanisms and the ECU are respectively the asset and the liability side of the EMF's balance sheet.

The credit mechanisms and the exchange rate arrangements represent alternative means by which tension among member currencies may be relieved within the System.

3.2.1.1 Credit Mechanisms

3.2.1.1.1 Present Position

There are three mechanisms :

i) the very short-term financing facility - this follows largely from a snake type intervention mechanism. Compulsory interventions in the currencies of the system make it necessary that the relevant currencies are available to the intervening central banks in unlimited amounts. This facility has been used fairly extensively since the start of the EMS. Duration was increased from 30 to 45 days after the end of the month during which the intervention took place.

ii) & iii) The short-term support and medium-term assistance were expanded as the Tables 3.1 and 3.2 shows at the start of the EMS. The duration of short-term credit was increased from a maximum of six to nine months by allowing the possibility two-three month extension instead of only one. But neither mechanism has been activated within the EMS and their previous use was very limited.

Table 3.1 : Increase in the short-term monetary support and medium term financial assistance (million ECU)

<u>Short-term monetary support</u>				

Quotas				

Debtor				

Creditor				

	Old	New	Old	New

Banque Nationale de Belgique	200	580	400	1160
Danmarks National Bank	90	260	180	520
Dentsche Bundes Bank	600	1740	1200	3480
Banque de France	600	1740	1200	3480
Central Bank of Ireland	35	100	70	200
Banca d'Italia	400	1160	800	2320
Nederlandsche Bank	200	580	400	1160
Bank of England	600	1740*	1200	3480*
	-----	-----	-----	-----
Total Quotas	2725	7900	5450	15800
Rallonges	3000	8800	3000	8800

Table 3.2 : Medium-term financial assistance

Commitment Ceilings		

	Old	New

Belgium/Luxembourg	400	1035
Denmark	180	465
France	1200	3105
Federal Republic of Germany	1200	3105
Ireland	70	180
Italy	800	2070
Netherlands	400	1035
United Kingdom	1200	3105
	-----	-----
Total:	5450	14100

* There is an agreement that the UK will not use its increased quotas until it has become a full participant in the exchange rate mechanism of the EMS.

3.2.1.1.2 Consolidation of Credit Mechanisms

The resolution of the European Council in Brussels states that the credit mechanisms 'will be consolidated into a single fund in the final phase of the EMS'.

Three alternative formulae can be conceived:

- i) consolidate the very short and short-term mechanism;
- ii) consolidate the short-and medium term mechanisms;
- iii) consolidate all three mechanisms.

The choice between these formulae will influence the nature of the Fund. It is thought that the shorter the duration of the mechanism the stronger the 'Central bank character' of the institution (Fund) responsible for it. (Money, the produce of central banks, is itself of a short-term nature and, the existing medium term mechanism is at present not the responsibility of central banks.).

3.2.1.1.3 Development of the Credit Mechanisms

At the start of the EMS the most significant change in the credit mechanisms was the change in the amounts available. However, more fundamental developments of the mechanisms rather than just expanding them in their existing form need to be considered. The connection between credit mechanisms and the definition of the means available to the EMF is at present not clear. The credit mechanisms developed historically into a structure, that

has to do with the decision to endow the fund with 20 per cent of member countries' gold and dollar reserves. The existing credit mechanisms have the advantage of making available to each country an amount of reserves greater than its contribution. On the other hand, the endowment of the Fund with deposits of gold, dollar and national currencies has the advantage of clearly defining the asset side of the balance sheet. But the liability side, the ECU does not correspond at the moment; the amount of resources available to the Fund once the deposits both of reserve assets and possibly national currencies are made, does not correspond in quantity or availability to the amount that countries could receive through the different support mechanisms.

There is also a problem of consistency within the set of the three mechanisms. Very short-term credit, is designed to deal with erratic and accidental pressures on the exchange rates, those that are not based on any real disequilibrium in the economy. Inability to repay at maturity, may indicate that same kind of disequilibrium is there, possibly of, a seasonal or even a cyclical nature. Credit has then to be granted for a longer duration. Similarly, medium-term credit may be granted to deal with even more serious disequilibria of a cyclical or of a structural character, which can be eliminated only over a longer period of time.

3.2.1.2 The Exchange Rate Arrangements

3.2.1.2.1 Present position

Exchange rate arrangements (i.e., both intervention rules and realignment procedures) and credit mechanisms are two instruments by which tensions among currencies can be relieved. Within a country, where exchange rates are irreversibly fixed, only credit (or transfer) mechanisms are at work. Within the EMS as it is now exchange rate adjustments are limited by (a) exchange rate agreements (intervention rules, etc.) and (b) realignment procedures.

With respect to the EMS, the currencies outside the system are towards the floating end of the spectrum, although there is an agreement that unlimited fluctuations of currencies like the dollar may cause problems within the System. As far as the currencies within the System are concerned the experience of the September 1979 realignment would suggest that we are moving towards the direction, taken by the snake since 1976, of a crawling peg without formal decision rules about the size or frequency of the crawl. Tensions need to be resolved to a longer extent through policy changes, backed up if necessary by credit from the Fund than frequent exchange rate changes. Increasing interdependence of the economies, capital mobility and the role of expectations in exchange rate determination have led to a weakening of the effectiveness

of exchange rate policy to complement domestic stabilization policy, e.g., with low capital mobility, exchange rate flexibility may no doubt enhance the effectiveness of domestic monetary and fiscal policy, as either a monetary expansion or a fiscal stimulus will lower the exchange rate by increasing imports and reducing exports. However, with high capital mobility the direction of exchange rate movement, following a fiscal stimulus, becomes uncertain. Such a stimulus, with an unchanged money supply, will raise the domestic rate of interest and give rise to capital inflows, if capital is very mobile, the effect of the capital account of the balance of payments could outweigh that on the trade deficit and the exchange rate would appreciate, offsetting the effects of the stimulus.

