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THE POLITICS OF MONETARY INTEGRATION IN THE EUROPEAN COMMUNITY

Theory, Practice and Prospects

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ABSTRACT

The aim of this thesis is to reappraise the European Community's progress towards Economic and Monetary Union (EMU) and to set out the lessons which can be derived from this experience and from economic and political theory with regard to the kind of *strategy* which must be followed to achieve EMU in Europe. It compares the three monetary systems, Bretton Woods, the Snake and the EMS, which account for the development of European monetary relations in the post-war period and tries to explore the parallels and their respective strengths and weaknesses, to draw conclusions as to the conditions which are necessary for the successful operation of an adjustable- peg type of exchange rate system and to assess the chances of such a system to achieve full and permanent EMU in the Community. It looks into the economic and the political factors which account for the successes and failures so far, their relevance today, as well as some of the interconnections that exist between EMU and integration in other fields. The thesis concludes that the EEC has as yet failed to make the decisive break towards monetary union because the full implications of EMU and the commitment necessary to achieve it have not been understood or accepted by Europe's national governments. The co-ordination approach to EMU, which has underpinned the Community's efforts in this direction from the early 1960s to the recent Delors proposals has been an inappropriate one for the task. The best way to achieve EMU in the Community, especially given the dramatic developments in Eastern Europe, is through the creation of a European parallel currency which would depoliticise monetary policy and would allow EMU to be implemented at a pace dictated by Europe's need for it, rather than by the twists and turns of national politics. Finally, the firm belief is stated that true EMU can only be realised within the framework of a federal Europe.

To my parents

PREFACE

In the course of the preparation of this thesis, I received invaluable help from a number of individuals and I wish to take the opportunity to express to them here my deepest gratitude and appreciation. I would like first of all to thank my supervisor at the London School of Economics, Dr. Paul G. Taylor, for his unfailing help, patience and encouragement throughout, as well as professor Susan Strange, now with the European University Institute in Florence, who found the time to read an early version of part of this study and offered much useful advice.

I was able to profit on many different occasions from contact with various officials and employees of the Commission of the European Communities at its offices in Brussels, London and Athens, who provided me with masses of information, literature and precious advice and who are far too numerous to mention individually here. To all of them go my sincere thanks, as they also do to Ms. Lesley Neale who did the typing and proof-reading for a substantial chunk of this study.

Any new contribution to a particular field owes an immeasurable debt to the work of all those authors who have already laboured and given of themselves to advance our understanding of the subject, and I do feel this debt especially strongly here. There cannot be many areas of study which have attracted such a consistently high calibre of authors who have made it such a challenging and rewarding experience to try to follow on their footsteps and, hopefully, push the limits of the subject a little further. I have tried to repay a small part of this debt through a comprehensive use of references where I have been able to draw from the work of others and by

the provision of an extensive, though by no means exhaustive, bibliography which includes those works which have helped my own understanding of the complexities involved in international monetary affairs, whether or not they are referred to directly in the text.

Last, but certainly not least, I would like to express my thanks, my love and my gratitude to my mother and father who provided most of the financial and much of the emotional support for the completion of this study. It is only fitting and natural that it is to them that this thesis is dedicated.

London, March 1990.

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INTRODUCTION

In March 1971, the member states of the European Community embarked on an ambitious project designed to achieve full economic and monetary union (EMU) in Western Europe by the year 1980. Less than three years later, in January 1974, the EMU project lay virtually abandoned. In December 1978, the European Council decided to set up the European Monetary System (EMS) whose much more limited declared aim was to create a zone of monetary stability in Europe. In this aim the EMS has been remarkably successful, but the system still has failed to develop further in the way envisaged at the time of its creation. So, eleven years later, the EEC had another go. In June 1989, eleven of the Community's twelve heads of government approved the proposals submitted by a committee set up especially for this purpose and headed by the President of the Commission of the European Communities, M. Jacques Delors, which put forward yet another plan for the progressive realisation of EMU.

The fact that the political leaders of Europe have been striving after the implementation of EMU with such persistence over a very long period of time shows that they consider monetary unification to be an important objective for the European Community. That they are *still* at it, however, also shows that, public declarations of intent notwithstanding, this has also been a rather low priority objective and one, at that, which is very hard to achieve. There are various reasons for this apparent lack of significant progress: Part of the explanation might be that the necessary conditions for monetary unification in Western Europe have never really existed. Politically and economically, the member states of the EEC are too divergent for full EMU to be possible - the Community does not fulfil to an adequate degree the criteria for the creation of a

viable currency area.[1] Or it could be that unfavourable external circumstances (monetary instability elsewhere, the oil crisis and its consequences) have so far prevented the implementation of EMU. Or, still more plausibly, that given the initial characteristics and dissimilarities between the member states and the very real influence of external circumstances, the political leaders of Western Europe have not been able or willing to embrace the kind of strategy for monetary unification that would be equal to the task.

This thesis is intended as a contribution to this debate. As the European Community now stands poised to have another attempt at EMU, it seems opportune to reappraise the progress made so far, the successes and the failures, the factors which influenced them and the lessons which have, or *should* have been learnt. To this purpose, we take an eclectic look into the post-war monetary history of Europe, concentrating on the years from the late 1960s onwards, and into the three monetary systems, Bretton Woods, the Snake and the EMS, which account for the development of European monetary relations in this period. An attempt is made to compare these systems, to explore the similarities between them, their respective strengths and weaknesses, and to draw conclusions with regard to the conditions which are necessary for the success of an adjustable peg type of exchange rate system, as well (and more importantly from the point of view of this study) as to assess the chances of such a system and of the theoretical approach to EMU which accompanies it to achieve full and permanent monetary integration in the European Community. At the same time, I have tried to keep track of the parallel development of *thinking* on the subject and to outline briefly the ideas of the major schools of thought and the suggestions, plans and proposals put forward by a variety of academic and official sources, both inside and outside Europe, to improve the way the system operates or to reform it altogether.

Throughout the thesis the emphasis is on policy. I have sought to provide neither a comprehensive historical survey nor an exhaustive theoretical treatment of EMU.[2] The focus of the study is firmly on any light that economic and political theory and the actual experience of monetary integration in Europe can throw on the kind of strategy which must be followed to achieve EMU in the Community. One can find in the literature two general approaches to EMU:[3] First, there is what could be called the *common currency approach*[4] which would achieve monetary union in Europe through the creation of a common currency, either in a big leap or through a process of open competition between national monies or, better still, through the establishment of a European parallel currency. Although this strategy has from time to time generated considerable interest within the academic community and despite the fact that (at least in its better variants) it is usually thought capable of achieving the objective of EMU in a way which combines the economic and political advantages of both *gradualism* and *automaticity*, it has never been taken as a serious option by Europe's political establishment, for it is seen to challenge too directly the hold of national governments on the levers of national economic sovereignty. The official approach of the Community to the problem of monetary integration has, instead, always been the so called *co-ordination approach* which relies on co-ordination of the exchange rate policies of the member states (backed by arrangements for intervention in the currency markets and, usually, provisions for monetary support to weaker members) or on *ex ante* co-ordination of their domestic monetary policies or, as in the case of the European Community, a mix of both. This strategy tends to present less of a challenge to the autonomy of national governments, but is beset by a number of economic and political disadvantages which make it rather inappropriate for the task. "The most one can expect ... from the co-ordination approach is greater exchange rate *stability*. It cannot assure permanent exchange rate *fixity* and it does not lead to the creation of a common currency. *A fortiori*, it is not a strategy, even in its

most ambitious form, that will lead to monetary union".[5] It is, therefore, part of the conclusions reached in this thesis that the EEC has failed so far to make the decisive break towards monetary union because the full implications of EMU and the extent of the commitment necessary to achieve it have not been properly understood or accepted by the national governments of Western Europe. As a result, the chosen co-ordination strategy may have been politically acceptable, but it is rather unlikely to quickly achieve its objectives. Or, if one wished to take a more cynical view, it could be that the co-ordination strategy has in fact been politically acceptable *because* it is rather unlikely to quickly achieve its objectives.

In a philosophy seminar when I was a first-degree student, we reached the conclusion, I remember, that the best way scientists can preserve the maximum level of objectivity in their work is to state their prejudices clearly at the outset, and I have found this advice to be useful ever since. I believe that I started this study with only two preconceptions: One, that the emergence of a united Europe is good and two, that, as a result, monetary unification must be a desirable objective for the European Community. It was probably inevitable that these two starting points would eventually lead me to a preference (or at least willing acceptance) of federal solutions over purely intergovernmental ones, to a preference for some method of exchange rate management over freely floating currencies and to some positions which might be seen as anti-American, to the extent that the formation of a strong European monetary bloc and the creation of an internationally attractive common European currency may be seen to opposed to the interests of the United States (US). At the same time, I have made a determined effort to consider and to do justice to both sides of the argument, whether the debate was an intra-European or a US-European one, or that between contradictory prescriptions from different schools of economic or political thought. The history of EMU, let alone human experience,

does anyway suggest that rarely does one side have all the argument and the reason and the merit on its side and, looking at it from a practical point of view, it is only slightly less rare that the best solution does not come out of a thorough familiarity with and understanding of the all the views and interests involved and an intelligent and selective combination of as many compatible elements of them as would truly promote the objective to be achieved.

The approach employed in this thesis is basically a non-mathematical one, what is usually called a political economy approach. During the past twenty years, there has been a plethora of econometric studies, an abundance of rules and directions on how best to co-ordinate national monetary policies and set multilateral targets of economic growth, the budget deficit and the balance of payments consistent with the goal of maintaining monetary and exchange rate stability. Advances in computer technology have made number-crunching easier and more tempting and increased academic demands and competition have transformed economics into a more rigorous, formalised science. How far, though, has this transformation improved our understanding of how the international economy really works? For every economist who claims that flexible exchange rates have not contributed to a slowdown in world economic activity there is one who claims they have, for every study which claims that a devaluation can bring about a real adjustment of the external sector there is another, often referring to the very same country, which has reached the opposite conclusion, while economic theory and the most expert and well-paid of forecasters have been equally dumbfounded by the way reality seems at times to cock a thumb at theoretical expectation and economic logic - witness the persistent German surpluses of the 1970s despite massive real appreciation of the Deutsche Mark (DM), or the gravity-defying US dollar throughout the 1980s despite the most spectacular accumulation of debt in the history of the world.

The fact is that international monetary relations are only partly the stuff of econometric models, objective indicators and rigorous economic analysis. Such things can explain the mechanics, show the way one economic variable may relate to others and, with luck, sometimes point out causal links between them in a way which helps to suggest methods and solutions to practical problems. Yet, international monetary relations have also always been the stuff of mis-information, rumour, prejudice, prestige, cock-ups, superstition, coincidence, personal relations and whims, as well as more mundane things such as political influence abroad, differing perceptions of the national or short-term party-political interest, national electoral calendars, political developments and military conflict in far away places and structural and institutional differences between nations in things like political stability, the maturity of the financial sector, the modernity or obsolescence of the economy, the degree of independence of the central bank, industrial relations and the strength of trades unions. These factors are rarely to be found in econometric models for they are by their nature non-quantifiable and, if ever, they are referred to in the literature only in passing. Still, a brief look at the history of world money shows that although objective indicators may rule the routine and influence the longer term, it is in fact these other factors which govern the extraordinary and the short term, it is they which finally determine the vital decisions, it is they on which monetary systems have been built or rejected, it is they on which has hinged their success or failure. How does one enclose in a model General De Gaulle or Mrs. Thatcher? How can one quantify the head-start given the EMS negotiations simply because of the warm personal relations between the French President, Valery Giscard d' Estaing, and the West German Chancellor, Helmut Schmidt? And yet, only a fool would under-play the decisive influence of these factors in the history of European monetary unification.

The problem therefore is not so much that econometric models are by their nature imprecise because they cannot possibly include elements which are not quantifiable, but that, if taken as the only point of reference, they can in fact sometimes be misleading, as they exclude those very factors that make the decisive impact in the real world, and direct attention instead to other, less important ones. Econometric research can offer valuable information about the economic background against which national policies are formulated and suggest the possible advantages and disadvantages of different ways forward, but it is very rarely able (or indeed meant) to paint a complete picture of the process by which national leaders and governments decide on issues which may have an influence lasting well beyond their term of office and even their lifetimes. As one of the best known economists of his generation, Fritz Machlup, once said, over-reliance on econometric research "can earn the economic profession increasing disrespect or contempt for professional naivete and stupidity".[6] Clearly, any serious study of European monetary relations which aspires to contribute to more than just a purely technical understanding of the economic issues involved must strive for a better balance.

This thesis attempts to do just that. I have employed the conclusions of relevant econometric research and the concepts of economic theory throughout, as in the end EMU is primarily, though not only, about ordering in a more efficient way the *economic* relations of the states of Western Europe, whether as separate political entities or, eventually, as members of a federal system. As an economist, I feel more comfortably anyway with these concepts than with some of the more ambiguous, political ones. At the same time, I have tried to underline those instances where non-economic factors have had the final say, where political expediency, coincidence or personal whim have played the crucial role and tried to draw conclusions from them.

In his doctoral thesis in the 1970s, my compatriot Loukas Tsoukalis argued that monetary unification does not fit very well the prescriptions of the neo-functionalist strategy for the furtherance of European integration. Money is far too political an issue. Too political, in fact, to be left to bureaucrats. What this thesis is trying to show is that money is indeed too political. *Too political to be left to politicians.* It is my contention here that a monetary system which depends on favourable coincidence of electoral calendars and on political will and agreement for its fine-tuning and further development can possibly succeed in achieving a zone of relative monetary stability and, with luck, a strengthening of the consultation and co-ordination procedures in the formulation of economic policy, as the EMS has done, or before it and in a more limited way the Snake. It is unlikely though to lead quickly to permanent and irreversible monetary integration operating at the union level and to bring about the creation of a fully functional common currency accepted beyond the spheres of the trading and financial communities and the multinational enterprise, which would become a powerful unifying force and symbol for the nations of Europe, as a single currency like, for example, the American dollar represents for a country such as the US. This objective, I believe, can best be achieved through the establishment of an "automatic" system which, although dependent itself for its creation on a monumental initial act of political will, would not be continuously subject to the ups and downs in the political fortunes of personalities or of national governments. A system of this kind would allow monetary policy to be operated at the union level on technocratic criteria and would denationalise and depoliticise money, in the sense of money being managed by a politically independent or semi-independent monetary authority with a fixed, legally defined and widely understood and agreed goal in mind, such as the maintenance of the real value of the currency, rather than be available for manipulation for the achievement of short-term narrow

political aims, pre-election booms and such like. The best way to effect such a system would be through the early establishment of a viable and attractive European parallel currency. This would gradually displace national monies and achieve EMU in the Community at a pace determined by free market choice rather than political discretion, it would prevent the division of the EEC into a hard and a soft currency bloc, would promote the course of further integration in other fields and would ensure that a soon to be reunited Germany would find it difficult to dominate Europe, while at the same time making certain that it would continue to play its full part within the Western alliance.

The structure of the thesis is pretty straightforward. There are three chapters, each of which deals with one of the three monetary systems which are being compared. Chapter I serves as a kind of international background to the study and looks into the events which led to the partial breakdown of the Bretton Woods exchange rate system in August 1971 and the subsequent transition to generalised floating in March 1973. It describes the tensions which arose between and within the main participants on both sides of the Atlantic, and the differences in the economic and political philosophies and interests which generated them. A brief examination of these issues is indispensable for a clear understanding of the future course of European monetary relations, not only because the European Community's first attempt to establish EMU in the early 1970s had its prime motivation in events related to the progressive disintegration of Bretton Woods and the need to protect the Customs Union and the Common Agricultural Policy (CAP) from the effects of currency instability such as the 1969 realignments, but also because the very attitudes and policy preferences of the member states on the whole question of EMU throughout this time (and thus the eventual fate of the EMU project, the Snake and, later, the EMS) were crucially influenced by the way each of them viewed and was affected by

developments in the international monetary system. Chapter I looks into these factors and makes a first attempt to set out those conditions which the experience of Bretton Woods suggests must be met if a system of fixed but adjustable exchange rates, whether on a world or a regional basis, is to operate successfully. A tentative hypothesis emerges that such a system will work only if there is among its participants a country which is able and willing to exercise legitimate and responsible hegemony over the others and to the extent that all members will accept to abide by the strict code of responsibilities which the adjustable peg and a hegemonic order dictate.

The subject of chapter II is the regional monetary scheme operated by some countries of the European Community between 1972 and 1973, better known as the "Snake". It explains the factors which contributed to the establishment of the system and the process by which it was gradually transformed from an ambitious instrument for the promotion of European integration on a wider basis to a much more limited, though still important, scheme whose objective became to maintain a zone of relative stability between the currencies of an inner core of European countries centered round the DM. It describes briefly the changes in the international economic environment and the new tensions the Snake had to deal with, the progressive disillusionment with flexible exchange rates and the failure of the negotiations on world monetary reform. It makes an attempt to highlight some of the non-economic factors which affected the course of European monetary relations and compares the experience of the Snake and the lessons learnt from it with those drawn in the previous chapter. The reality of the Snake as it operated in the 1970s, it is argued, tended to bear out two important conclusions, and these form part of the main argument of the thesis: One, it confirmed the working hypothesis of the first chapter with regard to hegemony as a necessary condition for the success of an adjustable peg type of

exchange rate system, both negatively (as shown by the loss of members and the difficulties experienced by the Snake during its first couple of years, when this condition was absent) and positively (as shown by the relative success of the mini-Snake, once hegemony had been well established through the undisputed leadership of West Germany). Two, it demonstrated clearly the shortcomings of the Snake as an instrument of monetary *unification* as opposed to *stabilisation* and the limitations of the strategy of co-ordination which underpinned the Community's approach to EMU. Chapter II then turns to examine in some detail the various proposals which were advanced to reform the Snake, both within the existing economic and institutional framework and through the creation of an automatic system and a European parallel currency. Finally, there is a brief description of the monetary crises of 1976-78 and the travails of the French franc, the lira, sterling and the US dollar, which eventually brought about the creation of the EMS.

Chapter III deals with the EMS itself and the recent efforts to advance beyond it, towards the implementation of a full EMU in the European Community. There is a discussion of the economic and political factors which contributed to the creation of the system, including a brief examination of the problems of speculation, the J-curve and overshooting, as these apply to the specific reality of the economies of Western Europe. This is followed by an exposition of the events which led to the establishment of the system in December 1978, an attempt to evaluate its novel features with a view to deciding whether the EMS is, in fact, all that different from the Snake, and a short account of the actual experience of the EMS in the first decade of its existence. The EMS, it is argued, has proved remarkably successful in its aim of providing a zone of monetary stability in the Community, but much less so as an instrument for the promotion of further European integration, as it has been unable to achieve substantially greater

convergence between the member states in other fields, let alone in securing complete and irreversible EMU.

The final section of the thesis turns to the future: It places monetary union within the context of the wider "Project 1992", adopted in December 1985 by the European Council, and examines the recent Delors proposals for the progressive realisation of EMU as well as the developments which have taken place since the publication of the Delors report. These tend to suggest that, although the strategy advocated by the report is burdened by the economic and political perils and uncertainties of the co-ordination approach, there is now unprecedented fair political wing behind the proposals owing to the recent political upheaval in Eastern Europe, the collapse of Communism and the prospect of the forthcoming reunification of Germany, as well as the internal logic and dynamics of the single market idea, all of which have created an unmistakably different political environment in the Community, favourable to the speedy implementation of EMU. However, the strategy advocated by the Delors report is not the only credible approach to EMU and, experience shows, probably *not* the best one. Chapter III therefore proceeds to look further into the parallel currency option as an alternative strategy for the realisation of EMU and explores the interconnections between monetary unification and other kinds of integration in the economic, political and social fields, defence, the Community's regional and structural balance, the size and distribution of the EEC budget. Particular attention is paid to the link between monetary union and political union and the firm belief is stated that true EMU can only be realised within the framework of a federal Europe. Finally, a number of suggestions are made which should improve the chances of successful monetary unification in the Community.

The conclusion to chapter III and the thesis as a whole brings together the various arguments developed earlier and offers some passing thoughts on the wider implication of the successful implementation of EMU in Western Europe. Monetary unification and the eventual emergence of a single, common currency will have consequences for the Community's industrial and taxation policies, its institutional and decision-making mechanisms, the north-south division between the member states, as well as the prospects of further enlargement. Naturally, the treatment of these issues here tends to be rather epigrammatic and more in the way of suggestions for further study. There are two reasons for this. The first has to do with choice: Monetary unification has linkages with most fields of economic, social and political activity and in a thesis concerned with the choice of *strategy*, I took from the beginning a decision to mention but not digress widely into those factors which have only an indirect bearing on the subject, to avoid making this an endless sprawl of interrelated issues and to resist following every tangent, no matter how interesting or intellectually tempting. Some of the issues mentioned above have to do more with the question of whether EMU is a desirable objective (which this thesis has taken as granted) and with what happens once EMU is in place to make it economically successful and politically acceptable, rather than with the more immediate question of *how* to achieve EMU, and were therefore left out of the main body of the thesis. The second reason was a matter of necessity: A full and proper examination of these issues would require at least as much space again as that already occupied and so it was impracticable to undertake within the confines of this study.

Throughout the thesis, I have tried to avoid terminological complications and excessive technical detail. I have not, for example, made any attempt to give a precise definition to the term monetary system, distinguish between the concepts of monetary *system* as compared with

monetary *order*, or devoted any space to separate the various units of account employed at different times and for different purposes by the European Community, the Unit of Account, the European Unit of Account, the European Monetary Unit of Account, the unit of account used for agricultural purposes and so on. Such distinctions, although valid and of certain interest to the academic or the technocrat, can be found elsewhere[8] and I do not feel they add much to what is essentially a critical review of European monetary relations for the purpose of determining the kind of strategy which must be followed and the conditions which must be fulfilled for the successful implementation of economic and monetary union in Europe.

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LIST OF ABBREVIATIONS

BDI:	Association of West German Industry.
BFR:	Belgian franc.
BIS:	Bank for International Settlements.
BLEU:	Belgium-Luxembourg Economic Union.
CAP:	Common Agricultural Policy.
CBI:	Confederation of British Industry.
CDU:	Christian Democratic Union (West Germany).
CEC:	Commission of the European Communities.
CRU:	Composite Reserve Unit.
CSEMU:	Committee for the Study of Economic and Monetary Union.
CSU:	Christian Social Union (West Germany).
C-20:	Committee of Twenty (1972-74).
D:	Federal Republic of Germany.
DK:	Denmark.
DKR:	Danish krone.
DM:	Deutsche Mark.
DRA:	Greek Drachma.
ECOFIN:	Council of Economics and Finance Ministers of the EEC.
ECSC:	European Coal and Steel Community.
ECU:	European Currency Unit.
EEC:	European Economic Community.

EFTA: European Free Trade Association.

EIB: European Investment Bank.

EMA: European Monetary Agreement (1958).

EMF: European Monetary Fund.

EMS: European Monetary System.

EMU: European Monetary Union.

EMUA: European Monetary Unit of Account.

EPC: Economic Policy Committee.

EPU: European Payments Union (1950-58).

ERDF: European Regional Development Fund.

ERM: Exchange Rate Mechanism (of the EMS).

ESC: Portuguese escudo.

ESCB: European System of Central Banks.

EUA: European Unit of Account.

F: France.

FDP: Free Democratic Party (West Germany).

FECOM: European Monetary Co-operation Fund.

FF: French franc.

FOMC: Federal Open Market Committee (of the US Federal Reserve).

GDP: Gross Domestic Product.

GNP: Gross National Product.

G-7: Group of Seven.

G-10: Group of Ten.

HFL: Dutch guilder.

I:	Italy.
IMF:	International Monetary Fund.
IR:	Ireland.
IRL:	Irish punt.
JPN:	Japan.
LFR:	Luxembourg franc.
LIT:	Italian lira.
MCA:	Monetary Compensatory Amount.
MFTA:	Medium Term Financial Assistance.
NDP:	National Democratic Party (West Germany).
NKR:	Norwegian krone.
NL:	Netherlands.
OAS:	Secret Army Organisation (France).
OECD:	Organisation for Economic Co-operation and Development.
OEEC:	Organisation for European Economic Co-operation.
OPEC:	Organisation of Petroleum Exporting Countries.
OPTICA:	European Commission study group on Optimum Currency Areas.
OTH:	Other.
PCF:	French Communist Party.
PCI:	Italian Communist Party.
PLO:	Palestine Liberation Organisation.
PPP:	Purchasing Power Parity.
PSI:	Italian Socialist Party.
PTA:	Spanish peseta.

RPR:	Rally for the Republic (France).
SDR:	Special Drawing Right.
SEA:	Single European Act.
SFR:	Swiss franc.
SKR:	Swedish krona.
SPD:	Social Democratic Party (West Germany).
STMS:	Short Term Monetary Support.
TUC:	Trades Union Congress (Great Britain).
UDF:	Union for French Democracy (France).
UK:	United Kingdom (of Great Britain and Northern Ireland).
UKL:	UK pound sterling.
US:	United States (of America).
USD:	US dollar.
VC:	Vicious and virtuous circles.
$:	US dollar.

CHAPTER I:

THE COLLAPSE OF BRETTON WOODS

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Ia. 1968, 1971 or 1973? A note on chronology

The world exchange rate system established at Bretton Woods, New Hampshire, in July 1944, is generally said to have broken down on Sunday night, 15 August 1971, when US President Richard Nixon "temporarily" suspended the convertibility of the dollar. There are, however, another two dates of considerable importance to the understanding of the causes of the collapse, as well as the course of subsequent developments. Indeed, if the "gold-exchange standard" (convertibility of the dollar) is seen as the crucial characteristic of the Bretton Woods arrangement, as usually is the case, 17 March 1968, which saw the closure of the London Gold Pool, could also be taken as the date of the effective termination of the system. For, either *de jure*, by the Washington Agreement (for the private sector), or *de facto*, by the need not to undermine the ailing system even further (for foreign monetary authorities), the freedom to convert was drastically curtailed.

If, on the other hand, one sees the "adjustable peg" (relative stability of exchange rates) as the essential feature of the arrangement, as the writer does, one is more inclined to accept 12 March 1973, which marked the beginning of the joint float by the currencies of the European industrial countries, as the "correct" date and this is the one used here. All three instances, however, are important. For, each altered the rules and the very nature of the system and had lasting effects on official thinking and the expectations of private market operators, with significant consequences for the future and the object of this study.

Ib. 17 March 1968

By the late 1960s, the Bretton Woods monetary system was faltering. The official price of gold, fixed at $35 ever since 1934, was totally out of line with the underlying market situation. Although the initial price had probably been too high and gold production peaked in the 1960s, the combination of a fixed price and a growing nominal economy inescapably led to an excess demand for gold by the private sector, as the supply of money was, in most countries, regulated to achieve full employment rather than to conform with the availability of gold reserves. The exact timing of the inevitable gold crisis was influenced by a variety of both monetary and non-monetary factors, such as the increase during the 1960s in the industrial demand for gold, the inflationary bias inherent in full employment policies as they were applied from the mid-1960s onwards, the French gold-hoarding policy following General De Gaulle's famous press conference of 4 February 1965 and, chiefly, the 14.3% devaluation of the pound sterling announced by the British Chancellor of the Exchequer Mr. James Callaghan on Saturday 18 November 1967, after repeated denials that this would occur, which generated fears that similar American denials concerning the US dollar were equally worthless, as indeed they turned out to be.[1]

Given the inevitability of the crisis, the American authorities could have responded by raising the official price of gold (thus devaluing the US dollar relative to gold) to give the system breathing space. This option, however, was considered unacceptable for a number of political and economic reasons, to which we will return in a later section.[2] Alternatively, they could have negotiated with their major economic partners a change from the gold-exchange standard to

either an SDR standard, by establishing the newly-created SDR as the primary reserve asset for the world economy, or a *de jure* dollar standard, by abandoning official gold transactions altogether. Instead, they opted for the easiest, least-resistance response (first proposed in the so-called "green stripe" plan advanced by Governor Guido Carli of the Banca d' Italia and the US Federal Reserve staff), according to which the US would maintain official gold transactions unchanged, but would simply abandon the obligation to trade with the private sector. As the crisis deepened and the London Gold Pool continued to report large losses of gold, a final agreement on these lines was indeed concluded at a weekend meeting in Washington D.C. on 17 March 1968. This established a two-tier market for gold and effectively altered the basis of the Bretton Woods system, with grave consequences for its already perilous chances of survival. From the devaluation of sterling in November 1967 to the closure of the market on 15 March 1968, the Gold Pool had sold a total of $3 billion worth of gold, of which the US share amounted to some $2.2 billion.

"The reason that the adoption of a two-tier gold market marked an important stage in the collapse of Bretton Woods is that it constituted acknowledgement that free portfolio choice between gold and dollars - which is the basic tenet of the gold-exchange system - was no longer possible".[3] Indeed, from then on and until its final breakdown, the system ceased, in effect, to be a gold-exchange standard and instead became one which could, more accurately, be characterised as a *de facto* dollar standard.

With the abandonment of the Gold Pool, one of what Robert Triffin called "the fire extinguishers", intended to prolong the survival of Bretton Woods,[4] fell away. But, it was the market confidence problem, which was thereby given a further twist, which potentially

presented the most serious threat to the system. Orderly monetary conditions are intimately linked with confidence in the issuer of money. Yet, the typical manner of devaluation in the years preceding 1968 had been quiet weekend meetings, when the exchange markets were closed, with the authorities' prior denials of the event discounted as part of the scenario and forgiven in advance as a "white lie". Prime Minister Harold Wilson even praised the 1967 devaluation of sterling as a "perfectly managed operation".[5] With each successive deceit though, the confidence of the public was further eroded, to the point that, eventually, persistent denials by the authorities of a forthcoming change of parities came to be taken as *the* certain indication that such an event was indeed imminent!

March 1968 marked an important milestone in this process. To use Benjamin Klein's suggestive concept,[6] precious "monetary confidence capital" was squandered by the revocation of the obligation to defend the gold price. The monetary crises of 1968-69 and the inherent instability of the system, coupled with the public's belief that the authorities could no longer be trusted and that sufficient speculative pressure would force them to give in, signalled the end of Bretton Woods long before it eventually became a reality. The lesson of 17 March 1968 should therefore have been that making undertakings which cannot in fact be respected turns out in the long run to be counterproductive, but it is a lesson which the world in general and the Europeans in particular did not appear to have learnt during the few years that followed.

Ic. To 15 August 1971

Ic1. The Monetary Crisis of 1968-69

Before the impact of the closure of the Gold Pool had been fully absorbed, another crisis shook the international monetary system. The political unrest of May 1968 in France and the huge wage increases of the June pay agreement (minimum wages rose by 36% and wages in general by close to 30%), with which the French government bought peace in the streets, seriously undermined market confidence in the parity of the franc and generated a belief that a devaluation was imminent. At the same time, the West German current account was heading for an all-time record surplus due to the explosive growth in foreign orders for industrial products (18.2 % up on 1967), which necessitated very low interest rates and huge capital exports to keep the balance of payments in some kind of equilibrium. By mid-1968, however, the situation was getting out of hand. In September, the Central Bank Council of the Bundesbank advocated a revaluation of the DM to deal with the imbalance, but this was rejected by the federal government. In October, pressure on the franc intensified and there was renewed speculation against sterling, despite (or arguably because of) the relatively recent devaluation of 1967. The equivalent of DM 9 billion swamped West Germany in the first three weeks of November, forcing the closure of the exchange markets.

At the Group of Ten (G-10) monetary conference, held in the Economics Ministry, Bonn, on 18-20 November 1968, the federal Ministers of Economics and Finance, Professor Karl Schiller and Herr Franz-Josef Strauss respectively, successfully resisted demands for a DM revaluation,

choosing instead to adopt a disguised revaluation of 4% in the form of "border adjustments" (taxes on exports and subsidies on imports, excluding agricultural products). On the French side, the impression was given that the Economics and Finance Minister, M. Francois-Xavier Ortoli, had agreed to devalue the franc. But then, General De Gaulle, possibly provoked by some insensitive comments by Herr Strauss and the headlines of the German press, staged another one of his famous surprises. On 24 November, Paris announced that the franc would not be devalued after all. Instead, the government would adopt stricter exchange controls, a deflationary economic package and a program of export credits.

Naturally, these half-measures did not prove sufficient. Helped by Herr Strauss' comments, on 26 April 1969, about a possible revaluation of the DM, another speculative wave swept Germany. Between the end of April and 9 May, the equivalent of DM 16 billion entered the country. This time, the economic debate split the CDU-CSU/SPD coalition government along partly lines, with the Economics Minister, Professor Schiller (SPD), supported by Karl Blessing, the President of the Bundesbank, and Herbert Giersch of the Council of Economic Experts, arguing in favour of a revaluation, against the Finance Minister, Herr Strauss (CSU) who opposed it. Finally, the view of the senior partner in the "Grand Koalition" prevailed and revaluation was again ruled out.

In the meanwhile, in France, Georges Pompidou succeeded General De Gaulle as President of the Republic, following the General's resignation on 28 April 1969. Valery Giscard d' Estaing returned to the Finance Ministry (from which he had been ousted by the General in favour of the "orthodox" Michel Debre in January 1966) and promptly, on 8 August 1969, devalued the franc by 11.1%.[7] The long defence of the old, unsustainable parity during the preceding fifteen

months had cost France approximately $5 billion in lost reserves. Moreover, by this time, another speculative wave was well under way, hitting the Federal Republic in September, shortly before the federal elections, and forcing once again the suspension of the exchange markets. A short period of floating followed and, after the formation of the new SPD/FDP coalition government, the DM was finally revalued by 9.3% on 24 October 1969.

This, however, proved to be too little too late to pacify the currency markets. For, in the meanwhile, the domestic overheating of the economy had unleashed inflationary pressures which could not be controlled by revaluation alone. Wage rises, adjusted for productivity increases, came to 13% in 1970, compared with 6% for the US and an average of around 9% for the other European economies. Still, although the foreign capital which had entered the country fled after the revaluation, owing to the general inflationary climate of the time, the German current account surpluses persisted. Moreover, in an effort to stabilise the domestic economy, the Bundesbank tightened even further its already restrictive monetary policy and raised the discount rate to 7.5%, with grave consequences for international monetary stability.

Ic2. The Attack on the Dollar

For, at this point, a serious imbalance between the US on the one hand and, chiefly, West Germany (but also most of the other European economies and Japan who were following similar, if not so rigorous, anti-inflation policies) on the other, became apparent. For some time, the US Federal Reserve, under its Chairman William McChesney Martin, had been running a restrictive monetary policy aimed to attack the inflationary psychology generated by the escalation of the Vietnam war after 1965, and President Lyndon Johnson's "Great Society". Central to this strategy was the squeeze applied upon bank liquidity through Regulation Q, which imposed a ceiling on the rate of interest payable on bank time-deposits (deposit accounts). With domestic loan demand growing strongly, the major American banks tried to circumvent Regulation Q by borrowing heavily in the Eurodollar market through their overseas branches. Between 1968 and late 1969, the Eurodollar borrowing of American banks doubled to $15 billion and the dollar strengthened artificially, disguising for a time the continuing and accelerating deterioration of the American current account.

This situation was completely reversed in 1970. In January, Dr. Arthur Burns succeeded McChesney Martin as Chairman of the Federal Reserve Board. At the swearing-in ceremony in the White House, President Nixon, who had himself taken office the previous January, concluded his introduction by pleading with a big smile: "Dr. Burns, please give us some money".[8] Being less independent a character than Martin, and with the support of most of his colleagues in the Federal Open Market Committee (FOMC) and the two main political parties which had been criticising the Fed for its excessively restrictive policies in the face of mounting

recession, Dr. Burns did just that (helping in the process to re-elect the President in 1972). The Fed's credit policy was progressively relaxed until, in the spring of 1971, the 3-month interest rate was down to 3.5%. The US money supply rose by 12.6% in 1970, from -0.7% in 1969.

In response to this reversal of interest rate differentials, "hot money" fled heavily from the US, through the Eurodollar market, into the European national money supplies and central bank reserves. A large proportion of this flow represented repayments of American banks to their overseas branches, which reduced the total amount outstanding from $15 billion in 1969 to less than $8 billion by August 1971. The rest reflected heavy borrowing in the Euromarkets by mainly West German companies trying, in the absence of controls on foreign borrowing, to circumvent the stringent monetary conditions existing at home. The Bundesbank realised the serious threat to international monetary stability represented by another large speculative build-up and, starting in mid-1970, tried to squeeze out the interest-arbitrage incentive to short-term capital inflows by relaxing its restrictive policy stance, with the result that, by early April 1971, the West German discount rate had fallen to 5%.

No similar degree of concern, however, existed on the other side of the Atlantic. Since taking office, the Nixon administration had displayed an alarming lack of concern for the worsening condition of the US balance of payments, being mainly preoccupied with the state of the domestic economy. But, its attempts to control the recession were proving largely unsuccessful. The rate of unemployment rose from 3.5% in 1969 to 5% in 1970 and 6.6% in 1971, while average hourly earnings advanced by 4.6% in 1970 and 7.2% in 1971. Dr. Burns's call for a price and wages policy was ignored and the budget deficit ballooned out to $23 billion in 1971, from a surplus of $3 billion in 1969. It was this disregard of the payments situation and the

worsening state of the dollar that soon led to accusations, voiced by foreign monetary authorities and the American press, that the government was pursuing a policy of so-called "benign neglect" of its international financial obligations, though this was repeatedly denied by the administration's spokesmen.

Speculation grew as events followed each other in quick succession. The US balance of payments recorded a deficit of $9.8 billion in 1970 and another $5.8 billion in the first quarter of 1971. In the Hamburg meeting of the EEC Council of Economics and Finance Ministers (ECOFIN) on 26 April 1971, Karl Schiller proposed a joint European float or revaluation against the dollar, to which Valery Giscard d' Estaing responded by asking instead for a devaluation of the dollar. Details of the meeting leaked to the press and the speculative backlash forced the Bundesbank to suspend forward purchases of dollars as from 28 April. On 3 May, the five leading West German economic research institutes unanimously reported that they favoured either a revaluation or the flotation of the DM.

Then, on 4 May, came the inevitable denial. US Secretary of the Treasury John Connally (who had succeeded David Kennedy in February 1971) issued a statement saying that "no change in the structure of exchange parities is necessary or anticipated".[9] It was the last straw! The very same day, the Bundesbank was forced to take in $1.2 billion of speculative funds and another $1 billion within 40 minutes of opening on Wednesday 5 May. It then suspended operations, followed by the central banks of Austria, Switzerland, Belgium and the Netherlands. In the Brussels ECOFIN meeting on 8-9 May, Karl Schiller repeated his call for a joint float, but was again denied by the French and the Italians. As a result, the DM was floated unilaterally, followed by the Dutch guilder, joining the Canadian dollar which had been floating for a year.

Belgium decided to rely on a two-tier exchange rate system and France adopted stricter exchange controls to limit capital inflows. Finally, on that same day, Austria revalued the schilling by 5% and Switzerland the franc by 7.1%.

These actions and the continuing convergence of interest rates eased the pressure a little but, alas, not for long. In a speech to the International Banking Conference of the American Bankers' Association in Munich on 28 May 1971, John Connally put the blame for the continuing imbalance and the resultant disorderly conditions in the exchange markets on to excessively restrictive and protectionist policies employed by Western Europe and Japan and on to the disproportionally large defence burden born by the US relative to its allies. And he, once again, repeated the "unalterable positions" of the US: "We are not going to devalue. We are not going to change the price of gold".[10] To no avail. In late June, the powerful and respected Subcommittee on International Exchange and Payments of the Congressional Joint Economic Committee (better known as "Subcommittee Reuss" from its chairman) reported its conclusion that the dollar was overvalued and called for an international conference to deal with the situation or, in its absence, the suspension of the convertibility of the dollar until an appropriate realignment of parities had been negotiated. Then, as if to confirm its findings, the US balance of payments recorded a new huge deficit of $6.3 billion in the second quarter of 1971 and, as a result, after some relative calm in June and early July, speculation grew again to mountainous proportions.

Finally, on Friday 13 August, President Nixon and a few of his closest economic advisers met at Camp David to try to work out a solution to the problem. And, on Sunday night, 15 August 1971, the President announced, in a television address to the nation, that he had decided to

"suspend temporarily the convertibility of the dollar into gold and other reserve assets, except in amounts and conditions determined to be in the interest of monetary stability and in the best interests of the United States".[11] And, in pure Connally style, he added: "This action will not win us any friends among the international money traders. But, our primary concern is with the American workers and with fair competition around the world".[12] The package came complete with a set of domestic measures and a 10% surcharge on foreign imports to the US, to even out the playing field and to compensate for the "unfair competition" practiced by America's trading partners. The long transformation process that had begun back in March 1968 was now complete. By unilateral US action, the world was moved to a dollar standard.

Ic3. The causes of the collapse

There has been a number of interpretations advanced in the literature, competing to explain the causes of 15 August 1971. One of them focuses on the internal contradictions of the gold-exchange standard, known ever since 1960 as the "Triffin dilemma". The US, the argument goes, was the primary source of international liquidity and, given the relative inelasticity of the world supply of gold, it had to run sizeable balance of payments deficits so as not to strangulate the expansion of world economic activity. But, the continuous accumulation of deficits would gradually lead to an unacceptable ratio of US liquid-liabilities to gold-holdings and progressively undermine confidence in the dollar. A run on the dollar would eventually develop as foreign central banks and private market operators would rush to convert dollars into gold and the system would come down in a crash.[13] The establishment of the SDR in 1967 eliminated only one prong of the dilemma, at a time when the world's monetary system was speeding towards the other. That the situation therefore developed in reality exactly as Triffin had predicted and that the US was, in fact, forced to close the gold window under pressure from foreign central banks, was for a long time the most popular explanation of the event and has received forceful "inside" confirmation by William Safire.[14]

An alternative interpretation, associated with international Monetarist circles, the advocates of a dollar standard and the Marxists (though the latter from a fundamentally different viewpoint), puts the blame on the inflationary financing of the Vietnam war and the "Great Society" programs which undermined the ability of the American monetary authorities to provide the system with a stable pivot and so destroyed its legitimacy. The administration's own

interpretation on the other hand, both at the time and during the negotiations of the Committee of Twenty (C-20), looks to the failure of the adjustment process and the short-term political and long-term economic pressures generated by ever-mounting deficits. Had the Europeans and the Japanese been willing to agree to a series of equilibrating measures, the argument goes, the breakdown of 15 August 1971 need not have taken place. This view of the crisis as a problem of economic policy co-ordination has been authoritatively propagated by Robert Solomon, who at the time was serving with the Federal Reserve Board.[15]

However, co-ordination of monetary policy presupposes agreement on the aims and the direction of monetary policy and this, as Otmar Emminger of the Bundesbank has stressed, was not the case in 1970-71. At the root of the speculative build-up of those years lay a reversal of interest rate differential between the US and, mainly, West Germany after 1969, which resulted from the easing of American monetary policy, aimed to counteract a deepening recession and heavy unemployment, when at the same time in Germany and other industrial countries monetary policy was being tightened to combat the threat of inflation, which had been exacerbated by the overheating of 1968-69, as well as by large capital inflows *caused*, to a great extent, by American policy. A situation of genuine conflict in monetary aims therefore arose as Europe and the US found themselves at different stages of the trade cycle, and this precluded better co-ordination of policy.[16]

A final interpretation, however, completely by-passes the question of the feasibility of such co-ordination. According to Charles Coombs (at the time the Federal Reserve's chief foreign exchange operator), the system collapsed simply because of a loss, on the part of the American authorities, of nerve and/or conviction that it was worth defending.[17] Official preferences were

in any case moving in favour of the adoption of a floating system and American monetary diplomacy started to have increasingly nationalistic overtones after John Connally's arrival to the Treasury. August 1971 provided the opportunity to demonstrate the continuing supremacy of the US in the international economy and to remind the Europeans and the Japanese who was still calling the tune in world monetary affairs.

These various interpretations are not, of course, mutually exclusive and, as is usually the case, the truth probably lies in an eclectic combination of elements from all of them. The French gold war after February 1965 certainly gives credence to Safire's view. But, it is also true that, during the same period, the other central banks and, after the General's departure, sometimes even the French, displayed considerable caution in their occasional requests for conversions to gold. It is a fact that, on Friday 13 August 1971, the Bank of England requested and obtained the conversion of an amount of $750 million by means of a Federal Reserve swap, which is said to have triggered the weekend meeting at Camp David. It does seem, however, that the decisions taken there were by this time already well under way and that the Bank of England's request was little more than an irritant. The amount converted was about equal to the Bank's dollar accruals for August and certainly did not stress the swap line which would have permitted much bigger drawings, up to $2 billion. Subsequent reports prove conclusively that a central bank run on the dollar never really materialised and that the British request was a routine operation which, at most, provided the occasion and the excuse for, rather than the actual cause of the closure of the gold window. Total US gold losses from January to mid-August 1971 amounted to no more than $845 million, of which only $413 million represented foreign central bank conversions into gold, the rest being mostly debt transactions in the IMF (usually involving the French).[18]

More plausibly, the real *causes* of the collapse lie in a combination of elements from the other three interpretations. The inflationary financing of the "Great Society" programs and the escalation, after 1965, of the Vietnam war were certainly partly to blame. US military spending shot up by an extra $13 billion in 1966 and a further $9 billion in 1967, an increase which the Johnson administration failed to meet with any kind of increase in taxation until June 1968. This, together with many other factors, helped to create an "overhang" of inconvertible (or only partially convertible) dollars which were speedily rushed out of the country when the first sign of persistent imbalance and the potential danger of parity changes became apparent.

Also, to make matters worse, the US on the one hand and Western Europe and Japan on the other, did find themselves at opposite stages of the trade cycle in 1970-71, which caused them (short-sightedly perhaps, given the high degree of interdependence between their economies and an exchange rate system which negated their efforts) to apply contradictory monetary policies. Huge capital inflows led to an expansion of the money stock (M2) in Europe that averaged 10% in 1970 and 17% in 1971 and generated intolerable inflationary pressures, which could only realistically be held back by allowing the currency to float upwards, as Germany did in May. The failure of the adjustment process, on the other hand, and the resultant accumulation of deficits (even financeable ones) were bound to create political pressures on the American government to take some sort of countering action. For, increasingly, the American public came to believe (and was, no doubt, led to do so in order to divert criticism from the government) that the cause of the deficit did not lie with hard-working American labour, but with the neo-mercantilist trading attitude of their allies and the grossly overvalued state of the dollar and began calling for a change of course. In July 1971, a Gallup poll indicated that 50% of Americans were in favour of a price/wage freeze, while an AFL-CIO conference on jobs

revealed that American labour was being won over to the idea of import controls as the best way to safeguard employment in the face of rising imports.[19]

Initially, monetary authorities on both sides of the Atlantic (excluding, of course, the French) tried to avoid provoking speculative capital flows by pretending that there was no cause for alarm and that adjustment would occur automatically, with no need for action on their part. It soon became obvious, however, that the situation could not be left to sort itself out, but that drastic solutions were required, which would necessarily have to include a realignment of exchange rates. Parity changes were not ruled out under Bretton Woods. The system lacked, though, clear and precise rules about the timing and the responsibility for initiating adjustment. For a variety of reasons, national governments tried, as a rule, to avoid changes in the parity of their currencies or, at any rate, at least to delay them. So, for example, the pound sterling was finally devalued in 1967, though it had been clearly overvalued ever since 1964 (if not 1962), the realignment of the DM/FF cross parity was delayed for more than a year and so on. On each occasion, the taxpayer had to shoulder the cost of the delay in adjustment, either directly, to make up for the reserve losses of a central bank which intervened to support an overvalued currency, or indirectly (through inflation tax), as in the case of undervalued currencies.

This, of course, contrary to what is sometimes suggested, is not to say that once a state of "fundamental disequilibrium"[20] is diagnosed absolutely no delay in implementing the necessary parity realignment is justified. Indeed, if a devaluation is to have any significant effect on the balance of payments, rather than result in a wage and price explosion in the devaluing country, it has to be accompanied (and preferably preceded) by a variety of fiscal and monetary expenditure-reducing and expenditure-switching domestic measures,[21] so time and money spent

defending a parity in order to introduce such measures is time and money well spent. However, sound economics was not usually behind the reluctance of national governments to accept parity changes. More often, their decisions were guided by other, political considerations, such as the loss of prestige which accompanies devaluation in the eyes of the electorate, or the lobbying strength of major exporting sectors which would be hurt by a revaluation and so on.

Furthermore, even when it was generally agreed that a realignment was necessary and unavoidable, there still remained the problem of who should be responsible for the bear the cost of the adjustment. This was precisely what happened in 1971. That the US dollar was grossly overvalued in relation to the European currencies and the yen was a fact nobody seriously disputed. But, this is as far as agreement went. The Americans thought the US deficit to be essentially demand-determined (that is, caused by the growing demand of other nations for trade surpluses and international reserves) and relatively irresponsive to US economic policies.[22] Other countries, they thought, could not possibly be sincere in their professed alarm over the continuing imbalance, for if they truly disliked their surpluses they could easily eliminate them by revaluing. The fact that they (excluding Germany) were reluctant to do so and, later on, once the inevitability of a dollar devaluation was conceded by the American authorities, they (including Germany) specified very definite limits as to the maximum loss of competitiveness of their currencies against the dollar that they would tolerate, seemed to many Americans to confirm their worst suspicions about the real wishes and intentions of their partners.

The "demand-determined" hypothesis may well have had some validity in the immediate post-war period of acute international liquidity shortages (though for a great deal of that time the US was, ironically, accumulating surpluses!) but not, as we shall see later, after the mid-1960s. It is

true that, certainly the Japanese and, to a lesser extent, some of the Europeans saw "export-led" growth as the key to their economic success. This, together with the danger of structural dislocation that could result from a rapid elimination of their trading surpluses, made these countries unwilling to accept hasty changes to balance the current account. However, no country can be reasonably said to have an interest in accumulating continuous surpluses in the overall balance of payments, as this would mean a net transfer of resources to the rest of the world. Indeed, not only did the two major surplus countries, West Germany and Japan, repeatedly deny accusations to that effect, but they backed this up by actually taking vigorous steps to encourage net capital outflows. Moreover, the "demand-determined" hypothesis does not explain why, with the creation of the SDR (which meant that the demanded growth in international liquidity could be provided in alternative ways, rather than by ever-mounting American deficits), US payments difficulties escalated in the early 1970s, instead of disappearing altogether (as should happen, had the hypothesis been correct).

