

How the EMS will work

The technicalities and politics of the new system

In their recent public statements, West German Chancellor Schmidt and French President Giscard d'Estaing, the original proponents of the new European Monetary System, have left little doubt that their project is intended to eventually develop into a worldwide monetary system replacing the broken-down Bretton Woods agreement. The new system's broad objective is to generate a worldwide economic recovery by transforming hundreds of billions of presently idle and continually shifting Eurodollar funds into viable, long-term credits for industrialization of the Third World and modernization of the advanced-sector countries.

A final communique released on Dec. 7 by the European Community heads of state following the two-day summit in Brussels that formally inaugurated the EMS (see accompanying excerpts) details how the EMS will work in its initial phase. A close examination of the communique reveals that virtually the entire British and American

press establishment has been guilty of spreading two falsehoods concerning the EMS: first, that the EMS will establish a new international reserve currency, the ECU, which will replace the dollar, and second, that the EMS is merely a currency stabilization scheme.

In fact, the EMS will establish a *European central bank* the European Monetary Fund, which will generate long-term development credits and, eventually, supplant the International Monetary Fund, whose policies and program have long been dominated by the EMS's bitter enemies in London.

To summarize the main features of the EMS, and their far-reaching implications:

1. Establishment of relatively fixed currency parities in Europe

In recent months leading European as well as Japanese

The Brussels communiqué

From the unofficial English translation of the "Resolution of the European Council of 5 December 1978 on the establishment of the European Monetary System (EMS) and related matters":

A. THE EUROPEAN MONETARY SYSTEM

1. Introduction

1.1 In Bremen we discussed a "scheme for the creation of closer monetary cooperation leading to a zone of monetary stability in Europe." We regarded such a zone "as a highly desirable objective" and envisaged "a durable and effective scheme."

1.2 Today, after careful examination of the preparatory work done by

the Council and other Community bodies, we are agreed as follows: a European Monetary System (EMS) will be set up on 1 January 1979 . . .

1.4 The following chapters deal primarily with the initial phase of the EMS.

We remain firmly resolved to consolidate, not later than two years after the start of the scheme, into a final system the provisions and procedures thus created.

This system will entail the creation of the European Monetary Fund as announced in the conclusions of the European Council meeting at Bremen on 6-7 July 1978, as well as the full utilization of the ECU as a reserve asset and a means of settlement. It will be based on adequate legislation at the Community as well as the national level.

2. The ECU and its functions

2.1 A European Currency Unit (ECU) will be at the centre of the

EMS; the value and the composition of the ECU will be identical with the value of the EUA at the outset of the system.

2.2 The ECU will be used: (a) as the denominator (numeraire) for the exchange rate mechanism; (b) as the basis for a divergence indicator; (c) as the denominator for operations in both the intervention and the credit mechanism; (d) as a means of settlement between monetary authorities of the EC.

2.3 The weights of currencies in the ECU will be reexamined and if necessary revised within six months of the entry into force of the System and thereafter every five years or, on request, if the weight of any currency has changed by 25 percent.

Revisions have to be mutually accepted: they will, by themselves, not modify the external value of the ECU. They will be made in line with underlying economic criteria.

spokesmen have stressed again and again that a restoration of fixed exchange rates — not only within Europe but internationally — is essential for the expansion of world trade and industrial growth. The old system of fixed rates based on Bretton Woods disintegrated following President Nixon's floating of the U.S. dollar on Aug. 15, 1971, and the resulting "floating rate" regime has been a constant source of financial instability ever since.

As an intermediary step toward restoring fixed parities, the EC communique specifies that, as of Jan. 1, 1979, a system of narrowly fluctuating currency parities will be established among those European countries participating in the EMS. Each currency will be allowed to fluctuate against the others by a margin of only 2.25 percent above or below a specified "central rate." Countries which did not previously belong to the currency "snake" and have special problems, such as Italy, will be allowed fluctuation margins of up to 6 percent. The communique adds that these margins "should be gradually reduced as soon as economic conditions permit."

2. Pooling of dollar and gold reserves in a central fund

Beginning Jan. 1, 1979, the European countries will pool 20 percent of their dollar reserves and 20 percent of their gold reserves — valued at about 25 billion ECU (European Currency Units), or \$33 billion — in an already existing

EC institution known as the European Monetary Cooperation Fund (FECOM). One purpose of the reserve-pooling is to achieve maximum coordination and firepower among the central banks in carrying out foreign exchange operations to maintain stable parities among the European currencies and in relation to other leading currencies, such as the U.S. dollar and Japanese yen. An additional objective is to provide centralized credit facilities to cover a host of European needs (see below).

A tantalizing aspect of this plan is that gold has been effectively remonetized, disregarding the International Monetary Fund's articles of agreement which allegedly "remove gold from the system." Although this is not explained by the communique, informed European sources say that the EC intends to establish a new official gold price somewhere between \$200 and \$240 an ounce, which will become the basis for valuing gold internationally.

3. Creation of centralized credit facilities for development

The pooling of reserves in the FECOM is merely transitional to the formation of a full-fledged *European Monetary Fund*, which, the communique states, will come into existence "not later than two years after the start of the scheme." The EMF, according to high-placed West German and French officials, will function as an international development bank capable of issuing long-term credits to Third World and other non-European countries, as well as to the immediate EMS membership.

...the Brussels communiqué

3. The exchange rate and the intervention mechanism

3.1 Each currency will have an ECU-related central rate. These central rates will be used to establish a grid of bilateral exchange rates. . . .