Two propositions - for a move towards more stable exchange rates within the Community.

1) The volatility of the exchange rates in terms of short and medium-term fluctuations was often such as to serve no useful purpose as regards balance of payments adjustments. Instead it had the undesirable effects of both distorting resource allocation between tradeables and non-tradeables through large swings in their relative prices, and of discouraging investment and trade and hence reducing growth and employment through increasing risks.

2) Flexible exchange rates may entail inflationary ratchet effects. (M. Goldstein, 1977).

The case can most clearly be argued for Italy and the UK, the 'overshooting' of exchange rates in Italy in 1976 and in the UK in 1974 seemed to contribute to inflation. Causation between exchange and inflation rates works in both directions and in the short-run the direction is from exchange rates movements to prices.

3.2.1.2.2 Future Developments of the EMS in the area of exchange rates focus on two points

a) the appropriate intervention rules (including a common dollar policy, intra-marginal intervention, etc.) that could reduce tensions within the system, and

b) the possible evolution through which the existing margins could gradually narrow to approach a fixed exchange rate system, itself taken as the final stage of monetary union.

3.2.1.2.3 Conditionality, Cost and the Balance between Credit and Realignments as Alternative Means of Relieving Tensions

There is no conditionality in the very short term facility, but it is only automatically available for intervention at the margins. An important difference between the EMS and the Snake arrangement is the use of the divergence

indicator which is in general expected to sound an alarm before bilateral margins are reached.

Since in the EMS interventions should in principle be made in participating currencies, these should be automatically available for intra-marginal interventions as well, and not only for interventions at the margins. This could be made subject to the understanding or condition, that a national currency would only be used by another participant when that currency is on the opposite side of its central rate as compared to the currency of the intervening central bank so that the action would have the effect of bringing it closer to its central rate. The practice under the present system for intra-marginal intervention is to ask permission and there could be instances where this is not granted, then the only alternative would be to intervene in dollar. The short-term facility, like the very short-term has no element of conditionality initially, but there can be some conditionality in granting an extension. The medium-term financing has a strong element of conditionality involving non-monetary aspects of policy such as budgetary policy, etc. The introduction of new elements of conditionality is conceivable and desirable aiming of variables such as interest rates, growth in monetary aggregates, exchange rates, etc., i.e., variables that are within the strictly monetary.

horizon and the responsibility of central banks.

As to the cost of credits to a debtor in the short-term and medium-term mechanisms this is decided at the time of granting credit. In the very short-term facility, the interest rate is calculated as the weighted average of the official discount rates of all EEC central banks, with the weights corresponding to those in the ECU.

There should be an appropriate balance between the use of credit and parity adjustments in the exchange rate mechanism. Given the potential size of international capital movements, no volume of credit is sufficient to hold an exchange rate at a non-equilibrium level for long, it seems that adjustment of central rates has been resorted to more and more frequently, and that credit facilities have been used very little.

3.2.1.3 The ECU

3.2.1.3.1 Meaning

The ECU is a 'basket' currency of a special kind (like SDR) - by an official institution. The currencies making up the ECU are linked together, through an exchange rate mechanism; their inclusion in the basket is not therefore the only bond uniting them. Direct ties also exist in that there are rules governing their exchange rate relationships and the procedures to be followed in cases where

their relationships come under pressure. ECU is thus a monetary expression of an integrated economic area, of a genuine common market and of economies that have been unified.

a) Official ECU's

Purpose : The official ECU is an asset created by revolving three-month swaps of gold and US dollars against amounts denominated in ECU's with the EMCF. Official ECU's are intended as financing in support of the exchange rate arrangements of the EMS.

Supply : The amount of official ECU's held by an EMS central bank is determined by the value of its gold and US dollar swapped with the EMCF, adjusted by any uses or receipts of ECU's in transactions with other participants in the EMS.

Under the present provisions, calling for swaps of 20 per cent of members' gold and US dollar reserves the creation of official ECU's is determined by the price of gold, the exchange rate of the US dollar and the respective amounts of these two assets in the member countries' reserves. At the start of the EMS' operations, ECU 23 billions was created when in July 1979, the United Kingdom decided to voluntarily deposit 20 per cent of its gold and US dollar reserves with the EMCF, the amount increased to

ECU 27 billion. Since that time, the amount of ECU's in existence has varied with fluctuations in the price of gold, the exchange rate of the dollar, and the volume of dollars in members' reserves.

The swap mechanism was originally set up by the EMS central banks for a period of two years, that is the duration of the originally envisaged transitional stage for the EMS. Since the stage of establishing the EMF has not been achieved so far, central banks, by unanimous consent, have extended the mechanism every two years for a new period. Since July 1965, the ECU interest rate has been based on interest rates on specified short-term instruments in the money markets of the EC countries, weighted in accordance with their respective currencies' relative importance in the ECU's valuation basket as derived from the prevailing ECU control rates.

Uses : The official ECU can be used to settle intervention related obligations between the monetary authorities of the EC countries. In case of need, EMS central banks can also mobilize part of their ECU holdings to obtain US dollars from EMS members. In October 1985 the European Council adopted a regulation enabling the EMCF to grant 'other holder' status to non-EC central banks and international monetary institutions such as the

Bank for International Settlements (BIS) to obtain official ECU's from EMS central banks by means of sale and repurchase agreements or reversible swap transactions. Furthermore, ECU's can be bought and sold voluntarily among holders against currencies, SDR's, gold and other monetary assets. (EMS agreement, 1985).

b) Private ECU's

The ECU, the SDR or any other composite currency unit may be used, in principle, for denominating financial instruments. Private ECUs, that is, ECU denominated financial instruments outside the context of the EMS have developed and grown in amounts and variety.