The Europeans, on the other hand, had a very different view of the problem. The US deficit, they thought, was created and maintained by irresponsible US policies (primarily the inflationary method of financing the Vietnam war), a proposition which seemed to be supported by the fact that, once the brief and quite exceptional Franco-German crisis had been sorted out, no major bilateral imbalances appeared to exist between the other industrial countries, but only between them as a group and the US. The conclusion was therefore drawn that it was *the US*, rather than themselves, which was out of line and should have to undertake the necessary adjustment. Moreover, the counterpart of the huge American deficit was not an equally concentrated surplus, but rather a widely and thinly spread one. With the exception of West Germany and Japan, no other country was in so strong a payments situation as to contemplate an

individual revaluation which would have decreased its competitiveness not only relatively to the US, but that with the rest of the world as well.

The alternative would have been to effect some sort of joint action by the industrial countries, either a joint-float or a concerted revaluation against the dollar. The former was, as we have already seen, repeatedly advocated by Karl Schiller, only to be rejected by his ECOFIN colleagues (not surprisingly, the French and the Italians, who had been steadily increasing their gold holdings and so had most to gain from a revaluation of gold). As for the latter, it became increasingly impossible for the majority of Europeans to accept the American demand that the necessary realignment be carried out by means of a series of revaluations on their part, rather than by a single devaluation of the dollar, especially given their belief that the current mess was the Americans' fault to start with, the political unpopularity of initiating parity changes, and last, but by no means negligible, the administrative complexity of negotiating and effecting such a series of adjustments.[23]

In August 1971, however, the US government was still determined to resist the twin pressures to restore the gold-exchange standard by means of a dollar devaluation relative to gold and, as a consequence, to resolve the problem of international liquidity through the remonetization of gold, rather than by the further development of the SDR or, even better, by the *de facto* imposition of a dollar standard. Not without some good reasons either. For, in the inflationary climate of the time, a dollar devaluation could have been only a temporary solution to a problem which was, essentially, lasting in nature. A rise in the price of gold would have enabled the US to meet its international financial obligations and to maintain full official convertibility of the dollar, as well as, possibly, to re-extend this to the private sector, from which it had been

withdrawn in March 1968. Eventually though, US gold holdings would be unable to keep up with the nominal growth of the international economy and the speculative cycle against the dollar would reappear at an accelerated pace, reinforced by the now confirmed belief that sufficient pressure would force the authorities to give in.

Given the central position of the dollar in the world monetary system, the resultant unpredictability of the dollar exchange rate would be disastrous for international economic activity. The usefulness of international money (the dollar) would be greatly impaired in all three of its functions (numeraire, means of exchange, store of value). As a result, the problems of predicting and avoiding exchange risk in international trade and investment, which the system of fixed exchange rates was supposed to alleviate, would instead be aggravated and economic resources would be wasted in "hedging" and "covering" in the forward exchange market.

The degree of disruption and the welfare loss to the international trading community would, of course, depend on the financial self-discipline (or lack of it) exercised by the reserve centre (the US). It was in relation to this that the Americans were able to point out a logical inconsistency in the views of those who urged the restoration of convertibility and of the gold-exchange standard through a devaluation of the dollar. The very purpose of convertibility in the system was to impose some sort of financial discipline on the reserve centre, similar to that exerted on other countries by the danger of reserve depletion. But, once US governments had learnt that they could solve their external problems and avoid painful internal adjustment by as simple a solution as a change in the dollar price of gold, this constraint disappeared and, with it, the need for convertibility.

Finally, whatever the economic considerations, a change in the gold-dollar parity was undesirable on political grounds. A devaluation of the dollar, seen as an explicit manifestation of failure, would hurt America's standing in the world. It would also hurt those countries which had placed their trust with the US for the maintenance of the real value of the dollar (including a number of poor, third-world countries whose limited international reserves consisted mainly of dollars), and reward the gold-hoarders (France) and the undemocratic regimes of some of the big gold producers (South Africa and the Soviet Union).[25]

These arguments, however, carried only limited weight outside the US. For they were, essentially, related to problems which arose out of the special status of the US and the dollar in the Bretton Woods monetary order and it was precisely this special status that was seen by some to be the main fault and weakness of the system. The French, in particular, attached great political prestige to monetary independence and currency stability and (in a strategy strikingly reminiscent of their attitude towards sterling after 1928) had, ever since February 1965, invested heavily both political and economic capital in a policy of antagonising the US in world monetary affairs, with the aim of restoring gold, in place of the dollar, as the cornerstone of the international monetary system.[26] This policy, in its basic outlook though not always in its specific applications, remained unchanged even after the departure of its architect, General De Gaulle, from office in April 1969.[27]

Part of this dissatisfaction with the system was particularly "French" in character and can be interpreted in terms of the well-known and documented nationalistic resentment in that country of monetary dominance by the Anglo-Saxons. There were, however, plenty of economic and political arguments against the status quo which were equally shared outside France. For,

Bretton Woods was built on a basic asymmetry in the position of the US vis-à-vis other countries, which conferred to it certain benefits that came, increasingly, to be considered inordinate by most of its trading partners. This was especially true in the years following 1968, when, with the effective (though not as yet complete) termination of convertibility, any remaining pretences were dropped and the system was exposed as a *de facto* dollar standard.

First, there were the seignorage benefits associated with the creation and issue of international reserves. While the rest of the world was obliged to finance payments deficits with real financial assets ("asset settlement"), the US was able, for as long as the dollar remained effectively inconvertible, to finance deficits by borrowing at low cost and/or simply printing money, thus exporting its own inflation abroad and avoiding the need to undertake painful adjustment measures and/or stockpile low-yielding international reserves ("liability settlement"). Adjustment obligations were, instead, shifted on to other countries. This "exorbitant privilege" seemed especially objectionable to its partners when the US was using this freedom from financial discipline to pursue policies abroad with which they basically disagreed, such as the US military involvement in Vietnam.

The exact magnitude of these benefits depended, of course, on the degree to which the international trading community accepted, or indeed preferred, the dollar to other currencies as a means of international settlement. Apart from the size of the US economy and the scope and openness of its financial markets, however, preference for the dollar was artificially boosted by yet another built-in asymmetry in the Bretton Woods design. The intervention mechanism of the system specified that the exchange rate of any particular currency was to be officially maintained within a margin of +/-1% of its current central rate relative to the dollar (+/-0.75%

for members of the European Monetary Agreement of 1958). This meant that the maximum fluctuation of a currency against the dollar was 2% (if it were to move from its dollar floor to its dollar ceiling or *vice versa*), while the permitted fluctuation of the cross parity of any two non-dollar currencies was double that (if they were to exchange places at the top and bottom of the dollar tunnel). As a result, holding and dealing in dollars implied, in effect, a much lower exchange risk for the international operator, thus helping to maintain the attractiveness and dominance of the dollar in the world economy. (This, as we shall see, was one of the important considerations when designing the European currency Snake).

Furthermore, given the status of the dollar as the world's major reserve and intervention currency, the US was free from the kind of financial losses that accompanied successful speculation in times of crisis which had, instead, to be born by foreign central banks. As Williamson has noted, since most of the speculation was the work of multinationals and most multinationals were US-based, it can even be argued that the US had a financial interest in parity changes being preceded by speculative runs.[28] American professed concern for the interests of those countries which held significant amounts of dollars in their foreign reserves, on the other hand, appeared to the Europeans as false and hypocritical, for they rightly considered that the single most important factor threatening the real value of those reserves was the instability and inflation exported to the international system by the US itself. But even the overvalued state of the dollar, despite its obvious cost to certain sectors of the US economy, was not totally without some benefit. For, it allowed Americans to travel abroad and purchase foreign goods and services at inordinately low prices. It also enabled American enterprise to start up European subsidiaries and acquire European companies on the cheap. The book value of US direct

investment overseas quadrupled from $6.7 billion at the end of 1960 to $27.7 billion by the end of 1971.

Finally, there were political advantages for the US in the preservation of the status quo. American foreign policy carried enhanced influence derived from the ability to lend extensively to other countries in temporary financial difficulties, or the refusal to do so (Britain and Suez, 1956). In a general sense also, there were great political benefits for the US in being explicitly recognised as the money manager of the world. This special status probably reflected quite accurately the realities confronting the participants of the Bretton Woods conference in July 1944 and the economic strength of the US, in relation to that of the war-ravaged rest of the world, at that time. It was, however, completely out of proportion in the 1960s and early 1970s, by which time Japan and Western Europe had closed the gap considerably and were still catching up fast.

All this, of course, does not mean that the US alone benefited from the arrangement. For, as a group of influential economists, known as the "dollar standard school", claimed, provided that the US exercised its international financial obligations responsibly, the economic benefits of the system for the rest of the world economy (arising from orderly monetary conditions and the elimination of conflict in the exchange markets) would by far outweigh the likely seignorage gains for the US. The argument was based on what is usually referred to in the literature as the "n-1 problem" of consistency in balance of payments targeting. In a world of n countries, the stability of the system requires that there be only n-1 independently set payments targets.[29] For, if all countries decided to pursue separate external objectives, these might well turn out to be mutually inconsistent and this would eventually lead to such self-defeating policies as

protectionism, interest rate wars and competitive devaluations and/or deflations, of which the international economy had had so bitter an experience in the 1930s and which the creation of Bretton Woods had been intended to prevent from re-occurring.[30] If this kind of conflict was, therefore, to be avoided, it followed that there should be one country (and, indeed, a country with certain economic characteristics at that), which would be prepared to pursue a passive external policy, to allow the others to adjust to the payments positions they considered desirable.

In the Bretton Woods setting, the US was the obvious candidate to assume this role. The dollar was already established as the major reserve currency in international trade and finance. The US was by far the biggest economy in the system and, as such, it accounted for a significant proportion of both world trade and that of any of the other countries taken individually, so it was the US who could operate a passive external policy most credibly and efficiently. Finally, its economy being less "open"[31] than those of its trading partners (the product of both size and structure), it was the US who could best *afford* to run such a policy (the domestic implications of external imbalance would be smaller than for any of the other economies).

The proposals advanced by the "dollar standard school" were, accordingly, that the system be officially recognised for what it had, effectively, become since 1968, and the dollar standard be legalised. Thereafter, the US not only could but *should* pursue a policy of "benign neglect" and thus accept that its deficit (or surplus) be demand-determined. A kind of international division of labour would then take place, with the US given the responsibility to keep close control of domestic (and so international) liquidity and thereby ensure stability in the value of the dollar and orderly, non-inflationary development of international trade and finance, while the

obligation to undertake exchange rate adjustment and/or other corrective measures would now lie exclusively with foreign governments and central banks.[32]

For a short while in 1969-70, it seemed that the American authorities were following precisely this kind of prescription in their attitude towards world monetary affairs. As we have already seen, the "demand-determined" hypothesis dominated the thinking of American officials and, though it was never publicly acknowledged, "benign neglect" seemed to be one of the most (if not *the* most) prominent characteristics of US financial policy during the early part of the Nixon administration. But, the supporters of the dollar standard were soon to be disappointed. For, before long, it became obvious that the administration did not share their concern for the fate of the international monetary system, but had very different views of its own as to what was necessary or desirable and how to go about achieving it. Ironically too, it was the very same theoretical and policy framework developed by the school to ease the tension in the system which was, in the end, twisted viciously around to provide a powerful tool for its destruction!

To start with, the American government proved unwilling, in the face of a mounting recession, to observe the *sine qua non* condition for the successful operation of the dollar standard, which called for a tight control of domestic liquidity and inflation. Deciding instead to put domestic politics first, it responded to rising unemployment with an expansionary fiscal and monetary boost, when both external considerations and high American inflation directed precisely the reverse course of action. The recession also, combined with the weakening of the American balance of payments, highlighted the chronic problem of the overvaluation of the dollar and raised questions as to whether it was possible for the American authorities to treat the US deficit and the exchange rate of the currency as the object of a passive policy of "benign neglect". For,

it increasingly came to be thought by ordinary Americans that, by keeping their currencies undervalued relative to the dollar and by being unwilling to shoulder their proper share of the cost of defending the West, their allies (principally the Japanese) were unfairly protecting their own industries and workforces at the cost of American jobs. Similar complains were also voiced with regard to the generally overprotected character of the Japanese economy (non-tariff barriers to trade and such like), as well as against particular protectionist policies applied by the countries of the European Community in sectors such as steel, textiles etc. Finally, the EEC's Common Agricultural Policy (CAP) was vehemently and persistently attacked in Congress and outside by the powerful agricultural lobby.

While there was undoubtedly a certain amount of truth in these accusations, the fact, of course, was that a similarly long list of American unfair trading practices had been amassed on the other side of the Atlantic and that there existed, as we have seen, a variety of other (and better) reasons which could explain the overvaluation of the dollar and the progressive weakening of the American balance of payments. But, whatever the rights and wrongs of the argument, the feeling was growing in the US that it was being "done" by its allies, a view which found powerful expression in the person of John Connally. With Connally's arrival to the Treasury in early 1971, the US and its partners were set on an inevitable collision course. American monetary diplomacy began to resemble more the rough style of Texas than the gentlemanly environment of Basle. Having given up Bretton Woods and the IMF as a complete loss, Connally embarked on a campaign of "confrontation politics", culminating in his Munich speech of May 1971, which amounted to a political "tour de force" that managed to antagonise even those who were basically sympathetic to American aims.

At the same time, other important changes were taking place. The old-guard of technocrats and crisis-managers from the Treasury and the Federal Reserve who had been directing American financial policy so far and had, over a long time, cultivated a climate of mutual trust, understanding and co-operation with America's trading partners (and who were, it must be added, responsible for some spectacular successes, such as the negotiation and activation of the SDR agreements), found themselves progressively cut-off and isolated from the new centres of economic decision making.[33] Economic policy began, instead, to be increasingly determined within the complexes of the White House by the President and his closest advisers, many of whom believed that the US should be free to pursue its chosen domestic policies totally unhindered by external constraints, and were thus in favour of a floating dollar.[34]

The result of these developments was that American international monetary policy in 1970-71 appeared confused, ambiguous, contradictory and, at times, plainly schizophrenic and offered little or no reassurance whatsoever to the outside observer searching amidst the mounting crisis for some visible sign of continued American commitment to the preservation of the system and the maintenance of a fixed parity for the dollar. Nor could much comfort be drawn from the other side of the Atlantic. For, the Europeans themselves were also divided on almost everything, other than their reading of the causes of the imbalance and their common dislike of the subordinate political role assigned to them by the dollar standard: "Some were politically antagonistic to the United States, others regarded trans-Atlantic partnership as the central principle of their foreign policy; some wanted to restore gold, others to demonetize it; some favoured liberal capital movements, others capital controls; some wanted to discipline the United States into deflating, others were ultra-Keynesians who never thought any country should deflate; some wanted more flexible exchange rates and thought the United States should not

stand aloof from this movement, while others were opposed to greater flexibility in principle; some wanted to press ahead quickly with the development of a European Monetary Union, others deplored the very idea".[35] The problem, therefore, in 1971 was not so much that the positions of the US and the other industrial nations of the West differed fundamentally, as that there were *no* concrete, adequately formulated and easily recognisable positions, which could form the basis of negotiations (assuming, of course, the will to negotiate) with a view to avert the threatened breakdown. "Benign neglect" had come to dominate the world monetary scene by default!

In the vacuum of action that this official paralysis created, international speculators were bound to thrive. For they were presented with this rare and most desirable of situations, the opportunity to realise a quick and riskless gain. It is in the very nature of the adjustable peg that, once a serious and persistent imbalance is spotted by the market, pressure on the exchange rate becomes a safe, one-way bet. An overvalued currency may or may not go down in the short-term, but it is rather unlikely to go further up. (In the long run, and in the absence of corrective measures, it will *have* to go down. Whether it does so in the short run instead depends, to a great extent, on whether there is sufficient speculative pressure to force through a parity change. Speculation thus tends to become a self-fulfilling prophesy).[36] As, therefore, it became clear in 1971 that there was a complete break of communications and policy co-ordination between the US and its major trading partners, and as the realisation slowly sank in that America's "benign neglect" was, after all, quite *unbenign* in nature (which is to say that the US authorities were not using this policy so as to ease the strain on the system, but so as to precipitate the confrontation which would enable them to renegotiate or even abandon it), the speculators sniffed a quick gain and rushed to cash in. The flotation of the DM and the guilder, as well as the other restrictive

measures adopted by the Europeans in May, did manage to mitigate the inflationary impact of the capital inflow on their domestic economies, but could not and did not stop the exodus from the dollar which, encouraged by continued American inertia, thus reached flood proportions by mid-August.

At this time of crisis, and with a sense of inevitability hanging in the air, American officials were bound to start worrying seriously (if they had not already done so) about a possible run on the currency and the consequent depletion of the US gold stock, and about what they could do to prevent it. Although such a run, as we have seen, did not (or, some would argue, did not have the *time* to) materialise, US officials may, by that time, have been psychologically prone to interpret any major gold purchase, such as the one requested by the Bank of England on 13 August 1971, as the foreteller of such an event. At Camp David, Federal Reserve Chairman Arthur Burns argued strongly against the closure of the gold window, taking the view that a major statement of radical changes in American policy, such as was in fact included in the package of 15 August, would have been sufficient to turn the tide. He may well have been right. In the event, however, he was defeated by John Connally, budget director George Shultz and the pro-floating majority of those present, aided by some straight-forward twisting of the facts.[37] The decisive factor may in the end have been that, as the American deficit exploded in pre-election 1971, President Nixon himself, who was convinced that unemployment had cost him victory in 1960, may have been more susceptible to protectionist demands and calls for a show of strength than usual. Thus was convertibility ended.[38] President Alfred Hayes of the New York Federal Bank (which handles the Fed's daily foreign exchange operations), the State Department (which would have to deal with the reactions of other countries and the diplomatic repercussions) and the IMF were not consulted, or even informed of the decision!

Ic4. Lessons from August 1971.

"The modern world economy has evolved through the emergence of great national economies that have successively become dominant... Every economic system rests on a particular political order; its nature cannot be understood aside from politics" Robert Gilpin has argued[39] and his view seems definitely to be supported by the history of international monetary relations. As the monetary stability which prevailed in the last few decades of the 19th century and up to the first World War clearly reflected the political and economic predominance of Great Britain, so the post World War II monetary order under Bretton Woods was based on the emergence of a new hegemonic power, the US and a hegemonic currency, the US dollar.

The international economy's dependence on the dollar was highlighted by the concentration, at the end of the war, of almost three-quarters of the world's monetary gold stock in Fort Knox and the early realisation that stepping up production to increase the supply of gold would not suffice to provide the liquidity urgently needed to rebuild the war-shattered economies of Europe and Japan. It fell, therefore, to the US, as the only country able to do so, to finance this task, first (during the immediate post-war period of American surpluses and the "dollar-shortage") through long-term loans and aid grants, notably the Marshall plan, and later through persistent balance of payments deficits (mainly on the capital account side, reflecting heavy American direct investment overseas). As a result, the dollar became the "vehicle currency" for international trade and investment, as well as the major reserve asset of foreign central banks, and remained so even after the restoration of convertibility for the European currencies in 1958.[40] Thus, through multilateral in formal design, Bretton Woods developed in actual practice into a system

highly centralised round a single hegemonic currency. Not surprisingly therefore, the argument arose that the world's governments should recognise these developments officially and place this currency formally at the centre of the system. Put in a different way, this view simply stated that the logical conclusion of Bretton Woods was, in fact, a dollar standard.

An effective dollar standard was indeed, as we have seen, established for a while with the decision, on 15 August 1971, to suspend the convertibility of the dollar.[41] However, this was never accepted by the rest of the world and was, in any case, short-lived, as it came about precisely at a time when the necessary preconditions for its successful operation were disappearing fast. These points can probably best be made (and the balance of the argument as to the strengths and the weaknesses of the system determined) by a closer examination of the fundamentals of the organisational principle on which Bretton Woods and the dollar standard proposals were based, the principle of "hegemony".[42]

Looked at from a technical viewpoint, hegemony has the obvious advantage of eliminating conflict in the exchange markets, thus solving what is known as the consistency or confidence problem. In the words of Roland Vaubel: "... parity systems can function consistently only if there is a hegemonial or dominant currency. Just as a private cartel or oligopoly, facing frequent and unpredictable shifts in demand for its products, needs an explicit or implicit leader, so the fixed-exchange rate cartel of central banks has to confer the "exorbitant privilege" of pivot-currency status on one of its members".[43] Of course, hegemony is not, strictly speaking, the only possible solution to the consistency problem. For, there exist, at least in theory, other options varying greatly both in economic effectiveness as well as (and probably more important) in political realism and acceptability. In his study of the world monetary system from an

organisational viewpoint, Benjamin Cohen distinguished three such alternatives: *Automaticity* (a system operating on automatic rules of adjustment, such as the gold standard), *Supranationality* (a world central bank) and *Negotiation* (a system which relies on multilateral negotiation for the resolution of conflicts).[44] In the end, however, the unmistakable lesson of modern international monetary history is that "in practice, only a system of hegemony - which characterised the operation of both the classical gold standard in the last decades before World War I and the Bretton Woods system in the first decades after World War II - has ever succeeded in preserving stability for any length of time. In both cases, the monetary system was organised around a single hegemonic leader ...".[45]

Hegemony, of course, like any other organisational principle, is not free from technical weaknesses. Thus, it has been argued that aggregate adjustment costs might be smaller under a more balanced division of the responsibility for initiating adjustment and that, at times when the economic performance of the reserve centre gets out of line with those of its partners as a group, it would be easier to effect the necessary realignments through a single parity change on the part of the reserve centre rather than by a series of adjustments in the parities of other currencies.[46] Finally, cyclical needs might well differ between the reserve centre and its partners. (The last two points did, in fact, arise in the context of Bretton Woods and were discussed in the previous section). Most critics, however, admit that, on technical grounds at least, the strengths of hegemony by far outweigh its weaknesses. Similarly, the reluctance of the rest of the world to accept the *de facto* dollar standard unilaterally thrust upon it by the US cannot be attributed to doubts about the *technical* merits of the system (these were never at the heart of the matter), but to increasing reservations concerning the two preconditions necessary for its successful operation.

The first of these conditions is that hegemony must be exercised in a *responsible* manner. That is, the economic policy of the reserve centre must be stabilising. For "clearly, a pure key-currency system is not well designed to deal with instability in the key-currency country itself, although it can handle considerable upheaval elsewhere".[47] The possibility does exist however that, sooner or later, the hegemonic country might be tempted, for reasons of self-interest, to exploit its dominant position. Indeed, it has been claimed that "it is unlikely that monetary hegemony will not eventually be abused".[48] The system then becomes economically unstable and politically unacceptable and finally disintegrates.

The designers of Bretton Woods were fully aware of this possibility of irresponsible action on the part of the reserve centre and tried to deal with it by imposing on the US the obligation to convert on demand unwanted dollar balances into gold. In Robert Mundell's words, "the sole function of gold convertibility in the Bretton Woods arrangement was to discipline the US".[49] In the immediate post-war period there were few worries on that score. The economic policy of the US was, for the most part, stabilising and the medium-sized deficits of the 1950s and the early 1960s could well be explained by the desire of other countries to rebuild their war-depleted exchange reserves (the "demand-determined" hypothesis). The threat that irresponsible action at the centre might eventually wreck world economic stability did not go away through. In as early as 1961, the French economist (and President De Gaulle's adviser) Jacques Rueff pointed out the institutional fact that a deficit in the US did not produce a corresponding monetary contraction and claimed that this ability of the US to run "deficits without tears" removed all incentives to adjust and would eventually precipitate the confidence crisis Triffin had already warned about a year or so earlier.[50]

Rueff was proved right. At some point in the 1960s (precisely when is a matter of some dispute among international monetary economists), the American deficits ceased to be simply demand-determined and, from 1965 onwards, owing to the Democratic administration's ambitious goal to provide guns and butter simultaneously, their size escalated rapidly.[51] As a result, the confidence of the exchange markets in America's will and ability to run a stabilising monetary policy was inevitably eroded. For the first time since the war, the dollar was now not "as good as gold" and the world began to talk of a "dollar glut" instead of a "dollar shortage". Whereas up to 1958 less than one-tenth of the US' deficits had had to be financed by transfers of gold to the rest of the world, in the decade which followed almost two-thirds of America's cumulative deficit was financed by this method. To this, as we have seen, the US government responded with a two-stage suspension of the convertibility of the dollar, thereby unilaterally imposing an effective dollar standard, but failed at the same time to reaffirm loudly and clearly the commitment to domestic and international monetary stabilisation which was the indispensable condition for the operation of such a system. On the contrary, US financial policy resulted in ever increasing instability, which the adjustable-peg exchange rate system was uniquely equipped to transmit, in turn, to the rest of the world.

Under these circumstances, it was (rather optimistically) argued, the only way to attain stability in the world economy and to eliminate the possibility of irresponsible action at the centre would be to ensure that foreign governments were able to influence the formulation of economic policy in the US itself. Proposals to that effect were indeed put forward in the late 1960s, notably by Charles Kindleberger (who suggested that foreign representatives be included as voting participants of the FOMC) and Robert Mundell (who proposed an international committee,

operating through the G-10 or the IMF, to determine and to administer American monetary policy).[52] These proposals, however, never got anywhere, for they were fatally flawed by a serious (and unexpected, given the quarters whence they originated) misunderstanding of the nature of the system as it had evolved in reality. For, as Cohen points out, since the benefit for the US from the implementation of the dollar standard lay in policy autonomy, acceptance of such proposals would have implied sacrificing the end (policy autonomy) to save the means (the dollar standard).[53] Thus, if the suggested foreign representation was to be effective it would also be objectionable to the US authorities but, were it not so, the difficulty would have hardly been resolved at all.

Responsible administration of monetary policy is then a necessary precondition for the successful operation of a key-currency monetary system. It is not, however, a sufficient one. Hegemony must also be *legitimate*. For, hegemonic leadership does not have to be irresponsible to generate feelings of exploitation and/or conflict over the distribution of the political and economic benefits which accrue from the operation of the system (though, of course, such conflicts become sharper if it is). The potential for political conflict is in-built in the structure of a hegemonic monetary order, which is based on a fundamental inequality between nations and, in turn, helps perpetuate distinct asymmetries in the rights and the responsibilities of the participating countries, which might sooner or later become disagreeable to some of them as the circumstances that gave rise to the initial imbalance change or completely disappear.

Some of the objections which were raised against the asymmetry between the US and its partners in the context of Bretton Woods were ideological. Marxist and radical writers, for example, saw in the dollar standard the inevitable manifestation of "the power of American

Imperialism within the international capitalist system".[54] An unequal distribution of rights and responsibilities and an asymmetric power relation were not just a by-product of this system but were necessary to perpetuate international capitalist exploitation, as such a system "orders intercapitalist relations and suppresses conflict ... Without a dominant power, the exchange relations of the capitalist world are basically unstable and break out in destructive, competitive rivalries".[55]

Ideology, however, was not the only (or even remotely the most important) grounds on which opposition to American hegemony and the dollar standard was based. During the immediate post-war period, Western Europe and Japan had no choice but to accept the leadership of the US as legitimate. As David Calleo has written, "circumstances dictated dollar hegemony".[56] An implicit deal was therefore struck, according to which America undertook to aid the reconstruction of the economies of its partners, while they, in turn, agreed to allow it the freedom from tight external constraint that it needed in order to exercise effectively its newly-assumed role as leader of the Western Alliance.[57] These circumstances could not last indefinitely however. For, "in the long run, ... shifts in economic efficiency and the location of economic activity tend to undermine and transform the existing political system. This political transformation in turn gives rise to changes in economic relations".[58] By the mid-1960s, Western Europe and Japan were no longer the economic dwarfs, totally dependent on the good will of the American giant, they had been twenty years earlier. On the contrary, their relative importance in international trade and their monetary reserves had by now come to exceed those of the US. Inevitably, questions began to be asked as to the justification of the special privileges the US continued to enjoy, and there were calls for the international monetary system to be adjusted to reflect more accurately the changed relative economic and political weights of its

participants. The essentially defensive American response to this mounting challenge to the legitimacy of American hegemony[59] was ill-equipped to meet the criticism, especially as it came at a time when the external freedom which the system afforded the US was being exploited for purposes basically disagreeable to America's partners (the Vietnam war) and when, partly as a result, US international financial policy had turned highly destabilising. The post-war deal was bursting apart and, with it, the monetary system to which it had given rise.

There are three main lessons to be drawn from the experience of August 1971 and the circumstances that led up to it. The first and probably most controversial of these concerns the preconditions for the satisfactory operation of an adjustable-peg type of monetary system and sums up the above discussion: In the absence of a central, supranational monetary authority, performing for the international economy a function similar to that of a central bank in the domestic context, and of firm and unquestionable political commitment to the success of the international monetary system over and above the perceived short-run national or party-political interest (both, conditions which have never existed to date, nor are likely in the near future), *a system of fixed but adjustable exchange rates is likely to work consistently only under conditions of responsible and legitimate hegemony.* (A narrower conclusion derived ultimately from the same logic is that there may be an inherent element of instability in a system with multiple reserve assets).[60] The validity of this assertion would increase with the number of participants in the system (the more the participants, the greater the likely dissimilarities in political and/or economic characteristics, outlooks and interests). This lesson was, as we shall see, confirmed later on, both in a negative and in a positive way, by the final collapse of the Bretton Woods exchange rate arrangement in March 1973 and the subsequent "regionalisation" of the international monetary system, as well as by the experience of the European currency Snake,

which was eventually transformed into a DM zone of relative monetary stability, though, once again, the original design was multilateral in nature.

The other two lessons, by contrast, refer to the actual organisation of a fixed exchange rate (and, indeed, any "non-automatic")[61] monetary system, and have been foreshadowed in the previous section. The IMF articles of agreement were extremely vague as to *when* member countries ought to undertake adjustment measures, *who* should initiate such adjustment and *what* exactly these measures should be. The final transformation of Bretton Woods into a *de facto* dollar standard should, in theory, have closed this gap, for such a system implied a very definite and unambiguous division of responsibility between its members. In practice, however, both the US and its partners proved unwilling to abide by the rules of the game. The Americans, on the one hand, wished to preserve the external freedom which the system afforded them, but declined to take the internal discipline measures which would have made this arrangement acceptable to the rest of the world. Moreover, worried about the consequences of their role the "nth currency" country on unemployment, they finally came to a schizophrenic rejection of the passive external policy which was necessary for the consistent operation of the system. In short, they wanted to have their cake and eat it. The Europeans and Japanese, on the other hand, welcomed the US' "benign neglect" and the American deficits as long as these helped them to rebuild their monetary reserves, accumulate surpluses and foster the growth of their economies, and then turned to attack those very policies (most of them, *but not all*, because of growing American financial irresponsibility), but were equally unwilling (excluding West Germany and the Netherlands) to effect the parity realignments which would have relieved the pressure on the system, and which was, in any case, their responsibility according to the rules of the dollar standard. (Again, this could be explained only *partly* by the fact that these rules had not been

negotiated but imposed, instead, unilaterally by the US). What was lacking, therefore, on both sides was a clear and effective (that is put to practice) understanding of the fundamental principles which govern the kind of monetary system Bretton Woods had in fact developed into. As Charles Kindleberger wrote: "The dollar standard would be a good international monetary system if it were understood".[62]

It follows then that, if misunderstandings of this kind are to be avoided, a satisfactory global or regional monetary system must contain an explicit and unambiguous set of rules and regulations as to the proper role of its participants and the division of rights and responsibilities between them, including a reasonably clear assignment of the responsibility for initiating adjustment. Such a system should, moreover, embody an agreed, effective and crisis-proof mechanism for the restoration of equilibrium among member countries.[63] Lack of an explicit "code of conduct" would surrender the future development of the system hostage to temporary economic and political circumstances (such as the Vietnam war or the oil-crisis and the emergence of the OPEC surplus) and to the short-term political agendas or whims of individual governments and personalities (De Gaulle or John Connally). The risk is not a small one. For, as Abba Eban once put it, "nations and governments behave rationally ... only after having exhausted all other alternatives".[64]

Id. To 12 March 1973

Id1. The Smithsonian Agreement

For a full week after Nixon's closure of the gold window, most of the major exchange markets round the world remained closed. Tokyo provided the one important exception: In response to the "Nixon shokku", the Japanese authorities bravely (and foolishly) decided to ride the waves and keep the market open, and managed to do so for two weeks. In that time, and despite a tightening of exchange controls, the Bank of Japan had to absorb close to $4.5 billion, as Japanese industry and banks were converting into yen dollars held by and borrowed from every conceivable source. Finally, on 28 August, the authorities accepted the inevitable and allowed the yen to float (though they continued to intervene, to limit the extent of the appreciation).

Meanwhile, in Europe, ECOFIN met on 19 August 1971 to consider a common response to the Camp David announcements, as well as the implications of these for the Community's infant Economic and Monetary Union (EMU) project, recently adopted by the Council's resolution of 22 March 1971.[65] It soon became clear, however, that the same doctrinal inflexibilities and differing perceptions of the national interest that had precluded agreement in May would again prevent the adoption of a united, "European" position in August. On the one hand, the French refused to concede even the smallest appreciation of the franc relative to the dollar through either an individual or a joint flotation or revaluation and threatened to follow the dollar downwards if it was devalued. For, they argued that the cause of the US deficit was excessive investment overseas and not, as the Americans claimed, an unfavourable trade balance. Indeed,

the US trade account had been in surplus until as late as April, while its subsequent slide into deficit could well be explained by the cyclical upturn in demand which followed the relaxation of fiscal and monetary policies in the US. The proper Community response would therefore be to limit excess American investment (since the Americans could not be relied upon to do so themselves) by the collective or individual imposition of exchange controls. This prescription reflected the traditional French position that capital account disequilibria should be dealt with through capital controls, while exchange rate adjustments should be reserved for imbalances on the current account.

The West German position, on the other hand, was in almost every respect the exact reverse of the French. The federal government in Bonn believed that the solution to the American payments problem lay in a relative depreciation of the dollar through (preferably) a concerted or (failing that) an individual flotation or revaluation of the European currencies. Contrary to the French, it had no doctrinal objections to adjusting the exchange rate to deal with difficulties on the capital account, for it considered the exchange rate as an instrument to equilibrate a country's *total* transactions with the rest of the world and not only those on the current account. The West Germans (Finance Minister Schiller in particular) did, however, have a doctrinal distaste for measures interfering with the operation of free capital markets (which went contrary to France's favourite solution of exchange controls) as well as grave reservations as to the applicability and effectiveness of such measures in the West German economy. Furthermore, whatever the doctrinal and the theoretical considerations, an appreciation of the DM appealed to the money managers of the Bundesbank on practical grounds, as it would serve to decrease aggregate demand in the domestic economy and dampen the inflationary overheat, both via the current account (by reducing the volume of exports, increasing that of imports and lowering import

prices) and the capital account (by reducing or eliminating the speculative motive for capital inflows).[66]

Among the other European countries, the only significant change of position since May was that of the Belgians, who now argued with West Germany and the Netherlands in favour of a joint float. With the two main protagonists of the European monetary scene diametrically opposed in their preferred solutions though, agreement was never within reach and the Council, in typical Community fashion, agreed to disagree. Germany continued with its individual flotation and was reluctantly joined this time by Italy, while France adopted a two-tier exchange rate system. When the exchange markets re-opened, on 23 August 1971, barely five months after the adoption of the ambitious EMU project, the only fixed link existing between the currencies of Western Europe was that of the Benelux countries which floated their currencies together within 1.5% of their pre-May parities.

These divisions, however, did not last long. For, the Europeans understood well that, if they were to be able to achieve the abolition of the American import surcharge and to influence the future form of the international monetary system, they would have to present a united front, for together they accounted for a very significant part of world trade (and that of the US itself) and so carried a negotiating weight that no single country could adequately command on its own. Moreover, after a short period of satisfaction with their chosen policies, both Bonn and Paris began to have second thoughts. The Germans saw the DM rise to a level which was far above what was justified by international cost differentials. By the end of October, the DM stood at a premium of 10% relative to the dollar on the pre-May parities and an average of 6.5% relative to the currencies of West Germany's other trading partners. Anxious about the squeeze on profits

in their export industries, the possibility of permanent loss of vital export markets and the slackening of economic growth that was bound to follow such a rapid appreciation, the authorities began to flirt with the idea of capital controls to hold the currency to a more reasonable level.

This significant step towards the French position did not stay unanswered in Paris. The French had found the separation of the two market sectors in their favoured two-tier arrangement to be far less water-tight than they had expected and the leakages from the unofficial (unregulated) to the official (regulated) market became at times very sizeable indeed. This, together with the threat which floating exchange rates represented for the survival of the CAP, finally convinced the French government of at least the necessity (if not the wisdom) of an appreciation of the franc and the other European currencies relative to the dollar.[67]

The basics of a compromise were eventually agreed in the ECOFIN meeting of 13 September 1971 and were further developed over the weeks that followed so that, by early November, the EEC countries were at last able, for the first time in this crisis, to formulate a common negotiating position to face the American challenge. The Six noted their agreement that the international role of the dollar should be reduced and that speculative capital movements should be restricted through either a widening of margins of currency fluctuation or through direct capital controls, and called for the abolition of the American import surcharge and a return to fixed exchange rates and convertibility. For their part, the Europeans agreed to accept an appreciation of their currencies relative to the dollar, on the condition that the US would also contribute to the necessary realignment through a formal devaluation of the dollar and that any

subsequent improvement in the American balance of payments would not be effected through the current account alone.

Meanwhile, important developments were also taking place on the other side of the Atlantic. In a speech in the House of Representatives on 21 September, the former bulwark of the fixed gold price, Henry Reuss, indicated a change in his position on the subject. He would now support a devaluation of the dollar as part of a general realignment (on condition that convertibility would not be restored) and, together with Senator Jacob Javits, he in fact introduced a concurrent resolution to that effect in Congress on 1 October.[68] On a general scale also, the feeling was now growing among US officials that time was not on their side and worries were expressed, notably by Fed Chairman Arthur Burns and the President's national security adviser, Dr. Henry Kissinger, as to the damaging effects of a further prolongation of the dispute on the international effectiveness of American economic and foreign policy and on the cohesion of the Western Alliance.

Thus, by the time the G-10 Ministers and central bank Governors met again in late November, the gap between the two sides had narrowed considerably and there existed, at last, the political will to reach an agreement. At the meeting itself, held in the Palazzo Corsini, Rome, on 30 November and 1 December 1971, John Connally gave the first clear signs of this will when, following a long and fruitless discussion (and, it seems, against his own personal preferences), he took his colleagues by surprise, put on the table a "hypothetical" 10% devaluation of the dollar and asked for their reactions. It then became obvious, however, that having won a concession from the American delegation on the question of a dollar devaluation as a matter of principle, the Europeans and Japanese were immediately concerned to limit the extent of the

realignment in order to protect the competitiveness of their export industries. Not without reason either. For, as has been pointed out, acceptance of a dollar devaluation by 10%, a rate corresponding to the American import surcharge, would have been tantamount to accepting that surcharge and would have turned political victory into economic defeat.[69] Irrespectively of the magnitudes and technicalities involved though, it seems that agreement was not reached in Rome simply because the French Minister of Finance, Valery Giscard d' Estaing, (and to a lesser extent the British and Italian Ministers, Messrs. Anthony Barber and Mario Ferrari-Aggradi) did not possess the political authority to settle there and then on their own.[70]

Despite the inconclusive outcome of the Rome negotiations however, it was now clear that a resolution of the four-month old dispute was close. At a meeting in Paris on 4-5 December, President Pompidou and Chancellor Brandt came to an agreement on a target level for the pivotal DM/FF cross-parity and, with this out of the way, the other EEC exchange rates were quickly settled. Thus, when M. Pompidou met President Nixon in the Azores, on 13-14 December 1971, he was able to present the European case with the full backing of a united Community. By this time though, the American President himself (unlike some of his advisers, notably his secretary of the Treasury) seems to have been convinced about the inadvisability of further continuing the conflict, and determined to negotiate a settlement. An agreement was therefore reached, according to which the US would lift the import surcharge and would devalue the dollar by 7.9% while, in return, those currencies which were clearly undervalued would be revalued and the Europeans would not press for an early restoration of convertibility. The two Presidents also agreed on the introduction of wider bands of fluctuation and on the initiation of international negotiations to examine the fundamental problems raised by trade disequilibria.

This agreement was formalised at the G-10 meeting of Ministers and central bank Governors which took place in the Smithsonian Institute, Washington D.C., on 17-18 December 1971. The import surcharge was abolished and the price of gold was raised by 8.6%, from $35 to $38 per ounce (which was equivalent to a 7.9% devaluation of the dollar).[71] The DM, Yen, Swiss franc, Dutch guilder and Belgian franc were revalued by varying amounts, the French franc and pound sterling remained unchanged relative to gold and the Italian lira and Swedish krona were allowed, after much squabbling, to devalue by 1%.[72] A solution was also found to the question of wider currency bands (which the Azores meeting had left unresolved). With the Americans, Germans and British favouring new margins of fluctuation of +/- 3% around "central rates" (the new fashionable name for "parities") and the French insisting on no more than +/-1.5%, the conference finally decided to accept the compromise solution put forward by the Belgian Minister of Finance, Baron Snoy et d' Oppuers, and adopted the arithmetic mean of the two proposals, +/-2.25%.

With the business of the meeting thus successfully concluded, President Nixon came over from the White House to congratulate the participants and, in the press conference which followed, heralded the newly-concluded deal as the "most significant monetary agreement in the history of the world".[73] He was, indeed, well justified in feeling pleased with the result of the negotiations. For, although it may not appear immediately so, the Smithsonian Agreement was, in effect, a total victory for the US. The Europeans and others, apart from a moral blow to the inviolability of the dollar, had achieved nothing positive compared with the pre-August 15 situation (certainly nothing which they could not have accomplished equally well, and with less anguish, through a concerted revaluation of their own currencies). Quite the reverse. Apart from the book-keeping losses of countries like West Germany (and a number of poor third world nations)

TABLE 1

Realignment of exchange rates under the Smithsonian Agreement, 17-18 December 1971

Currency	Revaluation relative to gold (%)	Revaluation relative to the USD (%)
Gold	---	8.6
USD	-7.9	---
UKL	0	8.6
SFR	4.9	13.9
SKR	-1.0	7.5
Yen	7.7	16.9
DM	4.6	13.6
FF	0	8.6
BFR/LFR	2.8	11.6
HFL	2.8	11.6
LIT	-1.0	7.5

NOTE: A rise of a(%) in the dollar price of gold implies a devaluation of the dollar by a/1+a(%). Currencies which remain unchanged against gold revalue relative to the dollar by a(%). On the other hand, currencies which undergo an additional revaluation of b(%) against gold revalue relative to the dollar by a+b+ab(%).

which kept a significant proportion of their foreign reserves in dollars and which now found the real value of these reserves substantially reduced, the failure to secure an immediate return to convertibility left the dollar in a more unchallenged position than before the crisis started. There remained in the world an overhang of inconvertible, devaluation-prone dollars and, simply, nobody could do anything about it.[74] Indeed, the effect of the Smithsonian Agreement was to legitimise the *de facto* dollar standard which the Americans had unilaterally imposed on the world with the decision to suspend convertibility in August 1971. Moreover, this was a particularly vicious version of the dollar standard which had now been accepted and one not at all related to the neat designs of the academics who had first invented it. For, while the dollar was confirmed as the system's main vehicle currency and reserve asset on which the rest of the world willingly or unwillingly had to depend, the American authorities still refused to make any effective commitment to stabilise the domestic economy and so to safeguard the new rate of the currency. Indeed, it would be hard to find any incentives for them to do so, for the US had already obtained almost all it wanted through the Smithsonian Agreement. In one stroke, the American economy was more competitive internationally, the value of foreign-held dollars (US liabilities) in terms of other assets had been reduced and the dollar was in a more unassailable position than ever before. The triumph, however, was short-lived. For, such one-sided and unbalanced deals carry in them the seed of self-destruction, as inevitably they prove to be economically unstable and politically divisive in the longer run. So it was that, barely fifteen months later, the "most significant agreement in the history of the world" collapsed and passed into the history books as one of the more insignificant (albeit well known) episodes in the world's monetary history.

Id2. Towards floating exchange rates.

The serious defects of the Smithsonian Agreement were widely recognised from the beginning and many immediately predicted its downfall (some, indeed, with remarkable accuracy!)[75] In the currency markets, the new exchange rate structure was viewed with mistrust and suspicion. The "unthinkable" *had* happened and the dollar *had* been devalued, so why not again and more often? Tentative speculation against the dollar thus reappeared during January and February 1972, but was thwarted by determined and well-orchestrated intervention by the European central banks.

Doubts about the viability of the new arrangement persisted however. The Smithsonian realignment failed to produce a quick improvement in the American balance of payments. On the contrary, the US trade deficit, which had come to $2.7 billion in 1971, deteriorated even further to almost $7 billion during the course of 1972, while low American interest rates and fears of yet another devaluation prevented any significant inflow of capital into the US, such as might have been expected to take place after the realignment. These developments were, in turn, reflected in a general swelling of payments surpluses in the other industrial countries, with the exception of the UK.

The failure of the 1971 devaluation to turn around the American balance of trade can be explained by a variety of factors. It has been argued that, in terms of "effective" exchange rates,[76] the Smithsonian realignment was totally insufficient to restore international cost comparability. Grossly undervalued currencies became only a little less so as a result of the

realignment, while others, which were (if at all) only slightly overvalued, now became clearly uncompetitive.[77] On the calculations of the US Federal Reserve staff, the "effective" rate of the DM went up by only 4.75%, far too little to restore equilibrium in the current account, whereas the already suspect pound sterling actually *rose*, in "effective" terms, by 1.75%.[78] But, the deterioration of the American current account, at least in the short run, should also have been expected because of two other considerations. First, there was bound to be the usual adverse effect on the trade balance caused by the differential lag of adjustment of prices and quantities traded to a change in the exchange rate, known as the "J-curve" effect. Import and export prices respond quicker to movements of the exchange rate than the quantities imported and exported, with the consequence that the initial effect of a devaluation will be to *worsen* the current account deficit (as expenditure on imports increases and receipts from exports fall) while the improvement, if any, will only occur later.[79] (In the case of the US, the beneficial impact of the 1971 devaluation on the balance of trade began to show in early 1973). Second, the fact that the US economy was emerging from a recession meant that American demand (and imports) were bound to rise faster than those of America's trading partners who at that time were trying to squeeze domestic demand to prevent an inflationary outbreak.

Far more worrying, however, from the point of view of the currency markets, than these predictable difficulties, was the apparent difference of commitment to the defence of the new exchange rate structure manifested on the two sides of the Atlantic. On the European side, the West German Bundestag amended, on 10 December 1971, the Foreign Trade and Payments Law to enable the Bundesbank to impose controls on the foreign borrowing of German firms (excluding trade credits), which had been one of the major sources of capital inflows in 1970-71, and the Bundesbank did, in fact, apply a 40% reserve requirement (Bardepot) on such borrowing

with effect from 1 March 1972. The discount rate was also lowered, on 23 December 1971 and again on 4 February 1972. The other European countries reacted in much the same way to the speculation of early 1972. The Banque de France began to reintroduce exchange controls in February, while the Benelux central banks acted swiftly to reduce interest rates. Moreover, the Europeans reinforced their commitment to currency stabilisation with the resumption, on 21 March 1972, of their efforts towards intra-EEC exchange rate concertation, through the establishment of a narrower fluctuation band of 2.25% for the EEC currencies within the wider 4.5% Smithsonian limits, an arrangement known as "the Snake in the tunnel".[80]

By contrast, in the US interest rates actually fell and remained lower than in the other industrial countries throughout this period and no more than lip-service was paid by American officials to the need for international stabilisation. It was, therefore, not surprising that, with the American authorities watching idly as the European central banks fought successive waves of speculation in January-February 1972 and another one in March, the exchange markets finally began to suspect that the US was prepared to accept (and might even welcome) a further devaluation of the dollar. Before this hypothesis could be put seriously to the test however, the determination exhibited by the European monetary authorities together with an increase in American interest rates won the day and the exchange markets experienced a spell of relative calm during April and May. So, in fact, the first currency to find itself in serious trouble under the new arrangements was not, after all, the dollar but the pound sterling.

Despite the devaluation of 1967, by the end of the decade sterling was once again showing obvious signs of overvaluation and the balance of payments was only kept in surplus because of the deflationary measures adopted by Labour Chancellor of the Exchequer Roy Jenkins (who

had taken over at the Treasury upon James Callaghan's resignation shortly after the devaluation), in order to restore some degree of stability and competitiveness to the British economy. Following the general election of 1970, however, the new Conservative government led by Mr. Edward Heath, in a curious reversal of traditionally expected roles, progressively abandoned these policies and tried to court political popularity and to counter growing social unrest by pursuing instead a strategy aimed at achieving high rates of economic growth. Although this was bound to undermine the external stability of the economy, and in order to facilitate an agreement during the Smithsonian negotiations, the British government did not insist on even the smallest devaluation of sterling to follow, at least in part, the downward movement of the dollar, and thus accepted, as we have seen, a higher "effective" rate for the currency. The speculative attack on the dollar in early 1972 helped to disguise the situation for a while and sterling actually rose a little (though, alone among the European countries, Great Britain did not experience an improvement in its balance of payments as a consequence of the deterioration of the American current account). Thus, it was only after speculation against the dollar had abated that the full extent of sterling's underlying weakness was exposed.

In the first quarter of 1972, the UK balance of payments surplus all but disappeared and, more significantly, the current account also recorded a deficit of UKL 13 million (from a surplus of around UKL 270 million during the last quarter of 1971). This generated feelings of unease in the exchange markets as to the long term viability of sterling's current exchange rate, which were fuelled by other factors, such as worsening industrial relations and a rapid increase in the number of strikes (prominent among them the miners' strike) which were bound to affect output and the balance of trade, inflationary wage settlements that were running ahead of those in other countries and were thus reducing Britain's ability to compete in both foreign and domestic

markets and, finally, a continuing expansionary economic policy, exemplified by the 1972 budget which added an estimated 2% of GDP to domestic demand and which was expected to lead inevitably to a sizeable increase in imports, especially when taking production problems at home into account.[81]

As if there were not already sufficient grounds for anxiety however, and disregarding the fact that sterling was more vulnerable to speculation than most other currencies due to its role as a reserve currency for a number of Commonwealth, Middle Eastern and Far Eastern countries who keep their foreign exchange accounts in London, the new Chancellor of the Exchequer, Mr. Anthony Barber (who replaced Iain McLeod upon the latter's sudden death), went out of his way to encourage those speculators who, having been so recently rebuffed by the continental central banks, were still hesitant, by proclaiming in his budget speech of 1972 Britain's own version of "benign neglect": "The lesson of the international balance of payments upsets of the last few years is that it is neither necessary nor desirable to distort domestic economies to an unacceptable extent in order to maintain unrealistic exchange rates, whether they are too high or too low".[82] While as a statement of economics this was undoubtedly correct, in the particular circumstances it was bound to be (and was) interpreted by the currency markets as a virtual assurance that, if and when pressure on the pound sterling was applied, the British government would only be prepared to offer limited resistance before it gave in.