3.3 In principal, interventions will be made in participating currencies. . . .

3.5 An ECU basket formula will be used as an indicator to detect divergences between Community currencies. A "threshold of divergence" will be fixed at 75 percent of the maximum spread of divergence for each currency. It will be calculated in such a way as to eliminate the influence of weight on the probability to reach the threshold.

3.6 When a currency crosses its "threshold of divergence," this results in a presumption that the authorities concerned will correct this situation by adequate measures,

namely: (a) diversified intervention; (b) measures of domestic monetary policy; (c) changes in central rates; (d) other measures of economic policy. . . .

After six months these provisions shall be reviewed in the light of experience. At that date the questions regarding imbalances accumulated by divergent creditor or debtor countries will be studied as well. . . .

3.8 To serve as a means of settlement, an initial supply of ECU will be provided by FECOM against the deposit of 20 percent of gold and 20 percent of dollar reserves currently held by central banks.

This operation will take the form of specified, revolving swap arrangements. By periodical review and by an appropriate procedure it will be ensured that each central bank will maintain a deposit of at least 20 percent of these reserves with FECOM. A member state not participating in the exchange rate

mechanism may participate in this initial operation on the basis described above.

4. The credit mechanisms

4.1 The existing credit mechanisms with their present rules of application will be maintained for the initial phase of the EMS. They will be consolidated into a single fund in the final phase of the EMS.

4.2 The credit mechanisms will be extended to an amount of 25 million ECU of effectively available credit. . . .

5. Third countries and international organizations

5.1 The durability of EMS and its international implications require coordination of exchange rate policies vis-a-vis third countries and, as far as possible, a concertation with the monetary authorities of those countries.

5.2 European countries with

In the interim, however, the scope of the FECOM's credit-generating capabilities is more limited. According to the communique, the FECOM will utilize its gold and dollar reserve base to generate up to 25 billion ECU (\$32.8 billion) in credits as required by member countries, including 14 billion ECU (\$18.3 billion) in short-term credits for foreign exchange intervention and 11 billion ECU (\$14.4 billion) in medium-term credits to cover balance of payments deficits.

An additional 1 billion ECU (\$1.3 billion) a year in long-term credits will be made available to less prosperous European countries during the next five years through the already existing European Investment Bank. Special interest rate subsidies of 3 percent (about \$260 million a year) will be provided on these long-term loans, which will be used to finance "selected infrastructure projects and programs." In a recent speech to businessmen, Giscard said that the expanded credit facilities should foster the building of cities, ports, and highways, as well as the development of high-technology industries like computers and electronics.

4. Open-ended EMS membership

The fifth section of the EC communique calls for "concertation with the monetary authorities" of third countries, leaving the door wide open for the extension of the EMS into a worldwide system. The communique specifies that "European countries with particularly close economic and financial ties with the European Community" may

link up more directly with the EMS through participation in the exchange rate and intervention mechanism. Candidates for such "associate membership" in the EMS include such non-EC European countries as Switzerland, Austria, Sweden, Spain, Portugal, and Greece. Spanish officials have already announced that they intend to apply for associate membership, and would like to become full EMS members immediately following Spain's expected entry into the EC.

THE ROLE OF THE ECU

An issue which has generated considerable confusion in the international financial community is the role of the European Currency Unit in the new system. The confusion is due to the stream of misinformation and obfuscation from the British and British-influenced American press.

The British press previously presented the ECU as a "new international reserve currency" designed to supplant the U.S. dollar, and predicted a dire new crisis for the dollar once the EMS went into operation. When the EC summit failed to establish the ECU as such a new currency, the London *Economist* derided the conference as "the Brussels dud."

Then on Dec. 11, British Finance Minister Denis Healey told Parliament that Britain had failed to join the EMS because it was just an expanded version of the "snake." Therefore, he announced, he intended to conduct an international campaign to transform the ECU into an in-

particularly close economic and financial ties with the European Community may participate in the exchange rate and intervention mechanism.

Participation will be based upon agreements between central banks. These agreements will be communicated to the Council and the Commission of the EC.

5.3 EMS is and will remain fully compatible with the relevant articles of the IMF agreement. . . .

B. MEASURES DESIGNED TO STRENGTHEN THE ECONOMIES OF THE LESS PROSPEROUS MEMBER STATES OF THE EUROPEAN MONETARY SYSTEM

1. We stress that, within the context of a broadly based strategy aimed at improving the prospects of economic development and based on

symmetrical rights and obligations of all participants, the most important concern should be to enhance the convergence of economic policies toward greater stability. We request the Council (Economic and Finance Ministers) to strengthen its procedures for coordination in order to improve that convergence. . . .

3. The European Council agrees that in the context of the European Monetary System, the following measures in favour of the less prosperous member states effectively and fully participating in the exchange rate and intervention mechanisms will be taken.

3.1 The European Council requests the Community institutions by the utilisation of the new financial instrument and the European Investment Bank to make available for a period of 5 years loans of up to 1,000 million EUA per year to these countries on special conditions.

3.2 The European Council re-

quests the Commission to submit a proposal to provide interest rate subsidies of 3 percent for these loans, with the following elements: the total cost of this measure, divided into annual tranches of 200 million EUA each over a period of 5 years, shall not exceed 1,000 million EUA. . . .

3.4 The funds thus provided are to be concentrated on the financing of selected infrastructure projects and programmes, with the understanding that any direct or indirect distortion of the competitive position of specific industries within member states will have to be avoided.

3.5 The European Council requests the Council (Economics and Finance Ministers) to take a decision on the abovementioned proposals in time so that the relevant measures can become effective on 1 April 1979 at the latest. There should be a review at the end of the initial phase of the EMS. . . .