The first EUA (the ECU's predecessor) bank deposit was placed by the European Commission in March 1976. The lead given by the Community Institutions since then has given important impetus to the private ECU market from 1987 onwards. (Wolf (1984) p.2 Guimbretiere). In that year, the first ECU - denominated certificate of deposit was issued, the first ECU bond issue took place and the first syndicated loan denominated in ECU's was extended. Also the ECU was officially recognized as a foreign currency by Italy in 1981, the first such recognition by an EC member.

In 1982, ECU retail sight and term deposits and ECU - denominated savings accounts appeared. A number of

firms, mostly multinational companies with subsidiaries in several EC countries, started to use the ECU in accounting for transactions between their subsidiaries and in some cases, for external invoicing. As a consequence of the increasing use of ECU for financial and commercial transactions an inter-bank ECU market emerged and has now become well established.

In 1983, a credit card denominated in ECU appeared, the world bank issued its first bonds denominated in ECU, and all remaining member states of the EC, with the exception of the FR Germany, officially recognized the ECU as a foreign currency. In 1985 travellers' cheques denominated in ECU were introduced.

3.2.1.3.2 ECU as an Artificial Currency Unit (ACU) (or Synthetic/Syncretic money)

Reasons : The values of such key currencies as the US dollar and the British pound have been highly unstable since the emergence of floating exchange rates; there has, therefore, been a growing effort to create a substitute, so called 'artificial' currency units (ACU's) for use in international accounting and international settlements.

At its present stage, an ACU's main function is as a numeraire or a unit of account in international transactions. Even though the value of a payment obligation is expressed in an ACU, the actual payment is generally made

in one of the national currencies.

ACU is thus an international quasi-money serving as a numeraire in international transactions.

In general, ACU's are of two types :

i) ACU's created by official institutions primarily for official international transactions.

ii) ACU's introduced at the initiative of private banking enterprises for commercial and financial transactions.

Triffin wrote in 1957 :

"A first step in this direction (towards monetary integration in Europe) might be to legalize the use of legal guarantees in terms of the EPU Unit, in the writing of private as well as public contracts. This could aid greatly in the revival of capital markets now paralysed by exchange fears and risks." (page 291).

The first private ACU was inaugurated in 1961, when, with the help of a bank syndicate led by the Kreditbank, a large Portuguese oil company, SACOR, floated a bond issue denominated in an ACU called the EUA. Thereafter, however, a host of official private ACU's were created, some of them as a reflection of unsettled international monetary conditions such as dollar inconvertibility and the floating of major currencies.

SDR (1970), ECU (1970), Eurco (1973), B Unit (1974), Accru (1974), AMU (1974) and IFU (1975).

Table 3.3 : Summary classification of ACU

Type of ACU	Year of creation	Value tied to	No. of currencies in basket
<u>Official</u>			
EUA : Old	1950	Gold	-
New	1975	Current basket	9
SDR : Old	1970	Gold	-
New	1974	Currency basket	16
AMU	1974	Currency basket	16
<u>Private</u>			
EUA : Old	1961	Gold	-
New	1972	Gold	-
ECU/EMU	1970	Immutably fixed exchange rate	-
Eurco	1973	Currency basket	9
Arcru	1974	Currency exchange rates	8 out of 12
B-Unit	1974	Currency basket	5
IFU	1975	Currency Basket	10

<u>Notes</u>	EUA	:	European Unit of Account
	SDR	:	Special Drawing Rights
	AMU	:	Asian Monetary Unit
	ECU	:	European Currency Unit
	EMU	:	European Monetary Unit
	Eurco	:	European Composit Unit
	Arcru	:	Arab Currency Related Unit
	B-Unit:	:	Barclays Unit
	IFU	:	International Financial Unit.

The essential difference between national currencies and ACU's is that the former developed in a domestic context as essentially national means of payments, while the latter have been created exclusively in the context of international transactions, initially as units of account but with the potential of being developed to a limited extent into international means of payments. In the absence of an international legislature with the power to confer legal tender status, establishment of the social convention leading to the emergence of a new international currency is not an instantaneous event, but rather, a time-consuming social adjustment process.

ECU (or European Monetary Unit)

In December 1970 the ECU or the EMU was created on the occasion of the floatation of a bond issue for the European Coal and Steel Community. The value of the EMU was fixed irrevocably in terms of the currencies of the six original EEC members for the duration of the bond issue, which had a fifteen-year maturity. Regardless of what might happen to the relative exchange rates of the six European currencies, one EMU was set immutably at

DM	3.66	BF	50	F	3.62
Lit	625	Lux F	50	F	5.55419

At the time of the bond issue in December 1970, one EMU was equal to one US dollar on the basis of the then

prevailing exchange rates between the dollar and the six EEC currencies. Any subsequent devaluation or revaluation of an EEC currency could not alter the original relationship between the EMU and that currency. In consequence, an investor in EMU bonds was guaranteed full protection against devaluation as well as the right to benefit from a revaluation of any of the six currencies. For example, if the French franc were to depreciate by 10 per cent, vis-a-vis the German mark, French investors in EMU bonds could demand payment in German marks at the fixed rate of EMU 1 = DM 3.66 and convert the mark proceeds into French francs for an exchange gain of 10 per cent. If the mark were to appreciate vis-a-vis the other five currencies all non-German investors could demand payments in marks, to be converted into their domestic currencies at a profit. In general, a holder of EMU bonds would realize exchange gains if his domestic currency was devalued against any of the six-currencies or if any of the six was revalued against his domestic currency. A bondholder whose domestic currency was revalued would have no exchange gain/loss. An issuer of EMU bonds would realize no exchange gain when his domestic currency was revalued, but he would suffer an exchange loss when his domestic currency was devalued. In return an EMU issue had two main advantages for him :

- a) Considerably greater sums could be raised through

it than through other Euro bonds, and

- b) the interest rate was usually a fraction lower than that on other Eurobonds.