With the knowledge thus secure that this bet would not only be one-way but also quick, it took only some more bad news on the balance of payments and the prospect of a dock strike to start off a new wave of speculation on Thursday 15 June 1972. In the week that followed, some $2.6 billion was spent by the Bank of England and the continental central banks in a vain effort to

support the currency, but eventually the inevitable was accepted and, on 23 June, the British authorities announced that the pound sterling would be floated for "a temporary period".

With sterling thus out of the speculators' sights, attention focused once again on the dollar which came immediately under pressure. This was partly because of continuing signs of further deterioration of the American deficit, but also a direct result of sterling's defence within the Snake.[83] Successive speculative waves in early 1972 had driven some of the European currencies and the Yen near or hard against their Smithsonian ceilings. When sterling came under pressure in June, the Bank of England intervened by selling those Snake currencies which had reached their bilateral 2.25% fluctuation limit relative to the pound, while the central banks of the countries concerned reciprocated by buying sterling with their currencies. As a result of this intervention, sterling was kept for a while within its permitted range of fluctuation but, more important, the stronger European currencies were artificially pulled well below their Smithsonian ceiling. In this unsustainable situation, speculators were quick to detect a two-way opportunity to go short of sterling and long of continental currencies, in the hope of profiting on both. Following the flotation of sterling, the other Snake currencies bounced straight back against their official limits relative to the dollar, once again generating fears of a wider realignment, a tightening of exchange controls, a European joint float, or some combination of these measures. This led to heavy outflows from the dollar to the European currencies and the Yen and, finally, to the closure of the exchange markets.

West Germany was again the main target of a speculative capital flow which bloated domestic liquidity and put the authorities' anti-inflationary strategy in jeopardy. In the federal cabinet meeting of 25 June, Finance Minister Karl Schiller once again argued that the only realistic way

to safeguard internal stability in the face of destabilising influences from abroad was to float the DM (preferably in a joint float with West Germany's Community partners or unilaterally if necessary). However, with a general election scheduled for before the end of the year and with a further appreciation of the DM (which would hurt the export trade) so soon after the Smithsonian realignment certain to be politically unpopular, his ideas found little support within the federal government which opted, instead, for tighter exchange controls as advocated by the President of the Bundesbank Karl Klasen. Professor Schiller openly voiced his disagreement to this decision and felt strongly enough about it to resign, on 2 July 1972. Though subsequent developments would eventually prove he had been right all along, neither his own colleagues nor the world in general were quite ready for his ideas yet. Schiller's successor at the Economics and Finance Ministries was the hereto Minister of Defence, Helmut Schmidt, a declared opponent of floating exchange rates.[84]

In the meantime, encouraged by continued American passivity in the currency markets, the speculative pressure on the dollar showed no sign of easing off. Between Wednesday 28 June (when the markets re-opened) and Friday 14 July, more than $6 billion had flown into the continental currencies and the Yen. At this point, US officials began to realise that, unless something was done pretty soon, the whole parity structure so painstakingly negotiated during the Smithsonian conference would be in grave danger of collapsing. So, on 18 July 1972 the FOMC decided, with the approval of the new Secretary of the Treasury, George Shultz (who replaced John Connally when the latter resigned, on 16 May, to devote his time to the campaign to re-elect the President)[85] to re-activate the Federal Reserve swap network, which had been unused since August 1971, so as to enable the New York Federal Bank to resume limited exchange market operations to defend the dollar.

The psychological effect of the Fed's intervention on the currency markets was remarkable. Although only $30 million was actually spent in intervention during the next few days, and despite the fact that the Treasury's commitment to the new policy proved to be far from unwavering,[86] the very fact that the American authorities had, at last, shown some interest in taking their share of the responsibility for the defence of their currency after such a long time of a "hands off" policy, proved sufficient to discourage further speculation. Pressure on the dollar subsided and the markets went through a welcome period of calm to the end of the year.

This happy state of affairs came to an abrupt end in early 1973, when a succession of events sparked off a major speculative crisis which, although originally unrelated to the condition of the American economy, spread rapidly to engulf the dollar. The process began on 22 January 1973, when the Italian authorities introduced a two-tier exchange rate for the lira in an attempt to halt the substantial capital outflow (mainly to neighbouring Switzerland) that the country had been experiencing recently. Italy was, at the time, running a balance of trade surplus, but political instability and a marked deterioration on the industrial relations front were undermining confidence in the economy's ability to compete in the long run. The second Andreotti government (a centre right coalition of the Christian Democratic, Social Democratic and Liberal parties, formed after the May 1972 general election) tried to court the support of the trade unions by instructing the Banca d' Italia to implement a policy of low interest rates aimed at speeding up economic growth (echoes of Britain!) and this resulted in a yawning interest rate differential with Switzerland and the other northern industrial countries, where the authorities were pursuing tight monetary policies to combat inflation, a situation which generated still more capital outflows.

The adoption of a two-tier exchange rate structure by the Italians created difficulties for a number of Swiss banks, which had been relying on Italian capital inflows to cope with the credit squeeze operated by the Swiss National Bank. So, as the lira influx slowed down, these banks began to convert some of their dollar holdings into Swiss franc as an alternative source of domestic liquidity and in doing so put pressure on the dollar-franc rate.[87] On the day following the Italian move, the Swiss National Bank decided to respond to this by a suspension of purchases of the dollar at a fixed parity, thus effectively floating the Swiss franc.

These developments generated a climate of uncertainty which was further exacerbated by the publication on the following day, 24 January 1973, of an (as it turned out) erroneous figure showing a sharp increase of the US trade deficit in December,[88] and there was renewed speculation against the dollar which spread very quickly to involve most other major currencies as well. The exchange markets were not terribly impressed by Helmut Schmidt's denial that the DM would be revalued and the Bundesbank was obliged to purchase $1 billion in the first two days of February, while the New York Federal Bank was intervening simultaneously in New York. Then, on Sunday 4 February, came the final blow. The "New York Sunday Times" carried a report (later denied) to the effect that, in a telephone conversation that weekend, Treasury Secretary George Shultz had advised his West German counterpart to float the DM.[89] Over the next five days, 5-9 February 1973, the Bundesbank had to absorb a further $4.9 billion and heavy inflows were recorded in the other European countries and Japan, forcing again the closure of the exchange markets.

On that same night, 9 February, Finance Ministers Helmut Schmidt, Anthony Barber and Valery Giscard d' Estaing met in Paris to consider a solution to the problem. The West German Minister revived his predecessor's idea of a joint float of the European currencies but, like him, he was denied, for although the French were, by this time, reluctantly moving towards acceptance of a joint float as the only realistic way of dealing with trans-Atlantic capital flows, Britain was unwilling to accept the internal discipline necessary for participation in the Snake which sterling had left not so long ago. At the same time, the US Under-Secretary of the Treasury, Paul Volcker, was flying on a shuttle mission to Tokyo, Bonn, London, Paris and Rome and from there, together with Italian Treasury Minister (and leader of the Italian Liberal Party) Giovanni Malagodi, back to Paris, where the five Ministers negotiated a second devaluation of the dollar by 10%, announced by Treasury Secretary George Shultz on the evening of Volcker's return to Washington, 12 February 1973. The Japanese followed this by floating the Yen and the Italians, on the insistence of the Governor of the Banca d' Italia Guido Carli, decided to float the commercial lira, thus taking the Italian currency completely outside the Snake.

It had been hoped initially that the second devaluation of the dollar would help demonstrate publicly the commitment of the US to the fixed exchange rate regime (though, in fact, it is very doubtful whether any such commitment still existed) and ease the pressure on the currency markets. Instead, what it did was to destroy what remained of official American credibility. For, in his statement of 12 February, George Shultz had been quick to point out that "we have, however, undertaken no obligations for the US government to intervene in foreign exchange markets".[90] How else, though, could a currency be kept at a fixed parity if not through a certain amount of exchange market intervention as and when required, the Secretary of the Treasury did

not bother to explain. What he was, in effect, saying was that the US dollar would maintain a fixed parity only as long as foreign governments and central banks were prepared to shoulder the responsibility for the defence of that parity (and the cost, in terms of intervention losses and inflation!)[91] and this was indeed the way his words were interpreted by the markets. So, after a brief two weeks of calm, a new tidal wave of speculation began to form, boosted by rumours of an imminent European float, which finally hit the European exchanges on 1 March 1973. On that day alone, European central banks had to absorb more than $3.6 billion, $2.7 billion of which by the Bundesbank, the highest amount ever traded by a central bank on a single day. That night, the exchange markets closed for the last time under the Bretton Woods exchange rate system. When they re-opened, on 19 March, the old system, which had served the world (though mostly only in form) for close to three decades, was history.

On the way there, however, a number of events were still to take place. On Sunday, 4 March 1973, ECOFIN met in Brussels and examined again the option of a European joint float, but no agreement proved possible as the British set forward a number of conditions for their participation (including the right to alter sterling's central rate on the basis of a simple consultation, unlimited and unconditional financial support, etc.) which were totally unacceptable to their partners (except Italy and Ireland), while the Italians who had seen the lira depreciate by seven percentage points in the short time since it had been allowed to float,[92] proved equally unwilling to commit themselves to anything but a much looser version of the Snake, as advocated by Guido Carli. ECOFIN, though, was able to agree on a common list of negotiating demands, which were presented to the US representatives at the Paris G-10 meeting of 9 March 1973, (enlarged on this occasion by the three EEC members that were not also members of G-10, Denmark, Ireland and Luxembourg). Faced, however, with what, despite

some encouraging rhetoric, amounted, in effect, to a totally negative response from Treasury Secretary Shultz and Fed Chairman Burns, the Europeans finally came to realise that a world solution to the problem was not forthcoming and that they would either have to compromise their preferred positions to achieve an agreement on a united Community stance, or prepare to face the crisis each on their own.

This choice ECOFIN was called upon to make in a long meeting in Brussels, during the night of 11-12 March 1973. The West Germans predictably repeated their call for a joint float as the only realistic alternative to individual flotation of the European currencies and were supported by the representatives of the Benelux countries and Denmark. Among the other EEC member states, it immediately became obvious that Great Britain would not join, despite the fact that she was offered generous monetary support by the West Germans through the proposed European Monetary Co-operation Fund (FECOM).[93] The British decision meant that Ireland would also be unable to participate as, at that time, the Irish punt was still linked in an one-to-one relationship with sterling.[94]

At this point, the Snake would be in danger of becoming little more than a small currency grouping loosely associated with the DM, were it not for the French decision to participate. This was the culmination of a long process of conversion for the French government from total rejection to reluctant acceptance of a joint float and was the product of a number of factors. Traditional Gaullist financial orthodoxy demanded, as we have seen, that it should be the countries whose currencies were out of line (in this case the US rather than France) which ought to undertake corrective action, and so was opposed to the flotation of the franc in any form. Arguing against this inflexible position of the old guard in the Gaullist party was the liberal

wing of the governing coalition led by the Minister of Finance, Valery Giscard d' Estaing, who shared the premises of this assertion but clearly saw participation in a joint float as the lesser of two evils, and who did not wish to see France excluded from developments in the European monetary scene. Giscard had realised, during the monetary crises of 1968-69 and 1971, the grave danger that individual flotation of the European currencies represented for the CAP and, eventually, for the Customs Union and the whole future of the European Community. A firm advocate of fixed exchange rates, he also saw in the joint float a dual opportunity, to preserve fixed parities in Europe and to give a concrete and visible form to the concept of a "European monetary personality" which would manifest Europe's independence from the US and which had long been and important objective of the French government.[95] However, the French Minister was not oblivious to the difficulties for the French economy and particularly its exporting industries that would result from a fixed link with the strong and appreciation-prone DM. For this reason, he demanded that the DM/FF parity be fixed anew and managed to obtain a 3% revaluation of the German currency as the price for France's participation in the system. (It is important to note here the role played, in the resolution of these matters, by the growing personal friendship between Giscard and his West German counterpart, Helmut Schmidt, something which had been conspicuously absent between the French Minister and Herr Schmidt's predecessor, Karl Schiller, and which proved to be vital in the future course of European monetary unification).[96]

With one more obstacle thus removed, the question of French participation in the joint float was finally decided by a historical coincidence. Sunday, 11 March 1973, was a day of parliamentary elections in France. The Gaullist party suffered a drop in popular support, lost a number of seats and so became more heavily-dependent on Giscard's Independent Republicans to form a

government. This, naturally, strengthened Giscard's hand within the French cabinet and may have given him the extra negotiating flexibility that he needed to clinch the deal in Brussels and to commit the franc to the European scheme.

Having secured, after much agonising, his own country's participation (and in characteristic French fashion), Giscard then took the lead in the effort to persuade the Italians to join. However, because of the relative inexperience of the Italian Treasury Minister, Giovanni Malagodi, the dominant voice in the Italian delegation was that of the Governor of the Banca d' Italia Guido Carli who was a confirmed and outspoken advocate of flexible exchange rates and so was opposed to the return of even a substantially devalued lira to the Snake. Giscard tried to neutralise Carli's influence on Malagodi and proposed that the Ministers reconvene in closed session, without their advisers. Realising the real purpose behind the request, the other Ministers immediately agreed. All but the important one! Malagodi hesitated to part from the expert advice of his central bank Governor and asked for his presence at the meeting. When Chairman Willy de Clercq, the Belgian Minister of Finance, reluctantly agreed, Giscard realised that any further discussion would be pointless and gave up.[97] The lira did not rejoin the Snake and was never to do so, not even when Emilio Colombo, a staunch supporter of fixed exchange rates, returned to the post of Treasury Minister[98] and Guido Carli retired in August 1975 (he was succeeded by Paolo Baffi, who was far more sympathetic than his predecessor to the cause of European monetary integration).

Intra-European exchange rate relations thus emerged from the meeting of 11-12 March 1973 exactly as they had been before it. With the obligation to keep within a narrow band round their bilateral central rates relative to the dollar gone, however, and with the major currencies, the

dollar, the Yen, the pound sterling, the Italian lira, the Swiss franc, the Canadian dollar and the European grouping (the six EEC Snake currencies plus the Swedish and Norwegian crowns, which had joined as associate members, and the Austrian schilling which, although not a member, was unilaterally linked to the Snake by the Austrian government) all floating freely against one another, this was a very different world that dawned on the closed exchange markets on the morning of Monday, 12 March 1973. Barely two months later, and less than a year and a half from the high hopes and the rhetoric of the Smithsonian Agreement, in mid-May 1973, the European serpent finally popped its head through the roof of the now-defunct Smithsonian "tunnel". The old exchange rate system of Bretton Woods was no more. The new era of floating currencies had begun.[99]

Id3. The 1971-3 monetary crises: Some final considerations

It is perhaps, somewhat surprising, given the frenzied activity of this period, to find that there was relatively little new to be learnt from the experience of 1971-73. For, most of the lessons to be drawn from these years were, in fact, already evident in 1971. However, the events that took place since then helped to highlight like never before two serious and related drawbacks of the adjustable peg (at least as it operated under Bretton Woods), the problems of destabilising capital flows and inflation, and we turn to look at these in more detail in this section.

The connection between inflation and the breakdown of the Bretton Woods exchange rate system is usually explained in two distinct, though interrelated forms. The most frequent of these is that it was the emergence of world-wide inflation in the early 1970s which brought about the abandonment of the fixed parity system and the subsequent transition to floating currencies. Inflation differentials between countries, this argument goes, are likely to be larger the higher the general level of inflation, and so, in an inflationary environment (such as the early 1970s) governments would be more likely to need the protection of flexible exchange rates, either in order to defend the "real" economy from the consequences of home-generated inflation (for weak currency countries), or in order to shield off imported inflation (for countries more successful with domestic price stability). Another group of writers, on the other hand, while not at all disputing the validity of this argument, maintain that, in the context of Bretton Woods, the primary chain of causation run in the opposite direction: It was the fixed parity system, in the first place, which gave rise to inflationary pressures and these, in turn, led to the adoption of floating currencies.[100] Not everybody agrees though, that it was indeed inflation that finally

brought the system down. Instead, the finger is pointed at the gradual development, from the 1950s onwards, of well-integrated and highly mobile international capital markets which transmitted inflationary pressures, as and when these arose, from one country to another, and allowed speculative capital flows to destabilise the system.[101]

If, however, the primacy of these competing interpretations is a matter of dispute among their proponents, the validity of all three should not be. For, not only are they not mutually exclusive but, on the contrary, they reinforce one another, and again, the truth seems to lie in an intelligent combination of elements from all of them. Bretton Woods, as we have already seen, was not designed to be a rigid fixed exchange rate system. For a variety of reasons, however, (the political stigma which accompanies devaluations and the lobbying power of major exporting sectors notable among them),[102] governments tended to behave as though it were, and appeared extremely reluctant to adjust parities as the need arose, but only as a last ditch measure which had to be avoided if at all possible. Indeed, as Richard Cooper has shown, resignation was often the honourable course of action which Finance Ministers who had presided over their currency's devaluation were expected to follow, and many of them did, in fact, pay for their "failure" with their jobs.[103]

Despite this public aversion to parity changes though, governments were not prepared, as a general rule, to adjust their monetary and fiscal policies to conform with the dictates of a fixed parity system. Instead, more often than not, the effort to maintain fixed rates in times of crisis took the form of a delaying operation through special financial arrangements and controls, in the hope that somehow the situation would be corrected by itself, or by the action of other countries. In the meanwhile, in order to keep speculators at bay, officials would offer public assurances

that the exchange rate would not be changed, which by itself helped to turn the maintenance of a fixed parity into an important political objective of the officials concerned, thus further delaying any necessary adjustment.[104] During the early part of the life of the system, these tactics could be sustained for substantial periods of time, as balance of payments disequilibria tended to be rather small and infrequent. This situation, however, changed rapidly from the mid-1960s onwards, when both the size and the frequency of payments imbalances escalated, at about the same time that inflation differentials began to widen. Moreover, by this time, the international capital markets had reached such a size and degree of mobility and sophistication as to be able, by 1971, to generate $1 billion's worth of speculative flow in just 40 minutes in anticipation of a parity change ($3.6 billion in a single day by 1973). These were pressures which the old exchange rate system of Bretton Woods could just not cope with.

It would be less than fair to the designers of Bretton Woods, however, if one failed to point out here that, quite simply, the system had never been intended to do so. The participants of the Bretton Woods conference created a monetary system which, naturally, reflected the predominant economic ideas and realities of their time. These ideas and realities had, for the most part, been formed in reaction to the disastrous experience of the inter-war period (whether correctly interpreted or not), which had seen the breakdown of international economic co-operation, excessive volatility of exchange rates and large and uncontrolled destabilising capital flows, which had eventually led to the collapse of the international capital market in the 1930s.[105] The new system, therefore, was to be based on the principle of international economic co-operation, would restore fixed (though adjustable) exchange rates and would operate in a climate of restricted capital movements. It was no coincidence that both the main protagonists of the Bretton Woods conference, John Maynard Keynes and Harry Dexter White, had already written

major works sympathetic to the idea of exchange controls.[106] In the words of Lord Keynes "control of capital movements, both inward and outward, should be a permanent feature of the post-war system".[107] This would prevent "short term speculative movements or flights of currency"[108] and "should greatly facilitate the restoration of international loans and credits for legitimate purposes."[109]

At the time of the creation of Bretton Woods, in July 1944, there already existed rigid restrictions on capital flows and these were widely expected to remain in place after the end of the war. As one of the system's negotiators later confirmed, the designers of Bretton Woods "did not foresee the extent to which exchange controls would be abolished after the war. The articles of agreement of the Fund are friendly to the idea of exchange control. It was practically assumed that there will be exchange controls on capital."[110] In fact, it was because of this very assumption that the International Bank for Reconstruction and Development (the World Bank) was created in parallel with the IMF to provide a solution to the problem of international financing in the post-war period.

The assumption of restricted capital mobility is of vital importance to our understanding of both, the structural logic of Bretton Woods and of its shortcomings as they were revealed later. For, with controlled capital movements, the speculative crises which plagued the system during the latter part of its life could not have taken place, and governments would have been given welcome breathing space to determine whether or not an apparent imbalance in the short run constituted a state of "fundamental disequilibrium" and, if so, to take action through either policy adjustment or the exchange rate.[111] It is, therefore, fair to conclude that "the adjustable peg was not an irrational choice of exchange rate system for the world that it was expected it

would be used in".[112] Reality, though, did not turn out at all as expected. An international capital market reappeared in the 1950s and developed rapidly after the return of the European currencies to convertibility in 1958. That same year also saw the emergence of the Eurocurrency markets, which were relatively free from exchange restrictions and which had come to amount to more than $100 billion by 1973. To the speculative potential of these developments came to add the unprecedented growth in international trade (up by almost six times between 1950 and 1973) which gave rise to other types of speculative opportunities, through slowing down or speeding up payments to shift funds through the current account, known as "leads and lags". Multinational corporations, with their power to reduce or extend trade credits to their subsidiaries in other countries, were particularly important in this respect. As Robert Solomon has noted, the capital flows generated in this way could be very substantial indeed. In 1971, the sum total of American exports and imports came to about $7.5 billion per month. Thus, one month's "lead" in the payment for imports and "lag" in the receipts for exports would theoretically result in a capital outflow of equal size. The corresponding figures for West Germany were $6 billion and for Japan $3.5 billion (equal to the total amount of officials reserves in Tokyo at the end of 1970).[113] However, the single most important contributing factor to this accumulation of speculative potential (as well as inflation) in the late 1960s and early 1970s was the explosive net increase in international liquidity, to which the US contributed massively through its balance of payments deficits, to the tune of $63 billion in the years 1970-3 alone.

These deficits and successive waves of speculation had a shattering effect on the stability of the international economy. As capital fled heavily into the coffers of central banks in Europe and Japan, the increase in the monetary base had a multiplier effect on the domestic money supplies

of these countries, rising by a combined total of 51% in 1970-72. During the two years from 1971 to 1973, the Deutsche Bundesbank alone was obliged to absorb the equivalent of approximately DM 74 billion, of which only about DM 10.5 billion was due to a surplus on the current account. Some DM 24 billion of this inflow took place in the five weeks from the beginning of February to mid-March 1973, causing the domestic money stock (M2) to rise at an annualised rate of 28% during the first three months of the year. Efforts to neutralise the inflationary impact of these inflows on the domestic money supply through "sterilisation", as the Bundesbank soon found out, were bound to be self-defeating, for in a system of fixed exchange rates and high capital mobility a restrictive monetary policy will only encourage further capital inflows. At the same time, as Rueff had warned back in 1961, there was no corresponding monetary contraction in the deficit countries. On the contrary, in the most important of these, the US, there was a record growth of the money supply just as the balance of payments deficit exploded in 1971-72. The result of this asymmetry in the adjustment obligations Bretton Woods placed upon the US and all other countries was that, whereas at the time of its conception the fear had been that the system would turn out to have a "deflationary bias", the Bretton Woods exchange rate mechanism in reality exhibited a definite and, under the circumstances, uncontrollable *inflationary bias* during the last few years of its existence.[114] In the words of the central banker who had to take the brunt of the speculative onslaught, "the international monetary system as it has evolved in practice, has not only yielded in too permissive a way to inflationary forces which emanated from domestic inflation in major countries, but has also been generating inflation on its own".[115] This ratcheting up of the general level of inflation (which was later reinforced by the commodity price increases of 1972-74 and the energy crisis of 1973-74) with every new payments deficit and speculative run, and the consequent widening of inflation differentials between countries can be seen as the immediate causes of the final

abandonment of the fixed parity system on a world-wide basis and its replacement by flexible exchange rates.

There is one main lesson to be drawn, or reaffirmed, from the experience of the monetary crises of 1971-73. If we exclude the conditions of a responsible and legitimate hegemony, a monetary system based on fixed exchange rates will operate successfully in an economic environment of high capital mobility only if and to the extent that there is widespread agreement on the aims, direction and methods of economic policy among its participants and if and to the extent that they are prepared to subject what they may perceive to be their national interest to the dictates of the system. In this light, US Fed Chairman Arthur Burns was probably quite right to argue that "the international monetary system will have to respect the need for substantial autonomy of domestic economic policies",[116] but was surely wrong to continue "No country should have to accept sizeable increases in unemployment in order to reduce its deficits. Nor should a surplus country have to accept high rates of inflation".[117] For, in a world of fixed parities and well developed capital markets, as Bretton Woods demonstrated clearly, you cannot have it both ways.[118] If the maintenance of stable exchange rates is an important objective of the system, some countries may have to accept a measure of unemployment to restore equilibrium in the balance of payments, while others may have to settle for a higher rate of inflation than they otherwise would opt for. Changes in the exchange rate can be usefully employed to allow a more gradual introduction of the necessary adjustment measures, to spread their impact over a longer period and, possibly, even to reduce somewhat the overall extent and cost of these measures, but cannot ever totally substitute for and postpone indefinitely such corrective action. On the contrary, the economic, social and political costs of the inevitable adjustment are likely to *increase* the longer it is delayed by temporary resort to parity changes alone.

"The only sound method of preventing short-term capital movements of the speculative and political kind is to remove their causes".[119] In theory, this can be achieved by concerted action and policy adjustment on both sides of the imbalance (for it is rather unlikely that individual countries will accept the whole burden of adjustment themselves). In practice, however, it may be more difficult to attain the level of international co-operation required to effect the necessary changes as long as economic policy continues to be determined at the national level, for the temptation will exist for individual countries to try to exploit their economic or political strength to shift to their partners more of the burden of any corrective action that might be necessary. *Joint* economic management and decision making is, therefore, a vital ingredient for the success of a monetary system of the type discussed here. For, if this is missing, tensions within the system will, sooner or later, become intolerable and one (or both) of its two characteristics, fixity of exchange rates or high capital mobility, will have to give. In the case of Bretton Woods, it was currency stability that was sacrificed. Subsequent experience with flexible exchange rates, however, suggests that floating currencies have not managed to insulate the domestic economy from external disturbances and restore policy independence to monetary authorities, or to resolve the problem of recurrent speculative crises.[120] It would, therefore, be tempting to conclude that a measure of intelligent exchange control is required (to clear away some of the obstacles which the pursuit of private ends creates for the smooth operation of the system and to protect it from the irresponsible actions of one or more of its members) in order to ensure that "non-automatic" exchange rate systems, whether based on fixed or flexible currencies, function properly. As Ragnar Nurkse put it back in 1944, "one need not contemplate the future as if all international movements of private funds would have to be severely restricted or prevented altogether. What may have to be prevented are the massive one-way movements, usually self-

aggravating in character, which serve no useful social function and which may wreck any orderly system of international monetary relations".[121] Unfortunately, however, reality is not that simple. For, as Lord Keynes himself admitted and Karl Schiller argued within the West German cabinet, once exchange controls are adopted, they will eventually have to be extended to cover certain *trade*, as well as capital, transactions. Moreover, such controls introduce various other distortions into the international and the domestic economic system and, to cap it all, they are rarely effective beyond the short term (and they have become less so with time). In the words of Sir Alec Cairncross "such is the perversity of the world of control that the more they are needed, the less likely they are to work, and the less they are needed, the more likely they are to work".[122] Indeed, this inability of the adjustable-peg to maintain simultaneously freedom of capital movements *and* orderly monetary conditions, and the fact that a system of this kind is likely to generate political friction over the precise division of the responsibility for initiating adjustment are two of the stronger arguments militating against the adoption of this type of arrangement and for an "automatic" system based on a "parallel currency", such as we will examine in the following chapter.

Ie. Conclusion.

Having started this chapter with an explanatory note on the chronology of "the collapse of Bretton Woods", it seems appropriate to stress in this final section (as in the very beginning of that note) that it was the "exchange rate system" negotiated in Bretton Woods in 1944 which progressively disintegrated during the period 1968-73. For, other important parts of the total design, such as the institutional framework and, most significantly, the fundamental principles of international economic co-operation on which Bretton Woods was built, never really died at all. Indeed, it has been claimed that the breakdown of the exchange rate mechanism did not, in a sense, constitute a serious dilution of the spirit of the system. In Thomas Willet's words: "The heart of Bretton Woods was in its principles, not its procedures. Indeed, it can be argued that the changing world economy has necessitated a change in exchange rate procedures in order to continue to adhere to the basic principles of Bretton Woods".[123]

Attractive as this proposition appears at first sight, however, the fact is that the change in the procedures was, in itself, very significant indeed. For, as Willett himself has pointed out, the fixed parity exchange rate regime was identified, whether justifiably or not, with a climate of international financial co-operation. The transition to floating, on the other hand, by default rather than agreement, came about as a reaction to the unwillingness of certain countries, chiefly the US, to accept the common discipline of fixed exchange rates and their desire, instead, to pursue their own independent economic objectives, even if these clashed with the interests of other participants and the dictates of the international monetary system. This retreat to economic nationalism, together with the growing doubts as to the legitimacy of the special

privileges which the system conferred to the US and the structural weaknesses of the Bretton Woods design (absence of clear rules of adjustment and of a proper defensive mechanism to fend off speculative capital flows) can, in summary, be said to have been the main contributing factors to the stage-by-stage demise of the Bretton Woods exchange rate system over the years 1968-73.

In its relatively short life, Bretton Woods demonstrated clearly the main strengths as well as some of the problems of a monetary system based on fixed but adjustable exchange rates. In the period up to the mid-1960s, it promoted the principle of international co-operation between its participants and, with a strong, confident and outwardly-benign America at its centre, it maintained monetary stability (helped, of course, by the fact that free currency convertibility was not re-established until 1959) and fostered the most unprecedented growth in international trade and prosperity to be seen this century.[124] In the end, however, as all monetary systems eventually must, this one too was, simply, overtaken by events. In the few years that followed, the conditions that had underpinned both American hegemony and the orderly expansion of the world economy were gradually eroded. The new economic tensions and political realities, as they had emerged in the 1970s, were clearly beyond the scope of the old system's design. A switch to joint economic decision making which, in the absence of hegemony, would have been necessary to maintain stability in the currency markets was never a realistic proposition, for, as Albert Hahn had said back in 1967, "Americans [were] not willing to put a muzzle on a dog (a GNP of 700 billion dollars) just because the dog wags his tail (a 2 to 3 billion dollar deficit)".[125] Instead, the rest of the world was faced with a situation where, whether or not the US still possessed the capacity to make the system work, the painfully relevant fact was that it certainly possessed both the capacity and, it seemed, the will to disrupt it severely if that was (correctly or

not) judged to be in its own national interest. A variety of factors accounted for this unique privilege of the US, among which were the size and diversity of the American economy and the openness and sophistication of its financial markets, but also (and ultimately more important) the extent of American influence abroad, through direct investment and the spread of the American multinational enterprise, the political leverage on other governments generated by defence insecurity and the underlying threat that "disobedience" in monetary affairs might induce a withdrawal of American military protection and, above all, the dominant position of the dollar in the world economy.

This power to disrupt was not in itself new, for it was the product of the economic and military imbalance in which the Western world found itself at the end of World War II and had been present ever since. What was new was that the US, feeling its economic supremacy threatened, was now prepared to lay the bare facts openly on the line: The international monetary system had, first and foremost, to be in agreement with the interests of the US, and the US was to ensure, by unilateral action (or inaction) if necessary, that it continued to do so. Under these circumstances, and in the stormy economic conditions of the 1970s, it is difficult to imagine that *any* monetary design, old or new, could have maintained stable exchange rates on a world-wide basis and for any significant length of time. The best any group of countries could credibly do to approximate to this goal was to aim instead at a smaller, "regional" scheme such as the European currency Snake, to which we will turn our turn our attention next. A new design of this kind, the experience of Bretton Woods suggested, would have to deal with two main problems, and the success of the solutions given to these would, above all, determine the success or failure of the entire undertaking. First, the system would to have to incorporate a clearly defined set of objectives and a workable, crisis-proof *internal* mechanism of decision making

and adjustment, in order to avoid the divisions and ambiguities which plagued and eventually brought down Bretton Woods. Second, the participants of the system would have to agree from the outset on the development of an *external* financial policy at the union level to deal with relations with the rest of the world (and on the creation of any such institutions as might be required to put this policy into effect) in order to ensure that the successful pursuit of the system's objectives were not jeopardised by policy developments elsewhere (which, at the very least, implied a common policy towards the dollar). On both counts, as we shall see, the European serpent was only marginally successful.

CHAPTER II:

THE SNAKE

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IIa. Under the umbrella of Bretton Woods: To 12 March 1973

IIa1. From bilateralism to convertibility: The years 1945-1958

Although it was not until the late 1960s that Western European nations embarked on the first ambitious project designed to achieve Economic and Monetary Union (EMU) between their countries, the roots of post-war monetary co-operation in Europe can be found in the few years immediately following the second World War. Whatever their military fortunes, in an economic and political sense there were no victors in the Europe of 1945. Industrial production and investment were lower than their pre-war level (less than 75% in France, West Germany and the Netherlands) and although the money value of exports and imports had increased due to the inflationary impact of the war, the physical level of Western European trade was lower than in 1939. The Europeans also found themselves unable to repair or replace quickly enough the capital equipment that was vital for the reconstruction and redevelopment of their economies, while stocks of raw materials and consumer durables had been depleted by the war. Much that was essential had therefore to be imported from countries outside the war zone, especially the US which had managed to expand its productive capacity throughout the war, increasing its GNP by more than 50%, so that by 1945 it accounted for more than half of the world's total production in all goods. This resulted in an aggregate Western European current account deficit of $7 billion in 1947 alone (to which was added a further $2 billion on the capital account), over 70% of which was accounted for by trade with the US. American surpluses over the years 1946-49 totalled some $32 billion.[1]

This imbalance in the world economy, coupled with the inflationary impact of the war, ruled out the immediate adoption of the agreed rules for the post-war international monetary system, as embodied in the Articles of the newly-created IMF, in particular those relating to the issue of currency convertibility. (The external convertibility of sterling was briefly restored in July 1947, but was abandoned again only six weeks later due to speculative pressure). Trade obligations had thus to be settled mainly in dollars or gold at a time when the inability of the European economies to generate sufficient export earnings was creating a severe dollar shortage. To this, the European economies responded by trying to economise on their scarce gold and dollar reserves, which were needed for essential trade with the US, and conducting their trade relations with one another on the basis of bilateral agreements and arrangements for commodity swaps, reciprocal export credits etc. This system naturally entailed significant constraints for the expansion of intra-European trade and seriously limited the potential for economic growth in Western Europe during the rest of the decade.

The stagnation produced by bilateralism and the lack of adequate international liquidity was somewhat relieved by American economic aid of around $26 billion through this period, in material transfers, soft loans and grants, approximately half of which was accounted for by the Marshall Plan. It was also in relation to this that the first significant post-war European economic institution, the Organisation for European Economic Co-operation (OEEC), was established on 16 April 1948, with the two-fold aim of helping to administer the recovery-aid program announced by US Secretary of State George Marshall in his Harvard speech of 5 June 1947, and of promoting economic co-operation between the European nations on a multilateral basis.[2] In the two years that followed, various measures were taken by European and other governments to re-establish the credibility of their currencies and to improve the prospects for

growth and for a return to free convertibility. Notable among these were the West German monetary reform of June 1948 and, sparked off by the British devaluation of sterling in September 1949, the world-wide wave of devaluations in 1949-50, aimed to establishing parities which reflected more accurately post-war economic realities.[3]

Despite these developments however, the problems of bilateralism persisted and the inadequacy of various early trade schemes promoted by the OEEC served to highlight the need for a multilateral clearing mechanism which would allow a country's deficits in one direction to be set off against surpluses in another and which would have access to sufficient funds to provide credits for the financing of temporary net deficits. This need was met by the creation, on 19 September 1950, of the European Payments Union (EPU), which was operated by the Bank for International Settlements (BIS) in Basle as an agent for the Union, in co-operation with the member states' central banks. Despite of a number of initial difficulties, the system proved to be an unqualified success and, under the guidance of the EPU and the OEEC, European trade and economic growth increased rapidly. In the years 1950-58, exports to the dollar area tripled and, by 1956, the dollar shortage was a thing of the past. By 1958, most of the Western European economies were sufficiently robust as to contemplate a return to full convertibility by the end of the year (though sterling had been effectively convertible since February 1954). Thus, on 27 December 1958, convertibility was officially restored for the major European currencies, the EPU was terminated and, in its place, the OEEC members signed the European Monetary Agreement (EMA), which had been negotiated back in 1955 and provided, among other things, for fixed but adjustable exchange rates according to the rules of the IMF, and for bilateral margins of fluctuation of +/-0.75% around central parities (compared with +/-1% for the rest of the system).

TABLE 2

Realignment of exchange rates, September 1949 - March 1950
(% devaluation relative to the US dollar)

Country	%
UK (and sterling area, except Pakistan)	30
Japan	0
Canada	9
Switzerland	0
Sweden	30
Norway	30
Denmark	30
Finland	30
Greece	33
Portugal	13
Egypt	30
West Germany	20
France	22
Italy	8
Netherlands	30
Belgium	13

Source: BIS, 20th Annual Report. (Figures rounded to nearest whole number).

IIa2. Monetary co-operation in the EEC: The transitional period

On 25 March 1957, the Foreign Ministers of France, Germany, Italy, the Netherlands, Belgium and Luxembourg signed in Rome the Treaty establishing the European Economic Community (EEC) which began operations in January 1958. Although there is no explicit reference in the Treaty to economic and/or monetary union, there is specific provision for most of the minimal conditions necessary for monetary union, with the notable exception of a firm commitment to fixed exchange rates.[4] The Treaty requires the member states to pursue such economic policies as to maintain confidence in their currency and ensure equilibrium in their balance of payments.[5] Moreover, member states should consider their exchange rates and short-term economic policies as matters of common concern[6] and should, accordingly, aim to co-ordinate their actions to the degree necessary to achieve the purposes of the Treaty. To promote this co-ordination and to provide a permanent forum for consultations, a Monetary Committee was to be created.[7] The Treaty also laid down general guidelines concerning the progressive abolition of exchange controls and the principle of free capital movement within the Community,[8] as well as various arrangements for mutual financial assistance to be available to members facing temporary balance of payments difficulties.[9]

In accordance with the provisions of the Treaty, a Monetary Committee (consisting of a high-ranking treasury official and the central bank deputy governor from each of the member states, together with two representatives of the Commission) was established on 18 March 1958, and a Committee for Short-Term Economic Policy followed on 9 March 1960. However, in as early as 1959, there were already new proposals for further action on the monetary field. The Economic and Financial Commission of the European Parliament proposed the creation of an

organisation resembling the US Federal Reserve System and one of the architects of the EPU, Robert Triffin, presented a plan for a European Reserve Union and a common European currency, a plan which was supported by the French Commissioner for Economic and Financial Affairs Robert Marjolin, as well as by Jean Monnet's Action Committee for the United States of Europe. Finally, in that same year, the Belgian Foreign Minister, Pierre Wigny, called for the creation of a European Unit of Account to become a visible symbol of the financial independence of the EEC as one of the three major economic blocs in the world, together with the dollar and sterling areas.[10]

Despite these proposals, the next significant initiative aimed to extend the scope of monetary co-operation in Europe did not come until three years later, with the EEC Commission's Action Program for the Second Stage of 24 October 1962.[11] There were two main reasons for this new move: First came the 5% revaluation of the DM and the guilder, effected by the West German and Dutch authorities on 6 and 7 March 1961. Second, there was the British application for membership of that year, which created fears among the "Europeans" in the Community about a possible dilution and loss of purpose in the EEC as a result of British participation. Britain, after all, had only recently rejected the tighter obligations of EEC membership in favour of the much looser discipline of the European Free Trade Association (EFTA), behind the creation of which, in January 1960, Britain had been the major force. "Deepening" the Community, by extending the scope and degree of integration beyond what had already been achieved and, indeed, beyond the limited provisions of the Treaty of Rome, was seen as a desirable and necessary counterweight to any adverse effects produced by the "widening" of the Community to include the British.[12]

The Commission's Action Program of 1962 attempted to plug the gap in the Treaty of Rome by arguing explicitly in favour of fixed exchange rates as the cornerstone of monetary integration and by establishing the idea of a common European reserve currency as a desirable objective for the future. It also stressed the need for a common monetary policy and for economic planning at Community level. Finally, it proposed the creation of institutions to foster consultations and co-ordination between the member states in the fields of domestic and international monetary policy, exchange rate policy and budgetary policy. However, these ideas and the detailed proposals submitted to the Council on 24 June 1963 met with stiff resistance in a number of countries led by West Germany, and this was only somewhat relaxed in the more favourable climate created by the Italian balance of payments crisis of spring 1964. As a result, the content of the Commission's proposals was watered down by the Council and such progress as was made was almost exclusively confined to the institutional field.[13] A Medium-term Economic Policy Committee was indeed established on 15 April 1964 and, shortly after, on 8 May 1964, ECOFIN decided to set up a Budgetary Policy Committee as well as a Committee of Central Bank Governors. In that meeting the Council also agreed on a procedure for "prior consultations" in the event of one or more of the members wishing to alter the central parity of their currencies.

These developments marked almost the full extent of the Community's progress in the monetary field during the first decade of its existence. There was scant attention paid to monetary matters in the years up to 1968, although there were a number of indications that the measures negotiated so far were not comprehensive or solid enough to deal with serious difficulties. The Italian balance of payments crisis of 1963-64 gave an early warning that the Community was still totally unprepared to face any internal imbalance of significant magnitude. Financial

assistance, provided for by article 108 of the Treaty, was not utilised and Italy turned instead for help to the US and the IMF. Furthermore, the consultations mechanism agreed by the Council remained little more than a talking shop, instead of being developed into a fully-fledged instrument of policy co-ordination. On at least one occasion, "prior" consultations were actually held *after* the action to be discussed had already taken place.[14]

Part of the reason for this apathy exhibited by the European governments was, of course, precisely the fact that the years up to 1967 had been marked by great prosperity, with all countries of the Community enjoying sizeable surpluses for most of the period, *and* by remarkable monetary stability, to the point that it had come to be regarded as something of a heresy to question the viability of the fixed exchange rate regime, at least within the EEC. Even the two exceptions to the norm, the revaluations of the DM and the guilder in 1961, had been in response to larger than usual *external* disequilibria with non-member states and were thus not seen as a challenge to the wide-spread belief in EEC circles that a *de facto* monetary union already existed in the Community. In the words of Raymond Barre, "the considerable progress made in the establishment of a Customs Union and in the field of agriculture engendered the feeling that monetary manipulations have become unlikely, if not impossible. The fixing of common agricultural prices, their expression in forms of a unit of account, reinforced this feeling so much more that economic and monetary relationships within the Community were harmonious between 1960 and 1967, at least in appearance. A climate of false security was created and this explains that insufficient attention was given to the co-ordination of economic policies and to monetary solidarity in the Community".[15]

Under these circumstances, pushing ahead with further monetary integration in Europe was inevitably (and wrongly) seen as a matter of lower priority rating, despite the fact that there had been, ever since the beginning of the decade, warnings about the inherent structural weaknesses of the Bretton Woods design and that increasingly ominous signs for the future stability of the international monetary system had begun to appear from 1965 onwards. The attention and energies of national governments and the EEC institutions were, instead, focused on the general question of international monetary reform and, particularly, on the establishment of the Common Agricultural Policy (CAP) and the successful completion of the Customs Union. Apart from any slowing down due to insufficient attention however, this precedence given to integration in other fields also complicated the chances of a rapid adoption of measures leading to EMU in Europe in another distinct way. This is best understood in terms of the interaction of two different types of integration, known in the literature as "negative" and "positive" integration. "Negative" integration refers to the removal of divergent national measures and the adoption of new, common ones, whose purpose is to eliminate discrimination and distortions of competitiveness between member countries. "Positive" integration, on the other hand, refers to the formulation of common policies in areas where policy would be more effective at the Union level and whose purpose is the achievement of welfare objectives other than the elimination of discrimination.[16]

The establishment of a Customs Union is a good example of the former type of integration, EMU of the latter. The difficulty arises from the fact that while progress with "negative" integration *usually* also aids the course of "positive" integration, as positive measures are necessary to compensate the losers and to smoothen out any inefficiencies and inequalities that may have been created in the process,[17] this is not *always* the case. On the contrary, it can often

be that "negative" integration hinders the adoption of common policies, because the removal of part of national autonomy puts a premium on the maintenance of such levers of economic management as still remain in the hands of national governments.[18] Thus, in the context of our subject, the setting up of the Customs Union created pressure for the adoption of rules to ensure order and stability in the exchange markets so as to prevent unfair competitive advantages between member states, as well as for the creation of a Community Regional Policy and/or direct transfers to compensate the weaker member states or regions of the periphery. On the other hand, the rules of the Customs Union forbid a member state facing a balance of payments deficit to impose tariffs, quotas or other quantitative restrictions on imports from other member states, while the existence of the Common External Tariff has the same prohibitive effect on separate action towards countries outside the EEC. The government concerned would then have only two remaining policy instruments for the restoration of equilibrium in the balance of payments: devaluation or deflation, accompanied by politically damaging higher rates of unemployment (or, to be effective, a combination of both). In these circumstances, such a government would be unwilling to accept a further reduction in its options by entering into an agreement that would restrict in any way its ability to alter the exchange rate. Both of these contradictory considerations proved to be important at different stages of the history of European monetary unification. It is clear though that, despite the favourable circumstances prevailing during the first half of the 1960s, at least some of the European governments were still reluctant to surrender their freedom to manipulate the exchange rate, a reluctance that had already been evident in the total absence of an explicit commitment to fixed exchange rates in the Treaty of Rome.[19]

Probably the most important reason, however, for the lack of significant progress towards monetary unification in Europe in the years up to 1969, was the divergent economic and political perceptions and preoccupations of national governments during this period. French official policy was marked by two predominant characteristics, a desire for Community-wide economic planning to compensate for the partial loss of government control over the economy implied by the Treaty of Rome, and the pursuit for the development of a "European monetary personality" to highlight the Community's independence from the US. Both of these elements were indeed very prominent in the Commission's Action Program of 1962 (understandably so, as the Commissioner in charge of Economic and Financial Affairs at the time, Robert Marjolin, was a Frenchman who had worked under Jean Monnet in the first few years of the Commissariat du Plan).[20] The strongest support for European monetary solidarity came from the French Treasury, led by the Minister of Economics and Finance, Valery Giscard d' Estaing, and officials of the Banque de France. This took the form of an unequivocal and outspoken preference for a regime of fixed exchange rates and the encouragement (though not open public advocacy, due to French political circumstances at the time) of the idea of a common European currency. On the international front it was proposed that a Composite Reserve Unit (CRU) should be created as an alternative to the dollar, for the purpose of providing the world economy with adequate international liquidity.

These ideas, however, were by no means shared by the French government as a whole. An influential group of politicians, led by Professor Jacques Rueff and close to General De Gaulle himself, objected to the supranational elements contained in the proposals for CRU and a common European currency and wanted, instead, to challenge the supremacy of the dollar in the international economy by a return to the gold standard. In the power struggle that ensued within

the French cabinet, it was this latter group which was ultimately victorious. General De Gaulle's press conference of 4 February 1965 marked the beginning of the "gold war", support for the CRU and European monetary union was dropped and France stood alone in the international reform negotiations against the creation of the SDR. Another by-product of this turn in political fortunes was the institutional crisis that engulfed the Community as a consequence of France's "empty chair" policy in 1965. Finally, Valery Giscard d' Estaing himself was replaced by the "orthodox" Michel Debre in January 1966.

Substantial disagreements, though of a completely different nature, also existed within the government of the other protagonist in the European monetary scene, West Germany. On the one hand, there were those, led by federal Chancellor Konrad Adenauer, who saw close co-operation with the other European nations and particularly France as imperative for the future economic and political stability and prosperity of the Federal Republic and for its full integration to the West, and so were in favour of plans for a European Union. On the other hand, there were others, led by Minister of Economics Ludwig Erhard, who took a more "Atlantic" view of their country's external relations and were unwilling to commit Germany to schemes which excluded both Britain and, in particular, the US. These politicians rightly considered that separate European monetary arrangements and the creation of a common reserve currency would be seen as a direct challenge to the standing of the dollar in the international economy, and were thus opposed to such proposals, for they regarded friendly relations with the US and the maintenance of American troops in West Germany as a guarantee for the political and economic security of the country.[21] The opposition of this "Atlantic" faction within the German cabinet to the French-inspired "European" ventures embodied in the Action Program of 1962 was further reinforced by this group's passionate support for the "social market economy" and the belief that any form

of economic planning would seriously interfere with the workings of the free market, which was seen to have underpinned the German "economic miracle" of the late 1950s and early 1960s.[22] These disagreements within the German government were accompanied by a division of opinion as to the relative advantages and disadvantages of fixed and flexible exchange rates. The ability to raise the central parity of the currency was considered as vital by those who saw revaluation of the DM as an indispensable weapon in the struggle to insulate the domestic economy from imported inflation, but appeared less important to those who were also anxious about the political costs of such revaluations, which would squeeze exporters' profit margins and reduce the incomes of farmers who have been traditionally thought to vote for the then governing Christian and Free Democratic parties.

The "Atlantic" group in the German cabinet seems to have gained the upper hand in 1963, with Erhard's elevation to the chancellorship and, as a result, Germany gave a very unenthusiastic response to the Commission's proposals of June 1963. This opposition, however, was soon partly mitigated by the Italian balance of payments crisis of 1963-64, which generated large inflows of funds into the Federal Republic and demonstrated clearly the need for greater co-operation between the European countries in the monetary field. It softened even further with the entry of the SPD in the "Grand Koalition" government led by Kurt-Georg Kiesinger, in 1966.

In the other European countries, opinion divided differently on different issues as between the French and the West German positions and reactions were influenced by the special characteristics (size, openness and competitiveness of the economy, the constitution of foreign trade, political attachments and institutional factors, such as the level of development of capital

markets and the degree of independence of the central bank) of the countries concerned, as well as by particular objectives pursued by individual governments (such as, for example, the Italian preoccupation with the development of a Community regional policy). As a rule though, Belgium and Luxembourg usually sided with France, whereas the authorities in Italy and the Netherlands, despite the strong pro-European feeling in both countries, shared to some degree the more "internationalist" attitude of West Germany. In particular, these countries viewed with caution schemes which might have hindered the future participation of Britain in the Community. General De Gaulle's veto to British membership, on 14 January 1963 and again on 27 November 1967, antagonised these countries and created a general climate of mistrust and ill-feeling which was hardly conducive to making significant progress in the monetary field. Scarcely had the Community had time to recover from the first of these trying experiences however, when it was shaken again by the crisis of supranationalism, brought about by the General's stern opposition to the proposals that were currently being put forward, to pursue further integration in Europe through the extension of the powers and responsibilities of the Commission and the European Parliament, rather than through direct intergovernmental co-operation, and the subsequent French boycott of the Community's institutions during the second half of 1965. The "Luxembourg compromise" (by the other member states to accommodate the General's demands) of 29 January 1966, circumscribed the role of the Commission, established the right of national veto and put firmly the brakes on hopes and new initiatives for further integration in the few years that followed.

Despite these setbacks however, there existed a number of factors already at work which increasingly focused attention once again on the need for closer monetary co-operation in Western Europe and which were to change the attitudes of national governments (and indeed, in

some cases, contribute to the removal of national governments themselves from office) before the end of the decade. From about 1965 onwards, the international financial policy of the country at the heart of the world monetary system, the US, became increasingly destabilising and this manifested itself before long in a gradual edging-up of the general level of inflation and a progressive widening of inflation differentials between EEC countries. Coupled with the monetary crisis of 1967-68, which led to the devaluation of sterling in November 1967 and the establishment of a two-tier price for gold following the closure of the London Gold Pool in March 1968, these developments were read as signs that all was not well with the international monetary system and pointed out the dangers of the complacent attitude which the member countries had exhibited during the past few years. As a result, starting in early 1968, there was renewed interest in the whole question of monetary co-operation and various schemes began to come forward by senior politicians, the business communities and the press in a number of European countries, including significantly both Germany and France. To these the Commission responded with a memorandum, submitted to ECOFIN in February 1968, containing the first ambitious set of ideas for progress in the monetary field since the Action Program of 1962.[23] In this, the Commission called for the creation of a European Unit of Account (EUA) and for the implementation of a mechanism of mutual financial assistance, as provided by the Treaty. It also proposed the elimination of currency fluctuations within the EEC and expressed the view that parity changes should in the future become a matter of common *agreement*, rather than just be subject to the largely cosmetic and ineffectual consultations mechanism, as was the case so far.

These ideas and the detailed proposals submitted to ECOFIN in December 1968[24] never received proper attention by the Council, for they were overtaken by the Franco-German monetary crisis

of 1968-69. This shattered any remaining illusions about the existence of a *de facto* monetary union in Western Europe and, although it made progress on the lines suggested by the Commission more difficult, it also made abundantly clear that, whether or not monetary union was a *desirable* objective in itself, a large measure of monetary co-operation was *necessary* if a number of hard fought for and cherished achievements of the Community were not to be put in jeopardy. In particular, the 1968-69 crisis demonstrated in a practical way the grave danger that disorderly conditions in the exchange markets posed for the two Community policies without which the EEC did not really amount to much, the Customs Union and the CAP.

Faced with strong upward pressure on the DM in the aftermath of the inconclusive Bonn monetary conference of the G-10 in November 1968, and unwilling to revalue, the West German authorities imposed, as we have seen, a system of border taxes on foreign trade.[25] Thus, it was paradoxically the country which is the chief beneficiary of the Customs Union which had now resorted to measures which ran directly against it. A similar dilemma also confronted the French government in relation to the CAP. Ever since the agreement on common cereal prices in December 1964, agricultural intervention prices had been fixed centrally in terms of a unit of account, in a way such as to guarantee equal prices for farm produce throughout the Community at the official rates of exchange. This meant, however, that when actual market rates varied from the official parities there was scope for price divergences which, under the rules of the EMA, could amount up to 1.5% of the intervention price. The incentive therefore existed on the margin to transfer agricultural produce from weak to strong currency countries, wasting resources on transportation and creating serious complications for the accounting mechanisms of the system.

Far more harmful though than these marginal differences created by currency fluctuations around the official rates, was the effect of parity realignments themselves. The central fixing of prices in units of account meant that changes in the official rates led to changes of equal size in the prices farmers were entitled to receive for their produce in terms of their own national currencies. Though under the Bretton Woods exchange rate system parity changes were few and far between, they also tended to be of significant magnitude, as governments tried to delay the necessary adjustment for the longest possible period. Thus, in 1969, the DM/FF cross parity was altered by close to 21.5% and this would have normally implied an equal aggregate change in the relative prices paid to French and German farmers in francs and DMs.

Such wide disturbances in the relative price structure and the unsettling effect on expectations that accompanied them were not conducive to the smooth operation of the CAP, as they did not in any way reflect market conditions and so distorted further the already fuzzy signals of the price mechanism to the farm community. Moreover, whatever the direction of a parity change, it invariably posed unwelcome political and/or economic dilemmas to the national government concerned. In a revaluing country, the authorities would have to cut agricultural prices and thus farmers' incomes and face the wrath of the agricultural lobby (an important consideration behind the German government's unwillingness to revalue in 1968-69). Conversely, in a devaluing country food prices would have to be raised by the full amount of the parity change, thus making the devaluation itself less effective as these increases worked their way through to the general rate of inflation and higher wage settlements. It was for this reason that the French government felt obliged, following the devaluation of the franc in August 1969, to introduce a system of border taxes to block the increase in French agricultural prices which would have otherwise resulted from the parity change. Ironically, once again, as a direct result of instability in the

currency markets, it was the member state which was the main beneficiary of a Community policy that was the first to adopt measures which were directly opposed to the spirit and the aims of that policy.

The severe threat that disorderly monetary conditions represented for the *"acquis communautaire"* and the resultant necessity to reinforce the existing mechanisms of monetary co-operation were the subject of a further Commission memorandum, submitted to ECOFIN on 12 February 1969. This became known as the Barre Report after its author, Raymond Barre, who had taken over from Robert Marjolin as Commissioner responsible for Economic and Financial Affairs in July 1967.[26] The report emphasised that the high degree of interdependence which already existed between the economies of the member states substantially impaired the effectiveness of national economic policies. In order to ensure that these policies were not mutually incompatible and in order to safeguard the hard won accomplishments of the Community, it was therefore important to co-ordinate national economic goals and the methods adopted to achieve them. Lack of progress in this respect, the Report stressed, could seriously damage the cohesion of the EEC, as it would inevitably lead to the adoption of purely national, regressive measures in the future. The Commission accordingly urged the extension of the system of prior consultations to cover *all* aspects of policy that affected other member states, as well as the improvement of the mechanism for the co-ordination of short and medium-term economic objectives,[27] the institutional framework of which had been in place since 1964. It also called for the creation of a two-tier system of financial aid, comprising of "short-term monetary support" and conditional "medium-term financial assistance", to be available to members facing balance of payments difficulties.

These proposals, though substantially less ambitious than those which the Commission had submitted to ECOFIN a year earlier, still met with opposition from the Dutch, Italian and West German governments, who thought that the Barre Report was tailor-made to suit France's needs in the current monetary crisis and who were convinced that the proposed increase in credit facilities would ratchet up the general level of inflation in the Community and encourage the adoption of irresponsible policies by member states.[28] In the months that followed, however, there were a number of developments which were to modify this opposition and strengthen the ranks of whose who were arguing for greater monetary co-operation within the EEC.

First came the resignation of General De Gaulle from the presidency of the French Republic following his defeat in the referendum of 27 April 1969 on the regions and the status of the Senate. Georges Pompidou, who was elected to succeed him on 15 June 1969, held appreciably different views on a number of aspects of European unity and did not share to the same extent the General's preoccupation with the maintenance of the parity of the franc as a symbol of France's independence and prestige abroad. Valery Giscard d' Estaing returned to the Finance Ministry and, bowing to economic realities, devalued the franc on 8 August 1969. Similarly, the federal election of 28 September 1969 in West Germany resulted in a narrow defeat for the Christian Democratic element of the "Grand Koalition" and an SPD/FDP government was formed under Willy Brandt. This new government brought with it a determination to widen and vary even further the scope of German foreign policy beyond the still-fundamental relationship with the US, and expressed this through the extension of its "Ostpolitik" and, partly as a counterbalance, through a desire for greater co-operation in Western Europe. Drawing its electoral support from a different political constituency, it also, even more than in France, did not share its predecessor's commitment to the defence of the existing parity of the currency (and

was, in fact, opposed to it, which as we have seen, had created a split in the "Grand Koalition"[29]). Thus, after a short period of floating, the DM was revalued on 24 October 1969.

Although the immediate effect of these developments was to diffuse the Franco-German monetary crisis, there was, at the same time, renewed pressure generated for progress on the monetary field. For, the measures taken by the French authorities to insulate the French agricultural sector from the effects of the devaluation, duplicated by the German government upon the flotation of the DM, were seen by the public as the forerunner of the eventual demise of the CAP and the press in both countries carried reports to that effect. This alarmed not only the authorities in Paris but also the federal government in Bonn, for the Germans knew very well that, in the implicit deal between the two countries that lay behind the creation of the EEC, the establishment and now the survival of the CAP was the price which *had* to be paid for France's continued acceptance of the Customs Union. Consequently, anything that represented a threat to the CAP also called into question the future of the Customs Union and ultimately the Community itself. Monetary instability had been abundantly shown to be such a threat and had therefore to be combated.

These considerations refer to what could be called the "negative" reasons for expanding monetary co-operation in Europe (the potential adverse consequences of the Community failing to make progress in this direction). These were also reinforced, however, by an important "positive" factor, which arose largely as the product of historical coincidence. Ever since its inception in 1958, the Community and its institutions had been preoccupied with the two main tasks of trying to establish the Customs Union and the CAP, and progress in European integration had been seen primarily in terms of the successful implementation of these policies.

By 1968 though, even before the official end of the transitional period, these aims had been essentially accomplished and this on the one hand created the opportunity for the Community's institutions to consider seriously new proposals, but also (and more important) it pointed out the need for the Community to look for, and embark on, projects of further integration in other directions in order to maintain the momentum towards European unification intact. Thus, in the run-up to the Hague summit of 1-2 December 1969, the Community found itself in one of these rare and happy situations, where reason (both carrot and stick), opportunity and political motivation (in the form of two new governments in the two leading countries of the EEC, both favourably predisposed towards a "European" gesture) all came together to advocate the undertaking of a new "European" initiative. Given its positive and negative linkages to other fields of integration, which had been clearly demonstrated during the Franco-German monetary crisis, monetary integration was the natural candidate to assume this role.

IIa3. The "Snake in the tunnel"

The Hague summit was dominated by three main themes, outlined by President Pompidou in his opening speech of the conference: *Completion* of the EEC (by which was meant the finalisation of the arrangements for the financing of the CAP and the creation of the Community's own resources); *Enlargement* (the opening of accession negotiations with the four applicant countries, the UK, Ireland, Norway and Denmark); and *Deepening.* These three issues were, of course, to a large degree interlinked, for to secure and extend the scope of integration in the Community was not only desirable in itself, but, as we have seen, it was also considered to be an important safeguard against any dilution of purpose in the EEC resulting from its enlargement. It was in this connection that, even before the summit, the French had begun to promote the general idea of monetary integration to give a more precise meaning to that initially rather vague term, "deepening". For, whatever all its other merits, monetary integration would also test the applicant countries' commitment to the Community, and in particular Britain's readiness to harness sterling to the discipline of a European scheme.[30] The first concrete initiative in this direction, however, came not from the French, but from the new West German Chancellor, Willy Brandt. Breaking with the more "Atlantic" tradition of West German international financial policy, Herr Brandt, in his reply speech at the summit, called for the creation in Europe of EMU in two stages and, in sharp contrast with the vague and general list of intentions put forward by the French President, he outlined the necessary steps and institutional developments (such as the creation of a European Reserve Fund) he thought should be taken towards that aim.

On the second day of the summit, President Pompidou also endorsed EMU explicitly as a desirable objective. He stressed the international aspects of the argument, called for a pooling of the reserves of the member states and common administration of SDRs (thus also breaking with French tradition) and in general emphasised the development of a "European monetary personality", which would enable the Community to present a united front in its dealings with the US and the IMF. The other countries made favourable, if cautious, responses. The summit ended with the six heads of state and government deciding to officially end the transitional period of the Community and to adopt the negotiated agricultural regulation by the end of the year. They also decided to open negotiations with the four applicant countries. Finally, the Council was instructed to draw up a plan for the establishment of EMU in stages and to explore the potential for an eventual political union in Western Europe.

The process of achieving EMU in the Community got off to an encouraging start. In the first ECOFIN meeting after Hague, on 26 January 1970, the Ministers finally agreed to set up a mechanism of Short Term Monetary Support for countries facing balance of payments problems (which had been approved in principle during the meeting of 17 July 1969) and also committed themselves, despite some reservations from West Germany, to the establishment of Medium Term Financial Assistance by the end of June. (Both of these decisions were the product of discussions initiated before the summit as a consequence of the Barre Report of February 1969). Thus, as the Council next turned to examine the question of how to create EMU in the Community, a small but important part of the task had already been accomplished.

It was, however, *what* to create rather than *how* which proved to be the first stumbling block of the negotiations, and one that continued to haunt the EMU project throughout its duration. For it

became immediately evident (as it should have been already at the time of the summit) that behind the apparent agreement between the French and German political leaders on the desirability of achieving EMU in Western Europe, lay two quite different visions of the object to be achieved. These differences were expressed more clearly during the Paris ECOFIN meeting of 23-24 February 1970. The West Germans, supported to a lesser extent by the Belgians and the Italians, put forward detailed proposals, aimed to change completely and irrevocably the political, economic and institutional character of the Community. "The question was no longer that of a Customs Union with some elements of one or two common policies and the rudiments of a political organisation, but rather the emergence of a new economic and political unit in the world. Political union would be reached indirectly, via a process of integration in the economic and monetary fields".[31] On the economic side, particular emphasis was placed on the co-ordination of policies, which in turn would create a favourable environment for the establishment of a monetary union. On the political and institutional side, it was proposed that the Community should revert to a system of majority decision making, powers be transferred to the European Parliament and that the Treaty of Rome be revised to provide the necessary legal foundation for these developments.

Despite the presumed agreement on the final goal, the French position was markedly different. For a start, Paris was shy of the supranational elements in the German proposals, which struck at the very heart of the Gaullist political establishment and the Gaullist-inspired status quo in the Community since 1966. A degree of change was seen to be acceptable (or at least unavoidable) and, in some ways, even *desirable* in French political circles; a complete abandonment of the idea of the nation state as the primary unit in world politics was not. But even on the economic side alone, while not completely disregarding the need for a degree of policy co-ordination at

some stage of the proposed EMU project (as was the case with the plan submitted by Luxembourg), it became immediately obvious that the French were primarily interested in the monetary aspects of the debate. These included the gradual liberalisation of capital movements within the EEC (broadly supported by everyone in principle, though the large flows of speculative capital during the recent monetary crises had dampened enthusiasm for initiatives in this direction), fixed exchange rates with narrow margins of fluctuation (supported in one or another of its variations by Luxembourg, Belgium and the Commission, whereas the Federal Republic, Italy and the Netherlands wanted to postpone the introduction of such a scheme until sufficient progress had been made with economic harmonisation) and the development of a "European monetary personality" through the establishment of a European reserve currency, a pooling of reserves and a common external financial policy which would make it possible for the Community to challenge the dominant position of the US dollar in the international economy. (This last aspect of EMU was also emphasised by Italy, Belgium and the Commission, but was ignored by the Netherlands and Luxembourg, whereas the West Germans were obviously reluctant to encourage any undertaking which would be seen to be pointed directly against the interests of the US).

In order to resolve these difficulties, in the ECOFIN meeting of 6 March 1970, the Council decided to set up a committee whose task would be to try to reconcile the different approaches to EMU and to work out a compromise strategy acceptable to all the member states. This became known as the Werner Committee after its chairman, the Prime Minister and Finance Minister of Luxembourg Pierre Werner, and consisted of the chairmen of the Monetary, Budgetary, Central Bank Governors', Short and Medium-term Economic Policy committees (thus ensuring the representation of all EEC member states), together with a representative of the Commission.

According to the degree of priority attached to either the economic or the monetary aspects of EMU, the participants of the group divided into what came to be known as the "Economists" and the "Monetarists". The "Economist" camp, whose views were summarised in the plan submitted by West German Economics and Finance Minister Karl Schiller, consisted of the representatives of Germany, the Netherlands and, on the majority of issues, Italy. The "Monetarist" camp, on the other hand, whose general ideas were best described in the plan submitted by Commissioner for Economic and Financial Affairs Raymond Barre,[32] consisted of France, Belgium, Luxembourg and the European Commission. The "Economists" took a long-term view of EMU and argued that monetary integration should be the crowning act of a determined effort of harmonisation which would bring the economic policies and performances of the member states closer together. In the absence of substantial progress in this direction, to go ahead with purely monetary measures would at best be pointless, unsustainable and wasteful, for such efforts would not be taken seriously by the exchange markets, and at worst be harmful, for the premature adoption of these measures would give rise to conflicts of interest between the member states and lead to inevitable turmoil and defeats in the markets which could seriously retard the course of monetary unification in Europe.

The "Monetarists" reversed this reasoning in two important ways. With impeccable neo-functionalist logic, they argued that, first, the early pursuit of monetary integration would in fact aid, rather than impede, the eventual accomplishment of a complete and viable EMU in the Community, for the goal of maintaining narrowly-pegged exchange rates would present national governments with a number of external financial constraints, which would induce them to speed up the co-ordination of economic policies that the "Economists" wanted. Second, whatever the

merits of harmonisation as a long-term policy objective, the unrest in the international monetary system and the recent Franco-German monetary crisis had brought the point painfully home that something needed to be done *urgently* about instability in the currency markets. This "something", according to "Monetarist" logic, consisted of two main tasks: (i) to undertake measures which would promote and guarantee internal currency stability among the member states and (ii) to initiate action to combat the external disorder emanated by irresponsible policy-making in the US, by attacking the special position of the dollar (the courier of this disorder) in the Bretton Woods monetary arrangement.

The "Monetarist" prescription for the accomplishment of these aims ran as follows: Maximum fluctuation bands between member currencies should become narrower, to reduce monetary uncertainty in the Community, as well as to progressively eliminate the exchange-risk advantage enjoyed by the dollar due to the fact that, under Bretton Woods rules, the maximum permitted divergence between any two Community currencies was double that allowed for any one of them and the dollar.[33] Such interventions as were necessary to defend these narrower limits should henceforth be conducted in Community currencies alone. A European Monetary Co-operation Fund (FECOM) should be created, to act as a kind of embryonic European central bank, into which the member states would pool an agreed proportion of their foreign reserves and which would administer the financial assistance schemes approved by the Council. Finally, the member states would seek to harmonise their financial policies and adopt common positions in international monetary negotiations. The successful implementation of these measures would enable the eventual creation of a European reserve currency which, apart from its economic benefits for the Community, would also serve as a highly visible and powerful symbol of European unity and of its independence from the US. Such a currency, backed by the combined

weight of the European economies, would then be in a position to provide a viable alternative to the dollar in the international economy.

Faced with what in many ways were two antithetical approaches to EMU, the Werner Committee decided to accept the compromise solution proposed by the Belgian delegation and opted for the strategy of "parallelism". The purpose of this was to explore the common ground between the two positions and to put forward a plan for action for the *first* stage of EMU by concentrating on those points on which the views of the two opposing camps concurred (or at least were not totally incompatible), while leaving the more controversial issues to be resolved at a later stage and with the benefit of the experience gained in the process. In practice, this led to an agreement that the Community should endeavour to advance on both, the economic and the monetary fronts simultaneously, a recommendation which was conveyed to the member states by the Werner Report, published on 8 October 1970.

The Werner Report defined the final objective of EMU as "... an area within which goods and services, people and capital will circulate freely and without competitive distortions, without thereby giving rise to structural or regional disequilibrium"[34] and went on to outline a number of measures to be taken for the achievement of this goal, which, in the spirit of "parallelism", drew on ideas from both the "Economist" and the "Monetarist" camp. From the "Economist" position came proposals for the harmonisation of budgetary, fiscal, domestic and international monetary policies, as well as those that referred to credit creation, indirect and company taxation and the regulation of financial markets. Power would be transferred from national to Community institutions through the creation of a "Centre of Decision for Economic Policy" responsible to the European Parliament, and a "Community System for the Central Banks" similar to the

Federal Reserve System in the US. Finally, the Treaty of Rome would be revised and completed to bring it up to date with these undertakings. From the "Monetarist" position came a commitment to fixed exchange rates with narrower margins of fluctuation for the first stage, leading to the eventual elimination of these margins and the creation of a single European currency; the possibility of intervention in Community currencies, though not during the first stage (as this would complicate intra-EEC exchange rate relations); the establishment of FECOM by the end of the second stage; and total liberalisation of capital movements within the Community. Assuming that the political will which had been demonstrated during the Hague summit was maintained, the Werner Committee considered that the whole EMU project could be successfully realised by the year 1980.

The publication of the Werner Report met with favourable reaction in the member states, with the exception of France, where the supranational character of some of the proposals, particularly those relating to institutional issues, gave rise to stiff opposition among the Gaullist element of the governing coalition. The Commission welcomed the Report and recommended its findings to the Council in a memorandum submitted on 30 October 1970, though, in an effort to mollify French resistance, it toned down the supranational elements of the original. (In deference to Italian demands, it also gave somewhat greater prominence to measures aimed to reduce regional and structural imbalances in the EEC).[35] In the few months that followed, however, it became obvious that not even this visibly watered down version of the Report would be sufficient to placate French resistance and, by the time of the Brussels ECOFIN meeting of 14-15 December 1970, it was clear to the other five that they would either have to leave out of any agreement those aspects of the Report which had given so much offence to the Gaullists, or risk having to abandon the EMU project altogether.

A way of this dilemma was finally found during a meeting between the French President and the West German Chancellor in January 1971 and the basics of a compromise (the "Kompromiss des Kompromisses", as one of the Werner Committee negotiators put it[36]) were worked out into a formal agreement during the ECOFIN meeting of 8-9 February, and adopted as a Council Resolution in the ECOFIN meeting of 22 March 1971, following consultations with the four applicant countries. The political and institutional questions raised by the Werner Report were left unresolved. The Ministers agreed, with small alterations, to implement the recommendations of the Report and the Commission with regard to the harmonisation of economic policies, and to restrict "on an experimental basis" the fluctuations between their currencies. This latter undertaking was stipulated, on West German insistence, as only a temporary measure that could be reversed if, after a period of five years, sufficient progress had not been made with economic harmonisation and the transition to the second stage (this stipulation, of course, had the added advantage of preventing the outcome of the negotiations from being presented as a total victory, in practice, for the "Monetarist" camp and particularly the French). Finally, the Committee of Central Bank Governors and the Monetary Committee were invited to draw up a report for the eventual establishment of FECOM.[37]

It is ironic, given the considerable effort that went into the making of this final compromise, that a major part of the decisions of 22 March 1971 was never applied. The Committee of Central Bank Governors[33] met in April and agreed to limit, with effect from mid-June 1971, the fluctuation of Community currencies within a maximum band of divergence of 1.2%, contained within the unchanged EMA band of 1.5% (+/-0.75) against the dollar, an arrangement which earned the new system the nick-name "the Snake in the tunnel". Before the new arrangements had been applied, however, the confidence crisis in the Bretton Woods exchange rate system,

which had long been simmering under the surface, erupted openly in the currency markets. Massive speculative pressure in early May led to the suspension of exchange markets, individual flotation of currencies, the introduction of capital controls and, finally, the severance of the fixed link of the dollar to gold, which had been the cornerstone of Bretton Woods since the end of the war.[39] By late August 1971, the extent of exchange rate fixity in Europe was limited to a joint flotation of the Benelux currencies (the "worm" as it became known in European monetary zoology) within EMA margins of fluctuation.

The emergence of a unified Community approach to the monetary crisis and the relevant events of this period have been briefly described in the previous chapter. The Smithsonian Agreement of December 1971 did temporarily restore fixity of exchange rates as the governing principle of the international monetary system, though within wider margins of fluctuation of +/-2.25% around central parities relative to the dollar. This, however, now implied a maximum permitted divergence of +/-4.5% between any two European currencies (an aggregate movement of 9%, if they were to exchange their respective positions at the top and bottom of the dollar tunnel), a degree of flexibility which was judged to be incompatible with the general aims of the European Community and which would certainly wreck the day-to-day operation of the CAP. Thus, in early 1972, the Community made a fresh attempt to relaunch the EMU project. A basic understanding was reached during another meeting between Messrs. Brandt and Pompidou in February 1972, worked into a formal agreement at the ECOFIN meeting of 28 February and officially adopted by the Council in its session of 21st March 1972. Six main elements constituted this new agreement: (i) The Ministers decided to establish a "steering committee" to overview the progress made with consultations and the co-ordination of economic policies. This was to be made up from one representative from each of the member states and the Commission;

(ii) Margins of fluctuation between Community currencies would be narrowed to 2.25% around their bilateral parities, or half that permitted by the Smithsonian Agreement (thus completely eliminating in one go the exchange risk advantage enjoyed by the dollar relative to the EEC currencies); (iii) Exchange rate interventions within the margins of fluctuation relative to the dollar would henceforth be conducted in Community currencies, while dollar intervention would be used only in order to prevent an EEC currency breaching its dollar limit. Debts accumulated by central banks owing to intervention in one another's currencies would be settled in proportion to the composition of the debtor country's reserves; (iv) The Council adopted a Directive aiming to enable member governments to control speculative financial flows and to neutralise their effect on domestic liquidity;[40] (v) the Council committed themselves to decide on the establishment of FECOM by the end of that year.

Exchange market operations under the new rules commenced on 24 April 1972, more than two months ahead of the official deadline approved by the central bank governors in their meeting of 10 April. Within a month, the Snake was augmented by the early admission of the currencies of the four applicant countries (Great Britain, Ireland and Denmark on 1 May, Norway on 23 May) some eight months before the expected entry of these countries into the Community. It was not very long, however, before the unrest in the international monetary system which had been temporarily eased by the Smithsonian Agreement, was to inflict upon the Snake its first serious and permanent injury. Faced with persistent speculative pressure, the British authorities announced, on 23 June 1972, the flotation of the pound sterling for an indefinite period.[41] The departure of sterling was inevitably followed by that of the Irish pound and the withdrawal, for a short period, of the Danish krone from the exchange rate mechanism (though the Danish currency was able to rejoin by October 1972), while the threat to the continuation of the lira's

membership of the Snake was only averted by granting the Italians special exceptions from the rules which had been negotiated barely three months earlier. Italy had just undergone its thirty-second post-war government crisis and, following the general election in May, the second Andreotti government had been formed but not as yet sworn in. It fell therefore to the Governor of the Banca d' Italia Guido Carli (who as a declared advocate of flexible exchange rates was naturally predisposed against the lira's participation in the Snake) to represent his country in the Luxembourg ECOFIN meeting of 26 June 1972. Bargaining (or bluffing) for the best price for keeping the lira in the system, Carli managed to extract two important concessions from his partners: The first of these was that Italy was permitted to conduct intra-marginal intervention in dollars, rather than Community currencies as specified in the Resolution of 21st March 1972. The real significance, however, lay in the second concession, according to which the Banca d' Italia was released from the obligation to buy back lire used in intervention by other central banks in strict proportion to the composition of its foreign reserves, particularly with regard to gold. Given the fact that gold, at the time, accounted for more than 40% of Italy's total foreign reserves, the weak state of the lira which necessitated substantial interventions, and the fact that gold, at the official price of $38 per ounce was still grossly undervalued in relation to its market price, this exception amounted to an appreciable reduction, in real terms, of the cost to Italy of keeping the lira in the Snake.[42] (In December 1972, owing to pressure from other central banks with sizeable gold holdings, the same ruling was also extended to the other member states and the obligation to repay intervention debts partly in gold was indefinitely postponed).

These early setbacks and the renewed speculative attack on the dollar which immediately followed the flotation of sterling did not appear to dampen the determination to proceed ahead with the EMU project. On the contrary, the communiqué of the Paris summit of 19-21 October

1972 was marked by a spirit of optimism which had long been absent from EEC monetary affairs and which was probably unjustified under the circumstances. The nine heads of state and government reaffirmed their commitment to complete the EMU project by 1980 and to proceed to the second stage, as scheduled, at the beginning of 1974 (although what exactly constituted this second stage still remained unspecified!) They gave their approval to plans, drawn in the London and Rome ECOFIN meetings of 17 July and 12 September 1972 respectively, to establish FECOM by April 1973 and a European Regional Fund by the end of that same year and agreed to adopt a united position in the C-20 negotiations on international monetary reform. Finally, they urged their Finance Ministers to work towards the creation of a common anti-inflation policy and asked for reports to be prepared on the adjustment of the Short Term Monetary Support Mechanism and on the pooling of foreign reserves.

The Paris summit communiqué has often since (with the benefit of hind-sight) been characterised as overoptimistic, naive and unrealistic. In truth, however, this was only an early and more extreme case of what has increasingly become the norm in European monetary relations: there is a yawning gap between words and real intentions and a bigger one still to actual results. So it was with the declarations of October 1972. On 5 December 1972, barely a month and a half after the Paris summit, ECOFIN adopted a Resolution for an impressive anti-inflation policy, which included a precise target for a 4% increase in consumer prices over the year to the end of 1973, explicit targets for government spending and the money supply, as well as specific exceptions for those countries experiencing particularly severe unemployment difficulties. The member states then went on to completely disregard it! On 20 December, the EEC's central bank governors, meeting in Basle, decided to amend the intervention obligations specified in the resolution of 21 March 1972 so as to permit intra-marginal interventions in dollars. On 22

January 1973, substantial capital outflows forced the Italian authorities to introduce a two-tier exchange rate for the lira. Three weeks later, the Snake suffered its second permanent injury: On 13th February, the day following the second devaluation of the dollar, the Banca d' Italia also floated the commercial lira, thus taking the Italian currency entirely outside the Snake.[43] This was seen to be a far more serious blow than the loss of sterling some eight months earlier, for whereas Britain did not formally join the Community until January 1973, Italy was one of the original six of the EEC and one of the Snake's founder members. For the first time since its inception, the European serpent was now substantially smaller than a Community-wide creation.

For reasons we have already examined,[44] the second devaluation of the dollar failed to pacify the currency markets. Faced with unprecedented levels of speculation against the existing parity structure, the European exchanges were again suspended and ECOFIN met on 11-12 March 1973 to consider the joint flotation of the European currencies, as proposed by the West Germans with the support of the Benelux countries and Denmark. It soon became obvious that the British, who had seen sterling depreciate by some 15% relative to the other Community currencies since its flotation in June 1972, were not willing to commit themselves to the tight discipline of an upward-bound Snake. The participation of the French, who had hereto been the most persistent opponents of the joint float, on the other hand, was achieved thanks to a deal with the West Germans, which provided for a 3% revaluation of the DM (the first parity realignment within the Snake). There remained Italy. The French Minister of Finance, Valery Giscard d' Estaing, and the new Commissioner for Economic and Monetary Affairs, Wilhelm Haferkamp (who had taken over from Raymond Barre in January), took the lead in the effort to persuade the Italian representatives to return the lira to the Snake and, to this purpose, they pressed for a generous settlement on the creation of FECOM, in which Italy, in a reversal of

previous policy,[45] had exhibited renewed interest following the recent trials of the lira. Their proposals were based on the Commission's general ideas for the establishment of FECOM, which had been communicated to the Council on 24 January 1973. These called for a well-endowed fund of EUA 10 billion (close to 20% of the current total foreign reserves of the nine and a very sizeable increase on the EUA 1.36 billion that was already available under the existing mechanism for Short Term Monetary Support), to be made up of 10% gold, 20% dollars and the remaining 70% of the national currencies of the member states on a quota basis. The Fund would be given responsibility for intervention in the exchange markets. Monetary support credit facilities would be extended to a maximum of three times each member's quota with the Fund.

With the West German decision to agree, also against previous policy, to the establishment of such a fund in order to facilitate the return of the lira to the Snake, the Community faced a historic opportunity, on the night of 11-12 March 1973, to reach the kind of agreement between its members which had been beyond the limits of "parallelism" and to create, in FECOM, both the potent symbol of its progress towards EMU desired by the "Monetarists" and the "European" institution exercising effective and meaningful power at the Union level which was part of the "Economist" prescription, and thus to achieve the visible success for the EMU project that had eluded it so far. But, it was not to be. Due to the particular circumstances of Italian domestic politics at the time,[46] the most influential voice in the Italian delegation was, in practice, that of Banca d' Italia Governor Guido Carli, who was determined to preserve the newly-won freedom to vary the exchange rate of the lira and was not willing to be bought-off again in the way he had been eight months earlier. The Italian decision not to participate cost the Community more than just the absence of a second major EEC currency from the Snake. The outcome of the meeting

was presented to the public as a great success, in that the Snake had survived intact the most severe speculative onslaught known in history and that the abandonment of the dollar tunnel and the transition to a joint float had been negotiated successfully. Notable though both these achievements were, however, underneath the official self-congratulation and the sense of confidence and optimism for the future which characterised, on the surface at least, relations in the Community over the few months that followed, what had also (and in the long run more seriously) really happened was a change in the underlying political climate, which was to retard progress in the Community in various important ways. We will indeed claim in a later section that, more than just a milestone in the history of European monetary unification alone, the meeting of 11-12 March 1973 was, in a sense, the moment of truth for the European Community as a whole. But, for the present, suffice it to say that the Commission's ambitious proposals for FECOM were never adopted (not even in the drastically watered down version in which they were again presented to the Council in November 1973) and, even after the creation of FECOM had been officially agreed, in April 1973, that institution never came to amount, in reality, to much more than "a nameplate on a wall" in Luxembourg.[47] The change in the political climate was also manifested in the decision of West German deputy Foreign Minister Hans Apel to block the generous budget proposed for the European Regional Fund, the main beneficiaries of which would have been the two big non-Snake countries, Great Britain and Italy. But, most significant of all, the failure of the meeting of 11-12 March 1973 to restore the membership and to deepen the content of the Snake heralded well in advance the failure of the EMU project and its change of character, from an ambitious Community-wide scheme designed to achieve a single, unified European economy, to a limited Nordic experiment in exchange rate stability centered round the DM (important though this was in the turbulent years that followed, both for the participating countries themselves and for the future of the Community in general).

TABLE 3

Official reserves of the countries of the EEC, March 1973

Country	Total	Gold and gold-linked assets		Foreign exchange	
		(a). Million EUAs			
West Germany	26,255	6,034		20,221	
France	9,269	4,558		4,771	
Italy	5,182	3,554		1,628	
United Kingdom	5,003	1,467		3,536	
Netherlands	4,995	3,093		1,902	
Belgium/Luxembourg	4,034	2,512		1,522	
Denmark	892	200		692	
Ireland	867	91		776	
EEC	56,497	21,509		34,988	
		(b). As a % of the			
	EEC	Country	EEC	Country	EEC
West Germany	46.5	23.0	28.1	77.0	57.8
France	16.4	49.2	21.2	50.8	13.5
Italy	9.2	68.6	16.5	31.4	4.7
United Kingdom	8.9	29.3	6.8	70.7	10.1
Netherlands	8.8	61.9	14.4	38.1	5.4
Belgium/Luxembourg	7.1	62.3	11.7	37.7	4.4
Denmark	1.6	22.5	0.9	77.5	2.0
Ireland	1.5	10.5	0.4	89.5	2.2
EEC	100.0	38.1	100.0	61.9	100.0

Source: Commission of the European Communities (1973b).

IIb. A DM zone of monetary stability, 1973-1978.

IIb1. The energy crisis and the withdrawal of the French franc.

For nearly two and a half months after the introduction of the joint float, the Community enjoyed a welcome period of relative monetary stability. When the exchange markets re-opened, on 19 March 1973, the Swedish krona joined the Snake as an associate member, thus underlining the serpent's divorce from the EMU project and its change of nature from a Community animal to an association of countries, whether members of the EEC or not, concerned with maintaining relative currency stability. On 3 April, (only two days after the deadline imposed by the Paris summit!), ECOFIN officially decided to establish FECOM. Agreement, however, was only made possible by avoiding the controversial issues of pooling of reserves and the integration of the monetary support and intervention mechanisms. The fund thus created amounted, in practice, to no more than an elaborate multilateral book-keeping operation, "...whose council met routinely, albeit for sound practical reasons, in Basel, whose day-to-day business was conducted by its agent, the Bank for International Settlements and whose only physical presence in the Community, despite the Council decision of 24 July fixing Luxembourg as FECOM's "provisional seat", consisted of a post office box".[48]

Encouraged by what, on the surface at least, still appeared to be positive developments, the Commission submitted to the Council its proposals for the Second Stage, on 19 April 1973. These contained plans for the harmonisation of economic policies, as demanded by the "Economist" countries, with emphasis on the co-ordination of budgetary and taxation policies

and targets to be set for the money supply, interest rates and the extension of credit. Attention was also given to the regional and structural imbalances within the Community and the intention to establish a Regional Fund was re-affirmed. Finally, the Commission put on the table for the first time the option of a "common fence" against destabilising capital movements. The idea of this was to gradually establish different rules for movements of capital within the Community from those involving other countries and thus to enable the member states to progress towards their stated objective of abolishing exchange controls and achieving a free capital market within the Community, while at the same time they would be able to protect their economies from damaging speculation.

Despite the ambitious nature of the general ideas, the most noticeable characteristic of the Commission's proposals for the Second Stage was its apparent unwillingness to set out forthright the specific measures it thought necessary to achieve these aims. Although this diffidence can be partly explained by technical considerations, it also reflected strongly the growing doubts about the degree of progress which could realistically be hoped for in the worsened political climate that followed the meeting of 11-12 March and with so many of the fundamental questions raised by the Werner Committee still unresolved. These doubts were further reinforced by the adjustments made to the CAP on 30 April 1973, intended to insulate the agricultural sector from instability in the currency markets, a tacit recognition that a return to a Community-wide system of fixed exchange rates was not expected in the near future. (It should also be noted that, by making it possible for the CAP to operate without too much disruption from the currency markets, the measures of 30 April removed what had long been seen as one of the principal *raisons d' etre* of monetary integration in the European Community). Concrete proof, if any was still necessary, that the EMU project was stuck in low gear came on 27 June

1973, when the Commission presented to the Council a set of proposals which attempted to deal with the issues which had been conveniently side-stepped in April to make possible the creation of FECOM. The member states were asked to provide FECOM with EUA 500 million working capital of its own and to pool 20% of their foreign reserves, with the remainder to be transferred in four equal instalments by the beginning of 1980. A six-fold increase in quotas and a number of technical modifications to the short-term financial support and intervention mechanisms were also proposed. Although none of these ideas were new and some, such as pooling of reserves and the strengthening of the mutual support mechanism, had been there for the taking on the night of 11-12 March, the best that the Council was now able to achieve was to refer the Commission's proposals for further study, a striking measure of the ground the Community had lost in the space of just three and a half months.[49]

On the external front, the introduction of the joint float managed briefly to pacify the currency markets and the Snake initially remained comfortably within its former Smithsonian limits. This state of affairs was soon ended by a combination of the continued deterioration of the American current account and the stringent monetary measures adopted, in various degrees, by the EEC governments in order to offset the inflationary impact of the liquidity influx of February and March. Once again, the dollar began to slide and, on 15 May 1973, the Snake finally burst through the ceiling of the Smithsonian tunnel. The exodus from the dollar reached epidemic proportions in early July when, in the space of just one week, the American currency fell by about 10% relative to the Snake currencies and the Swiss franc. By 6 July, a number of New York banks were refusing to quote rates on the major European currencies and the exchange markets had come to a standstill. The resumption by the Fed of open market operations in support of the dollar had a marked but only temporary effect and the slide

continued until, by 18 July, the DM stood at a premium of over 40% on its Smithsonian rate and even the weaker Snake currencies had appreciated by about 25%, before a slight relaxation of monetary conditions in Germany and an increase in American interest rates in late July restored order in the currency markets. Similar doubts about the long term international competitiveness of the Italian economy led to renewed pressure on the lira in June 1973. In response to a request by the Italian government, the Community agreed to grant financial assistance of EUA 1.56 billion (the first time that the mechanism for the provision of mutual support was utilised, though FECOM was only notionally involved). The decision represented a political success for the Community as the amount agreed was considerably larger than the credit line of $1.25 billion Italy had already been able to secure from the US.[50] Further assistance was also provided by the West Germans on a bilateral basis.

At the same time, differences in the vigour with which member governments pursued the fight against inflation inevitably led to pressures for another realignment within the Snake. In order to support the existing parity structure, the Bundesbank had to absorb some EUA 500 million in early June and another EUA 700 million on 29 June alone, at which point the decision was taken to revalue the DM by 5.5%. The total Snake-related inflow sustained by the Bank over the months of June and July amounted to some DM 5.8 billion. This was by no means as great or damaging as the influx of the previous February and March, but was nevertheless deeply worrying, given the fact that this latest incident, though fuelled by disorderly conditions outside the Snake, had been caused mainly by imbalances within the Snake itself. Similar pressures enveloped the Dutch economy in September and, after a vigorous defence of the existing parity to the tune of some EUA 200 million in the first two weeks of the month, the guilder was finally revalued, on 17 September, by 5%. In doing so, the Dutch authorities only bothered to consult

their Benelux partners, probably in order to register their annoyance at having been left on the margin of the more serious monetary negotiations earlier in the year.

Before there was time to absorb this latest setback, the European economies and the Snake were gravely tested by the unfolding of the energy crisis which broke out in late 1973 as a result of the Yom Kippur war. On 16 October, the representatives of the major oil producing nations of the Middle East (OPEC) decided to limit the production of oil and to impose an export embargo on a number of European countries and the US, in an effort to force the West to support a settlement of the conflict between Israel and her Arab neighbours more favourable to the interests of the latter. The result of this drastic reduction in the supply of the world's main energy source and the quadrupling of its price in 1973-74, coming as it did on top of a variety of other (and preceding) unfavourable factors for the international economy, was to start off a long period of high inflation and low economic growth, which created a great deal of uncertainty and altered in a profound way some of the assumptions and parameters within which economies operated. There was a transfer of income, spending power and wealth from the industrial world to the oil producing countries and a number of Western governments had now to come to terms with the potential of a serious balance of payments constraint on the conduct of economic policy.[51] Internally, the oil crisis threatened to depress domestic output severely and throw the industrial economies into a prolonged downward spell in the economic cycle, while both the energy constraint and balance of payments considerations ruled out the traditional method of raising aggregate demand to combat depression, as in the circumstances this would only have had the effect of giving inflation a further upward twist.

TABLE 4

Changes in the Bundesbank's net external position, 1973-8, (DM billions).

Year	Period	Total	Intervention in the Snake	Other
1973	January-March	+19.9	-0.6	+20.5
	April-May	-0.9	-1.5	+0.6
	June-July	+8.5	+5.8	+2.7
	August-September	+3.4	+4.3	-0.9
	October-December	-4.5	-1.1	-3.4
	January-December	+26.4	+6.8	+19.6
1974	January	-2.5	+0.2	-2.8
	February-June	+5.4	+4.1	+1.3
	July-September	-6.4	-3.5	-2.9
	October-December	+1.6	-0.7	+2.3
	January-December	-1.9	+0.2	-2.1
1975	January-March	+5.0		+5.0
	April-September	-6.6	-1.8	-4.8
	October-December	-0.6		-0.6
	January-December	-2.2	-1.8	-0.4
1976	January	+0.1		+0.1
	February-March	+9.7	+8.7	+1.0
	April-July	-4.6	-1.4	-3.2
	August-mid-October	+7.7	+8.0	-0.4
	Mid-October-December	-4.1	-3.5	-0.6
	January-December	+8.8	+11.9	-3.1
1977	January-June	-0.8	-1.5	+0.7
	July	+2.0	+0.0	+2.0
	August-September	-2.0	-0.3	-1.7
	October-December	+11.3	+3.1	+8.2
	January-December	+10.5	+1.3	+9.1
1978	January-March	+4.1	-1.1	+5.2
	April-June	-4.1	-0.1	-4.0
	July-mid-October	+12.8	+10.1	+2.7
	Mid-October-December	+7.3	-1.1	+8.4
	January-December	+20.1	+7.8	+12.3

Source: Deutsche Bundesbank, Annual Report, 1973-8.
(Period figures are rounded and may not add to totals for year).

Indeed, in the context of the European Community, it was the difference in the importance attached by the member states to the struggle against inflation (as compared with other policy objectives) which the oil crisis brought out in sharp relief in the latter part of 1973. Contrary to popular conviction, the emergence of world inflation in the early 1970s did in fact *predate* the energy crisis and had its roots in the simultaneous expansion of demand in the major industrial countries during 1972, aimed to jolt the international economy out of the recession of the previous year. This was reinforced by the spectacular boom in the commodities markets in late 1972 and given a vicious twist by the inflationary nature of the international monetary system. The "Economist's" price index for food items rose by some 50% in the first half of 1973 and that for non-food items by even more until, at its peak in March 1974, the all-item index (excluding oil) stood at well over double its 1971 level.[52] The result was that consumer prises in the OECD countries rose in 1973 by an average of 7.9%, compared with an average of 3.9% per annum over the previous decade. This rate of inflation was considered unacceptable in every country of the European Community and already, by the late spring and summer of 1973, the governments of all Snake member states were applying a variety of measures aimed to deal with the problem. However, the degree of real priority given to the fight against inflation differed from country to country and this was made clear by the on-set of the energy crisis, which was widely forecast to add a further 2-3% to the existing price level. At the one end stood the Federal Republic, where the authorities were determined above all else to squeeze the inflation rate and to reduce the level of aggregate demand to well within the confines of a reduced supply. At the opposite end stood France, where the authorities were mindful of the likely contractionary effect of the energy crisis on domestic output and employment and opted to maintain economic activity at the highest possible level, short of pushing up inflation from the demand side. In the middle were the Benelux countries and Denmark who wished to reduce the rate of inflation within the bounds

TABLE 5

Economic effects of the oil crisis on the countries of the European Community (1974)

Country	Dependence on oil in total energy consumption (%)	Estimated change in the current account:		
		Pre-oil crisis	Post-oil crisis	
		(% of GNP)	(billion US$)	(% of GNP)
West Germany	55	+3.1	-5.8	-1.6
France	67	-0.3	-5.3	-2.1
Netherlands	50	-2.4	-0.9	-1.5
Belgium/Luxembourg	60	+3.5	-1.2	-2.5
Denmark	95	-1.2	-0.9	-2.8
United Kingdom	50	-1.1	-0.9	-2.8
Italy	74	-3.3	-4.2	-3.0
Ireland	69	-7.1	-0.2	-3.3

Source: Commission of the European Communities (1974b).

of an essentially unchanged level of economic activity. The consequence of this difference in political priorities was that, although all the member states had been at a comparable phase of the economic cycle at the beginning of 1973, their economies soon started to diverge and, by the later part of the year, aggregate demand was slowing in West Germany, maintained at an approximately constant level in the Benelux countries and Denmark, while it was actually increasing in France.[53]

These differences in political perspectives had two important consequences for the EMU project. The first of these was that the member states failed to agree on the measures which were necessary to make possible the transition to the second stage which was scheduled to take place by the end of the year. It had already been clear in June that there remained substantial difficulties in achieving sufficient common ground between "Economist" and "Monetarist" states as to the precise nature of this second stage and the necessary preconditions for it and these were now amplified by the uncertainties induced by the energy crisis. Nevertheless, the Commission presented, on 15 November 1973, a set of five draft decisions which were essentially the same as the proposals advanced in June, with the exception that the member states were now being asked to pool 10% of their foreign reserves into FECOM rather than 20%. It soon became clear, however, that even this would not prove acceptable and that, in the face of the oil crisis, member governments were unwilling to cede even a small measure of their national autonomy. In the ECOFIN meeting of 3-4 December, the Ministers refused to assign any capital or real power to FECOM and Helmut Schmidt, the German Minister of Finance, wondered whether in the circumstances it did not make more sense for the Community to pool its *oil* reserves. Two weeks later, on 17 December 1973, the Council approved in principle the remainder of the Commission's proposals, but made such adjustments that anything of real

significance was excised. It also became clear that the political differences which had dogged the EMU project from the beginning would prevent a transition to the second stage. The French refused to accept such a transition until the lira and the pound sterling had rejoined the Snake. The West Germans stressed that insufficient progress had been made with the harmonisation of national economic policies and performance. The Dutch argued that a transition to the second stage could not be contemplated without substantial progress in the institutional field. Finally, the Italians and the British were prepared to veto all further proposals until a definite decision had been taken on the creation of a Regional Fund. Although immediate progress was thus ruled out, however, the member states showed at the same time that they were not willing to abandon what had been achieved so far and that they had come to appreciate the benefits of economic co-operation and of a common stance towards the world outside, imperfect as both had been. Thus, although the EMU project as first conceived and in its original timetable was now seriously in trouble, the Snake and the consultation mechanisms did survive, and if transition to *the* second stage was blocked, the Community was at least prepared to consider *a* second stage.

The second consequence of the energy crisis and the members states' differing approaches to it was the emergence of renewed strains within the existing parity structure of the Snake, which led to the revaluation of the oil-rich Norwegian krone by 5% on 16 November 1973 and (of vastly greater significance for the Community) to the withdrawal of the franc in January 1974. As we have seen, there was a big difference in the stringency of the anti-inflationary policies adopted in France from those applied in West Germany and this difference was underlined by the new measures announced in the two countries in December 1973 in response to the oil crisis. Given the fact that France was the only member of the Snake who already had a payments

deficit, this discrepancy was bound to create pressures for a realignment within the system. Such pressures did indeed develop in the early part of January 1974 and quickly acquired a speculative nature. Neither an interest rate increase of 2% by the Banque de France and a similar increase in the reserve requirement nor the strenuous defence of the parity to the tune of some EUA 650 million succeeded in halting the outflow of capital from the country and finally, on 19 January 1974, the French authorities decided to float the franc, turning down a generous loan of a further $3 billion offered on a bilateral basis from West Germany. France was simply unwilling to add any more to its debt burden for the single purpose of staying in the Snake and President Pompidou instructed the Finance Ministry to preserve the country's depleted reserves exclusively for the payment of imports and not for the defence of the franc.