Nevertheless, investors had an undue advantage; they obtained not only full protection against a devaluation but also the right to profit from the revaluation of any of the six currencies. Thus, the exchange rate risk to which borrowers exposed themselves was the main deterrent to a wider use of EMU bonds. In fact, the EMU bond was nothing but a multiple currency bond. The only distinguishing characteristic of the EMU bond was that, instead of the customary two currencies of a multiple currency bond, it had six - the currencies of the European Coal and Steel Community and a few other independent agencies that could expect continued revenue inflows in all six currencies, few borrowers could afford the luxury of assuming the exchange risk inherent in a multiple currency issue with six option currencies. Consequently the EMU has rarely been used since 1972.

3.2.1.3.3 Uses of ECU's

The ECU has qualitatively a wide range of applications though quantitatively it is limited. The ECU is used primarily in connection with the EMS; the Community budget, CAP, EDF, etc., are expressed in ECU's.

ECU also has non-official/private uses -

a) certain bank accounts, bond issues are denominated in ECU.

b) Contracts are concluded in ECU.

Originally the role of the ECU was that of a unit of account. With effect from April 1979, the ECU was introduced into the CAP, but with specific conversion rates (green rates). In January 1987 the ECU replaced the EUA in all the sectors in which the latter has been used and has thus become the sole unit of account used by the Community authorities. With the inception of the EMS, the official use of the ECU and its field of application have become much larger. In particular, the ECU has become a key reserve asset created by the EMCF for the EEC central banks, against the transfer by these banks in the form of 3 month revolving swaps of 20 per cent of their gold assets and 20 per cent of their dollar reserves. A debtor central bank can use ECU to repay debts incurred under the very short-term financing arrangements of the EMS when such debts fall due for settlements. However, the creditor central bank is not obliged to accept settlements in ECU of more than 50 per cent of its claim. In other cases ECU's may be used by Central banks by mutual agreements. Thus settlements can be made in ECU's and apart from its role as a reserve asset, the ECU also serves as numeraire for

the exchange rate mechanism as the basis for calculating the indicator of divergence and as the denominator for operations in both the intervention and credit mechanisms. However, it is the use of the ECU in the private sector which has recently proved the most dynamic field of activity.

Parity Grid : In the exchange rate mechanism the ECU is used for defining the central rates and so it is formally the numeraire. When ECU are created against dollars, one numeraire is simply substituted for another, but when ECU are created against gold, there is genuine money creation either because gold has ceased to be a means of payment or because the rules for converting gold into ECU permits a revaluation of gold that many central banks did not undertake prior to establishment of the EMS. ECU is not used in practice as the numeraire when there is a realignment of central rates. The consequences for the ECU are deduced from the desired bilateral nature of the system.

Divergence Indicator : ECU is also used as a basis for the calculation of the divergence indicator, but this potentially important function is somewhat satisfactory, adjustments that have to be made because of the non-participation of sterling and the adoption by the lira wider margins.

Intervention Credit Facilities

Finally credit under the very short-term facility is by nature given in Community currency, but it is accounted for in and settled in ECU subject to the condition given above. There is a provision that short-term credit can be granted in ECU, but as seen above, these facilities have not so far been used. Thus, while the creation of ECU is now linked to the specific and temporary swap mechanism, its use is restricted to the official Community circuit and even within it, its use is limited. It was in 1982, that the ECU may be said to have 'taken off' in the private sector, with the creation of the complete banking infra-structure which was necessary once issues were to be not only denominated but also settled in ECU. There has been considerable diversity in these developments between member countries, depending upon the scope provided by differing national legislation. Thus Belgium, which is the seat of Community's Institution which are substantial borrowers in ECU, has become the Centre for banking and lending operations in ECU. In Italy the ECU is used above all for export and import finance, while in France there have been a number of cases of the ECU being used for commercial purposes.

3.2.1.3.4 Conclusion

If the ECU are to have a permanent existence of their

own, the temporary arrangements have to become permanent, i.e., the swaps made to continue for ever, with an independent exchange risk.

The use of the ECU could be extended in various directions -

1) In the Community's official circuit - A full utilisation of the ECU should entail the elimination of the existing 50 per cent limit of acceptability in intra-Community settlements.

2) The ECU could be used outside the Community official circuit both on private markets and with third countries.

On the whole, the ECU seems to have overtaken the other basket type currency, the SDR, less two years after the composition of the latter simplified to include only five currencies.

The difference between SDR and the ECU help to explain the greater success of the ECU in private markets.

1) The ECU basket is much more homogeneous, its component currencies being officially linked in the exchange rate arrangements.

2) The ECU is the monetary expression of a highly integrated economic area and of a true common market, whereas, the SDR basket is composed of currencies of

countries whose economic ties are much looser.

3) The ECU provides a more complete alternative to the dollar as an asset than does the SDR in which the dollar is the largest single component.

4) The ECU is used for operational purposes by Community Institutions, e.g., (Community budget, borrowing lending, etc.).

5) The institutional organisation of the European Communities, which comprises Community law, several Community policies, a Community budget and an elected parliament, makes the ECU the expression of a political reality that is much more developed than that of other international organisations such as the IMF, and provides it with the core of the infrastructure of a monetary authority.

ECU - a genuine currency - ECU will become a full fledged currency once it has ceased to be a basket of currencies and has become a basket of goods and services, i.e., once the prices of a number of goods and services are expressed in ECU first, prices in other currencies then, being derived prices.