The withdrawal of the franc from the Snake was a more serious blow than the departure of either the pound sterling or even the lira had been, for it finally signified the abandonment of the EMU project and the separation of the Snake from it. As long as France participated in the system, the Snake was able to maintain a Community flavour, despite the fact that two of its major currencies were floating independently with little prospect of an early return. This was no longer the case in January 1974. Four out of the nine countries of the EEC, including three of the four major ones, were now outside the Snake which, on the other hand, included two non-Community countries, Norway and Sweden, as associate members and was unofficially shadowed by a third, Austria. The system had also been damaged in a very particular and important way, in that the Paris-Bonn axis, which had long been the pragmatic foundation and the psychological underpinning of the European Community was now broken. But, the divorce of the Snake from the EMU project was not only a matter of membership. On the weekend of 19-20 January 1974, the Finance Ministers of the five countries still in the Snake decided to turn

down the invitation of the President of the Commission, Francois-Xavier Ortoli, to meet and discuss the new situation created by the departure of the franc within the institutional framework of the Council of Ministers and chose instead to meet alone, on the evening of 21 January, at the Belgian Ministry of Finance in Brussels. There, they concluded that decisions on the management of, and any further developments in the Snake would be taken by the participants alone and thus, although the Commissioner responsible for Economic and Monetary Affairs, Wilhelm Haferkamp, had been invited to the Brussels meeting, the Commission was hence left out from future deliberations and was only informed when a realignment within the Snake had already been decided by its members. The five also decided to strengthen the consultations mechanism through a system of monthly meetings and to accept English as the working language of the Snake. These developments clearly signified that the Snake was no longer considered by its members to be a Community institution, a view also shared by the British and the Italians and, it seems to a point, even by the French Minister of Finance, Valery Giscard d' Estaing, who, although unshaken in his preference for fixed exchange rates and thus personally in favour of France's return to the Snake at the earliest opportunity, could still, in January 1974, describe the Snake as "an animal of European monetary pre-history".[54]

Indeed, what one witnessed in January 1974 was an extraordinary reversal in the positions of the main protagonists on the European monetary scene. The leading "Economist" countries, West Germany and the Netherlands, were still participating in the Snake and, with what used to be thought of as impeccable "Monetarist" logic, Helmut Schmidt explained that, by keeping their currencies within narrow margins of fluctuation, member states would be able to facilitate harmonisation of their economic policies. He also expressed his hope that, by keeping alive what remained of the EMU project, it would become possible for those countries who had left

the Snake to rejoin it at a later date. At the same time, France, the leader of the "Monetarists", was floating her currency independently and Valery Giscard d' Estaing was forcefully propagating closer co-ordination of the economic policies of the member states as a necessary precondition for the success of further initiatives, which as recently as one month ago had been the battle cry of the "Economist" camp.

Thus, at the moment when the EMU project was finally abandoned, it was the "Economist" view of the road to economic and monetary unification which seemed to have emerged triumphant. The "Economist" point had been made that a system of fixed exchange rates was bound to crumble, unless the member states were prepared to sacrifice a good deal of their national economic autonomy and to subject it to the dictates of the system. The main casualty of the inability to appreciate this to an adequate degree had been the leading "Monetarist" country, France. That the Snake, clearly a "Monetarist" creation, survived, was now led by an "Economist" country and came in time (wrongly) to be thought of as identical with the EMU project and to dominate monetary developments in the EEC for many years was but tangible evidence that the Snake had acquired a new, more limited but significant role, that of maintaining stability between the currencies of a smaller group of countries, centered round the DM. It was no longer possible to consider the Snake in terms of a grand strategy leading to economic unification in Western Europe, for no such strategy was conceivable that excluded either West Germany or France. On the other hand, the smaller area now covered by the Snake still accounted for over half the foreign trade of the Benelux countries and around a quarter of West Germany's and it was to the advantage of all concerned to eliminate currency uncertainty and to conduct this trade under a regime of stable exchange rates. The German decision to commit the massive intervention potential of the Bundesbank to the defence of the Snake

discouraged speculation and the fact that four of the five partners were of only medium size meant that such intervention as was necessary would put minimal pressure on German reserves. Thus, despite considerable initial variation in inflation rates, the Snake was able to experience a welcome two-and-three-quarter years of internal currency stability, and although seriously tested by the fever that gripped the exchange markets in the spring of 1976, there were no further realignments in central rates until the October of that year. Moreover, the discipline which membership of the Snake entailed led to a progressive narrowing of inflation differentials and to a high degree of economic policy co-ordination between the five. Just as the "Monetarists" had always said it would!

IIb2. The limits of intergovernmentalism: Lessons from the EMU project

There were two main reasons for the failure of the EMU project. The first of these was a matter of timing: The Community had let the 1960s, a decade of prosperity, high economic growth, monetary stability and relatively few economic problems, go by and lost a golden opportunity to make the advances in monetary co-operation which would have been easy to accomplish then and which would have stood it in good stead in later years.[55] With the mentality of "if it works don't tinker with it", the governments of the member states exhibited a monumental lack of foresight and took the Bretton Woods exchange rate system very much for granted, although there had been plenty of warnings about the inherent weaknesses of that system and despite the fact that these started to show themselves in reality from the middle of the decade onwards. It was only when monetary instability began to affect the internal operations of the EEC itself that national governments felt the need to do something about it, but even then they continued to make the same mistake of not paying full attention to monetary developments elsewhere, over which the Community had little or no control. The EMU project was designed against the background of an imaginary world which did not have much to do with reality and was poorly equipped, in terms of political will or economic provision, to deal with the eruption of the speculative crises of the early 1970s and, finally, the collapse of Bretton Woods itself in 1973.

The second and most important cause of failure was the fact that national governments failed to live up to the spirit of the Hague summit and exhibited a singular lack of political will to put the demands of EMU before what they saw as their short-term national interests. In fact, soon after Hague it became obvious that the commitment to establish an EMU in the Community had been

made without any precise understanding of the task that was being undertaken. "At government level, there was no analysis, even approximate, of the conditions to be fulfilled. It was as if the governments had undertaken the enterprise in the naive belief that it was sufficient to decree the formation of an EMU for this to come about at the end of a few years, without great effort nor difficult and painful economic and political transformation".[56] As the full implications of EMU started to emerge in more detail however, national governments began to realise that, although monetary unification was probably a goal worth pursuing as a long term welfare objective, its practical implementation implied severe limitations for their own independence of action in the short run and might consequently prove disastrous for their chances of re-election. Indeed, the lack of enthusiasm with which some national governments approached the EMU project can be at least partly explained by the fact that in the short and medium term, which is the timespan of concern to most political authorities, monetary integration may well have appeared in a negative light, for whereas the costs of EMU tend to be visible (in terms, say, of higher unemployment or the inability to pursue an independent monetary policy) and concentrated on specific economic sectors and geographical regions, the expected benefits out of greater efficiency and better utilisation of the factors of production are less obvious, diffuse and tend to be found in the longer term. The result of this was that, whatever the commitments undertaken at the Hague, most national governments were naturally reluctant to apply measures of policy co-ordination which would affect adversely the domestic economic and political scene and EMU was given a low priority rating throughout. "Quite simply, the Nine would not accept constraints on their conduct of economic affairs. It was this lack of the political will to put economic and monetary unification ahead of short-term national interest that in the last analysis doomed the initiatives aimed at fostering economic policy co-ordination to failure".[57]

This, of course, is not to say that the EMU project failed simply because national governments tended to equate the national interest with their chances of re-election. For a start, there were instances when the nations of Europe were confronted with extraordinary circumstances and great uncertainty about the future (as, for example, at the on-set of the oil crisis) and in such times it can be credibly argued that national governments acted very much within the responsibilities entrusted to them by the electorate in concentrating on the short term and in trying to maximise freedom of action, even at some cost to a less immediate "European" ideal. But more significantly, the fact is that there were objective differences between the member states of the European Community which had to do with such things as the modernity of the domestic economy, the development and dynamism of the financial sector, the health of the balance of payments, the economic and political muscle of trade unions, the existence or not of regional disparities and so on. These factors created *real* differences between the interests of the various member states and the interpretation of these by national governments did not, on the whole, tend to diverge greatly from the general public opinion in the countries concerned. It was these differences of national interests between the member states and their independent pursuit by national authorities that was incompatible with the discipline of the EMU project and was thus partly responsible for its abandonment in early 1974.

The different priority ratings assigned by Bonn and Paris to the defeat of inflation as compared with the pursuit of full employment serves to highlight the point: In West Germany, experience of hyperinflation in the interwar period and in the years immediately following the second World War and the attendant economic, political and social upheavals left a deep influence on national values and generated an almost obsessive aversion to inflation, with the result that price stability became an overriding economic objective of the German authorities. France, on the

other hand, had a different historical experience of inflation, having learnt over the best part of a century to tolerate (and sometimes even to utilise for political aims) a fairly high level of price increases. French public opinion, and thus French politicians, have instead been historically more sensitive to the maintenance of full employment and it was the achievement of that objective that loomed larger in the eyes of the government in Paris. To supplement these differences, there were a number of structural factors which also help to explain the different priorities of the two governments. Between 1968 and 1973, the French supply of labour increased by about 1% a year as a consequence of a birth boom in the early post-war period, an increase in the number of women seeking employment and a sectoral migration of about 4% of the agricultural workforce leaving the land. To maintain full employment required the creation of some 400,000 new jobs each year and this, of course, was bound to affect national economic priorities. By contrast, in Germany there was no significant sectoral migration from the land and the domestic supply of labour remained essentially static, with a modest increase in the working population being largely offset by longer education and earlier retirement.[58]

On top of economics, there were also other factors which had an important influence on the outlook of national governments, which were of a political or psychological nature. The reality of the nation state is a lot more recent in countries like Italy, West Germany and Belgium than in, say, Great Britain or France, while war, defeat and occupation had discredited that reality in the eyes of the Italians or the Germans in a way that it never did for the British who thought that, on the whole, the nation state had served them rather well. Similarly, whether seen in terms of economics or national security, the geographical location and the smallness of such countries as Belgium, the Netherlands or Luxembourg made them feel that their own future lay less in separate national development and more in the emergence of a united Europe and thus, in

common with the Germans and the Italians, these nations were more prepared to accept the diminution of the nation state and the transfer of authority to European, supranational institutions than the British or the French who tended to see the future of Europe more in terms of co-operation between sovereign states. Finally, the perceptions of the other two countries of the European Community were coloured by their own historical, economic and cultural characteristics, Ireland influenced by the tight economic link and the love-hate relationship with Great Britain and Denmark by its sense of kinship with its Scandinavian neighbours to the north.

Another important factor which affected the outlook of national governments on the whole question of EMU was their attitude towards, and their economic or military dependence on the US. The creation of a powerful regional monetary bloc in Europe to supplement the EEC's current standing as the world's major trading force and the eventual development of a common European currency were likely to present a serious challenge to the dollar's dominant position in the international economy and the US could hardly be expected to view favourably steps leading in that direction. Even before the Community embarked on the EMU project in 1969, the American government had used political pressure to pursue its monetary objectives, chiefly the threat to withdraw American troops from Europe. Although this was an issue which, in various degrees, influenced all European governments, it was particularly important for West Germany. The West German authorities fought an annual diplomatic battle with Washington on the contribution to be made towards the maintenance of US troops stationed in the country and Bonn was conspicuously reluctant to take too prominent a role in any monetary initiative which was likely to upset the US.[59] Thus, the West Germans took a more "Atlantic" view of international monetary relations and were distinctly uncomfortable about notions of developing a "European monetary personality" which would be seen as a direct challenge to American

hegemony, whereas at the other extreme, France, with a very different perception of the external aspects and objectives of EMU and nowhere as dependent on the US for its defence, promoted the idea at least in part for that very reason.

In the light of these differences in national characteristics and economic and political priorities between the member states, both plans put forward in 1970 for the realisation of EMU appear understandable and consistent and both made a reasonable job of expressing the interests of the countries where they had originated in a way which would also genuinely promote the cause of European integration, though what would promote that cause was seen to be different in each case. Thus, the fact that the Schiller plan left a reduction in the margins of fluctuation and any thoughts about the introduction of a European reserve currency for the later stages of EMU reflected West Germany's "Atlantic" viewpoint and its pro-free market economic philosophy, but earned its "European" spurs through its advocacy of extensive measures of policy co-ordination, which would put these monetary undertakings on secure economic ground, and through far reaching proposals on institutional reform which was necessary if the EMU project was ever to succeed and which would transform the political face of Europe in a distinct and irreversible way.

Given its view of a Europe consisting of sovereign nations, France was, of course, always likely to reject these supranational elements in the Schiller plan. With a long tradition of central government intervention in the economy and a more Eurocentric tilt in its international financial diplomacy, it stuck out instead for an early introduction of monetary measures and the creation of a common European currency which would serve as an alternative to the dollar. Yet, despite its final rejection of supranationalism, France's position was no less "European" than that of

West Germany. *There is* a powerful argument in favour of a common European currency in political, symbolic and psychological, let alone economic, terms. Moreover, France's support of the monetary aspects of the Barre plan was, in its essence, based on the logic of neo-functionalism on which the Community had built most of its successes so far.[60] To maintain "Monetarist" currency stability, the member states would also have to accept a large measure of "Economist" policy co-ordination and so, by committing itself to the tangible reality of the Snake, the EEC would become the more homogenous economic and political entity required for the success of the EMU project.

Similar clashes between national perceptions and interests and between two quite distinct but valid versions of "Europeanism" dogged the history of the EMU project throughout. The differences of opinion on such issues as reserve pooling and the provision of financial assistance to members facing balance of payments difficulties demonstrate much the same pattern. France, which faced regular deficits and which expected to benefit from easy access to Community funding was bound to have a different view of these schemes from West Germany which had a strong payments position and owned close to half the EEC's total of foreign reserves. Yet, looking at it from a "European" viewpoint, France was just as justified in claiming that EMU would, in the short run, aggravate external difficulties and that it made economic and political sense for the Community to be ready to help with these, as West Germany was in arguing that provision of funds on an unconditional basis would encourage financial irresponsibility and could end up raising the average level of inflation in Europe.

In order to reconcile these contradictions, the European Community adopted, as we have seen, the strategy of "parallelism". Though often derided in the literature and, at the time, by the press, parallelism was not a bad strategy for the achievement of EMU. *There is* both an

economic and a monetary aspect in EMU and the fact that both the "Economist" and the "Monetarist" plans made sense only reflected the reality that, far from been mutually exclusive, these two aspects are interdependent and tend to reinforce one another.[61] It was the *kind* of parallelism adopted by the Community which proved to be totally inadequate for the achievement of EMU, for this was a compromise based on the lowest common denominator, born out of the need to rescue something out of the grand declarations of the Hague summit. The crucial defect of this compromise was its refusal to acknowledge the full implications of EMU even as these started to become apparent and, in particular, the connection between EMU and political union. It was clearly impossible to achieve the aims of EMU and to place the economic and monetary affairs of Europe under the control of common institutions (whether of a supranational or an intergovernmental nature) without affecting in all kinds of ways the life of the ordinary European. And it would be totally fallacious to imagine that such a dramatic transformation in the economic field could ever be accomplished without serious consequences for the political profile of Europe. Both the Schiller plan and the Werner report were well aware of this: "Economic and monetary union thus appears as a leaven for the development of political union, which in the long run it cannot do without".[62] Yet, in the ECOFIN meeting of 14-15 December 1970 in Brussels, France stood resolutely against the political vision that was an inseparable part of EMU and thus, in essence, aborted the EMU project a good three months before it was born. Parallelism, without a clearly defined political destination, turned from springboard to vice. Not for the first or the last time in its short history, the Community had decided to play ostrich.

Since national interests had such a crucial influence in the development of the EMU project, it follows that a policy-oriented study of European monetary integration must give careful

consideration to the factors which determine the national interest in the member states of the European Community. Who decides what the national interest is and how does it change? A comprehensive answer to this question would, of course, require an exhaustive examination of the historical, economic, political, social and cultural background against which national policy is formulated and of the interrelationships of policy in the economic and monetary field with those in others, an examination which is far beyond the scope of the present study. As a sufficient approximation for our purposes though, it seems that part of the answer to this question lies, as we have seen, in the particular objective characteristics of each member country. However, this is only *part* of the answer. For, history shows that what proved decisive at crucial moments of the unification process in the EEC was not so much an objective and general notion of the national interest, but rather the *subjective* perception of it by the government of the day or by the politically dominant elements in it. This distinction may at first appear commonsensical or even pedantic, but a clear understanding of its implications has major consequences for the choice of a monetary unification strategy for Europe.[63] It means that relatively small shifts of public opinion in the member states that lead to changes in government, minor changes of political influence within the *same* government or government coalition, changes in the particular positions occupied by specific political personalities and even coincidence can play a decisive role in advancing or blocking the course of monetary integration in the European Community, and no unification strategy will be successful which would not find a way to deal with, or completely avoid, the extra difficulties created by this reality.

Let us look at a few examples: In September 1969, the West German federal election brought to power a new SPD/FDP government led by a charismatic former mayor of West Berlin, Willy Brandt, with a slightly different view of West Germany's relationship with Europe and the US

and with a need for a successful initiative in the EEC to balance its Ostpolitik. The two parties which made the new government *had not* won the election! In fact, their combined vote had fallen slightly and the centre-right CDU/CSU not only was the biggest party in the new Bundestag but had come within 0.7% of obtaining an overall majority on its own![64] Yet, it was Willy Brandt who became Federal Chancellor, thanks to the personal preference of Walter Scheel, the FDP leader, for the SPD as coalition partner and an earlier agreement behind the scenes to drop plans for electoral reform which would have effectively finished off the FDP.[65] The new government quickly revalued the DM (which the CDU, drawing its support from a different political constituency, had been reluctant to do),[66] thus relieving the speculative pressure on the DM/FF cross-parity and, three months later, in the Hague, Brandt together with the French President Georges Pompidou put the EMU project in motion. In the French parliamentary election of 11 March 1973, an unfavourable result for the ruling coalition made the President's majority dependent on support from Valery Giscard d' Estaing's Independent Republicans. That very night, France reversed its previous policy and decided to participate in the European joint float. A similar negative verdict for the government in the March 1976 county elections led, as we will see, to the opposite result, with Giscard, now President of the French Republic, deciding to take the franc for the second time out of the Snake. In two of these instances the cause of European monetary integration was boosted, in one it was held back. Yet, in neither was the *national* interest of France or West Germany greatly different after the relevant election to what it had been immediately before it.

The influence of political personalities in the formation of the "national" interest is even more pronounced. Strong political leaders sometimes imprint their own political philosophies, dogmas, whims and prejudices on the outlook of their nations in a way that can outlast their

period of office and which defies explanation through mere analyses of the economic and social characteristics of the country concerned. General De Gaulle's highly personal view of Europe, the world and France's destined role in them and his impact on the monetary and other affairs of the Community cannot be adequately explained by an examination of the fundamental characteristics of France's economy and society (any more than Mrs. Thatcher's vehement opposition to monetary union could be adequately explained by the fundamentals of the UK two decades later). The French gold war against the US after February 1965 and the vetoing of the second British application for EEC membership in November 1967 probably had a greater part of their explanation in the psychological make up of the General himself and his deep sense of pride in his country and in his own person, which had been hurt by being treated as less than an equal by the American President and the British Prime Minister during the War, than in any objective appraisal of France's national interest or the weak state of sterling.[67] Certainly, French interests did not suddenly change in such a dramatic fashion as to justify the complete reversal of policy that took place in 1965-6, from support for CRU at the world level and for monetary integration and a common currency in Europe to the advocacy of a return to the gold standard and the outright rejection of all "European" monetary ventures. What had changed was that the Gaullist element within the governing coalition had won the political argument in the cabinet and Michel Debre was now Minister of Economics and Finance in place of Valery Giscard d' Estaing.

A re-run of this internal power struggle within the French government only a few years later turned out to have serious consequences for the EMU project. In October 1970, the Werner Committee presented its report for the creation of EMU in the European Community. France's man in the Werner group had been the deputy-Governor of the Banque de France and Chairman

of the EEC's Monetary Committee M. Bernard Clappier, himself not an "orthodox" Gaullist and thus not representative of the views of the dominant political element in the country. The supranational proposals of the report enraged the Gaullist hard-liners and battle was joined again within the cabinet. The argument, the battlelines and even the main protagonists were the same as in 1965-6. So was the balance of political forces and the result.[68] Giscard lost again. Paris announced that M. Clappier had participated in the Werner group on a strictly private basis and that his presence did not in any way commit the French government to the recommendations of the report. Alone among the member states, France decided to oppose the political aspects of EMU. Even though the General was now dead, his shadow still fell heavy on efforts to achieve the unification of Europe.

Personal relations also affected the development of monetary integration in Europe in other important ways. The personal friendship which grew between the Finance Ministers of France and the Federal Republic, Valery Giscard d' Estaing and Helmut Schmidt (in place of the rather cool relation which existed between the French Minister and Schmidt's predecessor, Karl Schiller) helped to push through the European joint float in March 1973, eased the return of the franc to the Snake in July 1975 (by which time Giscard and Schmidt had both become the leaders of their respective countries) and was the decisive factor behind the establishment of the European Monetary System (EMS) in 1978. But, the development of personal links was also important (as a long term influence in fact *more* important) at a lower level. Probably the most invaluable and lasting achievement of the EMU project and the Snake was the development of an institutional framework, within which officials from the member states came together, got to know one another and one another's way of thinking and learnt to exchange experiences and ideas and to discuss problems at a Community, rather than a purely national level. Though the

precise significance of the personal links created in this way is hard to quantify, the ability to discuss informally mutual concerns and the development of a sense of shared interest across national bureaucracies has been and will continue to be an important influence in favour of increased co-operation in the European Community, both in the monetary and in other fields.

Finally, there was one other factor which affected the course of monetary unification in Europe: Chance. On the night of 11-12 March 1973, the Community faced a historic opportunity to make the decisive breakthrough for the EMU project which had eluded it so far, through a package deal which included the reintegration of the lira in the Snake, the establishment of a monetary co-operation fund equipped with some 20% of the total foreign reserves of the EEC and generous provisions for support to those member states facing balance of payments difficulties. Italy turned down the deal. For only a short interval which happened to coincide with this period of momentous developments in the international monetary system, the Italian delegation was not led by the familiar face of Emilio Colombo who would have certainly realised the enormous political significance of the offer. Instead, his successor at the Italian Treasury, Giovanni Malagodi, decided to follow the advice of the vastly more experienced Governor of the Banca d' Italia Guido Carli whose central banker's priority was to preserve the freedom to float the lira. The failure of the meeting of 11-12 March 1973 was the moment of truth for the European Community. That the EMU project was in trouble had been obvious since the ECOFIN meeting of December 1970 when France refused to accept the political and institutional implications of the project, and thus reduced it to a technical mechanism for exchange rate concertation. But, although it lowered expectations and the tone of the debate, that decision concerned, after all, developments in a far off and still hazy later stage of the EMU project and could, conceivably, have been changed when the Community reached there. March

12, 1973, was not at all like that. Here the opportunity was missed to reintegrate the currencies of all the EEC founding members into the Snake and to establish a Regional Fund and a strong and vital FECOM which would have probably altered the reactions of the member states to the energy crisis, upgraded the "European" element in national policy determination and contributed towards the development of a common external monetary policy at the union level such as the Community never in fact established. The aftermath of 11-12 March 1973 showed in practical terms that, when the chips were down, the member states still considered themselves as separate entities and that the grand vision of a unified Europe implied in the Werner report was a long way off.

The history of the EMU project is marked throughout with such examples of instances where crucial matters were decided by factors which had very little to do with any objective calculation of the national interests involved. How significant was the impact of these factors in reality? Would the course of monetary integration in Europe have been substantially different had the OAS assassins succeeded in their aim of murdering General de Gaulle in August 1962? Or had Emilio Colombo been present in his usual place at the helm of Italian financial policy in March 1973? Though the answers to any of these questions would necessarily involve a great deal of speculation, by any reasonable criteria they would be affirmative answers. Yet, although these factors are sometimes mentioned in the literature they are rarely, if ever, given their due attention for the simple reason that they are hard to quantify and to include in theoretical models. Neither economic nor political theory seem to be adequately equipped to deal with the unexpected, the one-off and the irrational which seem to play such an important role in world monetary affairs. Economic analysis has to rely on a *ceteris paribus* assumption which seldom obtains in reality and which becomes totally nonsensical in the study of international monetary

relations. Similarly, neither economic nor political determinism can adequately explain the course of EMU in Europe and none of the major schools of political analysis, whether federalism, neo-functionalism or power politics, seems able to anticipate or describe it, let alone to prescribe a successful strategy for its achievement.[69] Indeed, just about the only theory that seems to fit the reality of monetary integration as it has developed in the European Community is a combination of cock-up theory and Murphy's law: Any cock-up that can happen *will* happen!

A proper appreciation of the manifold practical complications revealed by the experience of the EMU project has important consequences for the choice of a strategy for the achievement of monetary unification in Western Europe. In particular, it would seem to suggest that the co-ordination approach adopted by the EEC has been a highly inappropriate one and that its ability to produce quick results is very doubtful indeed. Throughout the history of EMU in the European Community, from the Commission's Action Program of 1962 to the Werner report and the EMU project and through the EMS to the Delors proposals of 1989, the strategy of co-ordination has been the official approach of the Community to the issue of monetary integration (though, as will we see, the Commission did present an alternative plan for the possible creation of a parallel currency in 1975). According to this, the progressive narrowing of margins of fluctuation between the currencies of the member states, backed by increased co-ordination of their economic and monetary policies, would lead to the establishment of permanently fixed exchange rates and the eventual creation of a common European currency. It must be stressed here that this strategy sees the complete elimination of fluctuations between national monies as an indispensable *precondition* for the establishment of EMU and a common currency. And yet, the history of European monetary integration would tend to suggest that the path to EMU

recommended by the co-ordination approach is bound to be an impossibly long and arduous one. Even during the quieter times of Bretton Woods, before the explosion of international liquidity and the subsequent general transition to floating, national authorities found it well near impossible to achieve total fixity of exchange rates. The experience of the Snake, on the other hand, shows that, even in those instances when the member states were able to agree on specific targets for policy co-ordination, these targets were rarely achieved in reality and were often ignored, sometimes blatantly so, as in the example of the anti-inflation resolution of December 1972. In the light of these facts, the EEC's insistence on the co-ordination approach to monetary unification would suggest either an extraordinary degree of political masochism on the part of Europe's leaders or that, public declarations of intent notwithstanding, member governments have never to date been ready to subject national autonomy to the common interest to the degree required for the achievement of EMU - which is to say that the pursuit of EMU has so far been a false issue.

In his study of the politics and economics of European monetary integration, Loukas Tsoukalis argued that EMU is not a good candidate for the application of the neo-functional strategy of European integration.[70] The management of monetary policy is a highly political issue which national governments cannot possibly leave to bureaucrats. Assuming that EMU is (or becomes) an important objective, however, what history also amply demonstrates is that in fact *money is too political to be left to politicians*! It is a central contention of this study that a strategy for monetary unification which depends on intergovernmental co-operation and the co-ordination of economic policies has only a limited scope for success. It may produce a system which maintains relative stability of exchange rates and an increase in the level of consultations and policy co-ordination, as the Snake and, even more, the EMS managed to achieve. It is

unlikely, however, to lead quickly to the establishment of full monetary union and to a fully functional common currency which would become accepted by a wider constituency than the trading and financial communities and the multinational enterprise and which would become a potent symbol of European unity. National interests, short-term political advantage, personalities, electoral calendars and pure chance are likely, if historical experience is anything to go by, at some stage to intervene and to militate against decisive progress.

This, of course, does not mean that the process of monetary unification in Europe must be totally separated from political and economic developments at the national level. Indeed, such a separation, even if it were possible would be hardly desirable. Monetary integration, after all, is not an end in itself but a means to an end, that of increasing economic efficiency in Europe and improving the lives of ordinary Europeans, as well as creating in the process a new political entity they could be proud of. On the other hand, practical experience suggests that, for a system of monetary integration to succeed, it must be free from daily interference by national influences which may have very little to do with the objective of EMU. A careful balance must be struck and it is a balance which, this study claims, is best served by the creation of an "automatic" system which, though dependent itself for its creation on a monumental initial act of political will and ultimately subject, thereafter, to political control in the important aspects of its development, would at the same time not be continuously affected by relatively trivial national events and the everyday ups and downs in the political fortunes of personalities and national governments. Such a system would enable monetary policy to be run at the union level on technocratic criteria which would aim to take into account the longer term interests of Europe as well as more immediate economic needs and would denationalise and depoliticise money by taking control of Europe's monetary affairs out of the hands of national governments (thus

precluding the possibility of manipulation for short term political advantage) and ascribing it instead to a politically independent or semi-independent monetary authority similar to those found in the US or West Germany, that would operate according to a fixed, legally defined and widely understood and agreed policy objective, such as the preservation of the real value of the currency. The best way to establish an "automatic" system of this kind would be through the creation of a European parallel currency. As the shortcomings of intergovernmentalism and the co-ordination approach to EMU began to become evident in the early 1970s, there were numerous proposals for the creation of such a currency and we will examine these below. First though, we will turn to look briefly at the international environment within which the Snake operated and these proposals were formulated and particularly the negotiations on world monetary reform.

IIb3. World monetary reform

The severe crisis of confidence which afflicted the international monetary system at the beginning of the 1970s and the unrest in the currency markets which culminated in the unilateral US decision to end the convertibility of the dollar soon led to calls for a comprehensive reform of the system to take into account the latest developments and to restore order in the international economy. To undertake this task, the IMF announced, on 26 June 1972, the formation of a Committee of the Board of Governors on Reform of the International Monetary System and Related Issues, better known as the Committee of Twenty (C-20), whose job over the next two years would be to examine such issues as the adjustment mechanism, international reserves, the nature of the exchange rate system and the role of gold in the new international monetary system.[71] The Committee, formally approved by a postal ballot of the members of the IMF in July, was to operate on two levels: The ministerial, where ultimate political responsibility lay, headed by Ali Wardhana, Finance Minister of Indonesia, and the technical, in the form of a committee of deputies, where the real detailed negotiations would take place, headed by Jeremy Morse of the Bank of England. Although the avowed aim of the exercise was the restoration of a system of "stable but adjustable par values", the work of the Committee was from the outset overtaken by events and the first meeting of the C-20 at ministerial level, on 26-27 March 1973 in Washington D.C., took place in the shadow of the general transition to floating already agreed ten days earlier, in the Paris meeting of the enlarged G-10 on 16 March. Straight from the beginning also, it became obvious that there existed a wide difference in what the main groups of participants saw as the basic objectives of reform, so that what may have appeared desirable to some of them was anathema to others and vice versa.

On the one hand, the Americans, believing that the cause of the chronic US deficit was other nations' wish to run surpluses, wanted first and foremost to achieve greater symmetry between the adjustment obligations of surplus and deficit countries. In order to do so, they wanted to establish a system of reserve indicators which would force surplus countries to take their share in any corrective action that was necessary and thus spread more equitably the burden of adjustment, which under Bretton Woods weighed more against deficit countries.[72] The Europeans and Japanese, on the other hand, believed that the root cause of the American deficit was the financial irresponsibility of the US aided by the reserve status of the dollar and so wanted to achieve greater symmetry of responsibility between the reserve centre and other nations. The US, they thought, would not be willing to continue to amass external deficits if it had to finance them with real (that is convertible) assets. Moreover, to move towards a system of more equitable adjustment obligations while the dollar remained inconvertible would downgrade the system to the level of the least responsible of its members and ratchet up the world level of inflation. Led by the French, therefore, the Europeans and Japanese pressed for a return to the convertibility of the dollar. Finally, the developing countries wanted any reform of the monetary system to be linked with action on the development front.[73] With such wide differences in basic objectives, it was no surprise that the proceedings of the C-20 quickly became deadlocked, though it should be also pointed out that the work of the Committee was complicated by a number of other, external factors, quite beyond its control or negotiating mandate: First, the oil crisis of late 1973 produced a retreat to economic nationalism which was quite detrimental to the chances of successful reform on a world basis. Faced with a future in which the only certainties were the prospects of balance of payments difficulties and of a deep economic recession, governments became naturally and quickly unwilling to surrender even

small parts of their national autonomy on the altar of world monetary reform, preferring instead to cling to their own best understanding and methods of running their economies. Similarly, the explosion in international liquidity and the wild gyrations of the currency markets in 1972-3 precluded the return to an official system of fixed parities for practical reasons. So, though some compromises were achieved and the Committee was able to present a Reform Outline at its final meeting on 10-11 June 1974, in Washington D.C., including a number of immediate steps, many of the fundamental issues remained unresolved and the Reform Outline could do no more than to try to encompass the various viewpoints in a series of appendices which listed the available options. The future course of world monetary developments was no longer in the hands of the reform negotiators. In the words of Sir Jeremy Morse: "The evolving monetary system will be the child of the reform discussion and of events; which parent will be dominant, time alone will show".[74]

Events it was. As recommended by the C-20, the IMF established, on 3 October 1974, an Interim Committee, chaired by the Finance Minister of Canada, Mr. John Turner, whose task would be to prepare a second amendment to the IMF's Articles of Agreement to take account of the conclusions reached during the reform negotiations. But, by May 1974, two new protagonists had already entered the world monetary debate: On the American side, William Simon, President Nixon's former Energy Secretary, was appointed to succeed George Shultz at the Treasury. On the European side, Jean-Pierre Fourcade took over as Economics and Finance Minister in the new French government formed by the leader of the neo-Gaullist party, Jacques Chirac, after the May presidential election and the elevation of Valery Giscard d' Estaing to the Elysee. Simon was a firm believer in the workings of the free market and the adjustment process and was thus in favour of flexible exchange rates. Fourcade, on the other hand, as befit

a French Minister of Finance and a close supporter of the new President at that, was equally firmly opposed to them. That neither was in the end triumphant was partly a matter of politics, but probably more due to the fact that current developments in the exchange markets were not being kind to either of them. Belief in the long term wisdom of the market and the equilibrating influence of flexible exchange rates was shaken by the wild short term exaggerations experienced in the period after the transition to floating: In the two years to the autumn of 1974, the rate of the dollar relative to the DM first fell by 31%, then rose by 30%, then fell by 17%, rose by 12% and fell again by 10%. Such movements in relative exchange rates could in no way be said to reflect economic fundamentals and did not conform with the theory of flexible currencies, which were supposed to provide independence for domestic monetary policy coupled with smooth adjustment of the balance of payments. On the contrary, these were fluctuations which were highly destructive for international trade and investment and which could not possibly be ignored by any government with a sizeable foreign sector. Similarly though, these very same fluctuations did not give much comfort to the advocates of a return to a world regime based on fixed parities. For, the fact was that a considerable part of this unrest had taken place under fixed, not flexible exchange rates and that fluctuations *did* seem to become smaller with time after the restrictive lid of Bretton Woods had been removed. Moreover, the expenditure of more than $100 billion in central bank intervention from the general transition to floating in March 1973 to the spring of 1975 had not managed to counteract to any great extent the successive waves of speculation and the gyrations of the currency markets and thus made a return to a system of fixed parities highly dubious. Indeed, in January 1974, France herself had been forced by intense speculation to join the enemy camp and float the franc for a temporary period.

Similar differences existed between American and European attitudes with regard to the role of gold in the new international monetary system.[75] At the beginning of 1974, central bank gold was still valued at $42.22 per ounce troy, the official price since February 1973, at a time when the price in the open market had exceeded $130. Faced with the prospect, or the reality, of serious balance of payments difficulties as a result of the oil crisis, some European countries with sizeable gold holdings, such as Italy, Belgium and France,[76] thus began to look to their hidden and grossly undervalued gold treasure as a possible solution to their problems. Prompted by Italian Treasury Minister Emilio Colombo, ECOFIN decided, at its meeting in Zeist, Netherlands, on 22-23 April 1974, to press for the remobilization of official gold reserves and asked for the official price of gold to be abolished and for central banks to be permitted to engage in gold transactions with each other and possibly with the private sector.

Such proposals met with a very mixed reaction in the US, for although the Americans were anxious to see gold dethroned from its special position in the world monetary system, and thus were all in favour of abolishing the official price, they strongly disliked the idea of central bank transactions in gold, which effectively remonetized the yellow metal. Though international monetary etiquette meant that they were never openly accused of it, and though it was certainly never openly admitted, the position of the US authorities throughout this period was crystal clear: The world was on an effective dollar standard, this suited the US fine, and nothing would be allowed to change the situation. This view, and this view alone, can adequately explain the totality of the attitudes displayed by the US, often in a minority of one, during the reform negotiations in the C-20 and after. It explains the US' reluctance to accept a system of asset settlement and a return to the convertibility of the dollar. It explains the US' objections to the dollar substitution account proposed in the C-20 by the Italian deputies Rinaldo Ossola and

Silvano Palumbo in 1973.[77] It explains the US' coolness toward the SDR, for which American officials who ought to know cannot find any alternative justification.[78] And, of course, it explains the US' hostility to gold. The remonetization of gold or any upgrading in the role of the SDR threatened the long-term predominance of the dollar as the world's reserve asset and quite simply had to be fought. This is why, throughout the reform negotiations, the US insisted on low, unattractive rates of interest for the SDR and why it firmly opposed the "SDR-Link" requested by the developing countries, but later supported a Trust Fund financed out of the sale of the IMF's gold stock, which aimed to fill precisely the same gap. The US was not opposed in principle to linking reform with the provision of funds for development aid. But, whereas the Link raised the importance of the SDR and thus indirectly decreased that of the dollar, the Trust Fund reduced the status of gold and raised that of the dollar.

By the end of 1974, some degree of convergence had begun to emerge between the antithetical European and US attitudes to gold. The official position was now, on both sides, that gold should be no longer part of the IMF's settlement arrangements and that the SDR should be further developed instead, to become the world's main reserve asset. And yet, behind the accepted term of *banalization* of gold (a term conveniently coined by Finance Minister Fourcade, leading the European camp, to describe this process) lay two widely differing conceptions of the future of the international monetary system: Treasury Secretary Simon saw in it the effective *demonetization* of gold and the consolidation of the dollar's dominant position in the world economy. (In the 1974 annual meeting of the IMF, Simon described the SDR as a unit of account not a reserve asset). Finance Minister Fourcade, on the other hand, saw the abolition of the special status of gold to mean precisely the opposite, that gold could now be treated like any other monetary asset, valued at market prices, that is he saw in it the effective

remonetization of gold. Indeed, following an agreement reached in late 1974 between Presidents Ford and Giscard d' Estaing in Martinique, France did revalue its gold stock on 7 January 1975, at a price of $170.40 per ounce troy, lower than the current market price of almost $200, though other governments chose not to follow for the time being.

There remained the problem of what to do with the gold held by the IMF in partial fulfilment of quotas by the member states. The US took the view that this gold was the legal property of the Fund and proposed the setting up of a Trust Fund to sell it off for the benefit of the poorer developing countries. So as to give further impetus to the process of demonetization, the Americans also announced that they would hold a series of periodic auctions to sell part of the gold reserves held by the US Treasury.[79] The French on the other hand, anxious about the depressing effect that these sales would have on the price of gold, argued that the IMF's gold stock legally belonged to the individual member states and wanted it to be "restituted" to them at the original price. In the end, a compromise was found in the form of a proposal put forward by the Managing Director of the IMF, Johannes Witteveen, in June 1975, approved by the Interim Committee at its meeting on 31 August 1975, in Washington D.C. According to this, gold would be eliminated from the IMF system and the official price abolished. One-sixth of the gold held by the IMF (25 million ounces) would be sold off at market related prices and the surplus raised be given to the poorest member states in development aid.[80] Another sixth would be restituted to its former owners, while the use of the remaining two-thirds would be left to be determined at a later date by a qualified 85% majority of the voting membership of the IMF.[81] Finally, it was agreed that the central banks would not act so as to increase their combined gold holdings for a period of two years (a limitation which some central banks, notably of Switzerland and France, decided to circumvent by buying IMF gold indirectly through the BIS).

Although this agreement contained a great deal of ambiguity and left many of the basic issues unresolved, it did meet the prime motivation behind it and managed to avoid a direct confrontation between the US and France over gold, for it contained elements on which each side could focus, so as to present the outcome as a victory to its domestic constituents. This strategy, however, though ultimately successful, did not prove to be without some political cost and the agreement did not pass totally unchallenged. In the US Congress there was severe opposition to it, as the feeling grew on both sides of the Atlantic that the US had been duped on the gold issue.[82] After having fought for well over a decade against a doubling of the official price to $70, as demanded by Jacques Rueff, the US had now conceded freedom for central banks to engage, at the end of two years, in gold transactions with each other and with the market at over *treble* the original price. Far from treating gold just like any other commodity, the compromise reached between the US and France mobilised the gold which had long laid unused in the vaults of central banks and governments were able to secure large loans to finance balance of payments deficits, using the increased market value of their gold reserves as collateral.[83] Still, despite what was widely seen as a tactical victory, there was also opposition to the agreement in France, not only from the Socialist and Communist parties, but also from the neo-Gaullist RPR, even though its leader, Jacques Chirac, had been France's Prime Minister at the time of the agreement. Although much of this seems to have been based on political and personality grounds,[84] the arithmetic within the French assembly was such that the government was forced to postpone ratification proceedings, so that even when the revised articles of the IMF finally came into force on 1 April 1978, they were still awaiting parliamentary confirmation by the French.

In the meanwhile, there were new developments on the exchange rate front. By the autumn of 1975, the initial enthusiasm with flexible exchange rates had been moderated by experience, international trade had sunk to its lowest level since the War and the suspicion had steadily grown that floating currencies were somehow responsible for making the recession longer and deeper than it need have been. By contrast, in Europe, the Snake was completing its second remarkable year of internal currency stability and France was once more inside it and preaching the fixed currency gospel. With the IMF conference on world monetary reform scheduled for the beginning of 1976, the stage was now set for a compromise and it was not long in coming. On 15-17 November 1975, the heads of state and/or government of the IMF's big five, Gerald Ford, Takeo Miki, Helmut Schmidt, Harold Wilson and Valery Giscard d' Estaing, plus Aldo Moro of Italy, invited in his capacity as the current President of the European Council, met at Rambouillet Castle, 30 miles southwest of Paris, and agreed that there was a direct connection between stability in domestic economic conditions and order in the currency markets. They pledged to work for greater stability and to counteract disorderly and erratic fluctuations in exchange rates, although they considered that current circumstances did not permit a return to a system of fixed parities and that the best that could be achieved in the foreseeable future was a degree of "viscosity", as opposed to fluidity, in exchange rate movements. In contrast to the gold issue, the US had won this one!

The agreement reached at Rambouillet settled the only outstanding dispute of any real significance between the US and France and cleared the way for the official adoption of the 2nd amendment to the articles of the IMF, which was approved by the Interim Committee at its meeting in Kingston, Jamaica, on 7-8 January 1976 and came into force on 1st April 1978. An adjustment of the member states' quotas as a result of the need to accommodate OPEC, an

increase in the credit facilities available to developing countries with balance of payments problems, as well as an agreement on international surveillance of the member states' economic policies by the IMF to ensure consistency of objectives completed the package. After a long three and a half years of strenuous reform negotiations, the main participants had not only agreed to disagree, but had institutionalised their disagreement in the reformed articles of the IMF. Article IV, as amended, now specified that member states could choose one of three alternative exchange rate arrangements, as they saw fit: They could (i) maintain a value for their currency in terms of the SDR or any other denominator, except gold; (ii) adopt co-operative arrangements to maintain the value of their currencies stable in relation to the currency (or currencies) of other members; or (iii) they could adopt any other arrangement of their choice.[85] In short, they could choose to fix their currencies individually or together, peg them to one single currency or to a basket, float them jointly or individually, or do anything else that they could conceivably think of, as long as it had nothing to do with gold! A return to a system of stable but adjustable exchange rates remained, in theory at least, as a possible aim for the distant future, but a transition to such a system would need a qualified majority of 85% of the voting membership of the IMF (thus ensuring that the US, with over 20% of the votes, would have a veto) and even then, individual member states would be free to opt out of the arrangement if they so wished.

IIb4. Proposals to reform the Snake. The parallel currency approach

The international monetary "non-system" agreed in Jamaica in January 1976 failed to do more than give the seal of official approval to what had already become practice in the world's exchange markets by default. The result of the political inability to establish specific rules of conduct was an "anything goes" kind of international monetary set-up, which emphasised that governments were losing fast the control and the initiative in world monetary affairs to the private operators, at a time when technological change and the emergence of new forms and ways of trading were about to render any attempt at official control more difficult anyway.

Specifically in the context of Europe, the reform exercise failed to resolve or to give any direction in either of the two fundamental problems which faced the Community after the departure of the franc from the Snake in January 1974: The major project which the EEC had adopted to carry forward the process of integration, the EMU project, had stalled and lay virtually abandoned, while the Community was now almost evenly divided between those member states which still participated in the Snake and those which floated their currencies, willingly or unwillingly. This division was more than just a question of different operational rules for the currency markets. For, in order to maintain exchange rate stability within the Snake, the participating countries engaged in a separate process of economic policy determination and co-ordination from which non-members and the Community's institutions were now excluded, with the result that, on such a crucial issue as economic policy, not only was the Community element downgraded, but there was the very real threat that the EEC might develop into two distinct groupings, each moving at its own speed towards different levels of

integration, something which could before long jeopardise the cohesion of the European Community and ultimately its very existence. To bridge this gap, there appeared in the next few years a number of plans and proposals from political, academic and institutional sources, which attempted to analyse the reasons why the EMU project had ended up in stalemate and to suggest ways out of it. None of these were taken up immediately, but the best of them did (and still do) influence the debate on how best to achieve monetary unification in Europe. The majority proposed more or less ambitious solutions within the existing political, economic and institutional framework of the time. Others started from the premise that the politicians' inescapable desire to retain as many levers of policy available for the pursuit of short-term political advantage would render such solutions unworkable and sought a more radical answer, usually involving the concept of currency competition and the establishment of a parallel currency.

On 21 September 1974, the new French Economics and Finance Minister, Jean-Pierre Fourcade, put forward a plan whose main aim was to facilitate a quick return of the franc, and possibly also the lira and the pound sterling, to the Snake.[86] He proposed a concerted float of all EEC currencies, with close links between the Snake and those currencies which were floating independently, backed by an extension of the credit facilities available to countries facing balance of payments difficulties. He suggested the creation of a new unit of account, as well as that, henceforth, intervention margins of +/-2.5% should be maintained between diverging currencies and a weighted average, rather than between the weakest and strongest currencies as was the practice in the Snake. Currencies which found themselves under unbearable strain should be able to withdraw from the system temporarily. Finally, attention should be given to ensure that the exchange rate structure of the Snake did not come under undue pressure because

of monetary developments elsewhere and for that purpose the EEC should aim to maintain a Community level for the dollar, recreating a kind of Smithsonian tunnel. This would be backed by the necessary interventions and co-ordinated action in the Eurodollar market.

The Fourcade plan was afforded a cool reception among the countries participating in the Snake who thought it tailor-made to suit France's needs, while it became immediately obvious that neither Great Britain nor Italy were ready to rejoin even the looser monetary structure proposed by the French Minister. The West Germans, in particular, were predictably unhappy about the implied commitment to buy unspecified amounts of depreciating dollars to maintain a Community level for the American currency (a burden which would have to be born disproportionally by their own central bank) and to pump equivalent amounts of liquidity to the domestic economy. But equally, the members of the Snake demonstrated on this as well as on later occasions, that they were unwilling to loosen in any way the tight discipline of the system, even in order to achieve the return of the floaters to the Snake. The Fourcade proposals were referred for further study and were never followed through, even in the modified form in which they were resubmitted in May 1975, in anticipation of the franc's return to the Snake.[87]

March 1975 saw the publication of a report by a Commission study group on the future of EMU, headed by the former Commissioner for Economic and Monetary Affairs Robert Marjolin. The report took a pessimistic view of the prospects for monetary unification in the near future, concluding that, if anything, the Community was further away from the goal in 1975 than it had been before the adoption of the EMU project in 1969. "The Europe of the Sixties represented a relatively harmonious economic and monetary entity which was undone in the course of recent years; national economic and monetary policies have never in 25 years been more discordant,

more divergent, than they are today."[88] The group detected a backslide to economic nationalism and a tendency to deal with problems through the adoption of purely national solutions, without reference to Europe as an entity. "The diagnosis is at national level; efforts are made at national level. The co-ordination of national policies is a pious wish which is hardly ever achieved in practice."[89] As there existed neither the political will among member governments to realise the grand design envisaged by the Werner Committee nor sufficient understanding of its implications, any progress during the next few years would have to be viewed in terms of small, concrete steps to deal with the macroeconomic and structural problems which faced the Community and endangered its future. The group therefore proposed a number of measures to improve the co-ordination of monetary and balance of payments policies, a system of Community loans, an unemployment benefit scheme and an exchange stabilisation fund, endowed with some $10 billion capital of its own, whose purpose would be to intervene in the foreign exchange markets to counter excessive currency fluctuation (though it was pointed out that no new institution as such would be necessary, as an upgraded FECOM could undertake this task equally well).[90]

On 29 December 1975, the Prime Minister of Belgium, Leo Tindemans, presented his report on European Union, which he had been asked to compile by the Paris summit of December 1974. In this, he put forward the idea of a two-tier Europe as the best way to advance the course of European integration and suggested further development of the Snake as a suitable application of this strategy.[91] The report claimed that it would be unrealistic to expect that, in all projects which the Community might adopt, all stages should be reached by every member state at the same time. Clearly, some countries would be better prepared for the implementation of any given proposal than others and these countries had a duty to forge ahead, while those member

states which had valid reasons not to progress temporarily, or to progress at a slower speed, should be permitted to do so. This, however, did not mean Europe a la carte: Every country would be bound by a collective agreement as to the final objective to be achieved - it would only be the timescale of implementation which varied.[92] A system of aid should be available to countries which were lagging behind, to enable them to catch up. Moreover, in order to avoid any dilution in the cohesion of the Community, all member states should be involved in the decision making process and the development of any given policy, whether they found themselves able to participate immediately or not. Thus, the current practice by which Ministers of Snake countries got together to decide important matters of economic policy to the exclusion of non-members should now be abolished, making the Snake once again truly a Community institution.

Unlike its predecessors, the Tindemans report came from a country which was actively involved in the Snake and so the emphasis on further development of the serpent as the best way to regain integrationist momentum in Europe was perhaps to be expected. What was also to be expected was the cool reaction of other national governments to the proposals. Among non-Snake countries, the general opinion was that the report was politically divisive and dangerous for the future of the Community, and it was argued that the Snake-orientation of the package would threaten to split Europe into a hard-currency and a soft-currency club. At the same time, there was not much interest expressed in the proposals from the countries of the Snake and, like the Fourcade plan before it, the report was soon shelved. Ironically, despite this rejection, the EEC then went on to develop very much in the way the report had forecast, a two-tier structure did emerge, strikingly so in the field of monetary integration, though without the additional provisions and safeguards which Tindemans had originally envisaged!

A very different approach to the problem was proposed in April 1976 by the French economist Serge-Christophe Kolm in the wake of the French, Italian and British monetary crises of early 1976. Kolm suggested that governments should abandon their efforts to maintain stability in terms of *nominal* exchange rates and try instead to keep to a minimum movement in *real* rates (that is exchange rates adjusted for differences in inflation).[93] A "real Snake" of this kind, Kolm thought, would be far more meaningful in the long run for the trading and financial communities and would also be easier to maintain as it would requite substantially lower levels of intervention by monetary authorities. However, everyday economic transactions do still take place in terms of actual, that is nominal, exchange rates and national governments have shown repeatedly that they cannot remain insensitive to drastic movements in these rates. Moreover, such a system as proposed by Kolm would lack the integrationist qualities that the Snake originally and potentially possessed and would forego the very real disciplinary effect which the Snake exerted on the participating countries in the matter of policy co-ordination. On the contrary, the "real Snake" would downgrade the importance of the fight against inflation and would accommodate inflationary expectations into the European monetary scene.

In July 1976, on the assumption by the Dutch of the presidency of the EEC, the Finance Minister of the Netherlands, Willem Duisenberg, presented a plan containing a proposal similar to the guidelines for floating recommended in 1975 by the Board of Governors of the IMF: Countries with floating currencies (individually or as a group as in the Snake) should establish a "target zone" within which they would aim to contain their effective exchange rate. There would be no positive obligation as such to intervene in defence of that zone, but participating governments would undertake to refrain from any action which would tend to move their currency out of or away from the target zone.[94] Such movements would act as an objective

indicator which would trigger a reinforced mechanism of consultations on policy co-ordination among the member states.[95]

The Duisenberg plan had a far more favourable reception among the floating countries than the Tindemans report, for it was seen as a genuine attempt to reduce the distance between those countries and the members of the Snake. It soon became clear, however, that the British at least, who had seen the pound sterling tumble in the course of the year, were unwilling to commit themselves even to the "negative" discipline required by the scheme, while the Bundesbank was firmly opposed to any attempt to fix a target rate for the DM, even in the vague terms suggested by the plan. The proposals were finally shelved during the winter of 1976-77, though some improvements were made in the mechanism for policy co-ordination as a result.

In the meanwhile, at the end of 1974, the Commission had set up a working group under the chairmanship of Sir Donald MacDougal, chief economic adviser to the UK employers' federation, the CBI, to look into the other aspects of EMU beyond policy co-ordination and the management of exchange rates and more specifically into the role of public finance in the process of achieving EMU in the European Community. The MacDougall report, which appeared in April 1977, gave a rather pessimistic appraisal of the prospects for reaching that goal in the near future, concluding that even pre-federal monetary integration would require a European budget equal to around 5-7% of the Community's aggregate GNP to correct the regional and structural imbalances which existed among the member states and which monetary integration would probably exacerbate. This compared with a current EEC budget of some 0.7% of aggregate GNP, three-quarters of which was being spent in agricultural subsidies to rich

farmers rather than on the redistributive measures which would be necessary if EMU was to become economically and politically feasible.[96]

While the MacDougall report took a long-term view of monetary integration in Europe, in February 1978, the Belgian Chairman of the EEC Monetary Committee, Jacques van Ypersele de Strihou, put forward another practical proposal aimed to deal with the existing situation in the Community and to bridge the gap between those countries which floated their currencies independently and the members of the Snake. He suggested that floating currencies be maintained within a target zone estimated in such a way as to initially reflect equally the movements of Snake currencies and of the US dollar. Subsequently, the Snake weighting of the target zone would be progressively increased and that of the dollar reduced, until the currencies in question had been smoothly reintegrated into the Snake.[97] This proposal, though technically sophisticated, did not have time to be properly considered, for it was largely overtaken by the Franco-German initiative which led to the creation of the EMS in December 1978, in the design and launch of which, as we shall see in the next chapter, Jacques van Ypersele was uniquely placed to play a crucial role.

All the proposals mentioned so far share a common view of the way towards EMU in Europe and a common strategy to achieve it: The exchange rates of EEC currencies (in the case of the Kolm plan the real exchange rates) were to be kept within specified margins of fluctuation, which would then be progressively narrowed, leading to the eventual adoption of permanently fixed exchange rates in the Community and possibly to the establishment of a common currency. This process would be backed up by increased co-operation between member states and by the co-ordination of their economic and monetary policies, without which no fixed

exchange rate regime was feasible. In taking this line, these proposals adopted the basic approach to EMU shared in the early 1970s by the EEC governments and by the Werner plan.

This was *not* the only approach however. From the beginning of the decade, there were some analysts who thought that the road to EMU chosen by the member states in 1971 was bound to be an unduly long and arduous one, and that the potential for success of a unification strategy based on the co-ordination of economic policies was doubtful to say the least. Policy co-ordination, to be effective, requires a degree of subjugation of what is seen as the national or short-term political interest to the achievement of common objectives at the union level. Yet, it was to national politics that ambitious politicians turned for their opportunity and their reward and to national remedies they ran when the going got tough, as in the period following the energy crisis of late 1973. Moreover, even in quiet times, the process of national economic policy formulation was and is crucially affected by election schedules and the calculation of short-term political advantage. Under these circumstances, it is the pursuit of the less immediate common objective which becomes subject to the dictates of national political expediency rather than the other way round, and policy co-ordination can disintegrate into a mere exchange of information among the participants. In John Pinder's words, "however genuine the intentions to co-ordinate may be, actions based on national policy instruments are inherently centrifugal in any matter that is important enough to be an issue in national politics".[98]

The answer to these problems would be the creation of a European parallel currency, which would allow the member states, or at least those constituent sectors of their economies which were most directly affected by instability in the exchange markets, such as the financial and trading communities, to enjoy part of the advantages of monetary union without having first to

undergo the process of harmonisation of economic policy and performance (and the attendant transitional difficulties) which the co-ordination strategy implied. Most of the initial contributions to this debate came from the academic sphere,[99] but, by the mid-1970s, a combination of high inflation with low economic growth, the apparent failure of the EMU project and the obvious lack of progress with policy co-ordination in the European Community led to a proliferation of plans which recommended one or another version of a parallel currency, ranging from fairly innocuous proposals, which saw a common EEC currency as a useful complement to national currencies for those member states and economic sectors particularly troubled by monetary uncertainty and instability, to far more ambitious schemes for a parallel currency designed to compete directly with national monies for the preference of the markets and whose eventual purpose would be to replace national currencies altogether.

In June 1975, the Commission's Report on European Union put for the first time the idea of a parallel currency in front of the Council of Ministers for official consideration. A common currency would initially be used as reserve asset and numeraire only, but it could later be further developed to become an intervention currency and a private asset too, possibly replacing the Eurodollar in European capital markets. The Commission did not attempt to specify a target date for the accomplishment of these aims but it did lay down clearly some of the measures it thought necessary for the purpose. Predictably, these included the pooling of the member states' foreign reserves, but also (and of much more significance) there was now an unambiguous statement that serious progress with monetary integration in the Community would require a *common* monetary policy at the union level, rather than mere co-ordination of national policies, as at present. To facilitate the adoption of such a policy, the role of FECOM should be

substantially extended, to enable it at some future date to assume the powers and responsibilities of a European central bank.[100]

The Commission's independent study group on optimum currency areas (OPTICA) of 1975 examined the idea of a parallel currency even further.[101] There was a number of possible answers, the group said, to the question of how exactly to create a parallel currency: (i) one of the existing national currencies could be adopted; (ii) all national currencies could be allowed to intercirculate throughout the EEC; (iii) an external currency could be accepted as European parallel currency; (iv) a completely new currency could be established. The first of these options was ruled out on grounds of political unacceptability. A solution which led to one country being seen to dominate Europe's money (and through that its politics in general) would hardly manage to get much further than the drawing board. Whatever the advantages in purely economic terms, it is unlikely that, say, French public opinion would be wildly enthusiastic about the DM being adopted as Europe's common currency. Equally, the government whose currency would be chosen for that role might itself have serious reservations, for such a development would severely constrain its freedom of action in the conduct of its own domestic monetary policy, which would now be subject to all kinds of political pressure (a possibility which would frighten the Deutsche Bundesbank even more than the most ardent Francophile)!

Similar difficulties surround the second and third options listed above. Allowing *all* national currencies to circulate as legal tender throughout the Community would not solve the problem of one country's dominance of the EEC's monetary affairs: In the long run, the currency with the best-proven record of stability would displace the others through a process of market competition and choice, having generated in the meanwhile the considerable transaction and

conversion costs which the creation of a common currency is precisely meant to avoid and ultimately raising once again the objections to one nation dominance discussed above. On the other hand, the adoption of an external currency such as the Eurodollar or some other Euromoney as EEC parallel currency has other drawbacks of a political or technical nature depending on the currency chosen, such as partial dependence on monetary authorities outside the control of the Community, or the various degrees of *dirigisme* that would be necessary for the system to operate effectively.

The conclusion, which the OPTICA report shares with most other studies on the subject, is that a completely new monetary unit should be created to take the role of parallel currency for the European Community. This unit moreover, in order to be successful, should be designed in a way that would make it at least as attractive in terms of exchange risk and maintenance of value as the national currencies it would aim to complement or replace, and preferably more. Depending on the priority given to either of these two objectives, there was a number of different ideas put forward on how to design the proposed European parallel currency, the Europa: The simplest of these, advocated by a group of prominent economists known as the Villa Pamphili group, was that the value of the Europa should be defined as a weighted average of EEC currencies by the same formula that was utilised in the creation of the official EUA in 1975.[102] An alternative proposal, put forward by Robert Triffin, was to link the value of the Europa to the currency which remained the most stable in terms of a weighted average of the currencies of the member states.[103]

Both of these ideas have stability of the exchange rate of the Europa as their primary objective. However, with the acceleration of world inflation in the mid-1970s and the advance of

monetarist views on the "right way" to manage the economy, the fight against inflation in the Community became at least as important a policy objective, with the consequence that proposals started to appear which attempted to combine the goals of monetary unification with those of currency reform and the struggle against inflation. These usually involved partial or complete indexation of the Europa, in terms of either an exchange rate guarantee or actual purchasing power or both.

Among the proposals suggesting a partial indexation of the Europa were two which were considered by the OPTICA group. The first of these was to give an exchange rate guarantee relatively to the currency which had appreciated the most among those currencies taking part in a European system of controlled exchange rate fluctuation such as the Snake (not always the same currency, unless there was a currency which never happened to depreciate in relation to the others). The second proposal, which was the actual recommendation of the OPTICA report, was to give the Europa the same "monetary standing" with the currency of the member state with the lowest inflation rate, that is to link the Europa with the strongest Community currency (which for most of the time, though again not necessarily always, was likely to be the DM).[104]

However, the best known proposal for a European parallel currency was that put forward by a group of nine economists in November 1975, in what came to be widely known as "the All Saints' day manifesto".[105] The authors of the manifesto stated that the case in favour of monetary union is similar to that for the transition from barter to a monetary economic system. In a radical departure from received wisdom they also claimed, however, that the benefits of monetary union lie in the use of a *single common currency,* not in the establishment of fixed exchange rates between separate national moneys. Fixed exchange rates cannot be regarded as

equivalent to a common currency and in some respects are inferior to a system of flexible exchange rates.[106] Only the introduction of a common currency would eliminate the socially unproductive transaction costs between separate moneys and convince the exchange markets of the permanent and irrevocable nature of a transition to full monetary union. Under an adjustable peg kind of monetary system like Bretton Woods, there had always remained an element of exchange risk in currency transactions, which it was possible to reduce but not to remove completely through the use of the forward exchange markets. Parity changes were infrequent but large and encouraged speculation, as guessing the precise timing of the next realignment became a very profitable occupation indeed.[107] Furthermore, the reintroduction of a fixed exchange rate regime, even if achievable, would be hardly appropriate in the specific context of the European Community, for experience with such a system had clearly shown that it will only operate effectively under the leadership of a hegemonic power and this would inevitably arouse resentments among the other member states, similar to those shared by the Europeans against the US under Bretton Woods.[108]

Another issue which distinguished the All Saints' day manifesto from most other proposals for a European parallel currency was its emphasis on the role of the Europa as a private asset from the early stages, not just as a reserve currency. The manifesto insisted on the creation of a *real* money which would circulate alongside the existing national currencies and which would be able to fulfil from the outset all three functions of a real money, as a means of transaction, numeraire and store of value. Furthermore, the authors of the manifesto thought that the aim of the introduction of a new parallel currency should be not only monetary unification but also monetary reform, and for this purpose they proposed that the new currency should possess purchasing power stability, in other words be inflation-proof. In order to achieve this aim, the

Europa would be managed so as to maintain a constant value relatively to a representative European commodity basket, defined as the weighted sum of the commodity baskets used to calculate the national consumer price indices in the member states. An independent European monetary authority would issue Europas against national currencies and would periodically adjust the exchange rate between them according to a crawling peg formula, in a way consistent with the guarantee of a constant purchasing power for the Europa.[109]

The basic belief underlying the manifesto was that the process of monetary unification must be a voluntary one and that it should be allowed to evolve gradually in the market place. Monetary union, it was argued, cannot possibly be brought about by official edict, legalistic structures or the establishment of institutions, no matter how well intentioned or designed: "We are convinced that it is for the people themselves to decide whether they want monetary union or not and that the only satisfactory way they can be given the opportunity to do so is by the introduction of a parallel stable money ... which they may accept or reject as they wish. We believe they will accept it but we believe equally they must accept it freely".[110] This approach to unification would have a distinct and important advantage over the traditional co-ordination strategy followed so far, in that it would avoid the regular clashes between the short-term interests of the member states and the inevitable delays and compromises which had already brought the EMU project to a standstill and would require instead from the governments of the member states only a single, though major, political decision, to permit their residents to hold *and to use* Europas in competition with their own national money, thus establishing a legal tender duopoly within the territory of each member state.[111]

The concepts of currency competition and the denationalisation of money generated a considerable amount of interest in academic circles in the middle 1970s, mainly as a consequence of what was seen as governments' failure to control world inflation, and received a forceful expression in the contemporary writings of the Austrian economist Friedrich von Hayek.[112] The advocates of currency competition argued that the monopolistic right of government to issue money would, like all monopoly, lead to the abuse of this right. The basic way that this abuse expressed itself in monetary terms was in the existence of inflation. National governments have a natural propensity to inflate, for they are able to extract seignorage out of (i) exchanging paper assets for real goods and services and (ii) imposing an additional burden on the holders of money equivalent to the expected rate of inflation, a burden which in fact amounts to an invisible inflation tax.

The introduction of an inflation-proof Europa would accomplish four basic aims: It would achieve monetary reform in Europe through the elimination of inflationary expectations; It would minimise the transitional economic costs of the adjustment from a high-inflation to a low-inflation system; It would induce national governments to replace the hidden inflation tax with explicit taxation; Finally, through its superior design and in a manner reverse to that described by Gresham's law,[113] the Europa would be able to outperform the existing national currencies, leading to true monetary union in the European Community. Moreover, this process of disinflation and the displacement of national moneys would not be in any way dependent on political discretion, but would take place through the free interplay of market forces and at a pace determined by those affected by it. In other words, the main strength of this strategy would be that it would combine the political and economic benefits of both *gradualism* and *automaticity*.[114]

In terms of economic theory, the manifesto was the ultimate expression of the views of the monetarist school of thought which originated in the US. The basic premise of the proposal is a monetarist belief in the "law of one price" and in the inability of monetary policy to determine real output and employment in the long run: Product and capital markets throughout the world had become so well integrated so as to force an equalisation of prices via a process of international arbitrage. In this set up, persistent differences in national inflation rates are owed exclusively to unwarranted increases in the stock of money and/or the rate of credit expansion. Although monetary policy can have a temporary effect on the level of domestic economic activity, in the long run it can only influence the rate of inflation and not the level of unemployment which will stabilise at a "natural" rate determined by the condition of the labour market, taxation policy and other structural and institutional factors. Thus, although in the short run monetary unification may generate a temporary recession, as a high-inflation country adjusts its price level to that of the union, in the long run monetary union entails no unemployment effects, though it might aggravate regional disparities. These should be tackled by a vigorous Community regional policy, which should concentrate on eliminating the *causes* of regional imbalance by raising the level of factor productivity in the poorer areas, while income transfers to alleviate the consequences of low productivity should be used as an interim measure only.[115]

As was to be expected with a proposal of this nature, the All Saints' Day manifesto was received by the economics profession with roughly equal measures of support and condemnation. Benjamin Klein argued that it was unreasonable to expect that national governments would be willing to cede their monopoly power over such a politically sensitive tool of economic policy as the money supply, or to replace the inflation tax with vote-costly explicit taxation.[116] He also

noted that the success of the launch of a new currency depends on the money users' confidence in the issuer of money and this takes a very long time to establish. There were no significant historical precedents where a new currency displaced an existing and long established money in the way envisaged by the manifesto. David Laidler also gave the authors of the manifesto a low score for political naivete, but added that the proposals were of dubious merit even on purely economic grounds.[117] For a start, although the creation of the inflation-proof Europa did indeed require but a single political decision, it was misleading to claim that the commitment undertaken by national authorities stopped there. Indeed, one extra commitment was admitted in the explanatory literature which accompanied the manifesto itself, where it was conceded that national treasuries would be called upon to compensate the Euro-agent issuing the Europa for the inevitable losses incurred in exchanging a fully-indexed liquid asset for depreciating national currencies. That aside, and assuming that national governments acquiesced in the initial creation of the Europa, it still was not all that clear that this would be able to displace national moneys in the neat way described in the manifesto, for national authorities would go to some lengths to ensure that this did not happen by, for example, requesting that taxes be paid in national money. But, even if the reasoning of the manifesto did after all turn out to be correct, the implementation of its proposals in the current situation of large disparities between the inflation rates of member states would be inadvisable on economic grounds, for it might produce too fast a displacement of national currencies and a transition to price stability in the high-inflation economies of the periphery, such as Great Britain and Italy, and this would generate a stabilisation crisis and an unacceptably deep recession in those countries. On this point, Roland Vaubel argued that, on the contrary, it was likely that the Europa would make its fastest inroads in the countries where monetary policy and inflation were least effective in reducing the level of unemployment, that is in the *central* areas (where, arguably, the Europa was in any case needed -

the least) rather than in the peripheral or structurally weaker areas of the Community.[118] The majority view was that the proposals contained in the manifesto made strong economic sense but were unlikely, in their current uncompromising form, to appeal much to national governments, and that it was a mistake to burden the call for the creation of a European parallel currency with a full-indexation provision which would make it politically unacceptable from the outset.[119]

If the response from the academic community was predictably divided, that from the political establishment was an even more predictable indifference. The manifesto and the Commission's proposals for a European parallel currency were never considered as a serious practical alternative and, soon after, the attention of member governments was diverted by the monetary crises of early 1976 which engulfed the franc, the pound sterling and the lira and which meant that any attempt to mend the Snake and to restore integrationist momentum into the EMU project was predestined to fail. In an ideal world it would have been precisely at this time of crisis that the Community would grasp the opportunity to make the decisive breakthrough. However, EEC monetary affairs have never quite been like that. Such international concerted rescue efforts as were made were of an intergovernmental nature and were put together at the level of the G-10 rather than the Community. For the most part though, the response of the governments concerned was a retreat to economic nationalism and to policies which sought to overcome the difficulties in purely national terms. By a turn of irony, at the very same time that they were disregarding the analysis and recommendations of the parallel currency approach to monetary unification, the governments of Europe were proving triumphantly the reasoning and the case for that approach!

IIb5. The second departure of the franc. The monetary crises of 1976-78

In May 1974, Valery Giscard d' Estaing was elected President of the French Republic, at about the same time as Helmut Schmidt became Chancellor of the Federal Republic of Germany. Thus, at the head of the two countries which had so far played the leading roles in the process towards EMU in Europe now were two men of long experience and international clout, both ex-Finance Ministers, both firm believers in stable exchange rates and a European identity vis-à-vis the rest of the world and, crucially, two men whose personal relations were by far warmer than those which had existed between the political masters of these two nations for many years.

Giscard, now at last free to follow his own mind, made a speedy return of the franc to the Snake a matter of political priority for the new government. On 21 September 1974, just one hundred days after the new team had been put together under Jacques Chirac, the leader of the neo-Gaullist RPR, French Finance Minister Jean-Pierre Fourcade presented to his colleagues in ECOFIN a plan intended to facilitate the return to the Snake of the franc and the other floating currencies of the European Community. The cool reception afforded by the members of the Snake to the looser structure proposed by Fourcade cost the immediate reintegration of the French currency in the exchange rate mechanism, but even so, it was now clear that the readmission of the franc to the system could only be a matter of time.[120]

In the meanwhile, EMU remained, in theory at least, an important if distant objective for the European Community. At the Paris summit of December 1974, the European Council[121] reaffirmed its commitment to EMU, though experience prevented the heads of state and/or government from setting a deadline for its achievement. British Prime Minister Harold Wilson

colourfully expressed the prevailing view at the time when he likened EMU to complete and general disarmament: "I'm all for it", he said, "but I do not expect it by 1980".[122] Yet, not long after, the Community managed to score a notable success on the road towards EMU, with the creation, in March 1975, of the European Regional Development Fund (ERDF),for a trial period of three years. Although the capital at the disposition of the Fund (EUA 1.3 billion) was only small, the establishment of the ERDF was of greater importance than that represented by the numbers alone, for the Council had now taken the first concrete step to meet the worries of countries like Italy, Great Britain and Ireland who were anxious about the detrimental effect of a full monetary union on the more backward regions of the periphery, such as most of Ireland, Scotland, the English north and the Italian Mezzogiorno. These worries and the lack of progress towards the creation of a regional Fund, as we have seen, had led Great Britain and Italy to veto the transition to a second stage of the EMU project in December 1973. But, although this veto was lifted early in 1974[123] and agreement was reached on the creation of the ERDF, it was clear that the political instability and the economic difficulties that both these countries experienced in 1974-5 ruled out a return of sterling and the lira to the Snake as a practical possibility, and that the only country in the floating camp where there existed both the political will and the economic conditions for such a return in the foreseeable future was France.

Following its flotation in January 1974, the franc initially went through a period of steady but controlled depreciation relative to its former partners in the Snake, shedding some 13% of its value by June. However, the combined effect of the government's anti-inflationary policy and of the 1975 recession soon began to tell and the rate of inflation fell from some 14% in 1974 to 12% in 1975 (though this was still double the West German rate of only 6%). At the same time, the competitive advantage now enjoyed by French goods, coupled with a lower domestic

demand, led to a strong recovery of the external sector, exports rose by 2% while imports fell by 8%, and the trade balance turned from a FF 21 billion deficit in 1974 to a FF 4 billion surplus in 1975. The result was a marked increase in the level of international reserves and a progressive appreciation of the franc which, by the spring of 1975, was nearing its previous rate within the Snake.

On 9 May 1975, the 25th anniversary of the Schuman Plan,[124] Valery Giscard d' Estaing finally announced that France intended to reintegrate the franc in the Snake at the same rate that it had left sixteen months earlier. Bernard Clappier, the Governor of the Banque de France and officials of the Finance Ministry voiced strong reservations as to the wisdom of repegging the currency at so high a rate given the wide inflation differential with West Germany, but the decision was taken largely in terms of France's prestige in the world and so was beyond normal economic reasoning.[125] Initially, luck and the markets seemed to be on Giscard's side: Within a week, the franc had moved within the Snake limits of divergence of its own accord and remained there comfortably, without need for central bank interventions to support it. A month later, on 16 June 1975, a meeting of Snake Finance Ministers and central bank governors in Luxembourg decided formally to readmit the franc to the Snake, with effect from 10 July. The absence of the French currency from the system had lasted three times the six months originally intended! As with the Fourcade Plan of the previous September, the existing members of the Snake showed once again that, although they considered the return of the franc a welcome development, they were nevertheless not prepared to loosen in any way the discipline of the system in order to achieve it. The only concession made to the French on the occasion of the franc's re-entry was an extension of the settlement time for liabilities incurred due to interventions within the Snake to three months.

In typical fashion, no sooner were the French once again inside the Snake than they began to assume a leading role in determining its fortunes. The most lasting consequence of this latest phase of France's European monetary diplomacy was the effective blocking in 1975 of Switzerland's admission to the Snake. Swiss interest in a formal association with the Snake had been voiced by the President of the Swiss National Bank, Fritz Leutwiller, in February 1975. In a series of intense negotiations over the next few months it had become evident that there existed a broad agreement between the two sides on the general idea of Swiss membership and that the only country opposed to it was France. On 10 July 1975, the very same day of the franc's readmission to the Snake, Finance Minister Fourcade expressed the view that Switzerland should not join as long as Britain, Italy and Ireland remained outside.[126] An early inclusion of the appreciating Swiss franc, the French feared, combined with a strong DM, would inevitably pull the Snake upwards and would not only make French goods uncompetitive in world markets, but would also make it more difficult for those currencies which were floating to rejoin and indeed (unsaid, but crucially important) for the French franc itself to *remain* in the Snake. Switzerland's banking secrecy laws and its willingness and/or ability to control capital inflows were other issues on which French and Swiss officials took different views. Though some progress was made and the Swiss were admitted to the daily market-information exchange network linking the central banks of the Snake, a final agreement was not found and, in a meeting in Brussels on 17 November 1975 (the evening the Rambouillet conference ended), Swiss Finance Minister Georges Chevallaz had to announce that further talks on the matter would be "temporarily" suspended.[127]

Despite some successes in the battle against inflation, France's attitude to this problem remained fundamentally different from that of its partners. The French authorities persistently paid more attention to the level of output and employment relative to the price level and thus selected a different point on the Phillips curve (a theoretical device showing the available trade-offs between unemployment and inflation)[128] than did most of the other members of the Snake and particularly West Germany. Thus, at the same time as it was recommitting the franc to the Snake, the French government began to take measures to combat the depressed state of the domestic economy which, in their timing and their extent, were quite incompatible with long term membership of the system.[129] As a result, prices began to rise again in the last quarter of 1975 and inflation reached 9.9% in 1976, as compared with 3.9% in the Federal Republic. This and the relative overvaluation of the franc had a detrimental effect on the French current account which sunk back into deficit to the tune of FF 27.5 billion in 1976, raising questions about France's ability and/or will to keep its currency in the Snake and leaving the franc once again prey to the speculators.

The first signs of trouble appeared in February 1976, when the franc came under serious pressure following the speculative attack on the Italian lira in late January and the devaluation of the Spanish peseta by 10% on 9 February. Concerted intervention by the Bundesbank, the Banque de France and the Federal Bank of New York managed to save the day, but not before around one-quarter of France's foreign reserves had been spent in the process. Yet, despite these developments and the French industrialists' clamour for a lower franc exchange rate, Finance Minister Fourcade, supported by President Giscard d' Estaing and Chancellor Schmidt, refused to concede the possibility of a realignment, let alone a departure of the franc from the Snake: "The franc has already seen other situations. It will remain in the EuroSnake. The word

devaluation is a word I don't know".[130] But it was not to be. Only one month later, in early March 1976, a wave of speculation directed initially against sterling quickly spread to engulf the franc, the lira and the Belgian franc. There was intense selling pressure on the franc and intervention was needed to the tune of FF 8 billion, of which some FF 4 billion on Friday 12 March alone. On that night, Fourcade asked the current President of ECOFIN, the Belgian Finance Minister Willy de Clercq, to arrange a meeting to discuss a possible realignment within the Snake and such a meeting did take place on the evening of 14 March at the Belgian Ministry of Finance in Brussels. The Commission was also invited. At the meeting, Fourcade offered a tentative devaluation of the French franc by about 2-3% and it became clear that the German Finance Minister, Hans Apel, was authorised to accept a similar revaluation of the DM. For obvious political reasons, Fourcade wished to make these changes part of a compete realignment of the parity structure of the Snake, and to this effect he also asked for a revaluation of the guilder and a small devaluation of the Belgian franc.

At this point, the Snake fell victim to one of these political coincidences which have plagued the history of European monetary unification with uncanny regularity and deadly effect. Sunday, 14 March, also happened to be the night of the second round of the French local elections. When the Finance Ministers interrupted their meeting in order to confirm their final positions with their respective governments at home, the results of the French elections had begun to come out and they painted a rather unfavourable picture for the President's governing coalition. Under such circumstances, political prudence required maximum independence for economic action and, consequently, Giscard instructed Fourcade to take the franc again out of the Snake. Shortly after the French decision had been taken, the Finance Ministers of the Benelux countries, Willy de Clercq, Willem Duisenberg and Raymond Vouel, announced that they would not, at present,

support a change in the rates of their respective currencies.[131] Moreover, due to the recent unstable conditions in the exchange markets, they had decided to abandon the special exchange rate arrangement which linked the Benelux currencies within margins of fluctuation of 1.5%, and which had so far survived intact, even during the monetary crises of 1971 and 1973.

The second withdrawal of the franc and the particular events that led to it helped to highlight two important issues: The first of these, which had by now been painfully proved on a number of occasions, was that relative currency stability within the Snake (or, indeed, *any* fixed exchange rate system) could only be preserved if there was general agreement among all the member states about the aims, methods and direction of domestic economic policy, or if member states were willing to subject their own domestic goals to the discipline of the system. Secondly, the specific circumstances behind the departure of the franc demonstrated clearly the vulnerability of the Snake to monetary disorder in the rest of the world as well as the dangers of the lack of a common policy to deal with it. The influence of the external environment and the need to develop this side of the Snake had been stressed by the French at the time of the Werner Committee and, more recently, in the Fourcade plan and during the negotiations on the Swiss application for membership. So far though, very little had been achieved in this direction beyond the adoption of some common positions in the international reform negotiations, which were in any case motivated more by mutual dislike of the US' determination to impose a dollar standard than by any genuine emergence of a "European" monetary identity. It was therefore a timely reminder of this crucial weakness of the Snake to note that, on both occasions when the franc came under attack, in February and March 1976, it was not the fundamental outlook of the French economy itself which was called into question. Instead, the franc became the victim of speculation which originated elsewhere and then spread to it and other currencies (thought of

course it was the divergence between the policies of the French government and those of its partners, particularly with regard to inflation, that created doubts about France's long-term will or ability to keep the franc in the Snake and thus sustained the speculative wave). Indeed, the adventures of the franc notwithstanding, the most striking disturbances in world exchange markets over the period from the general transition to floating in 1973 to the end of decade (which inevitably also affected exchange relations within the Snake) invariably involved floating currencies whose movements would, in theory, have been expected to be comparatively smoother over time. In Europe, there were the sterling and lira crises of 1976. From further afield, there were the complications created by the see-saw progress of the US dollar.

The departure of the lira from the Snake in February 1973 had been followed by a period of rapid decline for the Italian currency, which was accentuated by the energy crisis of 1973-74. To counteract this, Treasury Minister Emilio Colombo introduced an austerity program of economic stabilisation and, after the retirement of Guido Carli in August 1975 and his replacement by the more like-minded Paolo Baffi, he authorised the Banca d' Italia to resume interventions to support the lira. These were initially successful, the decline of the lira was temporally halted and, as a consequence, during the Rambouillet monetary conference of November 1975 and again at the Rome European Council meeting of December 1975, Colombo and Prime Minister Aldo Moro were able to hint that the Italian government was seriously contemplating a possible return of the lira to the Snake. Any such plans, however, were stopped dead by the government crisis of 7 January 1976. The lira came under intense speculative pressure and, in the two weeks that followed, some $500 million had to be spent in intervention to prevent a collapse of the currency. In the end, the Italian authorities had to admit defeat: On

21 January 1976, the Banca d' Italia announced the termination of interventions and suspended the official quotation of the lira.

The formation of the new Moro government did manage temporarily to restore confidence in the exchange markets. The official quotation of the lira was re-established on 1 March 1976 and Colombo asked the Central Bank to stand by to defend the currency should this still prove necessary (in the month which followed the cessation of interventions, the trade-weighted rate of the lira had already fallen by 17%). Then, on 4 March, the pound sterling came under severe pressure in London and from there speculation spread quickly to engulf the lira. Plagued by political uncertainty, the Italian currency tumbled, so that by early May 1976 it had shed almost half its 1972 value against the DM. As it had done in 1974, the Italian government responded to these developments with the imposition of import controls (50% advance cash deposits on imports) which were, as of necessity, reclassified by the Commission as "monetary" and approved as a temporary exception from the rules of the Treaty of Rome (yet another reminder of how instability in exchange rates could damage free trade between the member states). On 15 March 1976, it also managed to obtain an $1 billion from the conditional loan facility which the Community had set up on 17 February 1975 (through the utilisation of its triple A rating in the international money markets) to help member states overcome temporary difficulties caused by the oil crisis, on top of an EUA 1.16 billion credit it had already been able to secure under the Medium Term Financial Assistance scheme.[132] Ireland received a further $300 million. These developments had the desired effect: The slide of the lira was first arrested and then reserved in the aftermath of the election of 21 June 1976, which did not produce the widely expected losses for the governing Christian Democrats and kept the Communist party out of the government.

The minority Christian Democrat government formed by Giulio Andreotti with the tolerance of the Communist party featured a new chief in charge of Italy's economic policy: In order to facilitate the co-operation of the trade unions and the Communists in parliament, Emilio Colombo was moved from the Treasury. The new Minister, however, Gaetano Stammati, proved to be as keen on a policy of austerity and financial rectitude as his predecessor. In April 1977, Italy concluded an agreement of economic stabilisation with the IMF, which specified strict targets for the money supply, wage increases, the trade deficit and the budget deficit. By this time, adherence to the policy conditions set by the IFM and the Fund's seal of approval had already become the main indicator of a country's creditworthiness for the international private banking sector. Thus, although the amount acquired directly from the Fund only came to $537 million, the deal was important to the Italian government because it gave it access to secondary sources of credit which would have been closed to it otherwise. On 17 May 1977, Italy was also able to obtain a further $500 in two instalments from the Community's loan system. Despite the fact that the targets on public spending and the growth of the money supply were exceeded in 1977 and 1978, the Italian balance of payments turned into surplus in 1977 for the first time in years, thanks mainly to higher than average tourist earnings. This enabled the Banca d' Italia to rebuild its foreign reserves which had sunk to a low of $0.6 billion in late January 1976 and permitted the partial repayment of some of the country's foreign debt, which had grown from $16 billion to well over $20 billion in just one year.[133]

Great Britain's economic experience over this period parallels Italy's in many important ways. Both countries tried to finance economic prosperity in the early 1970s through higher than average monetary growth - both suffered the inflationary consequences of their pains. Both countries were troubled by balance of payments deficits and currency instability, before as well

as after the energy crisis. Both were handicapped by trade union militancy, industrial strife and an obsolete and inflationary pay-structure. Both were, finally, plagued for much of the time by debilitating political uncertainty, caused by indecisive election results. In Britain, the Conservative government led by Edward Heath was succeeded by a minority Labour government after the February 1974 general election and this was replaced in October 1974 by another Labour government with a majority of only three in the House of Commons, both led by Harold Wilson. Where the British experience differed from the Italian one was that sterling was still a major reserve currency and, as such, it was much more vulnerable to national and international economic developments and speculative pressures than was the case with the Italian lira. Apart from being the major reserve asset of various Commonwealth and third world nations, sterling was also being held by a number of oil producing countries traditionally linked with the sterling zone, which now chose to deposit their newly found wealth in London. As a result, official sterling holdings went up from around UKL 3 billion at the end of 1971 to UKL 4.9 billion by mid-1975.

On 4 March 1976, Nigeria sold a substantial amount of sterling in London and sparked off a series of large and disorderly withdrawals fuelled by loss of confidence in the exchange rate. The Bank of England intervened heavily in support of the currency to the tune of around $1.1 billion in March alone, but this managed only to slow down the slide of the pound for a temporary period. In April, Harold Wilson resigned as Prime Minister and was succeeded by the Foreign Secretary, Mr. James Callaghan, who had been Chancellor of the Exchequer at the time of sterling's last devaluation in November 1967 and who defeated an attempt by a section of the parliamentary Labour Party to elect in his place left-winger Michael Foot.

In the meanwhile, sterling's decline had continued uninterrupted and was not halted even by the successful conclusion of a national wage agreement between the government and the Trade Union Congress (TUC), which limited wage increases to just 4.5% for the year to mid-1977 (a cut in real incomes which was to be partly offset by tax cuts). By early June 1976, sterling had fallen to $1.71, down by some 29% on its Smithsonian level, and 16% in trade weighted terms since early March. At this point, by any reasonable criterion the pound was already seriously undervalued and fears were generated that speculation, emboldened by success against the British currency, might soon spread in other directions. Accordingly, the central banks of the G-10, the BIS and the Swiss National Bank put together a $5.3 billion credit line and made it available to the British authorities. As a result, the pound strengthened in June 1976 and remained buoyant during the summer (thanks partly to large numbers of tourists hunting for a bargain), before a new wave of speculation started off another cycle of depreciation in the autumn.

On 29 September 1976, Chancellor of the Exchequer Denis Healey announced that the government intended to ask the IMF for a medium-term stand-by credit of $3.9 billion, the largest amount ever requested so far by a single country. On 24 October, an article in the London "Sunday Times" suggested that the IMF intended to ask Britain to devalue the pound progressively to $1.50.[134] The following day, the London foreign exchange was predictably struck by a massive speculative wave which brought sterling down to $1.60. However, it was by now clear that Britain's economic partners thought that sterling's depreciation had gone quite far enough and that a reversal of the downward trend was only a matter of time. In December 1976, the US Federal Reserve and the Bundesbank extended credits of $500 million and $350 million respectively to support the pound. Despite difficult negotiations on the economic

conditions imposed by the IMF, an agreement was finally concluded which, significantly, contained a strict limit for the rate of monetary growth. As a result, the Fund was able, on 3 January 1977, to put to the disposal of the British government the $3.45 billion credit line which had been arranged by the G-10 and Switzerland. One week later, the BIS announced that seven of the central banks of G-10 and the Swiss National Bank would make available a further $3 billion to help the Bank of England reduce the level of official sterling balances in a progressive and orderly fashion. Finally, the British authorities were able to borrow another $1.5 billion from the Euromarkets.

The positive psychological impact of this concerted action by the community of industrial nations in support of sterling was, in the meanwhile, reinforced by encouraging news on the domestic economy: In late December 1976, Energy Secretary Anthony Wedgewood-Benn announced that Britain intended to double the oil output from the North Sea in 1978 and reach 115 million tons by 1980. The foreign reserves held by the Bank of England increased fivefold from just over $4 billion in 1976 to $20 billion in October 1977 and the pound rose strongly, even to the point that intervention was necessary to keep it within reasonable bounds. At the European Council meeting in London, on 30 June 1977, Prime Minister James Callaghan expressed his relief at the favourable turn of events and said that for the next five years, and for the first time since the second World War, British economic policy would not be dominated by considerations of sterling and the balance of payments. On 4 January 1978, almost a year to the day after the approval of the IMF loan, sterling touched $2.00 in the foreign exchange markets.[135]

Important though these movements of the Italian lira and the pound sterling were for the international economy, they were still of secondary importance by comparison to developments which affected the exchange rate of the US dollar. The American currency was still by far the major reserve asset and a good deal of international trade was invoiced in dollars, including, significantly, oil. The energy crisis and the US' lower dependence on imported oil combined in late 1973 to give a powerful boost to the dollar, which rose strongly against the European currencies. By mid-January 1974, the DM rate of the dollar was up by 23% relatively to that of the previous July and its effective rate was almost back to its Smithsonian level. As a result, Europe found itself for a while facing the double handicap of having to pay for more expensive oil in still more expensive dollars. This trend was reserved in late January 1974, when the elimination of all American capital controls, on 29 January, and the relaxation of the restrictions on capital inflows in West Germany started off another dollar decline. By mid-May, the dollar had lost most of the ground it had gained during the last upswing and was down by 21% relative to its DM rate of mid-January. Improving news on the balance of payments and the winding up of the Watergate affair then once again strengthened the dollar, while the DM was feeling the repercussions of the closure of the Herstatt Bank of Cologne, on 25 June 1974, for losses incurred in foreign exchange dealing. By early September, the DM rate of the dollar had risen again by more than 10% and its effective rate was above that of February 1973.

Gloomy forecasts about the American economy led to another decline for the dollar in the autumn of 1974. Industrial production, which had been running at a high level throughout the year, began to fall, while both unemployment and inflation rose rapidly. Good news on foreign trade, particularly the stronger than expected performance of exports, were not thought sufficient to balance the picture and, in the six months to February 1975, the dollar fell by some 14%

relative to the DM. As had by now come to be expected, this decline was then followed by a rise of almost equal magnitude: The 1975 recession produced a current account surplus which reached $12 billion for the year as a whole and this, coupled with higher American interest rates, led to a 15% recovery of the dollar between February and October 1975. In the meanwhile, as we saw in the previous section, a degree of official consensus was developing among the major industrial nations that excessive currency instability was, at least to some extent, connected with the downturn in world economic activity and would have to be combated, a consensus which reached its fullest expression in the Rambouillet agreement of November 1975. Partly as a result of the agreement, the dollar remained stable in late 1975 and throughout 1976, at just above its effective rate of February 1973.

This situation changed in January 1977, when the Democratic administration of President Carter took over. The new economic team, under Secretary of the Treasury Michael Blumenthal, appeared determined to out-do the Republicans in its faith in the workings of the free market and exhibited an almost religious belief in the adjustment process, part of which was an apparent disregard for the rate of the dollar. In response to the heavy deterioration of the balance of trade, which recorded a $9 billion deficit in 1976 compared with a surplus of equal size in 1975, Secretary Blumenthal said, in July 1977, that he was prepared to see the dollar go down to whatever level the market would take it and seemed to want the dollar to fall. Ready to oblige him, the market pushed the dollar down by 11% against the DM between June and December 1977. At this point, anxieties began to be expressed about the long-term role of the dollar as an international reserve asset and, with a meeting of OPEC Ministers scheduled to take place in Caracas on 20-21 December, questions were specifically raised as to how long OPEC would be content to leave the oil price unchanged and whether it would continue to price oil in devaluing

dollars rather than in SDRs or another more stable monetary unit. This led to a new attempt to talk up the dollar but precious little else and American financial diplomacy began once again to acquire the schizophrenic character it had displayed in 1970-71: In a speech, on 4 November 1977, before the National Foreign Trade Convention in Washington D.C., Secretary Blumenthal stressed the underlying strength of the dollar, but insisted that the US would only intervene to counteract disorderly conditions in the exchange markets. Yet, the following month, in a statement timed to coincide with the Caracas conference, President Carter announced that the US did not believe the recent slide of the dollar to be justified and was ready, in co-operation with its economic partners abroad, to undertake action to stop it. The means to effect this were unveiled on 4 January 1978: There was to be a reactivation of the Fed's existing swap arrangements, worth over $20 billion, an extension of the bilateral swap line with West Germany and the re-utilisation of the US Treasury's Exchange Stabilisation Fund, worth a further $4.7 billion.

Although this package had the desired effect for a short while and managed to halt the decline of the dollar, the effect was only temporary. In February 1978, West German Chancellor Helmut Schmidt successfully resisted Blumenthal's analysis that the American deficit was essentially determined by the desire of other nations for surpluses (the "demand-determined" hypothesis all over again) and turned down his suggestion that West Germany should speed up the adoption of measures aimed to promote economic growth and therefore act as a locomotive for the world economy. Even less obligingly, the US trade deficit exploded in 1977 to a massive $31 billion, over three times that of 1976. Finally, across the Atlantic, poll predictions of victory for the left-wing opposition in the forthcoming French parliamentary elections generated a crisis of confidence in the franc which soon spread to the dollar. Despite sizeable intervention, the dollar

crashed through the psychologically important 2 DM barrier on 1 March and, although it was temporarily shored up by gold sales from the US Treasury stock later in the year, the slide resumed in the autumn until, on 30 October, the dollar had reached an all-time low of 1.73 DM. To this, President Carter responded, on 1 November 1978, with a new and more resolute stabilisation plan, which finally did manage to stop the decline of the dollar. The package was estimated at around $30 billion, to be raised through the sale of foreign-denominated US securities, an extension of the Fed's swap lines and a doubling of the amount of gold auctioned monthly by the US Treasury to 1.5 million troy ounces as from December 1978. A number of monetary measures for the domestic economy were also announced, including an increase in bank reserve ratios and a rise of the discount rate to 9.5%.

IIb6. Towards a crawling peg?

It is a measure of the relative success of the Snake in this same period, that exchange rate developments between the participating countries were almost dull by comparison. This, of course, was partly due to the smallness of the Snake and the fact that it no longer contained any major currency other than the DM, which limited the scope for serious internal unrest. Still, the relative exchange rate stability enjoyed by the members of the Snake and the degree of policy co-ordination which that stability necessitated, and then in turn promoted, was of great importance to the participants, while a comparison with the upheavals experienced by non-members helped to demonstrate in the clearest possible way the attractions of a stable currency system, at least in the context of the European Community.

The second withdrawal of the franc in March 1976 eased tensions within the Snake and removed the pressure for an immediate realignment. The initial West German offer to revalue the DM, made as part of a proposed deal to keep the French in the system, was withdrawn at least until after the federal election, scheduled to take place on 3 October. Despite speculation against the Belgian franc and the Danish krone in the summer, the existing parity structure was maintained until the Snake Ministers, meeting in Frankfurt on 17 October 1976, decided on a complete realignment of the system: The DM was revalued by 2% as against the European Monetary Unit of Account (EMUA), the Danish krone was devalued by 4%, while the Norwegian and Swedish crowns were devalued by 1%. The Commission had not been invited, even though the meeting had been called to effect a realignment of exchange rates. The new parity grid survived until 1 April 1977, when Gosta Bohman, the Minister of Finance in the new Swedish centre-right

coalition government formed under Thornbjorn Falldin after the general election of September 1976, asked for and obtained a 6% devaluation of the Swedish krona, in an effort to make the Swedish economy, which had been hit hard by unfavourable wage and price developments and the linkage with the appreciating DM, more competitive overseas. Ever mindful of internal Nordic exchange rate interrelationships, the Danish and Norwegian governments decided on the same day to devalue their respective currencies by 3%. This adjustment, however, did not prove to have been sufficient. Just under five months later, at the Snake meeting of 28 August 1977 in Frankfurt, the Swedish delegation announced that the krona would be withdrawn from the Snake and would be pegged instead to a wider basket of currencies which would reflect more accurately the balance of the country's foreign trade. In response to the Swedish move, on that same day, the Danish and Norwegian crowns were devalued by 5%.

On 27 October 1977, in a speech in Florence, Roy Jenkins, who had replaced Francois-Xavier Ortoli as President of the Commission in January 1977, called for a new initiative on EMU. This eventually led to the establishment, by the European Council in Brussels on 4-5 December 1978, of the EMS which superseded the Snake and is the subject of the next chapter. On the way there, however, there were a few more developments within the Snake: On 13 February 1978, the Norwegian krone was again devalued by 8%. Eight months later, on 17 October 1978, there occurred the final realignment in the Snake: The DM was revalued by 4% against the EMUA while the Dutch guilder and the Belgian franc were both revalued by 2%. Finally, on 18 December 1978, in anticipation of the impending introduction of the EMS, the Norwegian krone left the Snake.

The extent and frequency of these central rate adjustments in the last two years of the Snake, raised questions as to whether the system still possessed any integrative qualities and, indeed, whether its practical *raison d' etre* continued to be a firm commitment to stable exchange rates, or whether it had evolved into a convenient mechanism resembling a crawling peg, whose purpose was simply to effect any realignments which might have been deemed necessary in a progressive and orderly fashion.[137] It is true that if the two associate members, Sweden and Norway, are taken into account, the Snake exhibited far more exchange rate variability in the years 1976-78 than befit a system committed to the maintenance of a zone of currency stability in a floating world. Before its final departure in August 1977, the Swedish krona went through a devaluation of 9% in two steps, whereas the Norwegian krone was devalued by as much as 23% in five steps, not counting the cumulative effect of these devaluations. In both countries, the proportion of foreign trade conducted with the other members of the Snake was substantially lower than in, say, the case of Benelux and thus they suffered more from close association with the appreciating DM. To make matters worse, both countries experienced adverse domestic wage and price conditions which contributed to large current account deficits, which in Norway's case reached some 5% of GNP in 1978. Both countries were finally able to maintain the real effect of their devaluations in the longer term through the application of a combination of fiscal and monetary measures, direct price controls and intervention in the labour market, which managed swiftly to curb domestic inflation and improve the external competitiveness of their economies.[138]

Turning now to the full members of the Snake within the European Community itself, one can distinguish between the cases of Denmark on the one hand and Benelux on the other. In Denmark, an expansionary fiscal policy, coupled with an increase in the money supply (M2) of

more than 25% in 1975 and early 1976, vastly outweighed the contractionary effect of the association with the DM and predictably created problems with both inflation and the balance of payments. The 18% devaluation of the Danish krone in four steps between 1976 and 1978 did no more than compensate for the diminishing competitiveness of the economy, leaving the effective rate of the currency essentially unchanged. In contrast to this, the governments of Belgium and the Netherlands decided to align their domestic economic policies to those of West Germany and to impose the internal discipline necessary through a close link of their currencies to the DM. The result was that exchange rate relationships between the Benelux currencies and the DM remained remarkably stable by comparison to those with the Scandinavian countries and those outside the Snake, with parity changes totalling only 4% in two equal steps by October 1978. The effective rate of both the Belgian franc and the guilder appreciated by about 10% between 1976 and 1978, though, due to lower wage costs, Belgian competitiveness remained virtually unchanged, while that of the Netherlands did actually improve a little (the real exchange rate depreciated slightly). For both countries, the judgement seems on balance to have been that close association with the rising DM enabled them to obtain the various stabilisation benefits of a hard currency area, while at the same time neither seems to have suffered any significant contractionary effects through their participation in the Snake.[139]

IIc. Conclusion.