3.2.1.3.5 A Comparative Analysis of the Functions of the ECU and the SDR

The terms 'ECU' and 'SDR' have come to have various meanings, as financial institutions, as the units by which

those instruments and transactions in them are valued, and as units used for other purposes. Though both units are at a relatively early stage of evolution the differences have already contributed to a number of contrasting developments in their uses in official and private circles.

Valuation of the ECU and the SDR

The methods used at present for determining the values of both units relative to their currencies are similar in a number of technical respects. Both are defined as fixed amounts of a number of national currency units which are valued at prevailing (changing) market exchange rates. ('Valuation', pp. 42-43 & 53-54.).

Functioning of the ECU and the SDR as units of Value and Account, as Official Reserve Assets and as Private Financial Instruments

a) The functions of the ECU and the SDR as official instruments differ markedly. The ECU unit serves as "numeraire" of the regional exchange rate arrangements of the EMS, and the "official ECU" - representing in essence a redenomination of other existing reserve assets - is used in settlements in support of those arrangements. The SDR serves no comparable "numeraire" or settlement function under present global exchange arrangements. It does, however, serve as the unit of account and denomination for all of the Funds transactions and operations, and the

"Official SDR" serves as a global supplement to other reserve assets, designed to contribute to a smoothly functioning international monetary system.

b) The differing degrees of emphasis on the various functions of the official ECU and SDR have led to substantial controls in their use. The official ECU, while forming a significant part of the EC members' reserves has been used relatively little in actual transactions because of limited circumstances and ranges of use at present envisaged under the EMS arrangements. Official SDRs have been created in relatively small amounts. Their use is less narrowly constrained, however, and demands arising primarily in connection with participants' transactions with the Fund have given rise to a relatively large volume of official dealings in SDRs. ("Uses", pp. 46-48 and 57-58.).

c) The ECU's regional currency composition its link to the exchange arrangements of the EMS, demands and promotion by EC entities, and to some extent the effects of restrictions and tax considerations have contributed to the rapid development of a market for private ECU financial instruments, primarily though not exclusively in European capital markets. The SDR by contrast, as a more "global" unit, has not attracted comparable interest in private markets, although it has been adopted as a unit of account

by a number of international organisations.

Prospects for Further Growth

Any prediction of growth in the ECU and SDR markets is highly uncertain; however, it is likely that the recent rapid growth of private ECU markets will moderate of its own accord. Some part of the ECU's recent growth has probably been the result of a new "product" developing its sustainable market share. If so, as that process is completed, the ECU market will likely grow at rates bearing a closer relationship to the overall growth of financial markets. Some part of the ECU's growth is probably a result of incomplete economic integration in Europe exchange and capital market restrictions, and the willingness of some EC member countries to give preferential treatment to dealings in ECU's. To the extent that economic integration proceeds, and controls are relaxed further, their special impetus to growth in private ECU's would diminish. The more enduring source of demand for private ECU's and SDR's is likely to come from their use for denominating all kinds of contractual obligations. The activities of the "parents" [the EC and its member countries, the Fund and its members] in creating demand for instruments denominated in these units, including their activities in the official ECU and SDR, will continue to be important in influencing overall demand. Apart from strong official

impetus, the ECU given its composition and regional context may also be a natural or appropriate unit in more market situations, than the SDR. Although the rate of growth of the ECU market may moderate, the market would now seem to have attained a reasonably firm basis in official interest and support, the ECU's characteristics, and the stage of development of the market itself. A number of fundamental questions would need to be addressed, including whether the private use of the SDR (or ECU) contributes to international financial stability and whether the functioning of the SDR as an official reserve asset would be enhanced by the development of the private SDR market or indeed by some form of integration of the private and official markets.

3.2.2 Institutional and Organizational Aspects of the EMF

3.2.2.1 Introduction

At first a distinction needs to be made between different aspects of the EMF problem, i.e.,

- i) the definition of the functions of the Funds
- ii) the definition of the organic structure of the Fund, and
- iii) the link between the Fund, national monetary authorities (treasury and central banks), and Community institutions.

The three aspects are related but different.

Secondly, today there is no unique formula valid in all member countries for the distribution of roles between the treasury and the central bank. The same function (setting official rates, changing reserve rates, fixing monetary targets, etc.) lies in the hands of the treasury in one country and in those of the central bank in another. This fact by itself suggests that the chosen functional solution has no obvious implication as to the 'Central bank versus treasury' nature of the Fund as an institution.

Thirdly, the choices that have to be made as to the powers and functions of the Fund should not be confused with the choices about the selection of the national institutions from which national representatives in the Fund will be appointed.

Four points of debate however remain :

1) The organic structure of the Fund. The IMF, EIB formula that distinguishes a technical from a political decision level and has some way of weighting votes is particularly interesting in this respect.

2) The need for a 'permanent' structure both with some powers to make technical decisions and with the function of supplying information and leading the decision process.

3) The problem of voting rules within the Fund

4) The scope of responsibilities of the Fund.

This is also the problem of placing the Fund in the context of other Community institutions.

3.2.2.2 Criteria Relevant for Defining the Role of the Fund

1. Procedures, rather than specific rules should be defined for the Fund in the area of exchange rate arrangements. The Fund should be endowed with decisional procedures, to be utilised in circumstances that cannot be forecasted to create a 'Zone of monetary stability'. This holds good both for interventions and realignments.

2. The degree of exchange rate variability should not be reduced directly, i.e., by applying more restrictive intervention and realignment rules; rather, it should be reduced indirectly, i.e., by creating conditions for both the conduct of domestic monetary policies and the use of conditional credit facilities to play a gradually greater role relative to parity changes.

3. An appropriate balance has to be found between the use of credit mechanisms and exchange rate changes and this in turn requires ^a clearly established role for the ECU.

A balanced role of these three aspects of the System can only be ensured by jointly managing them within the

same institution.

3.2.2.3 Reasons for setting up a Fund

1. Present state of the EMS

There are many reasons for thinking that the EMS is not a stable equilibrium.

a) There is a tendency for internal tensions to be dealt with by recourse to central rate realignments rather than policy adjustments and/or credit facilities. This polarisation is likely to be self-destructive as the System will abuse the realignment option to such an extent that it will no longer provide the external discipline for which it is designed.

b) There is no clear way of dealing with tensions produced from the exterior. This forms an integral part of the whole and there must be a well-balanced way of dealing with these tensions if the System is to survive.

2. Institutional Framework

If progress towards a 'Zone of monetary Stability in Europe' requires a tighter system and a better balance between the various elements, then the problem of creating an appropriate institutional framework arises inevitably. Only by dealing with credit mechanisms, exchange rate arrangements and the use of the ECU within one single body and to maintain an appropriate balance between them, within

one single body and one set of formal established procedures, will it be possible to succeed. Money is an institutional reality by its very nature and the ECU needs for its establishment to be the liability of a vital institution like the Fund.

3.3 Why EMS should develop further?

1. Without a closer monetary organisation the Community's achievements to date would be placed in jeopardy.
2. Need for monetary stability. - In all the countries of the Community (even with strong currencies) achieving monetary stability where prices are concerned, requires monetary organisation which goes beyond the national framework.
3. Development of the IMS - Now that the dollar has ceased to play a central role, the IMS has gradually broken up into a multi-polar system, with several currencies alternately playing the role of an international currency. The need therefore, is reliance on a combination of currencies in order that, in its present inevitable multi-polar phase, the IMS is able to operate in a sufficiently orderly manner, allowing further integration of world trade, or at least safeguarding what has already been achieved without undue risk.

3.4 How EMS could develop further?

In 1971-81 two opposite and yet complementary developments have dominated the world monetary relationships -

a) In the private area there has been an extraordinary and almost unprecedented rate of financial innovation throughout the world domestically and internationally.

b) In the government area there has been such a decline in the degree of the public authorities' involvement in international monetary and financial matters, that we would be tempted to say these matters now became an area of almost pure laissez faire.

These two developments have jointly contributed to, as well as, are determined by an almost unprecedented degree of instability and uncertainty about monetary standards, i.e., about the value of currencies both in terms of other currencies and in terms of their power to buy goods and services. The EMS is concerned with the problem of monetary stability - (we no longer believe in a fundamental conflict between high employment and price stability.).

Instruments for monetary stability

For any currency, the first need is monetary stability. For any group of countries monetary stability becomes a

problem when the external position of one of them deteriorates (BOP difficulty).

It can be resolved by three instruments -

- a) Exchange rate
- b) Financing of deficit
- c) Domestic economic adjustment.

A country in difficulties must operate within the change formed by these instruments.

3.4.1 Exchange Rate

The exchange rate instrument is already used within the EMS since the decisions on Central rates are Community decisions - No country participating in the system may adjust parity of its currency without following Community procedure. In spite of the Central rate adjustments made in 1979 and in March 1981, there has been very little movement in the effective exchange rates of the currencies participating in the EMS exchange rate mechanism. Trade between EMS countries has not therefore, been affected by the wide fluctuations in exchange rates internationally. This development contrasts with the widely divergent exchange rate movements recorded within the Community in the period 1973-78, and is an important factor for an area in which some 46 per cent of the trade (in 1979 for the EMS countries) is effected between member countries, this development means

that countries having less stable prices have imported stability through the mechanisms of direct price interdependence, while countries having more stable prices have gained from the slower rise in their costs.

3.4.2 Financing of the External Deficit

Financing of the external deficit is less clearly integrated in the Systems procedures -

i) the facilities under the system operate too automatically -- the quantity of ECU created is a function of the amount of gold or dollar contributions, i.e., it is largely dependent on the market price of gold. It also happens that the market price of gold has risen sharply since the inception of the EMS, this has led to the creation of a large quantity of ECU's and has allowed a number of countries to finance their external deficits easily and hence to postpone more radical adjustments to their economies.

ii) Member states find it easy to borrow from private international markets.

3.4.3 External Imbalance

External imbalance, namely, domestic economic adjustment, is even less subject to Community disciplines, since decisions on money creation and interest rate levels are currently taken under co-ordination procedures that are not

very strict. Countries with stable currencies have very few instruments with which to influence the monetary policies of countries with high inflation. The relative stability of effective exchange rates within the system has so far not been matched by a greater convergence of costs and prices. When expressed in national currencies average annual divergencies in cost and price trade between EMS partners were in many cases quite substantial. A shift from a low to a high relative cost and price level should serve to exert pressure in favour of increased domestic stability if backed up by appropriate policies. This is often the only way in which the real problems of domestic adjustment are forced into the open (Belgium). These problems would otherwise be obscured by the spiral of devaluation and inflation; and devaluations would do nothing to resolve the basic problems (e.g., UK and Italy between 1973-78.). It is important that the EMS stabilization mechanism should be allowed to operate in countries where inflation or the level of relative costs is still too low to operate in countries where inflation or the level of relative costs is still too high. This not only means that monetary policy must defend the exchange rate but also that domestic adjustment (incomes and public finance) must be facilitated and speeded up through other appropriate measures. From the existence of the EMS such internal

adjustment is necessary in order to open up possibilities of economic growth in conditions of stability and to increase employment. The EMS simply highlights the need for adjustment and helps its realisation along.