There are four main lessons to be learnt from the experience of the Snake. The first of these follows directly from the previous section, although it had already been brought out by the events that led to the final breakdown of the Bretton Woods exchange rate system, which we examined in the previous chapter. We argued there that a system of fixed but adjustable parities will work best under conditions of hegemony and this conclusion was confirmed, both in a positive and in a negative way, by the history of the Snake. Europe at the end of the 1960s was not dominated by a single country in the way that the US had dominated the world economy at the end of the second World War. Where it had then been natural that the US would assume the central responsibility for the running of the international economy and that the American currency would be the pivot of the system, no such presumption existed within Western Europe twenty years later. The growing economic preponderance of West Germany was still marked by political diffidence and, even when the economic giant started to shed its image of a political dwarf, economic reality as well as historical military and political rivalries prevented the emergence and acceptance of a hegemonic power in Europe. Instead, among the nine there were four states of comparable size, population and economic strength (West Germany, France, Great Britain and Italy), each with its own social, political and economic tradition and institutional set-up and each with different perceptions of the objectives and the priorities of economic policy as well as the meaning of EMU.

Under these circumstances, tensions inevitably developed which, aggravated by the general climate of monetary instability in the early 1970s, led to the withdrawal of first the British, then

the Italians and finally the French from the Snake. It is not surprising that three out of the four big countries, and *only they* and Ireland, were forced to abandon the system.[140] Put simply, the withdrawal of these states was necessary in order to realise the condition of hegemony within the system, as it was in fact realised within the reduced Snake which became, in effect, a zone of relative monetary stability centered round the DM. The short-lived return of the franc and its subsequent departure just eight months later, as a result of the different priority ratings assigned to the promotion of full employment relative to the defeat of inflation in Paris and Bonn, only serves to underline the point, as does a careful examination of monetary developments within the mini-Snake itself: There was now a hegemonic country within the system, a country which accounted for a large proportion of the foreign trade of the smaller members, which did pursue zealously the goal of price stability and which did not attempt to exploit its dominant position for its own advantage, as the US had been accused of doing in the context of Bretton Woods. (On the contrary, West Germany took its share in effecting the necessary parity changes, thus reducing the burden on the smaller countries). Hegemony thus been restored, one would have expected the mini-Snake to achieve its new objective of maintaining relative stability between the currencies of its members and it did. For those countries which decided to act according to the dictates of the system and to align their domestic policies to that of the hegemonic country, the Snake managed to maintain remarkably little variability of exchange rates over a generally turbulent period. On the other hand, those members which decided to pursue economic goals independent of those set by the hegemonic country experienced large depreciations and for these the Snake did, indeed, assume the appearance of a crawling peg.

This brings us directly to a second and related conclusion which has to do with the question of monetary confidence and the need to understand clearly the nature and the character of the

system, a conclusion which again was briefly touched upon in the previous chapter. A monetary system based on fixed, or fixed but adjustable, exchange rates will never become credible to the currency markets until national governments have demonstrated beyond doubt that they understand the economic logic and the rules of such a system and that they are prepared to accept the constraints that these rules impose on their national sovereignty. The logical conclusion of Bretton Woods would have been a dollar standard, but this was not understood (or accepted in practical terms, which amounts to much the same thing) either by the Europeans, who rejected such a system on political grounds of national prestige as well as on economic grounds of questionable monetary responsibility on the part of the US government, or by the Americans, who wanted the privileges which such a system confers on the reserve centre but not the constraints, thus justifying European fears to the fullest. Similarly in the Snake, not only did at times some member states undertake independent actions and apply policies which were incompatible with membership of a fixed exchange rate system but, worse still, the very purpose and the implications of EMU itself were never clearly defined and patently meant different things for different countries throughout. Although the Werner committee made a brave attempt to clarify the final objective and stressed that EMU went well beyond mere stability of exchange rates, ultimately to full *political* union, these more contentious elements were swept under the carpet in an effort to reach a compromise for a first stage package that would be acceptable to all. Thus, in 1971, the countries of the European Community embarked on a long journey towards destination unknown, equipped with only a patchily sketched map of the way and the arbitrarily taken decision that they wanted to arrive there by 1980. Hardly surprising that they failed!

The third lesson that can be drawn from the experience of the Snake is the need for a common external monetary policy towards the rest of the world. The member states of a regional monetary system such as the Snake (or subsequently the EMS) still conduct a sizeable proportion of their foreign trade and other economic relations with non-member states and movements in relative exchange rates with the currencies of those countries are bound to be of some interest to them. Moreover, as international capital and currency markets have become increasingly integrated, monetary instability in other parts of the globe has a tendency to spill over and, in fact, exchange rate relations within the Snake were on various occasions crucially affected by monetary developments outside the system, usually movements of the US dollar but also others which concerned those European currencies which had left the Snake. There is, accordingly, a need for an external monetary policy to complete and protect a regional system of stable exchange rates, as there was a need to establish the Common External Tariff to complete and protect the Customs Union. For the European Community, in practical terms this means a *common dollar policy*. A substantial share of world trade and services is invoiced in dollars even when no US-based agent is directly involved, including, of course, oil. Moreover, the US capital market is the largest and most liberal in the world and thus developments that affect the US dollar inevitably have an impact throughout the world financial system. So, in the context of the Snake, movements of the dollar did not affect all EEC currencies equally, for capital outflows from the American currency naturally tended to concentrate disproportionately on the stronger European currencies, primarily the DM, rather than the weaker ones and in this way created tensions in the internal parity structure of the system which were not justified by any real change in the underlying economic fundamentals of the member states. Indeed, as we will see in the following chapter, with time there developed a strong correlation of European realignments with periods of persistent dollar weakness, proving beyond doubt the need for a

European policy towards the dollar, despite which such a policy remained as elusive for the EMS as it had been for the Snake, although the necessity of it had already been made abundantly clear by the French as early as in 1974.

The final lesson to be drawn from the Snake is that a monetary unification strategy which relies on intergovernmental agreement and the co-ordination of national economic policies is beset with difficulties and is unlikely to lend quickly to the achievement of full EMU in Europe. Diverse interests, personal whims, temporary economic adversities, national electoral calendars, dogma and sometimes sheer coincidence will combine to block decisive progress. Any real attempt at monetary unification, therefore, must include as an indispensable part the introduction of a common parallel currency which would be allowed to circulate side by side with the existing national moneys. The advantages and disadvantages of various possible formulas for the creation of such a currency have already been dealt with in the appropriate section above and we will come back to these in the following chapter. In connection with this discussion on the lessons which can be drawn from the history of the Snake, however, it must be pointed out that the introduction of a parallel currency would either make it easier to apply these lessons in practise, or avoid the initial problem altogether. First, it would alleviate the problems connected with hegemony, for although national governments would still be induced to co-ordinate their economic and monetary policies and although any such co-ordination would tend to gravitate towards the policies of the strongest and most stability-conscious among the member states, the process of monetary unification itself would no longer rely on the maintenance of fixed exchange rates between national moneys. Second, should a member government decide to pursue policies incompatible with the aim of monetary stability and out of line with those of its partners, this would result in a faster displacement of the particular national currency concerned,

but would not now affect the course of the unification process or the market's confidence in it. Finally, it should be easier to conduct an external policy towards the dollar at the Union level and on the basis of a new and attractive common currency than through laborious co-ordination of many national policies designed to accomplish the same thing. Yet, despite the obvious benefits of a unification strategy based on the parallel currency approach, the political establishment of Europe remained unconvinced. The lessons of the 1970s were never learnt, progress towards monetary union continued to be viewed in terms of policy co-ordination and fixed exchange rates and when the EMS finally took over from the Snake, it looked suspiciously like an souped-up version of its predecessor. As Dr. Johnson once said about second marriages, "a triumph of hope over experience"!

CHAPTER III:

THE EUROPEAN MONETARY SYSTEM

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IIIa. Ten years of the EMS, 1979-1989

IIIa1. The political and economic background to the EMS

On 27 October 1977, the President of the European Commission, Roy Jenkins, used the occasion of the first Jean Monnet lecture at the newly-established European University Institute in Florence to call for a new initiative towards EMU in the European Community. The Commission President noted the progress that the EEC was making in the political field, with the first direct elections to the European Parliament scheduled for 1979, and in its external relations, through various agreements with third world nations and its impending enlargement to include three Mediterranean countries, Greece, Spain and Portugal, and compared this progress with the barrenness which characterised its internal economic affairs. He said that Europe was now being taken more seriously from outside than from within and warned that it was not possible to sustain this situation indefinitely. He stressed the political importance of EMU as a vehicle toward political integration and called the governments of the member states to make up their minds whether or not they were serious about their declared intention to establish a European Union, for there were great dangers in having declared aims which are not taken seriously. The Community needed urgently to make the big leap to transform both its economic performance and its own view of itself and it should do this by taking a fresh look at the idea of monetary union.[1]

According to Mr. Jenkins, there were various benefits to be derived from the creation of a single currency for Europe. Monetary union would lead to a more efficient utilisation of resources and would produce a greater degree of rationalisation in industry and commerce than the Customs Union could provide alone. The Community would reap the benefits accruing to any major issuer of money and would be able to insulate itself to some extent from destabilising influences generated elsewhere (a particularly relevant point at this time of great dollar unrest). Floating exchange rates had not worked in practice as their theoretical proponents had expected.[2] They had not allowed each country to select its own optimal combination of unemployment and inflation and had led to a higher level for both. Prices tended to rise when a currency was devalued but, at best, they only rose more slowly (rather than actually fall) in those countries where the currency was revalued, thus continuously ratcheting up the level of inflation: "Exchange rates may rise and fall, but the price level in all recent experience only goes up".[3] Currency uncertainties, high inflation and the Community's structural problems had, in turn, produced unacceptably high levels of unemployment which now called for a new initiative comparable with the major economic rejuvenations of the past two hundred years and in that context monetary union had a vital contribution to make.

Arguing very much on the lines of the recently published MacDougall report[4] the Commission President claimed that the task of injecting new life into the economies of Western Europe would require a slim-line federation with a budget of around 5-7% of the Community's aggregate GNP, which though substantially higher than the current EEC budget of less than 1% was still small by comparison to fully fledged federations, where the top-tier of government usually took an average of 20-25% of GNP. A European budget of this size, Mr. Jenkins said,

would be adequate to combat the structural and regional disparities which would have to be ironed out for a full EMU to become possible, while it still implied a level of policy decentralisation which would preserve the identity and individuality of the member states of the Community. The purpose of a European federation should not be to encroach into every aspect of Community life, but to advance common policies in those fields only where action would be more efficient (or efficient at all) *because* it was carried out at the Union level and over which the individual member states by themselves had to a large extent already lost effective control. "The prospect of monetary union should be seen as part of the process of recovering the substance of sovereign power. At present we tend to cling to its shadow".[5] And Mr. Jenkins added: "These arguments do not run against international co-operation, as for example in the OECD and the IMF. On the contrary, we need to improve the functioning of the international economy by a better shaping of its constituent parts. Monetary disunity in Europe is one of the major flaws of the international system as well as in the functioning of our small to medium-sized states".[6]

Although few outside observers would have given much for the chances of a new initiative towards EMU in the autumn of 1977, Mr. Jenkins' timing was in fact well chosen. There was now a world-wide feeling of disenchantment with flexible exchange rates and, although this was stronger in Europe than in the US, the opinion gradually gained ground that floating currencies had generally failed to deliver on their main theoretical promises and that they had, in the process, contributed towards making the post-1973 recession deeper and longer than had been necessary by creating a climate of uncertainty which was hardly conducive to investment and foreign trade. The reality of stagflation in the second part of the 1970s did not fit well with the theoretical expectations of the supporters of free currency markets: Although flexible exchange

rates had probably been of some help in the aftermath of the energy crisis, they did not manage to secure independence of domestic monetary action through the complete elimination of the external constraint.[7] Nor were they successful in bringing about a smooth adjustment of the external sector. On the contrary, countries with deficits and depreciating currencies (Britain, Italy, the US) were faced with both higher inflation *and* higher unemployment accompanied by still larger external imbalances, whereas countries with strong and appreciating currencies (Japan, West Germany, Switzerland) enjoyed low unemployment and inflation and a seemingly effortless payments surplus.

Much of this, of course, had been known before and was discussed during the negotiations on international monetary reform at the C-20 and the IMF Interim Committee.[8] But, whereas then the available evidence and the argument between the advocates and the opponents of flexible currencies had on the whole been equally balanced, by 1977 there were certain aspects of the actual experience of floating which began to tilt first academic and subsequently official views in favour of more stability in exchange rates. First, there was the ratchet effect on inflation mentioned by Roy Jenkins in his Florence speech, on which no more needs to be said here.[9] Second, there were the currency crises and the excessive level of fluctuation that took place in 1976-77, which were out of all proportion to the underlying economic fundamentals of the countries concerned. Third, there was the suspicion that floating currencies themselves were responsible for the perpetuation of inflation differentials and balance of payments disequilibria between countries, because they generated what came to be known as "vicious and virtuous circles".

According to the theory, a regime of floating currencies would be free from the destabilising speculative build-ups and the large, step-like parity changes which had characterised the last few years of the adjustable peg under Bretton Woods and would ensure, instead, a smooth, continuous and gradual adjustment of exchange rates over time, which would lead to the eventual elimination of balance of payments disequilibria. Reality, however, turned out to be rather different: Currency speculation (against both, floating currencies and those pegged in the Snake), actually increased after the general transition to floating in 1973, while fluctuations such as a 23% increase in the DM-dollar rate in the space of six months or the 5% drop in the value of sterling in a single day on 25 October 1976, were not only larger than anything experienced under Bretton Woods but were also totally out of line with underlying developments in trade flows or relative prices and costs or any reasonable measurement of purchasing power parity (PPP).[10] Naturally, governments (especially those in charge of countries with open economies and large exporting sectors) could not possibly ignore these shifts and stand idly by to watch the structural dislocation that they threatened. Thus, from early on, the central banks of most industrial nations took frequent action to correct overshooting and to lean against destabilising speculation and erratic fluctuations in the currency markets, a practice which became known as managed or "dirty" floating. Gross exchange market intervention by Western central banks, which had come to only $36 billion in the year from March 1973 to February 1974, reached a total of over $100 billion in 1977.[11]

Writing in 1953 to put the case for freely floating currencies (and against government intervention in the exchange markets), Milton Friedman argued that speculation cannot, on balance, be destabilising.[12] To claim the opposite would be equivalent to saying that speculators on aggregate habitually lose money, because for speculation to be destabilising it would have to

tend to push a currency *away* from its equilibrium rate and this would imply that speculators sell a currency when it is undervalued and buy when it is overvalued! This of course was, as the author himself admitted, a rather oversimplified view of a complicated matter, formed in a world of low capital mobility and inflation and of delayed exchange rate adjustment, where parity changes were expected to take place in response to changes in the international competitiveness of different countries, trade flows and such like. This, however, was not the situation in 1977. There was now an almost universal acceptance of the theory that, in the short and medium run, exchange rates are determined by the equilibrium in the market for financial assets and that only long term equilibrium depends on the real underlying economic conditions and on PPP. Under these circumstances, an anticipated balance of payments deficit would lead currency holders to expect a drop in the exchange rate and so they would wish to change the composition of their portfolios accordingly. Capital movements would, as a result, become disequilibrating, adding to the current account deficit instead of offsetting it, and the exchange rate would fall further than was justified by the original cause of disturbance. In this way, speculation would be both, quite rational *and* destabilising, leading to overshooting and, possibly, a downward spiral of further depreciation and inflation known as a vicious circle.[13]

The essence of the vicious and virtuous circle (VC) hypothesis is that a change in the exchange rate will not by itself be successful in bringing about adjustment in the balance of payments, because it will generate changes in the domestic price level which will, before long, offset most or all of the effect of the original change in the currency rate. Let us look briefly at the case of a depreciating country caught in a vicious circle, though the same analysis can be applied (with the appropriate sign changes) to that of an appreciating country enjoying a virtuous circle. According to traditional economic theory, a currency depreciation would initially be followed by

a further deterioration of the current account, as export and import prices adjust quicker than export and import volumes, which results in a larger deficit in terms of money. Once trade volumes catch up, however, the external sector begins to improve until, eventually, the original deficit disappears (the J-curve). The VC hypothesis challenged this view of a smooth and painless adjustment (which was one of the main perceived advantages of flexible exchange rates) on the grounds that it depended on the existence of a degree of "money illusion" in the depreciating country such as it had become unrealistic to assume in the inflationary world of the 1970s. A currency depreciation raises the prices of imports and import competing goods and reduces the real value of incomes, leading trades unions to demand larger increases in nominal wages and thus pushing up the country's general rate of inflation and negating the effect of the depreciation. Under these circumstances, the hoped-for improvement in the current account may well not materialise and the J-curve begins to resemble rather a U-curve. (Whether there is in fact any improvement at all would depend on various factors, such as the openness of the economy, the industrial and political might of trades unions, the degree of wage indexation and the speed by which a depreciation is translated into higher wage settlements in the labour market). To achieve the desired equilibrium in the external sector a further depreciation now becomes necessary, which in turn leads to still higher inflation and so on.[14] This vicious circle can be powerfully reinforced by the existence of overshooting and destabilising speculation which feed on, and in turn themselves aggravate, the initial perverse phase of the J-curve.[15] This process, of course, cannot be sustained unless it is accommodated by a permissive monetary policy in the depreciating country.[16] Thus in the end, in order to break the circle and to achieve adjustment in the balance of payments, the government or central bank concerned has no choice but to take action to effect a reduction, as well as a switch, in domestic expenditure. Flexible exchange rates, claimed the supporters of the VC hypothesis, were not a panacea. Under a

regime of floating currencies, the pursuit of responsible policies at home still remained the *only* way to ensure both internal and external equilibrium. Very much in fact as had always been the case under fixed exchange rates!

Although the smallness of the external sector relative to the size of GNP made the conclusions of the VC hypothesis largely irrelevant for a country like the US, they were crucially relevant for the economies of Western Europe which were characterised by both, a high degree of openness and widespread use of wage indexation arrangements, guaranteed in some countries by law.[17] Moreover, the existence of vicious and virtuous circles, in the European context at least, seemed to be born out by recent independent econometric evidence and by the Commission's own empirical work, which tended to confirm a speeding up in the transition of inflationary impulses from the exchange rate to the rest of the economy and the increasing inability of exchange rate adjustments to overcome persistent disequilibria in the balance of payments.[18] The monetary crises of 1976 and the subsequent slide of the franc, the pound and the lira had helped to highlight the contrast between the economic fortunes of those member states which had stayed within the Snake and those which had left it and underlined the division of the Community into a hard currency and a soft currency group. These developments and the danger they represented for the internal cohesion and the future of the Community had already produced, on the initiative of the French President, Valery Giscard d' Estaing, a joint Franco-German communiqué in February 1977, which asked that the EEC "should take up again in 1978 the course leading to economic and monetary union, a necessary passage on the way to European Union".[19] However, the most important and immediate impulse for a re-examination of EMU in the European Community came not from within Europe but from across the Atlantic, caused by the persistent instability of the US dollar and the American government's lack of response to it and by the

growing sense of dissatisfaction, irritation and disillusionment in Bonn and Paris with the performance, the leadership and the person of the new American President, Mr. Jimmy Carter.

Paradoxically, to start with, conditions had appeared rather favourable for a harmonious relationship between the new American government and Western Europe. In marked contrast with what seemed to have been his predecessors' way of viewing America's partners abroad, President Carter took office in January 1977 committed to revitalise the Atlantic alliance on the basis of consultation and partnership rather than hegemony and this wish was reflected in his early choices of personnel in key areas of the new administration, which looked more Atlantic-minded than had been the case in Washington for a good many years. Despite a promising start however, relations soon began to turn sour, a development which would have been in itself important enough for the Western alliance, but which was especially notable this time for the fact that this was not yet another episode in the usual confrontation between Washington and Paris, but primarily a clash between Washington and Bonn.[20]

There were three main areas which, in the course of 1977, generated conflict between the US and West Germany (and to a lesser extent France). First, there were problems over President Carter's human rights policy which threatened to damage profitable trade with Eastern Europe and recent warmer relations with East Germany. Second, there was conflict over the issue of exporting nuclear technology, which had been triggered by a 1975 agreement between West Germany and Brazil to provide that country with nuclear reactors and reprocessing and enriching technology. This had been turned into a campaign issue in the 1976 American presidential election by the Democrats, who were worried about the possibility of development of nuclear weapons elsewhere in the American continent, and had produced an open threat about

a possible withdrawal of US forces from German soil if the deal was allowed to go through.[21] Finally, the heavy depreciation of the dollar in 1977, coming as it did on top of the falls in the value of the franc, the pound and the lira created serious problems for the Snake and threatened to destroy the competitiveness of the West German industrial sector. Between June and December 1977 alone, the DM rose by 11% against the dollar while, largely as a consequence, it also rose over the year as a whole by 6% against the franc, 4% against sterling and almost 15% against the lira. This appreciation naturally strained the internal parity structure of the Snake. Partly as a result of the seemingly relentless upward movement of the German currency, Sweden was forced to leave the system on 28 August 1977 while, on the same day, the Danish and Norwegian crowns were devalued by 5%.

West Germany and France, together with the other countries of the European Community, resented the American government's feeble and self-contradictory attitude to the plight of the dollar, which the Belgian Foreign Minister M. Simonet characterised as "aggressive neglect",[22] and rejected the attempt by US Secretary of the Treasury Michael Blumenthal to place the responsibility and the burden of adjustment for the massive American external deficit firmly and squarely on the shoulders of Europe.[23] On the nuclear issue, there was an impression created in West Germany that the Americans were trying to exploit their position as main suppliers of uranium for commercial advantage and there were fears not only about the viability of the Brazil deal, but about the very future of the country's own nuclear programme. These reservations were fully shared by the French who had made similar nuclear agreements with Pakistan and South Korea and had also been criticised in Jimmy Carter's campaign speeches. Indeed, due to France's lower reliance on the US for its defence and with the long-established tradition of relative independence from the Americans behind him, the French President was able to be more

outspoken in his criticism of the attitude and the policies of the Carter administration than the German Chancellor, for whom too obvious a confrontation with the interests of the US may have been politically advantageous under the particular circumstances but also entailed political costs. Thus, for example, on the question of human rights, Giscard openly criticised the ideological dimension in American policy which compromised the process of détente with Russia and the Eastern bloc,[24] whereas Helmut Schmidt, though he made no secret of his own doubts and of his solidarity with Giscard, was less forthright about expressing them publicly.

To these considerations came to be added others of a more personal nature. In his exasperation over the Democratic position on the nuclear issue, federal Chancellor Helmut Schmidt had been led to make an uncharacteristic (and unwise) intervention in the American election campaign and to let it be known that he preferred the Republican candidate and incumbent President Gerald Ford to win. Even after the election however, it soon became obvious that the West German Chancellor and the American President did not exactly hit it off personally.[25] Neither, despite public assertions to the contrary, did Messrs. Carter and Valery Giscard d' Estaing. On the American side, President Carter showed a distinct preference for Mr. Callaghan and the British as the European partners he felt most comfortably working with. On the European side, there gradually developed in Bonn and Paris a feeling of mistrust of, and contempt for what was seen as the American President's weak and indecisive style of leadership. By contrast, relations between the French and West German political leaders, which had always been good, grew progressively stronger and there developed a genuine personal friendship between them. It was, looking at it from a "European" and an EMS point of view, one of the fortunate aspects of the history of this period that as the Washington-Bonn axis seemed to cool down, this process was

mirrored at almost every step by an equivalent strengthening of the Bonn-Paris axis at the highest political level.[26]

It would be difficult, when considering the history of the creation of the EMS, to overstate the significance of the personalities of the French President and the West German Chancellor and of the bond that existed between them. Looking back, one cannot fail to register the extraordinary parallels between the political careers of the elegant, aristocratic and flamboyant Frenchman and the more reserved but solid and purposeful German who, despite many outward differences in character and temperament and the friction which inevitably arose from having to defend their countries' sometimes contradictory interests first in ECOFIN and then at the European Council, still managed to become and to remain genuine friends, and who shared so many basic political instincts and beliefs, important among which was a common vision of the future of Europe and its true place in the world. Valery Giscard d' Estaing and Helmut Schmidt had both been Finance Ministers of their respective countries, ascended to highest office within days of each other and, some years later, were to depart from it, equally unexpectedly, again within a short time from one another. Now, in the period between the autumn of 1977 and the spring of 1978, there took place one more of these parallels, a spectacular transformation in the personal standing and the political fortunes of both leaders in their own countries, a favourable sequence of events which became in essence the foundation stone for the creation of the EMS.

In the early part of 1977, the West German Chancellor seems to have reached his low political ebb. The October 1976 federal elections had resulted in a setback for the Social Democrats. The SPD lost a million votes and ceded its position as the largest party in the Bundestag, which it had attained for the first time in forty years in the elections of November 1972.[27] This

unfavourable result was soon followed, in the winter of 1976-77, by another poor showing for the SPD in Lower Saxony, which led to the formation of a CDU/FDP state government and generated speculation about the possibility of a similar change in the federal government in Bonn. These developments caused a surprisingly protracted loss of morale in the governing coalition and called into question the authority of the federal Chancellor himself. To make matters worse, a new spy scandal was discovered in the Chancellery (the uncovering of East German spy Gunter Guillaume in April 1974 had brought about the resignation of Herr Schmidt's predecessor, Will Brandt) and the economic situation seemed to have turned sour. High inflation drew fire from the right-wing opposition, while rising unemployment resulted in continuous sniping from his own party's left wing and extra-parliamentary opposition from the "Jusos", the youth movement of the SPD. To cap it all, the country experienced a new wave of terrorist attacks by the Baader-Meinhof gang, which culminated in the kidnap and murder of the President of the West German Employers' Association (BDI), Hans-Martin Schleyer, in October 1977. A number of other, negative political developments, as well as ill health, completed the picture of an embattled Chancellor and generated persistent press speculation about Herr Schmidt's impending resignation. Yet, all this was to change in the autumn due to a chain of events which started on 17 October 1977 with the successful rescue at Mogadishu airport of the hostages from a Lufthansa plane hijacked by a combination of PLO and German terrorists, brilliantly carried out by the Federal Frontier Police unit, formed after the Munich massacre of 1972. The sense of relief and a surge of national pride in the success of the operation sparked off a spectacular change in the political fortunes of the Chancellor and led to a remarkable transformation in his mood, confidence and attitude. Measures were taken to stimulate the economy, tough new anti-terrorist legislation was enacted, a number of outstanding external disputes were settled and there now appeared to be a new decisiveness, statesmanship and

broadness of view about the Chancellor who, by early 1978, enjoyed a degree of political freedom and mastery over his country's affairs such as he had never possessed at any time before.[28]

At about the same time, a similar turnabout had occurred in the political standing of Valery Giscard d' Estaing. The French President knew that France could not hope to maintain its leading role in Europe as long as it continued to be handicapped by relative economic weakness and, thus, he thought it indispensable that his country should try to emulate West Germany's economic performance. To this purpose, he needed the discipline that a fixed exchange rate regime (a system with which his own sympathies lay in any case) would exert on the domestic economy, but, for reasons of national prestige, he wanted to establish a completely new system rather than to effect a third entry of the franc into the Snake, which may well have been politically unacceptable. However, in mid-1977, Giscard's freedom of action was severely limited by a number of political developments which hemmed the President in from both the right and the left of the political spectrum simultaneously. On the one hand, the anticipated unpopularity of the austerity programme imposed by Prime Minister Raymond Barre resulted in substantial progress for the left-wing opposition and in particular Francois Mitterand's Socialist Party in the March 1976 and March 1977 local elections and created strong expectations that the left would obtain an overall majority in the forthcoming parliamentary contest. On the other hand, the rise within the governing coalition of the neo-Gaullist leader Jacques Chirac, who had been dismissed by Giscard as Prime Minister in August 1976 and who had now managed to score a remarkable personal triumph by being elected Mayor of Paris, undermined Giscard's authority within his own side and in the country as a whole, leading M. Mitterand to claim that Giscard was a lame duck President "under house arrest".[29] In the event, luck and the French

people were on the President's side. The election of 12 March 1978 gave the governing coalition a strong majority and, equally important for Giscard, the RPR lost ground and the government's success was attained by an advance of the UDF, a loose federation of center-right parties associated with the President. Thus, at the same time as Helmut Schmidt was riding high in West German politics, his friend and colleague Valery Giscard d' Estaing also found himself in possession of a freedom of action and room for manoeuvre that was unrestricted by the kind of political considerations which he had had to keep constantly in mind since his election in 1974.

If, however, between the spring of 1977 and the spring of 1978 conditions became once again opportune for the undertaking of a new European initiative, it took the skills and the influence of a third forceful personality to direct this new-found freedom and the intellectual endeavours of the French President and the West German Chancellor towards a renewed drive for monetary union. This came in the person of the new British President of the Commission, Mr. Roy Jenkins. When Mr. Jenkins succeeded Francois-Xavier Ortoli in January 1977, the Community was going through a period of internal paralysis and self-doubt which threatened it with eventual disintegration. The Community seemed unable to find its place in the world, the EMU project lay in ruins and within Europe there seemed to increasingly emerge a centrifugal division between a strong central core and a weaker periphery, which did not augur at all well for the future, especially given the prospect of the EEC's forthcoming second enlargement. Among the three big countries of the Community, the West Germans still exhibited that peculiarly German reluctance to assert themselves and to assume the leadership of Europe's affairs. The French would have loved to do just that but were unable to because of the weak state of their economy, especially now that the franc had been forced to leave the Snake for a second time. The British, finally, who were facing a shaky political situation at home and were recovering from the recent

economic crisis and the attack on sterling, lacked both the inclination and the ability to do so. Despite a strong pro-European showing in the Common Market referendum of 1975, a government majority of just three made it necessary to placate the anti-EEC left wing of the Labour Party, a situation which was only partly relieved through a parliamentary pact with the Liberal Party in March 1977. In Peter Ludlow's words, "the Germans would not lead, the French could not and the British neither would nor could".[30] Into this political gap stepped Roy Jenkins, the first political heavyweight of anything like prime ministerial calibre to ever hold the post of Commission President. He quickly set out in the first few months of 1977 to raise the political profile of the Commission, utilised the support and the grievances of the six smaller member states to establish himself as a full participant in the European Council and began to make a new push towards EMU the cornerstone of his presidency.

In formulating his ideas Mr. Jenkins received invaluable help from Michael Emerson, who had helped draft the MacDougall report in the winter of 1976-7, and this influence was evident in the Commission President's speech in Florence. However, though well received in "European" circles and despite being in line with the joint Franco-German communiqué issued in February, Mr. Jenkins' first approaches on the subject of EMU in the second half of 1977 met with an almost uniformly negative reaction in the press and divided the Commission itself. Although some of the newer Commissioners, such as Messrs. Cheysson, Davignon, Gundelach and Tugendhat, supported the idea, the old guard was more sceptical. Just one week before Florence, Francois-Xavier Ortoli, who was not only Mr. Jenkins' predecessor but also the Commissioner responsible for Economic and Financial Affairs, let it be known that he considered Mr. Jenkins' initiative "politically absurd"[31] and his view was shared by the senior Commissioner from West Germany, Wilhelm Haferkamp.[32] The press reaction to the Florence

speech, when it came, was that suited to a well-intentioned pipe-dream, and the speech drew sceptical comments from the West German Finance Minister Hans Apel, as well as Count Otto Lambsdorf, the West German Minister of Economics. The Commission for itself decided to take the easier road. On 17 November 1977, M. Ortoli presented his own, less controversial set of ideas, a shopping list of things to be done, including a mild programme of economic policy co-ordination to prepare the way towards EMU. Thus, three weeks after Florence, the Commission's official view on the subject remained one based on precisely the kind of approach which Mr. Jenkins had discreetly but unmistakably criticised in his speech. Yet, as if to prove M. Ortoli's original analysis of current political reality, even this far less ambitious set of proposals received a mauling at the ECOFIN meeting of 20 November, particularly at the hands of the West German Ministers. But, by this time it really made no difference, for the Commission President had now already decided that the only hope for his ideas lay in by-passing normal Community channels of communication and had, therefore, embarked on a careful and determined campaign to link progress in EMU with German national interests and in particular to attract the West German Chancellor, Helmut Schmidt.

World economic developments played into the Commission President's hands. On the one hand, there was the decline of the dollar and the appreciation of the DM, not only against the American currency but also relative to those of its European trading partners (and competitors). On the other, there was the very real pressure exerted on the West German government in late 1977 and 1978, first by the US and subsequently by Britain, to take a more active part in the effort of moving the world economy out of recession by reflating. True, the "Locomotive theory" of 1975-76, which placed the burden of achieving an adequate rate of economic growth on the big three, had now been replaced by the "Convoy theory", under which Great Britain and

Italy, whose external payments positions had recently improved considerably, were also expected to contribute. But in reality, because of the explosion of the American trade deficit in 1977, under the "convoy" the US was effectively taken out of the calculation, so that the burden would fall even more heavily on West Germany and Japan. "The convoy was a convenient slogan. The reality looked suspiciously like a train that, owing to accidents along the line, would now have to be pushed by two engines rather than three".[33] Thus, in the middle and later part of 1977, the West German government found itself squeezed on two fronts simultaneously: Outside Germany, it was criticised for not pulling its weight and not doing enough to stimulate the world economy. At the G-7 London Summit in May and again at the IMF meeting in September, the Federal Republic found itself in the dock, being accused of irresponsibility for having pursued what it simply saw as virtuous economic management, a situation which struck most West Germans as unfair. Bonn's protests that it was already running an overgrown government deficit, a 10% increase in the 1978 budgetary expenditure announced on 14 September 1977, and the German retort that it would not help the world economy to turn one of its healthier constituents into a sick one had only a limited effect and the external pressure to reflate continued well into 1978. Inside Germany, the pressure was the other way round. There, the right-wing opposition parties accused the government and the Chancellor of buckling under foreign pressure and of putting the country's domestic economic stability in jeopardy, and urged immediate measures to reduce public spending and the federal deficit.[34]

Thus, in late 1977, Helmut Schmidt found himself facing a dilemma and this Mr. Jenkins was able to skilfully exploit. In their Bonn meeting on November 18, the Commission President put it to the West German Chancellor that he had, in effect, two options open to him: Either to reflate or to work towards a Community solution to the problem, through the creation of an

integrated, hardcore European economy based on a new drive toward monetary union. Mr. Jenkins knew that in his effort to put EMU back onto centre stage and to persuade Herr Schmidt he could count on the support of the French President, Valery Giscard d' Estaing. He also received crucial help by one of those coincidences which have so regularly marked the history of EMU and which now brought Belgium to hold the presidency of the European Community during the second half of 1977 and the Belgian Prime-Minister, Leo Tindemans, whose own report and call for a new effort towards EMU had received less than the attention it had merited in the previous year, to be the Chairman of the European Council. The comparison with the British presidency of the first part of the year was striking. Where before the attitude of the presidency had been negative, some anti-EEC Labour Ministers, notably Messrs. Anthony Wedgewood-Benn and John Silkin, had used their chairmanship of their respective Councils to bring disarray and near-stagnation to the workings of the Community and Mr. Jenkins himself had been, on occasion, personally snubbed, the Belgians went to some lengths to ease the way and to ensure a fair and favourable treatment of the Commission's ideas at the Brussels European Council on 5-6 December 1977. There, as a result of a forceful presentation by Mr. Jenkins, the active encouragement of Herr Schmidt and the skilful chairmanship of Mr. Tindemans, the heads of state took a more favourable view of the new proposals than ECOFIN had done two weeks earlier and asked the Commission and the Council of Ministers to continue the study of EMU, so that the subject could be discussed further at the next meeting of the European Council scheduled to take place in Copenhagen in April. Mr. Jenkins' strategy had finally begun to pay off. EMU was not, after all, politically as dead an issue as most outside observers had thought!

IIIa2. The creation of the EMS

At some point in early 1978, the West German Chancellor Helmut Schmidt was finally convinced by the arguments of the Commission President Roy Jenkins and the latest developments in the world economy that a new initiative towards EMU was in the interests of both the European Community in general and of his own country in particular and resolved to throw his political weight fully behind it. He informed Mr. Jenkins of his decision during their Bonn meeting of 28 February and, at about the same time, discussed the subject with the French President Valery Giscard d' Estaing whom, as expected, he found to be in basic sympathy with his ideas. Given this agreement and the personal commitment of the two most important political leaders in Europe, the full extent and depth of which was not as yet known but which was forcefully exhibited in the months that followed, the real question now was not *whether* there was going to be a new drive towards EMU but rather one about its content and timing, as well as the more immediate problem of how best to deal with the opposition which such a move was bound to engender. From the beginning, the German Chancellor seems to have thought (correctly as it turned out) that, given the recent experience of the EMU project, the continuing divergence in the economic performances of the member states and the current instability in the exchange markets, any new initiative towards monetary integration in the Community would face implacable resistance from finance ministries and central banks, not least from within his own Federal Republic. He therefore concluded that the best hope for such an initiative lay in the kind of strategy which Mr. Jenkins had successfully pursued so far, and decided to by-pass normal official and diplomatic channels and to appeal directly to his colleagues at the European Council.[35] On this fundamental point of strategy and the other essential elements of his proposal he was able to persuade the French President at their meeting at Rambouillet Castle on 2 April

1978, just five days before the Copenhagen European Council. The way for the EMS was open. Having set the process in motion, the President of the Commission, Mr. Roy Jenkins, was now able to recede more to the background as the new project increasingly became the "Helmut and Valery show".[36]

The main thrust of Herr Schmidt's proposals was revealed at an informal, after-dinner conversation between the heads of state and government of the member states, acting without the presence of advisers, which took place at Marienborg Castle on the evening of the first day of the Copenhagen European Council of 7-8 April 1978. There, after some preparatory work by M. Valery Giscard d' Estaing, the West German Chancellor announced the general outline of a plan which called for the extension of the role of the EUA to turn it from just an accounting device to a reserve asset and an international means of settlement, a pooling of 15-20% of the member states' foreign reserves, increased use of Community currencies in exchange market interventions and the creation of a European Monetary Fund (EMF) which would take over the functions of FECOM and the European Investment Bank (EIB). The plan took Herr Schmidt's colleagues by surprise, but most of them gave positive reactions, although the Italian Prime Minister, Sr. Giulio Andreotti, appeared to have some reservations and the British Prime Minister, Mr. James Callaghan, expressed at some length his serious misgivings about the possible effect that the proposed scheme would have on the position of the IMF and the dollar and did not even try to hide his annoyance at the way the West German Chancellor's initiative had been sprung without warning upon the rest of the European Council.[37]

Since the proposals were at such an early stage of development and so far represented only Herr Schmidt's personal point of view, it was decided, on the Chancellor's insistence, not to make

them public, at least for the time being. Indeed, the European Council did not decide on any particular procedure to be followed in relation to the proposals and it was at first mistakenly thought that Mr. Callaghan's reservations about the scheme had effectively killed it. Far from that being the case, however, Messrs. Schmidt, Callaghan and Giscard d' Estaing had in fact decided between themselves in Copenhagen that the best way to proceed would be to appoint a small team of one technical expert from each of the three countries to examine further and in secret the issues raised by the German Chancellor's plan. The three experts nominated were Dr. Horst Schulmann, Herr Schmidt's chief economic adviser at the Chancellery, Mr. Ken Couzens, Second Permanent Secretary to Her Majesty's Treasury, and M. Bernard Clappier, Governor of the Banque de France. The three men started work on the details of the new scheme soon after Copenhagen, but it quickly became obvious that there existed a gulf between the German and French representatives on the one side and their British colleague on the other in that, whereas the former were basically sympathetic towards a new attempt at EMU and in tune with their political masters' personal commitment to it, Mr. Couzens and the British in general had totally misjudged the depth of that commitment and were far less enthusiastic about a new monetary venture anyway, fearing the possible impact this could have on the already shaky condition of the dollar and worried about the probable upward pull of the DM on sterling. This gulf between the experts did not close as time progressed and it was eventually considered necessary to exclude Mr. Couzens from the final phase of the deliberations. The other two summarised their conclusions in a joint document and it was this which Helmut Schmidt and Valery Giscard d' Estaing decided, at a meeting in Hamburg on 23 June, to present as a common Franco-German proposal to the forthcoming Bremen European Council, scheduled to take place on 6-7 July 1978.[38]

In the meanwhile, as news slowly filtered out that something important had been discussed in Copenhagen in relation to EMU, the relevant bodies of the Community, the Monetary Committee, the Committee of Central Bank Governors and ECOFIN began to pay renewed attention to the subject. Particularly important here was the contribution of the Monetary Committee which, under the energetic chairmanship of Jacques Van Ypersele de Strihou, had started on a reappraisal of the chances of a new drive towards EMU, as well as a careful examination of ways to improve the functioning of the Snake and to bring the currencies which were currently outside it back in, even before Helmut Schmidt made his plans known in early 1978. The result was that, between April and June, reactions to the prospect of a new initiative towards EMU became gradually more favourable and all the member states took an active interest to ensure that the proposed scheme should meet their needs and deal with their concerns. What these were was clearly expressed in the ECOFIN meeting of 19 June 1978: The non-Snake countries wanted to ensure that the new system would achieve greater symmetry between the adjustment obligations of weak and strong members, that it would be backed by adequate facilities for financial support, that it would be directed against the vital interests of other countries, that it would possess sufficient flexibility to allow parity changes when necessary and that some transitional arrangements would be agreed for the weaker currencies to cushion the blow of their return to a fixed-rate mechanism. The Snake countries on the other hand wished to emphasise in addition that the Snake should continue to exist for its members (a stipulation which was seen as indispensable so as to avoid a speculative attack on the parity structure of the Snake in the run-up to the new system) and that participation entailed strict economic policy commitments aimed to achieve a progressive narrowing of the differences in the economic performance of the member states.

These were, of course, much the same issues that had occupied the secret negotiations between the technical experts and a constructive synthesis of the various views had been found in the joint Franco-German document which Helmut Schmidt and Valery Giscard d' Estaing commended to their colleagues as a point of departure for further discussion during the Bremen meeting of the European Council on 6-7 July 1978. Despite the fact that there was some initial annoyance at the secretive and exclusive way in which the proposals had been put together (the Italian, Danish and Benelux governments had been briefed on the Schulman-Clappier-Couzens talks only a few days before Bremen and the Irish government had not been briefed at all), the members of the European Council did not allow this issue to overshadow the vast political significance of the proposals before them and there was not a revolt by the smaller member states as some, notably Mr. Callaghan, had expected. Despite continued reservations on the part of the British Prime Minister (shared in part by Sr. Andreotti and the Dutch premier, Mr. Andries van Agt) and an attempt to prevent publication of the Franco-German proposals, the European Council finally decided to accept the Schulmann-Clappier document in its entirety as a basis of further studies on the technical feasibility of establishing a European Monetary System (EMS). These studies should be concluded by the end of October at the latest, in time for a final decision to be taken at the next meeting of the European Council, scheduled to take place in Brussels at the beginning of December 1978. It was agreed that the new system would have at its centre the EUA, now to be called the European Currency Unit (ECU) and that in terms of exchange rate management it would be at least as strict as the Snake, although wider margins would be available for a limited period to currencies not participating in the Snake. Interventions would in principle be conducted in Community currencies and the ECU would be used as a means of settlement between the participating central banks. The member states would undertake to co-ordinate their exchange rate policies towards third countries and to pool

20% of their foreign reserves. Not later than two years after the start of the system, a European Monetary Fund (EMF) would be created to take over the responsibilities of the existing institutions. FECOM would continue to operate in the intervening period, but the funds available for monetary support would be increased to the equivalent of 20% of total foreign reserves. The member states would co-ordinate their domestic economic policies so as to achieve greater stability and convergence of economic performance. Finally, in parallel with the technical feasibility studies, there would be a concurrent examination of measures to strengthen the economies of the less prosperous members of the Community, to enable them to take their full part in the new system.[39]

Having thus put the EMS train in motion within Europe, Chancellor Schmidt now turned his attention to ensuring a positive reaction to the scheme by the international community and to making the EMS an integral part of a wider deal for the reinvigoration of the world economy. The initial response of the US to the EMS proposals had been cautious but favourable, a position which arose as a compromise between those in the Carter administration who were naturally predisposed to see almost any well-intentional scheme that promoted European unity as a positive development and those, usually to be found within the US Treasury, who thought that a new strong currency bloc could prove a threat to American interests, especially if it laid the foundations for the creation of a viable single currency which could rival the role of the dollar in the world economy. This mild reaction on the part of the American government to the EMS proposals as well as a highly successful state visit by President Carter to the Federal Republic which cleared up some misunderstandings and led to warmer personal relations paved the way for a compromise on growth by the West German Chancellor and created the right conditions for a deal to be struck at the G-7 summit that took place in Bonn on 16-17 July 1978, just ten days

after Bremen. Herr Schmidt promised an increase in aggregate demand of up to 1% of GNP as a contribution to world growth (in the event, the measures which Bonn announced later in the month amounted to rather more than that). President Carter on the other hand confirmed his administration's generally positive view of the EMS and promised to enact a US energy policy which would aim to curb America's seemingly insatiable appetite for imported oil.

Within the European Community, domestic political opinion was favourable to the EMS proposals as they had been unveiled in Bremen and Bonn in three out of the four non-Snake member states. France was, of course, one of the two co-sponsors of the scheme and, with few exceptions, the views of the political establishment and the press seemed to concur with the President's own analysis of the situation. The EEC, Giscard argued, was the only major industrial area without internal monetary stability. Although the Snake had been of some use in this respect, it fell way short of what was necessary and had operated in practice just as a mechanism for currency intervention at the margin. The EMS would give a boost to trade, investment and economic growth in the Community and would promote the development of a common exchange rate policy towards the rest of the world, particularly the US dollar.[40] Political opinion was also favourable to the EMS in Ireland, where both the Fianna Fail government led by Mr. Jack Lynch and Fine Gail, the main opposition party, came out strongly for Irish participation even though this might mean a break with sterling if Great Britain decided to stay out of the scheme. Indeed, a break with sterling was deemed to be *desirable* on political grounds, while the rising significance of the rest of the Community in Irish trade made it a more acceptable option in terms of economics, though of course Britain still accounted for more than 47% of the country's exports and some 53% of its imports.[41] With only the small Labour party opposed to entry, Irish participation was thus virtually assured from the start and the

negotiations between the Dublin government and its more affluent partners over the next few months centered round the need to agree on an adequate financial package to provide funds for the various infrastructural projects which the Irish claimed were necessary to prepare the economy for the challenge of full membership of the EMS.

Despite the strong pro-European feeling in Italy, shared by parties across the political spectrum, the Italian response to the EMS was complicated by the habitual state of political instability in that country and by calculations of domestic political advantage. Following the latest government crisis, Giulio Andreotti put together a five-party coalition in March 1978, based on support in parliament from his own Christian Democrats as well as the small Republican and Social Democratic parties, Mr. Bettino Craxi's Socialists (PSI) and (for the first time in the majority since 1947, though still not in the government) the Communist Party (PCI) led by Enrico Berlinguer. Within this heterogeneous grouping opinions on the Franco-German scheme were always likely to differ and so they did. At one end, the Republican Party made it clear that it could not continue to support the government unless it gave its full and unconditional backing to the plan. At the other, the PCI came out against immediate entry, fearing that in practice the system would work in a deflationary manner with serious consequences for the lower income brackets whence the party drew most of its support. In the middle stood the Christian and Social Democrats who on the whole welcomed the proposals although with some reservations, and the PSI which was anxious to ensure the participation of the British in the scheme to minimise any adverse effects on the Italian economy through close association with a strong-currency group dominated by the present Snake.

This desire to secure the participation of sterling as a counterweight to the DM characterised the negotiating tactics of the Italian authorities after Bremen and led to a series of bilateral meetings

TABLE 7

Structure of EEC imports by country and region, 1958 and 1978

(% of total)

	Imports of															
	BLEU		D		DK		F		I		IR		NL		UK	
To	1958	1978	1958	1978	1958	1978	1958	1978	1958	1978	1958	1978	1958	1978	1958	1978
BLEU	--	--	4.53	8.58	3.81	3.62	5.37	9.17	2.02	3.34	1.83	1.97	17.85	12.50	1.61	3.68
D	17.16	23.82	--	--	19.84	20.80	11.64	18.85	12.13	17.36	4.00	6.53	19.48	25.45	3.60	10.81
DK	0.53	0.49	3.35	1.69	--	--	0.63	0.67	2.19	1.04	0.70	0.74	0.67	0.82	3.07	2.31
F	11.60	16.92	7.59	11.62	3.43	4.44	--	--	4.86	14.57	1.60	4.67	2.79	7.55	2.67	7.65
I	2.15	4.14	5.46	9.52	1.70	3.34	2.35	10.13	--	--	0.85	2.63	1.77	3.78	2.04	4.70
IR	0.10	0.47	0.10	0.39	0.01	0.27	0.05	0.62	0.05	0.21	--	--	0.05	0.53	2.90	3.53
NL	15.72	13.69	8.03	13.25	7.34	5.55	2.53	6.22	2.58	4.20	2.86	3.29	--	--	4.22	5.27
UK	7.40	8.65	4.38	5.08	22.82	11.44	3.59	5.54	5.50	3.39	56.41	53.31	7.39	6.71	--	--
EEC	54.66	68.18	33.44	50.13	58.95	49.46	26.16	51.20	29.33	44.11	68.25	73.14	50.00	57.34	20.11	37.95
US	9.92	5.85	13.57	6.74	9.10	5.46	10.04	7.33	16.23	6.78	6.98	7.56	11.31	8.60	9.34	11.87
JPN	0.63	1.65	0.61	2.91	1.48	3.18	0.18	1.99	0.41	1.20	1.07	2.84	0.82	2.26	0.94	3.29
OPEC	--	7.24	--	7.92	--	3.22	--	14.33	--	17.72	--	3.33	--	11.82	--	8.64
OTH	34.79	17.08	52.38	32.30	30.47	38.68	63.62	25.15	54.03	30.19	23.70	13.13	37.87	19.99	69.61	38.25

Source: European Economy No. 4, November 1979.