3.4.4 Conclusions

The objective of the EMS is not just to achieve stability of exchange rates between participating currencies but to achieve monetary stability in a wider sense that includes prices, as well as exchange rates. This is why the commitment to maintain fixed rates has been more of a constraint on the higher inflation participants than on the low-inflation ones. It is the former rather than the latter which have more often had to modify their internal policies in order to remain within the System. Belgium, Denmark, France and Italy have made substantial and far-reaching changes in their domestic economic policies because these policies were leading to an unacceptable loss of foreign exchange. Experience has shown that participation in the System, has not, in practice proved inconsistent with adherence to domestic monetary targets. From the point of view of the deficit countries participation in the EMS has probably strengthened the hands of the authorities in adhering to their targets. Surplus countries have been able to avoid intervention on a scale that would have produced large, unwanted increases in the

money supply by revaluing their currencies from time to time. In general, constraints on domestic monetary policy arise much more as a result of the openness of the economy of the country concerned than from its participation in the EMS. Small open economies with floating exchange rates have not found, that the absence of a formal obligation to intervene in support of the exchange rate, has enabled them to pursue domestic objectives regardless of the external consequences, e.g., Switzerland, some Scandinavian countries. Thus the System has greatly improved intra-Community exchange rate relationships, but has failed to produce the desirable degree of convergence towards price stability. The EMS was established with the objective of furthering economic convergence among the member states. Thus, it cannot really be considered a complete success until substantial progress towards that objective has been made. On the other hand, its achievement in avoiding unnecessary variability of exchange rates and in ensuring the orderly adjustment of parities when required, which is essential for the efficient functioning of the common market, is clearly seen. In this respect, the EMS is clearly a complete success, despite the fact that it has to operate in conditions that have been made particularly difficult by the long recession and the excessive exchange rate variability of the dollar and the yen.

It is true that if we look at the inflation rates and the balance of payments' performance of member countries in 1978 - the year immediately before the EMS was launched, and compare the figures with those for the years since EMS was launched, it appears that rates of inflation among Community countries were more divergent in 1982 than in 1978. But this is not the appropriate comparison to make, because, 1978 was a year of relative economic stability, whereas during the following four years the Community's economy had been subjected to serious shocks from outside, in particular, the oil crisis of 1979-80 and its aftermath.

Membership of the EMS has been important and an influential factor shaping individual countries' policies in such a way as to prevent them from getting too far out of line with those of their partners. It has produced greater efforts to bring down inflation than might have been made in countries where the inflation rate was high and has had some marginal moderating influence in countries where it was low. Had the EMS not existed one would not dare to say that price-trends would have been more stable and less divergent than they are. The relevant term of comparison is neither a pre-EMS nor a non-EMS situation but rather what we consider to be the best price-stability objective. Thus the System needs to be improved.

3.5 EMS as Compared to the Snake

3.5.1 Introduction

Measured against the objectives of economic and monetary union put forward in the Werner Report out of which the snake arrangements arose in April 1972, the snake's success was rather limited. The snake was unable to keep together the major European currencies, one after the other, sterling, the lira and the French franc, all dropped out. There are various reasons for this lack of cohesion. Most of them relate to the difficulties inherent to the effort to tie together under an exchange rate link countries differing in their economic situation, in the capacity of their policies to maintain internal and external equilibria and in the measures adopted in the pursuit of these policies. Less common commitment to monetary stability than today, less political commitment to monetary cooperation in Europe and greater hopes in the working of a floating rate system was the background against which the snake had to cope with the monetary consequences of the first oil-price crisis.

3.5.2 Differences

There are differences in the mechanisms between the snake and the EMS and differences between the political commitments. A much stronger element of Community monetary solidarity in the EMS is incorporated in the very definition

of the ECU as a basket currency compared with the former European Monetary Unit of Account (EMUA) which was defined in terms of gold. The basket definition of the ECU implies that exchange rate changes of one currency entail changes of all other currencies with respect to the ECU as well. In the snake, parity adjustments vis-a-vis the EMUA had no impact on partner currencies' EMUA rates and could be made after consultation by the respective monetary authorities. The divergence indicator which, however imperfectly, acts as a warning device, hinting at severe strains within the EMS exchange rate system and leading to an examination of the underlying conditions and a presumption that the authorities of the country concerned will adopt adequate measures to correct the situation is another feature of the EMS directly related to the basket definition of the ECU. Another example, is the impact of central rate changes on the CAP through their effect on monetary compensatory amounts and in 'a' second stage, on the setting of agricultural prices in ECU. The pooling of member central banks reserves at the EMCF and the upgrading of the amounts available under the credit mechanisms and the modifications of their terms, all reflect the increased significance of Community solidarity within the EMS, compared to the functioning of the snake.

3.5.3

Success of EMS as compared to the Snake

EMS has already proved more successful than the

snake. Thus, while sterling, the lira and the French franc had all dropped out of the snake within two years, the EMS has managed to hold together three of the Community's four major currencies over a period of four years, despite conditions which were just as unfavourable as those prevailing in the 1970's. It also has, despite the lack of progress in creating a formal institutional framework, been much more successful in achieving convergence of economic policies in member countries. During the snake period, each major member country pursued its own economic objectives without much regard for whether they were compatible with those of its partners and when this produced strains on the exchange rates, the deficit countries one by one, dropped out of the system. Since the inception of EMS, attitudes have changed; Policies have not, always been mutually compatible, but, in contrast to what happened earlier, when such incompatibility produced payments' imbalances and strains in the foreign exchange market, the major countries have been prepared to modify their internal policies in order to correct these imbalances and stay within the system, rather than stick with their policies and drop out. The EMS constraint has been an important factor in furthering the process of de-indexation in countries such as Belgium, Denmark and Italy, and this will improve the performance of these countries in achieving greater price stability in future. The EMS has established

the Community's monetary identity, in a way in which the snake never did; the most obvious expression of this identity is the ECU, which in contrast to the EMUA, is widely used as a unit of account, plays a useful role as a reserve asset and instrument of settlement between member countries and is now developing rapidly as a financial instrument in the private sector.

CHAPTER IV

SUMMARY AND CONCLUSIONS

4.1 Summary

Our study begins by pointing out how the different stages of economic integration have evolved one from the other; beginning from Preferential Trade Arrangement to Free Trade Area, Customs Union, Common Market and finally the Economic and Monetary Union, (1.2). Chapter I further explains as to why countries would want to integrate; generally the countries which integrate do benefit from economies of scale and specialization (1.3).

The study intends to present a (historical) review of the literature available on the economic integration within the EEC, Chapter I therefore, includes a brief outline of the establishment of the EEC as signed in the Treaty of Rome in 1958, the Smithsonian Agreement incorporating the Snake and finally the establishment of the EMS in 1979 (1.4).

From Chapter II we get an idea as to how the countries forming the EEC tried to come to a consensus regarding the idea of integration and international cooperation.

In 1967 M. Raymond Barre stressed the need for furthering economic and monetary integration so that the

interdependence already existing amongst the member countries would not go waste (2.3.1). Around the same period, at the Hague Summit (2.4), it was apparent that although all the members realized that EMU is the final objective of EEC countries, there was a difference of opinion regarding the means of fulfilling this objective. The Germans advocated coordination of economic policies as a pre-requisite for the establishment of an EMU, while the French insisted on a Regional Monetary Bloc.

To overcome these hurdles a Committee was set up to establish by stages an EMU in EEC, this has been highlighted in the Werner Report (2.4.1). The report suggested:

- 1) Fixity of exchange rates of the member countries;
- 2) Complete liberalization of all capital movements within the area;
- 3) Establishment of a Common Monetary Fund.

This was looked at as the Preparatory Stage (upto 1971) for an EMU.

On the basis of the Werner Report the EEC countries tried to lay out the stages to fulfil the goals of establishing an EMU. Thus in the Smithsonian Agreement in 1971 (2.5.3) the countries of the EEC agreed to manage their currencies so that their exchange rates moved in relation to one another and within narrow bands in relation

to the dollar. This principle of the snake-in-the-tunnel, as also how and why the snake left the tunnel has been explained in great detail in Chapter II. This is the first stage towards an EMU (1971-73) (2.5.1).

A report was submitted by the Commission in April 1973 on the first stage of EMU and the measure to be adopted in future. The Commission proposed a continuation of status quo. Thus from January 1974, EMU passed on to its second stage, the contents of which were not concrete (2.6).

However, since 1975, the EEC resembled a holding operation - wherein all major initiatives were left for the time when the economic crisis will have been overcome (2.6.2).

Towards the end of Chapter II, we get an idea of a number of new proposals (2.6.3), which could help the Community to break the deadlock already reached.

The various aspects of EMS together with its main characteristics - the EMF - (3.2), as also how the EMS is an improvement over the snake (3.5), has been outlined in detail in Chapter III.

The study is limited to the theoretical aspects of EMS, the applicability of which is wide, but beyond the scope of this dissertation.

4.2 The Present IMS (International Monetary System)

In 1979, the EMS was formed to revive the European snake and also to push monetary integration much further. Even though the UK chose not to join the EMS at the start, the pound was included in the calculations of the ECU, in the expectation that the UK would join later (Chapter III).

When the fluctuation of a member nation's currency reaches 2.5 per cent, of its allowed range, a "threshold of divergence" has been reached, and the nation is expected to take corrective steps to prevent its currency fluctuating outside the allowed range. Member nations are allowed/assigned a quota into the EMF, 20 per cent to be paid in gold (valued at the market price) and the remainder in dollars, in exchange for ECU's. The amount of ECU's is expected to grow as member nations convert more and more of their dollars and gold into ECU's. Eventually, ECU's are to become an important international asset and intervention currency rivaling the US dollar (3.2.1.3). The EMF is to evolve eventually into an EEC central bank, similar to the US Federal Reserve and engage in foreign exchange market intervention and open market operations (3.2.2).

4.3 The Future of EMS

The Community is at differing stages of development

in the wide variety of fields it encompasses and is thus lacking in cohesion. For EMS to work effectively the CAP requires full monetary integration, but at present this does not exist. A strong EMS could become a more effective instrument to foster price-stability and it could contribute to a better handling of two major problems, that trouble the European countries : the maintenance of the common market and the organisation of the world monetary relationships.

The EMS has failed to produce greater price-stability in the Community because it does not envelop all the dimensions of monetary policy into a unique set of common decisions directed towards monetary discipline.

Monetary relationships between member countries involve three policy dimensions : (a) Exchange rate variations, (b) Balance of Payments financing and (c) Domestic adjustment; and only a unified approach to these three dimensions will eventually allow (not ensure achievement of the twin objective of giving the Community its own monetary organization and of fostering monetary stability. Only discretionary policy decisions taken in common will enable the Community to pursue price stability through charging internal and external conditions. In the present system, neither the unity of approach nor the possibility of discretionary decisions are realized to a

sufficient degree. The unity of approach is impaired both by the large and unregulated access to extra-Community financing of intra-Community imbalances and by the loose constraints on domestic prices.

By the end of 1981, the total reserve pool of the EMF was about \$ 40 billion, and the value of one ECU was \$ 1.0852. During 1979 the Danish Kroner was devalued twice and the German mark was revalued once against other EMS currencies; in October 1981, and in June 1982 the French franc was devalued. This points to the fundamental weakness of the EMS in attempting to keep exchange rates among member nations within narrowly defined units without at the same time integrating their monetary, tax, fiscal and other policies. Furthermore, interventions in foreign exchange markets were made in dollars rather than in member nations currencies as originally intended.

At this stage, it is too early to judge whether or not EMS will be a success, so far, it is little more than a statement of economic and political aims. The shortcomings with the EMS consist in an insufficient discipline and in an imbalance in the way the various aspects of monetary policy are dealt with.

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