TABLE 7

Structure of EEC imports by country and region, 1958 and 1978

(% of total)

	Imports of															
	BLEU		D		DK		F		I		IR		NL		UK	
To	1958	1978	1958	1978	1958	1978	1958	1978	1958	1978	1958	1978	1958	1978	1958	1978
BLEU	--	--	4.53	8.58	3.81	3.62	5.37	9.17	2.02	3.34	1.83	1.97	17.85	12.50	1.61	3.68
D	17.16	23.82	--	--	19.84	20.80	11.64	18.85	12.13	17.36	4.00	6.53	19.48	25.45	3.60	10.81
DK	0.53	0.49	3.35	1.69	--	--	0.63	0.67	2.19	1.04	0.70	0.74	0.67	0.82	3.07	2.31
F	11.60	16.92	7.59	11.62	3.43	4.44	--	--	4.86	14.57	1.60	4.67	2.79	7.55	2.67	7.65
I	2.15	4.14	5.46	9.52	1.70	3.34	2.35	10.13	--	--	0.85	2.63	1.77	3.78	2.04	4.70
IR	0.10	0.47	0.10	0.39	0.01	0.27	0.05	0.62	0.05	0.21	--	--	0.05	0.53	2.90	3.53
NL	15.72	13.69	8.03	13.25	7.34	5.55	2.53	6.22	2.58	4.20	2.86	3.29	--	--	4.22	5.27
UK	7.40	8.65	4.38	5.08	22.82	11.44	3.59	5.54	5.50	3.39	56.41	53.31	7.39	6.71	--	--
EEC	54.66	68.18	33.44	50.13	58.95	49.46	26.16	51.20	29.33	44.11	68.25	73.14	50.00	57.34	20.11	37.95
US	9.92	5.85	13.57	6.74	9.10	5.46	10.04	7.33	16.23	6.78	6.98	7.56	11.31	8.60	9.34	11.87
JPN	0.63	1.65	0.61	2.91	1.48	3.18	0.18	1.99	0.41	1.20	1.07	2.84	0.82	2.26	0.94	3.29
OPEC	--	7.24	--	7.92	--	3.22	--	14.33	--	17.72	--	3.33	--	11.82	--	8.64
OTH	34.79	17.08	52.38	32.30	30.47	38.68	63.62	25.15	54.03	30.19	23.70	13.13	37.87	19.99	69.61	38.25

Source: European Economy No. 4, November 1979.

between Italian officials and their British counterparts, whose aim was to forge a common position towards the Franco-German proposals. However, although the two countries shared many basic beliefs on the priorities and direction of economic policy and could draw on a common pool of practical knowledge through their parallel experience of floating currencies, these talks eventually came to nothing, for it quickly became obvious that , whereas the Italians were basically in favour of joining if the right terms could be negotiated, the British, though very keen on the technical aspects of the debate, were essentially agnostic on the question of their own participation and preferred to take what came euphemistically to be called an attitude of "constructive caution". The Prime Minister himself did appear more favourable to the scheme after Bremen, fearing that if Britain did not join it would be isolated but this view had only limited appeal within the rest of the Labour party which had come to be increasingly dominated by its militant and anti-EEC left wing. There was vehement hostility to the EMS in the Cabinet, the National Executive Committee and probably a majority of the Parliamentary Labour Party, while the TUC, though generally in favour of fixed exchange rates, was afraid of the deflationary consequences of a link with the appreciation-prone DM on economic growth and on employment. The Conservative opposition was similarly divided over the issue, on the one hand wishing to live up to its supposedly pro-European credentials but, on the other, weary of the limitations that the EMS would pose on the ability to pursue the kind of independent monetary policy which it considered to be the only solution to the country's economic ills. There was also scepticism about the details of the scheme within academic circles and certain quarters which could not in any way be thought of as anti-European. Within the relevant departments of state, the Treasury's reservations were more than a match for the favourable attitude of the Bank of England, while the Foreign Office and its chief, Dr. David Owen, who would normally have been expected to push hard for the European cause were noticeably

lukewarm towards the proposals. The quality press, by contrast, came out generally in favour of British participation, arguing that the scheme would go ahead with or without Britain and what, by not joining, Britain would lose credibility and the opportunity to influence the course of future events and developments in this as well as in other issues of concern to her, such as the reform of the Community budget.

It was against this political background that negotiations took place on the technical details of the EMS in the summer and autumn of 1978. Once again (as had been the case after the Hague Summit of 1969) those who were called to put the decisions reached at Bremen into operation soon discovered that behind the presumed agreement lay different interpretations of what exactly had been decided and that serious disagreement existed even between the two co-sponsors of the scheme, West Germany and France, on two main issues, namely the role of the ECU in the intervention mechanism of the new system and the precise status and functions of the proposed EMF. The Schulmann-Clappier document specified that the ECU would be "at the centre of the system". The French, supported by the Italians and the British, took this to mean that intervention obligations in the new EMS would be based on deviations from a central rate relative to a weighted basket of all Community currencies as expressed in the ECU. The West Germans on the other hand, supported by the Dutch, insisted that the ECU would become a central numeraire for the system but that the obligation to intervene would be based on the bilateral parity grid, as it had been in the Snake.

There were two main reasons why the French and the other non-Snake member states wanted to create an ECU-based intervention mechanism. The first was a political one: These countries had left the Snake (France twice) and, if they were now going to rejoin a fixed exchange rate

European scheme, considerations of national prestige required that this should be substantially different from the Snake. The second reason was economic: Although the parity grid at first sight seems symmetrical as to the intervention obligations of strong and weak-currency nations, requesting *two* central banks to intervene simultaneously as their respective currencies reach the top and bottom of their bilateral band of fluctuation, in reality the system tends to operate in an asymmetrical way and is biased against the weak. This is so because the practical constraint on strong-currency countries, which effectively consists of an increase in the domestic money supply as a result of intervention in the exchange markets and which can in normal times be sterilised in part or in full through appropriate action by the government or central bank concerned, is very much lighter than the danger of reserve depletion faced by weak-currency countries, or the need to borrow funds for exchange market intervention which, according to the rules of the Snake, had then to be repaid within a period of thirty days. Moreover, the experience gained so far had shown that, more often than not, it had been a *strong* currency (usually the DM) reaching its upper limit which had created problems for the parity structure of the Snake rather than a weak one reaching its lower limit. An ECU-based system would identify *one* deviant currency in a way that the parity grid, which always showed two currencies at their margins, could not do and would place the burden of adjustment on the guilty government rather than on two, irrespectively of one's fault.

As was to be expected, the Snake countries objected to the basket system for precisely those same reasons that it appealed to the non-Snake ones. The Bundesbank in particular rejected any change in the intervention mechanism of the system, claiming that this would raise West Germany's inflation rate close to the Community average and that the French interpretation did not tally with the undertaking of the European Council in Bremen that the new scheme would be

at least as strict as the Snake. To these considerations came to be added two others of a more practical nature: First, an ECU-based system was found to be technically complicated and cumbersome. Second and more important, a closer examination of the details of the proposal revealed that the basket might not redress the balance of the system in favour of its weaker participants and, in this respect, it might in fact turn out to be *worse* than the parity grid. The problem arose because of the weighting method used to calculate the ECU, under which the weight of a currency in the basket increased when it appreciated and decreased when it depreciated. As a result, the Snake element in the basket would tend to pull the ECU upwards (especially if sterling did not participate as seemed increasingly probable) and this would expose the weak just as often as the strong as the single deviants.[42] Again, experience had shown that this was more than a theoretical possibility: Between April 1975, when the EUA was introduced, and September 1978, the weight of the DM in the basket had risen from 27.3% and that of the Snake as a whole from 47.5% to 55.1%.[43]

In the early autumn of 1978, the Monetary Committee and the other relevant bodies of the Community studied the options and searched for a solution which would take into account the technical complexities involved and would provide an acceptable synthesis of the views and interests of strong and weak currency member states. The breakthrough came on 7 September 1978, when what came to be known as the "Belgian compromise" was put forward in the Monetary Committee by its Chairman, M. Jacques van Ypersele. According to this, the intervention mechanism of the system would continue to be based on the parity grid. This, however, would be supplemented by an ECU-based divergence indicator, the aim of which would be to provide an early warning of divergence, before a currency reached its fluctuation limit so that corrective action could be initiated. A meeting in Bergamo on the following day, 8

September, between the Italian and French Finance Ministers and Central Bank Governors, Messrs. Pandolfi, Baffi, Monory and Clappier, concluded that the parity grid might after all have some advantages relative to a basket mechanism, even from the point of view of *weak* currency countries, and that progress should therefore be encouraged along the lines proposed by the Belgian compromise, a decision which generated caustic comments by the British that the French and Italians had capitulated to German pressure. Finally, in a bilateral meeting on 15 September in Aachen between Helmut Schmidt and Valery Giscard d' Estaing, the issue was settled and it was decided that the parity grid would continue to be the dominant element in the intervention mechanism of the system. The ECOFIN meeting of 18 September in Brussels confirmed this decision and accepted the ECU indicator as a secondary pointer of divergence, in a vain effort to placate the British Chancellor of the Exchequer, Mr. Denis Healy. The remaining outstanding issues were sorted out by the specialist committees and finalised at the ECOFIN meetings of 16 October and 20 November 1978: Maximum divergence spreads were agreed for each individual member currency in such a way as to take into account the effect of their different weights in the make-up of the ECU and to provide equal margins of fluctuation for all of them (in an undifferentiated structure the weightier currencies would have had larger effective bands, as their movement would pull the ECU in the same direction). A divergence threshold was agreed at 75% of the maximum divergence spread, beyond which there was a "presumption" that the government or central bank concerned would undertake corrective action (under normal circumstances, this would mean that the divergence indicator would be triggered before a currency had reached its bilateral fluctuation limit in the parity grid).[44] Finally, it was agreed that fluctuation margins of up to +/-6% would be available for a temporary period for those countries whose currencies were currently floating outside the Snake.

TABLE 8

Maximum divergence spread and divergence thresholds

vis-a-vis the ECU related rate.

Currency	Maximum divergence spread %	Divergence threshold 75% of maximum spread
BFR/LFR	+/-2.03	+/-1.52
DKR	+/-2.18	+/-1.64
DM	+/-1.51	+/-1.13
FF	+/-1.80	+/-1.35
HFL	+/-2.01	+/-1.51
IRL	+/-2.22	+/-1.67
LIT	+/-5.43	+/-4.07
UKL	--	--

Source: Commission of the European Communities (1979a).

Unfortunately, it did not prove as easy to reach an agreement on the other contentious point of the EMS negotiations, that is the scope and the functions of the proposed EMF. The French and the Italians talked in terms of a fairly ambitious institution, whereas the Bundesbank took a minimalist view of the Bremen decisions and claimed that the EMF should have a limited role and that its establishment should not in any way threaten the bank's ability to control West German domestic liquidity or raise the average level of inflation in the Community. To this end, the bank argued for strict limits on the available credit, limits on the amount of ECU a central bank would be obliged to accept (so other central banks could not exchange excessive amounts of ECU for DM) and warned that intervention in Community currencies should not end up meaning effectively intervention in DM. Although agreement was eventually reached on the questions of the size and duration of the available credit as well as its division between short and medium term financial instruments,[45] the failure to settle the next steps on the creation of the EMF within the timetable set out in Bremen showed that the disagreements over the institutional aspects of EMU which had plagued the EMU project earlier in the decade were still very much alive and was a bad omen for the chances of the Community to establish the EMF within the deadline of two years specified by the European Council.

Further problems arose during the concurrent studies undertaken to examine the impact of EMU on the weaker member states of the Community and to decide on an adequate transfer of resources to enable them to participate in the EMS. The relevant negotiations took place in the Economic Policy Committee (EPC), [46] quickly became deadlocked and remained so, to the point that they cast serious doubt on the success of the whole enterprise. The Irish delegation presented a detailed list of infrastructural projects they wanted to carry out and asked for a total of $650 million over five years in increased aid from the Regional Fund to pay for them. Italy,

TABLE 9

Short term monetary support and medium term financial assistance in the European Monetary System (million ECU).

Country	STMS debor quotas	STMS creditor quotas	MTFA commitment ceillings
West Germany	1740	3480	3105
France	1740	3480	3105
United Kingdom[1]	1740 (720)	3480 (1460)	3105
Italy	1160	2320	2070
Netherlands	580	1160	1035
Belgium/Luxembourg	580	1160	1035
Denmark	260	520	465
Ireland	100	200	180
Rallonges	8800	8800	--
Total	16700	24600	14100

Source: Commission of the European Communities (1979a).

[1] The creditor and debtor quotas agreed for the UK will become applicable once the country has joined the ERM. Until then, its old quotas will be used, as shown in parentheses.

on the other hand, presented a list of the kind of projects it thought the Community could support in order to help its poorer members and to balance somewhat the inequities of the EEC budget, but avoided to advance detailed proposals or to be more specific about figures. Finally, Great Britain took the view that the question of a transfer of resources and of EMU in general should be seen in the context of a complete revision of the EEC budget and combined with a thorough reform of the CAP.

As was to be expected, the countries who were likely to be called upon to finance any transfer of funds to the less prosperous member states, especially West Germany and France, took a very different view of the problem. Although there was general sympathy for the Irish case, it was hotly disputed whether Great Britain or Italy required special treatment and it was argued (with some justification) that these two countries should join the EMS for its own merits without need for special compensation. These arguments were reinforced by the current dispute between the Council of Ministers and the European Parliament over the latter's insistence on sizeable increases for the Regional and Social Funds in the 1979 budget to which the Council objected, as well as the fact that past experience suggested that a good proportion of the money allocated to these funds would not actually be used, because the member states entitled to it would not manage to come up with sufficient suitable projects. Finally, the British wish to link progress on the EMS with a reform of the budget and the CAP was seen for what it was, the opening tactical moves in a long-lasting battle over the size of the British contribution to the budget, which was to torment the Community for some time. By now it was clear anyway that Britain would not join the EMS, but even if the British protestations had been genuine and there had been agreement (*which there was not!*) on the reforms that London wanted, their implementation would have taken a lot longer that the deadline of the forthcoming Brussels European Council

which, it was agreed in Bremen, would be the occasion for a final decision on the establishment of the EMS.

The British decision not to participate was another example in the history of EMU in the European Community where an important and lasting decision was influenced more by the particular circumstances in the domestic political life of the country concerned than by any careful examination of the issues or the national interest. By the autumn of 1978, the Prime Minister, Mr. Callaghan, seems to have become convinced of the political importance of joining the EMS so that Britain would not be isolated and even some of the sceptics appeared to have second thoughts about the limitations which the system would impose on the government's ability to manage the British economy. As Mr. Healey said a few days before the European Council in Brussels, "I think the areas in which some people think we would lose control are areas where we do not have control anyway".[47] And yet, Britain did not join the EMS! On 7 September 1978, the Prime Minister seems to have taken the decision not to call a general election for the October of that year, despite opinion polls which strongly predicted a Labour victory. The momentous significance of this decision for Britain and for Europe is well known and will be touched upon in a later section. For the time being though, suffice it to say that with an election due to take place by the following spring, the Prime Minister became a prisoner of his left wing which managed to raise such hostility to the EMS in the left-dominated annual conference of the Labour party in October as to effectively kill any chance of Britain joining the system at its outset. With the opposition equally divided and uncertain to support him, Mr. Callaghan decided not to risk a split in his party during an election year and communicated his decision to the West German Chancellor, Helmut Schmidt, at their meeting in Bonn on 18 October. Britain, Mr. Callaghan asserted, wished to stay fully involved in the planning and the

development of the system and, although unable for the time being to take part in the exchange rate mechanism (ERM) of the EMS, it remained committed to join as soon as circumstances permitted.[48]

In the meanwhile, instability in the international foreign exchanges and in particular a new dollar crisis in the autumn of 1978 were creating problems for the internal parity structure of the Snake and reinforced the opinions of those who doubted that a fixed exchange rate scheme such as the EMS would hold together or that it could succeed in establishing a zone of monetary stability beyond the DM-dominated crawling peg type of arrangement represented by the Snake. Between August and end of October 1978, the dollar fell by 18% against the DM, while the Belgian franc came under heavy pressure in the Snake. The European monetary authorities tried to lean against the wind for a while and the Bundesbank was forced to spend over DM 10 billion in intervention between July and mid-October, of which DM 1.5 billion was spent on Friday, 13 October alone.[49] Finally, the inevitable was allowed to happen and exchange rates in the Snake were realigned, for the last time, on 17 October 1978.[50]

That despite these setbacks the EMS negotiations continued and that there was eventually an EMS at all was primarily due to the personal commitment and drive of the West German Chancellor, Helmut Schmidt, and the French President, Valery Giscard d' Estaing. But even further down the scale, the influence of particular personalities was pronounced, especially national officials who had spent time working, in some capacity or other, for the European machinery in Brussels, or who had come into close contact with one another through the work of the Council of Ministers or the Snake. The club-like atmosphere which had developed between these officials and the experience of thinking problems out in a "European", rather than a purely

national or Atlantic, framework proved to be invaluable in the EMS negotiations and therein lies a good deal of the explanation of the process by which accord was eventually reached often out of incompatible initial positions.[51] A few examples of such officials suffices to show their significance in the creation of the EMS: Dr. Horst Schulmann, Herr Schmidt's economic adviser and one of the two architects of the EMS, and Dr. Manfred Lahnstein, his predecessor at the Chancellery and now Permanent Secretary to the German Ministry of Finance and Chairman of the EPC, were both ex-Brussels men. The French Prime Minister himself, Raymond Barre, had been Commissioner for Economic and Financial Affairs. Within the EPC, Jean-Claude Payet, who was close to Giscard, used to work for Brussels, as also did Renato Ruggiero, who was close to the Italian Prime Minister, Sr. Andreotti. Bernard Clappier, the other architect of the EMS, had been involved with Europe since the time of the Schuman Plan in 1950, was France's man in the Werner committee and had been the Chairman of the EEC's Monetary Committee. The current holder of that post, Jacques van Ypersele, whose importance in the EMS negotiations cannot easily be overstated, was also now chef de Cabinet to the Belgian Prime Minister, Mr. Leo Tindemans.[52]

On 1 November 1978, US President Jimmy Carter announced a new package of measures worth some $30 billion, in an effort to halt the decline of the dollar.[53] The package proved to be remarkably successful. By the end of November the dollar had appreciated by almost 12% against the DM and the situation in the exchange markets, which had been chaotic for some time, started to become orderly once again. These developments created more favourable conditions for the expected launch of the EMS in the new year and the successful resolution of a few more of the outstanding difficulties with the negotiations during November created a strong anticipation that the forthcoming meeting of the European Council in Brussels on 4-5 December

1978, where the EMS was to be established, would be a diplomatic triumph for the Community and for the West German Chancellor Helmut Schmidt. In the event, the meeting came perilously close to being a complete fiasco. The European Council quickly approved the Belgian compromise, wider margins of fluctuation for the Italian lira, the half-way solution adopted for Great Britain and the other technical arrangements negotiated by the relevant committees over the preceding months. They also settled on a 45 day period of financial support through the very short term credit facility,[54] a compromise between the existing position of 30 days supported by West Germany and Holland and the 60 days demanded by Great Britain and Italy. At this point agreement ended and the Council quickly became deadlocked over two issues: First, there was the late French decision to demand that, as a condition of agreeing to the establishment of the EMS, there should be a Council undertaking that Monetary Compensatory Amounts (MCAs)[55] would be phased out, which in the end forced an addition to the presidential draft of the European Council resolution pointing in that direction. Second, there was the difficulty over the size and choice of instrument for a transfer of resources to the less prosperous member states which had remained unresolved even after an emergency meeting had been held to discuss the subject at Frankfurt airport on 1 December 1978. Ireland, as we have seen, had from the start put forward a request for $650 million over five years. Now, the Italian Prime Minister, Sr. Andreotti, faced his colleagues in the European Council with an additional request for $1.2 billion in grants over three years, plus subsidised loans from the EIB, the Ortoli facility and Euratom as Italy's price to participate. The French President, Valery Giscard d' Estaing, refused to agree to these amounts, claiming that to approve these funds would undermine the case of the Council of Ministers in its dispute with the European Parliament over the budget. The most the French were willing to concede was subsidised loans which, in terms of capital value, were estimated to amount to around $450 million for Italy and $225 million for Ireland

over five years. These amounts, of course, represented a drastic reduction in the claims of the two countries concerned and, as a result, the Italian and Irish Prime Ministers felt unable to commit their respective governments to the new scheme on the spot, asking instead for a pause for reflection. Thus, the EMS was launched on 5 December 1978, but with only six members. After eight long months of negotiations and the high hopes after Bremen, there was now finally the danger that, in terms of membership at least, the EMS would turn out to be no more than the Snake, with the franc once again included!

In the days which followed the European Council in Brussels, a tremendous diplomatic effort got under way to persuade the two countries which had not as yet officially made up their minds to participate. In the Italian case, there was no more money offered and the reasons for the short delay, as well as the eventual decision seem, once again, to have their roots in domestic politics. By delaying to declare his hand and finally coming out in favour of immediate entry despite the objections of the PCI and doubts from the Confindustria, the PSI and even some Christian Democratic Ministers, the Italian Prime Minister, Sr. Andreotti, was able to acquire a degree of mastery over the factions in his own party and the government coalition such as is normally hard to achieve due to the fragmented character of Italian politics. As Peter Ludlow put it, "the EMS episode left him therefore obliged to almost nobody and in command of almost everybody".[56] Italy announced on 12 December that it intended to join the EMS. In the parliamentary vote which followed, the PSI could only abstain while the Communists, who thought that their electoral support had peaked and had therefore nothing to gain and, possibly, much to lose from an election did not think the issue important enough to precipitate a government crisis. The Irish situation, on the other hand, was different. The Irish claim had been viewed with great sympathy in Brussels and in the week that followed the West German

Chancellor, Helmut Schmidt, took the initiative to put together a new, additional package worth some $50 million in grants arranged by West Germany, France, Holland, Belgium and Luxembourg. Although the total sum thus offered was still substantially smaller than the amount originally requested, Ireland had little choice but to accept, for it was still at the time widely believed that Britain did truly intend to join the system as soon as circumstances were right and probably after the next general election in the spring of 1979. In these circumstances, Ireland would have no other option but to join herself, and so the Irish government thought that it would be better to take the plunge straight away, taking the political credit and the money on offer. So it was that, on 15 December 1978, the Irish Prime Minister, Mr. Jack Lynch, announced in the Dail that Ireland would also join the EMS, thus breaking the connection with sterling which had lasted for 150 years.

Unfortunately, not everything went as well for the EMS in the weeks that followed Brussels. In two simultaneous meetings on 18-19 December, ECOFIN and the Council of Agricultural Ministers failed to resolve their differences over the abolition of MCAs. Despite strong pressure from the French Minister of Agriculture M. Mehaignerie, the West German Farm Minister, Herr Josef Ertl, resolutely refused to scrap the cumbersome mechanism which guaranteed a hidden subsidy and higher incomes for his country's farming community. As a result, the French President, Valery Giscard d' Estaing, instructed his Minister of Finance, M. Monory, to put an indefinite reserve on the implementation of the decision for the establishment of the EMS, thus preventing the launch of the system as scheduled, on 1 January 1979.

The sudden transformation of the French President, from one of the two cosponsors and driving forces behind the creation of the EMS to the unbending politician whose tactics came perilously

close to causing serious and arguably irreparable damage to the system he himself had helped create, is one of the more curious episodes in the history of monetary unification in the European Community. Here was a political leader who, in the course of many months, had been one of the main promoters of the scheme, both inside and outside Europe, who had been instrumental in achieving the necessary compromises and had given an example of being prepared to be flexible when the course of the argument and the success of the negotiations so demanded and who now, at the very last minute, seemed willing to risk the final outcome over an amount which, despite Italy's unexpectedly large request, was still an once-off and a minor one when compared with the annual budget of some French government departments and over the issue of MCAs which, after all, was not even a new problem. Here was also an instance when the West German Chancellor seems to have been unaware of what was coming and when the celebrated personal relationship between the two men did not seem sufficient to bring a quick solution to the problem. Of course, that the French would have come to an important gathering such as the Brussels European Council with a small surprise up their sleeve was not totally without precedent, nor was the fact that, with the important details of the scheme in place, they did try to wring an extra concession from the occasion and, in an inimitable Gallic way, made this sound entirely plausible in "European" terms. It may also be that the French President had correctly judged the intentions of the Italian and the Irish governments before the meeting and knew that the risk of an irrevocable breakdown was not as large as it may have seemed at the time. These factors, however, do not adequately explain the tactics which the French President adopted in Brussels or his subsequent decision to block the launch of the EMS over the issue of MCAs. For a fuller understanding of the influences and the real reasons behind these decisions, one has again to look in more detail at the particular circumstances of the domestic political scene in France around this time.

As we have seen, the verdict of the French electorate in the parliamentary elections of March 1978 provided Giscard with an unexpected and welcome period of relative freedom from domestic political constraints. This, however, came eventually to an end around the late autumn of 1978, when the approach of the first direct elections to the European Parliament, scheduled to take place in June 1979, began to stir the old divisions and antagonisms between government and opposition, as well as those between the different component parts of the governing coalition. There were three main issues related to the subject of this study which surfaced during the pre-election period: First, there was the allegation, advanced in roughly equal measures by the opposition, the neo-Gaullist RPR and the press, that France had given far too much ground to West Germany during the EMS negotiations and that the President had allowed the new system to become a servant to West German national interests. Following the 15 September meeting between Messrs. Giscard and Schmidt in Aachen (where the French President had conceded that the dominant element in the intervention mechanism of the EMS would be the parity grid), French newspapers had carried persistent critical reports about the President's supposed obsession with the economic might of West Germany, and these had on occasion acquired a thinly-disguised anti-German flavour. Second, there was the problem of the status of the European Parliament itself, which had come up for renewed discussion owing to the approach of the direct elections. Trouble broke out over a decision by the Council of Ministers and the European Parliament to spend Community funds on a publicity campaign, the aim of which would be to inform the electorate on a strictly non-partisan basis about the powers and the responsibilities of this parliament to which they were being asked to elect members for the first time. The situation was aggravated by the European Parliament's attempt to amend the 1979 budget, which in its content, timing and justification was an explicitly political act. These developments created an outcry from the traditionalist wing of the neo-Gaullist party and

Giscard's old foe, Michael Debre, formed a "Committee for the Independence and Unity of France" to block any attempt to upgrade the European Parliament after the election which, he thought, would be "a crime against the nation".[57]

For the third time in fifteen years, the battle lines within the French government were drawn on familiar grounds. On the one side stood Giscard and on the other the "orthodox" wing of the Gaullist party, led by Michel Debre. The balance of forces, of course, was different this time, for now Giscard was the President of the Republic. Still, he could not have it all his own way. On 30 November 1978, RPR deputies joined the Communists and the Socialists to block legislation which would effect the May 1977 decision of the Council of Ministers concerning the transfer of a share of VAT revenues to the Community. (The measures was adopted a week later in a modified form). On 6 December, the RPR leader, Jacques Chirac, rejected Giscard's view that the majority should enter a common list for the elections to the European Parliament and announced that the RPR would form its own, separate list. Finally, on 11 December 1978, the RPR, led by Michel Debre, voted with the PCF to defeat the President's UDF (with the Socialists abstaining) to make sure that there would be no Community funds available for the election campaign in France.[58]

The third issue that came up in the run-up to the European elections had to do with the problem of MCAs and the worries of the French farming community which resented the inroads that unfairly subsidised West German farmers were making into the French agricultural market. Between 1976 and the first half of 1978, the share of French agricultural exports accounted for by the Federal Republic had dropped from 19% to 16.6%, while French imports from the Federal Republic had risen from 6.6% to 8.4%. It was natural that the French farming community would want to exploit the opportunity offered by the forthcoming elections to air

their grievances and they did so in a new bout of unrest. It was natural that the opposition parties and the RPR would attempt to exploit the issue to score points against a President who had seemed invulnerable only a few months ago. It was also natural, however, for Giscard the politician to take advantage of the highly publicised occasion of the European Council in Brussels to try to kill all three birds with one stone. There, basking in the attention of the television cameras and the French President was able to demonstrate visibly his and France's political virility by saying "non" to the West German Chancellor and endangering his favourite pet scheme, tripped up his RPR critics by asserting forcibly the supremacy of the Council of Ministers over the European Parliament and came over as a stout defender of the interests of French agriculture, which he had managed to bring to the centre of the debate. From here, it was only one more step in the same direction to block the launch of the EMS until a final solution had been found to the problem of MCAs.

A solution, however, was not found. For a whole two and a half months, the West German Farm Minister, Herr Ertl, refused to budge. Having gambled on the Chancellor's well known desire to see the EMS implemented to get a concession, Giscard was now in danger of having to contest the European elections while he was being held personally responsible for holding back the most significant project that the Community had embarked on for almost a decade. Thus, at the meeting of the agricultural Ministers on 5-6 March 1979, the French finally gave in. A face-saving compromise was put together, which specified that MCAs would not be increased for exchange rate changes of less than 1% and that they would be progressively reduced. The next day, 7 March, Giscard announced that the French government was now able to lift its reserve on the activation of the EMS agreement. A formal announcement was made at the European Council in Paris on 12 March and the EMS was duly launched on 13 March 1979.

IIIa3. A new system or an improved version of the Snake?

Thus, eleven months after Helmut Schmidt had first brought up the subject in Copenhagen, Europe now had its "new" monetary system. And yet, how new was in fact the EMS? Supporters argued that the system contained several elements (the ECU, the increased credit facilities and the divergence indicator) which made the EMS substantially different from the Snake it replaced in March 1979. Critics, on the other hand, claimed that the EMS was no more than a reinforced version of the Snake and that the differences, where they existed, were either non-essential, or they came down to questions of quantity rather than quality, or that they reflected the renewed desire of the member states to achieve more orderly conditions in the currency markets and to prevent the establishment of a two-speed Europe, rather than any significant improvement in the structure of the system itself or in the strategy that underlay it.

The most obvious difference between the EMS and the Snake as it operated in its later stages was membership: The EMS included all the countries of the European Community and although Britain had decided for the time being that it was unable to participate in the ERM it had declared its intention to do so as soon as circumstances permitted. By contrast, in 1978, four out of the nine Community currencies, including three out of the four larger ones, had been floating outside the Snake. Besides, unlike the Snake, the EMS did not have any associate members attached to it, though some countries, notably Austria and Switzerland, continued to shadow its movements, much as they had done with the Snake. These factors gave the EMS the feel of a Community instrument that would potentially be concerned with more than just the maintenance of a zone of monetary stability in Europe and underlined the integrationist qualities

in the new system which, though undeclared, had been strongly implied both in the European Council resolution and during the course of the negotiations. This, of course, possibly signified a welcome change in the recent attitude of some member states, but whether it also represented a major advance of the EMS over the Snake was another matter. After all, its future course notwithstanding, the Snake had been originally conceived as part of the EMU project, which was underpinned by an integration strategy which in its full implications was far more ambitious than anything that even the warmest advocates of the EMS could reasonably expect from the new system in 1979. Moreover, right at the outset at least, the Snake had also included every single one of the member states of the Community, participating fully. That the creators of the EMS had nearly managed to repeat that success in the more troubled economic conditions of the late 1970s and that all but one of the floaters had been persuaded to subject themselves again to the internal rigours of the adjustable peg was certainly encouraging, but it scarcely constituted a major advance of the EMS over the Snake or a guarantee that the same disagreements over the aims and priorities of domestic economic policy and the absence of protection from external shocks which had blown the Snake off course would not eventually return to plague the development of the new system.

As regards the other elements of the EMS, there where various improvements over the Snake, but nothing that altered the fundamental nature of the system. There was a new currency unit, the ECU, defined so as to be identical with the EUA it replaced, and like its predecessor it was meant to perform the function of general numeraire for the various operations of the European Community. In addition, the ECU would now serve as a reference unit for the establishment of central rates for the currencies participating in the ERM and for the divergence indicator, and as denominator for the intervention and credit mechanisms of the system. Finally, the ECU would

serve as a reserve asset and a means of settlement for EEC monetary authorities: The member states agreed to pool 20% of their gold and dollar reserves through a system of renewable three-month revolving swaps with FECOM [59] to enable it to conduct its operations on its own rather than have to rely constantly on the participating central banks. The initial supply of ECUs created in this way came to around ECU 23.3 billion.

The credit facilities offered by the new system represented a substantial improvement over the corresponding arrangements in the Snake: The settlement period for monetary support granted under the very short term credit facility was extended from 30 to 45 days. The maximum lending capacity of the STMS was increased from less than ECU 6 billion and there was now the possibility of a second extension of three months at the request of the debtor central bank, beyond the one already available under the Snake (giving a total duration for such credit of nine months). Finally, financial assistance under the MTFA was raised from 5.45 billion previously to ECU 14.1 billion, giving an effective total available for lending of ECU 11 billion, conditional on the observance of specified economic policy conditions and repayable within two to five years. The total amount effectively available in the EMS for monetary support under both the STMS and MTFA mechanisms thus came to ECU 25 billion, more than twice what had been available under the Snake, demonstrating that the Community now possessed both the will and the capability to provide the member states with the financial help they might require to overcome temporary balance of payments difficulties.

Although the new arrangements made for a tidier system and had sometimes a significance other than technical or operational, they changed little that was essential for the system. Thus, fixing central rates in terms of ECU may have been important in symbolic terms, to demonstrate the

independence of the EMS from the US dollar, and it was important for the operation of the divergence indicator (to the degree that the indicator itself was important for the EMS), but was not essential for the operation of the parity grid which was the basis of the intervention mechanism of the system. Moreover, although the ECU was now meant to be used as a reserve asset and a means of settlement between participating monetary authorities, no central bank was obligated to accept ECUs for more than 50% of any outstanding debt. Similarly, endowing FECOM with a proportion of the member states' foreign reserves may have been important in "European" terms, but it changed little in the way the fund actually operated. The real work continued to be done by the BIS acting as agent for FECOM, legal ownership of these reserves continued to be in the hands of the central banks and the "hot" institutional questions, concerning the establishment of the EMF and the further development of the ECU into a real currency to be used outside the world of Europe's monetary authorities were conveniently avoided, at least for the time being. Finally, the changes in the credit facilities offered by the EMS were important in order to demonstrate that the Community took prime responsibility for providing its members with adequate monetary support as and when required, but the difference from the corresponding facilities available under the Snake was that the of degree rather than a qualitative one. In fact, as a result of the greater availability of credit from the private sector in the 1980s and the fairly frequent realignments of central rates in the early years of the EMS, these resources remained substantially underemployed and there was no use made at all of either the STMS or the MTFA facilities during the first ten years of the system.[60] Thus, the only element in the EMS which did not appear to have and kind of parallel in the Snake but was a genuine novelty for the new system was the utilisation of the concept of measuring deviations from a currency basket to set up an objective indicator of divergence.

Supporters of the EMS saw the creation of the divergence indicator as a major achievement and probably the most significant advance of the new system over the Snake. Robert Triffin called it "an unprecedented breakthrough in international monetary arrangements"[61] and Niels Thygesen echoed his feelings by stressing that, for the very first time in the history of the Community and the world, an agreement had been reached "on the use of an objective indicator as a trigger for policy coordination".[62] The idea behind the indicator was to counteract the inherent bias of the Snake against the weaker currencies and to establish a mechanism which would identify in an objective way the single most deviant currency relative to a weighted basket and to place upon the monetary authorities of the country concerned the responsibility for corrective action. Although, as we have seen, it was finally decided that the parity grid would continue to be the dominant element in the intervention mechanism of the EMS, the ECU-based indicator was accepted as a secondary pointer of divergence. A divergence threshold was set at 75% of each currency's maximum weight-adjusted spread and there was a "presumption" (though not an actual obligation) that, unless they presented sufficient reasons as to why they should not have to do so, the monetary authorities of a country whose currency breached that limit would undertake corrective action, which would take the form of one or more of (a) diversified intervention; (b) measures of domestic monetary policy; (c) changes in central rates; (d) other measures of economic policy.[63]

Under closer scrutiny, the divergence indicator turned out to present more practical difficulties than its advocates had originally thought. For, though both a basket-based system and the parity grid are credible mechanisms each on their own, they are nevertheless founded on fundamentally different economic logic. "... Whatever the relative merits of a system of margins around ECU parities and one of margins round bilateral parities, each one has an internal consistency. The

indicator of divergence attempts to capture some features of both systems, but the resulting hybrid loses the internal consistency of either".[64] Trying to peg an exchange rate against a moving reference like a weighted currency basket already presents formidable technical and operational complications,[65] but superimposing onto this type of arrangement an obligatory intervention mechanism based on the parity grid led to some rather unexpected and, indeed, bizarre results. The intention behind the Belgian compromise was that the divergence indicator would pick out a deviating currency before that currency had reached its intervention limit and would trigger off a process of consultations and corrective action. In practice though, the indicator that was finally agreed possessed a number of mathematical properties which made it behave differently to what was expected in several important ways:[66]

1. Although it is possible that two currencies diverge from their ECU central rates by an equal amount but in opposite direction, they can never reach their threshold of divergence together. However, it is perfectly possible for up to four currencies to reach the threshold together in the *same* direction.

2. It is possible for two currencies to reach their bilateral intervention limits while the indicator remains silent.[67] (This actually happened within a short while from the launch of the EMS when, in April 1979, the Belgian franc and the Danish krone hit their respective floor and ceiling in the bilateral parity grid. With the other currencies grouped in the centre, the divergence indicator did not register a protest).

3. It is possible for two currencies to reach their bilateral intervention limits, the indicator remains silent, while it gives out alarm signals for a third currency, not currently at its intervention limit.

4. It is possible for the DM and the French franc, or any three of the larger four, or certain combinations of three medium and larger currencies to move together, appreciating or depreciating by their full margins relative to all the others, without ever triggering the indicator. By contrast, the indicator would flash if small currencies alone were involved.

Supporters of the EMS made an effort to defend some of the more peculiar aspects in the behaviour of the divergence indicator.[68] The indicator, they argued, was there to point out deviations of more persistent nature. Thus, it was not really surprising that it might stay silent while two currencies came against their bilateral intervention limits, for such a situation might well arise even if there are no conditions present of a more persistent divergence, because of short term unrest in the exchange markets, monetary developments outside the system, speculation and so on. Similarly, conditions of lasting divergence may develop even though a currency for some time. A few of the defects of the indicator could even be eliminated if the threshold of divergence was made lower, but this could not be accomplished without cost, for then the indicator would flash far too often, would be of less use in signifying real divergence and would not be taken seriously by Europe's monetary authorities.

Although the reasoning behind these arguments is undoubtedly correct, they do not make up a satisfactory answer to the arbitrary signals generated by the divergence indicator. There is no good economic reason why two governments pursuing divergent policies in the opposite direction (one excessively strict, the other excessively lax) should not *both* be shown to be deviant at the same time. The explanation cannot be that the indicator must show up only *a single* deviant, for as we have seen, it does permit up to four currencies to be shown up as

divergent in the same direction and as long as a large currency is not among them. Moreover, there is no evidence whatsoever that the indicator is, in fact, capable of recognising lasting divergence. Two currencies at their respective bilateral intervention limits may or may not trigger the indicator, depending on the particular configuration of the weights of the currencies involved and on what all other member currencies are doing, which in turn may be caused by short term, temporary influences or by factors of a more lasting nature. The fact is that the policy signals coming out of the indicator can at times be confusing, inappropriate and economically perverse, ignore various aspects of normal economic practice that relate to divergence, such as intramarginal and "intrathreshold" interventions and the resulting changes in the level of foreign reserves and cannot be relied upon to diagnose or even define a state of persistent disequilibrium between the member states, let alone to prescribe the "correct" policy action for its resolution.

With the most celebrated novelty in the EMS thus shown to be less than an unqualified success and comparing the two purely as monetary systems (which is to say that we put aside for the moment any comparison between the two systems on whether or not they also helped to promote the more general development of European integration, an issue we examine in the next section), to what degree can the EMS be considered to be substantially superior to the Snake?

Critics argue, to a very limited degree: "The new European Monetary System, in short, did nor represent a major advance over the snake. All the grand pronouncements notwithstanding, these new arrangements differed from their predecessors in very little that was essential... Indeed, the only respect in which EMS represented an advance over the snake system was that it included more of the member states, an important consideration, but one whose real significance

depended on the degree to which EMS represented progress towards economic and monetary union".[69]

Although this judgement seems to be rather unfair to the creators of the EMS and, with the benefit of hindsight, harsh on a system that has proved remarkably durable and far more successful in achieving its stated objectives than even the most enthusiastic of its advocates would have thought in 1979, it is nevertheless true that the similarities between the two systems were more striking than the differences and, among these, even more striking were the similarities in what was still *not* achieved than in what was!

First, there was again no external policy for the system (a common dollar policy), despite the fact that the experience of the Snake had proved the necessity for the internal parity structure of a European scheme to be protected from shocks originating elsewhere. (As we will see in the following section, every single currency realignment in the EMS occurred at a time of persistent or temporary dollar weakness).

Second, the strategy which underpinned the new system was the same, tried and failed co-ordination approach, which saw co-ordination of the member states' policies and exchange rate unification as prerequisites for monetary union and surrendered the future development of the system hostage to fortune and the discretion of national governments. The EMS paid dearly for this mistake straight away: On the one hand, national governments found themselves unable to reach an agreement on the future role and functions of the EMF and the ECU and they failed to sort out their differences by the deadline of March 1981 specified by the European Council resolution and, indeed, until the present day. On the other hand, Great Britain never joined the

system. At first, the justification offered in London was that the pound was too weak and the state of the British economy too precarious to allow participation in a scheme which included and was likely to be pulled upwards by the DM. Then, as sterling soared in the early 1980s, the official story changed to claiming that the pound was now too strong and participation in the EMS would put the government's anti-inflation policies in jeopardy. Besides, the flow of funds from North Sea oil exports conferred on sterling a new "petrocurrency" status, which, in times of economic difficulties, would tend to push the pound in the opposite direction to that of its other partners in the EMS and would make the maintenance of a fixed link with those currencies more or less impossible (a particularly important consideration at this time, as the establishment of the EMS happened to coincide with the second energy crisis of 1979-89). In reply, it was argued that most of these factors which were supposed to differentiate Britain from the other member states of the Community could well be taken into account when choosing an initial entry rate for sterling and that the system possessed enough flexibility anyway to allow for a revaluation of the pound if one proved to be necessary. In retrospect, it was later also argued that, had Britain joined the EMS at the outset, a great deal of the massive appreciation of sterling in the early 1980s, which made British exports so uncompetitive and played an important part in turning some formerly prosperous regions into industrial wastelands, might well have been avoided. These arguments however, were rarely given the attention that they deserved. For, behind the surface, the real reason for Britain's absence from the EMS was, at first, the vehement anti-EEC feeling of the left wing of the Labour party and then, following the Conservative victory in the general election of May 1979, the equally vehement opposition of the new Prime Minister, Mrs. Margaret Thatcher, and her closest economic advisers to any form of pegging the exchange rate and her instinctive suspicion of things "European" or at least those continental initiatives which she thought might lead to a European superstate at the expense of the ability of

national governments to run their own affairs. (Such prejudices were later reinforced by the squabble over the British contribution to the EEC budget, which proved Brussels-bashing to be a political asset with a large part of the British electorate). The real issues at hand, the strengths and weaknesses of the EMS and the significant benefits that the British economy and particularly the financial community at the City of London might derive (in terms of lower interest rates for any given rate of an EMS-pegged pound and the reduction of uncertainty and the exchange rate risk in international trade and investment) through participation, could never be a match for this powerful combination of prejudice and dogmatic economics and did not manage to tilt the decision even when the "petrocurrency" argument became weaker from the middle of the decade onwards, with the breakdown in OPEC discipline, the oil glut and the collapse of the oil price, or when the traditional sceptics at the Treasury had been finally convinced that the right conditions for sterling to join now existed.

IIIa4. The experience of the EMS, 1979-89.

From the point of view of exchange rate developments, the first ten years of the EMS can be divided into three periods: The first one, from March 1979 to March 1983, was characterised by fairly frequent realignments which became larger with time. During this initial phase, parities were adjusted every six months on average (with a notable exception of a sixteen-month break between the second and third realignments) and the size of bilateral changes was well above what had been experienced under the Snake. In the second period of the EMS, from March 1983 to January 1987, realignments became less frequent and their size progressively decreased.[70] Finally, during the third period, from January 1987 onwards, there were no realignments at all. Whatever else it may have failed to do, the EMS has certainly been increasingly successful in meeting its stated objective of creating a zone of monetary stability in Europe!

After the high drama of the preceding months, the launch of the EMS on 13 March 1979 came as an anti-climax. A market-aligned choice of initial central rates, careful preparation on the part of some member states (Italy had spent some $100 million to depress the market rate of the lira in advance of the new parity being fixed for the start of the EMS) and a weak DM, all made for order in the exchange markets and most of the member currencies remained comfortably within their prescribed margins in March and April 1979. The exceptions were the Danish krone and the Belgian franc, which reached their respective upper and lower limits in April requiring minor intervention.[71] With the other EMS currencies grouped round the middle, the divergence indicator did not register any protest at first, though soon after, both currencies breached their

lower thresholds of divergence, the BFR from the beginning of May to early July and the DKR in June 1989, which necessitated more intervention and a rise in the discount rate, from 6% to 9% in Belgium and from 8% to 9% in Denmark.

As had happened so often before, the first serious pressures on the intra-Europe exchange rate structure had their origin not within Europe but in the US. In late June 1979, the dollar began to weaken once again as a result of receding hopes of a firm energy policy, a pre-election boost in fiscal policy, high growth of the money supply, an inflation rate of 13% and a progressive easing of interest rates which made real yields lower than in other countries and sometimes negative. The inevitable deterioration in the capital account was aggravated by record trade deficits resulting from strong domestic demand, undiminished energy consumption and high energy prices. By comparison, West Germany was pursuing a stringent monetary policy aimed to control the increases in industrial prices which had been revealed by the publication of figures on producer prices for the second quarter. The cost of three-months money rose to 6.2% in May from 3.6% in January. As a result, there was a flow of some DM 13 billion into Germany in June and July which almost offset the DM 14 billion outflow that had taken place in the previous five months in response to the US measures of November 1978 and which necessitated substantial interventions by the Bundesbank to support the dollar.[72] The attack on the exchange rate eased somewhat in August but regained momentum in September, reinforced by pressures from within Europe, which acquired an increasingly speculative nature as a DM revaluation became more likely. The DM strained its upper limit against both the DKR and the BFR and large interventions were required on 13 September to defend the existing parities. Despite an increase of the discount rate to 11% in Denmark and 10% in Belgium, a new attack materialised on 21 September which led to more intervention and brought the total amount that the

Bundesbank had been forced to absorb since the beginning of the month to some DM 9.5 billion. (By comparison, there had been an inflow of only FF 662 million into France). Finally, on 24 September 1979, after an all-night session, ECOFIN decided on the first realignment in the EMS: There was a 2% revaluation of the DM and 3% revaluation of the Danish krone. Belgium successfully resisted calls for a devaluation of the franc, while the Dutch decided not to match the revaluation of the DM on this occasion, in order to leave Benelux exchange rate relations undisturbed.[73]

Whereas the revaluation of the DM, coupled with the tightening of the US' monetary policy announced two weeks later, achieved its basic aims and managed to stem the capital inflows to the Federal Republic, the 3% devaluation of the krone was not sufficient to curb the rapid deterioration of the Danish current account which grew from a deficit of DKR 1.4 billion in the first quarter of 1979 to DKR 2.9 billion in the second and DKR 4.6 billion in the third, mainly as a consequence of higher energy costs. Taxes on energy consumption imposed in the summer did not prove to be enough, while a 20% increase in the value of exports turned out, on closer examination, to be attributable more to higher prices rather than a higher volume of exports. With the burden of servicing Denmark's foreign debt reaching approximately a third of the country's current account deficit by the third quarter of 1979 and projected to reach two-thirds in 1980, the time was overdue for drastic policy measures. In September 1979, the Social Democrats, the senior partner in the governing coalition which had been formed in August 1978, put forward a budget package which included plans for an incomes and prices freeze, coupled with proposals aimed to give workers a greater say in the management of their companies. The junior partner in the coalition, the Liberal Party, agreed on the need for wage and price controls but did not want to make this conditional on prior agreement by the trades unions (as the Social

<u>TABLE 10</u>

Currency realignments in the European Monetary System, 1979-89.

(%).

Date of EMS realignment	Currency						
	DM	HFL	FF	L/BFR	LIT	DKR	IRL
24 September 1979	+2.00					-3.00	
30 November 1979						-5.00	
23 March 1981					-6.00		
5 October 1981		+5.50	+5.50	-3.50			-3.50
22 February 1982				-8.50		-3.00	
14 June 1982	+4.25	+4.25	-5.75		-2.75		
21 March 1983	+5.50	+3.50	-2.50	+1.50	-2.50	+2.50	-3.50
22 July 1985	+2.00	+2.00	+2.00	+2.00	-6.00	+2.00	+2.00
7 April 1986	+3.00	+3.00	-3.00	-1.00		-1.00	
4 August 1986							-8.00
12 January 1987	+3.00	+3.00				+2.00	
Cumulative change in ECU central rates since 13 March 1979	+21.96	+17.30	-16.02	-7.07	-22.61	-9.76	-13.77

Source: Commission of the European Communities.

TABLE 11

The ECU: Composition, currency weights and central rates, 1979, 1984 and 1989[1].

	Composition			Weights (%)			Central rates		
Currency	1979	1984	1989	1979	1984	1989	1979	1984	1989
DM	0.828	0.719	0.6242	33.0	32.70	30.10	2.51064	2.24184	2.05853
FF	1.15	1.31	1.332	19.8	19.06	19.00	5.79831	6.87456	6.90403
UKL	0.0885	0.878	0.08784	13.6	14.98	13.00	0.663247	0.585992	0.739615
HFL	0.286	0.256	0.2198	10.5	10.13	9.40	2.72077	2.52595	2.31943
B/LFR	3.80	3.85	3.43	9.5	8.57	7.90	39.4582	44.9008	42.4582
LIT	109.0	140.0	151.8	9.5	9.98	10.15	1148.15	1403.49	1483.58
DKR	0.217	0.219	0.1976	3.0	2.69	2.45	7.36594	8.14104	7.85212
IRL	0.00759	0.00871	0.00855	1.1	1.20	1.10	0.662638	0.725690	0.768411
DRA		1.15	1.440		1.31	0.80		87.4813	150.792
PTA			6.885			5.30			
ESC			1.393			0.80			

[1] 1979: 13 March 1979, launch of the EMS.
1984: 17 September 1984, following the 1984 revision of the ECU basket.
1989: 21 September 1989, following the 1989 revision of the ECU basket.

Source: Commission of the European Communities (1989) and various Commission press releases.

Democrats did) and rejected the demand for a compulsory scheme of profit-sharing and co-ownership which the unions put as their price for wage restraint. With the Conservative Party equally opposed to workers' participation, a political crisis was inevitable and the government fell on 24 September (the day of the first EMS realignment). However, the election of 23 October 1979 did not produce any significant change of political forces in the Folketing and eventually led to the formation of a minority Social Democratic government under the outgoing Prime Minister, Mr. Anker Jorgensen. As was to be expected, the unstable political situation in the country generated a fair deal of speculative pressure against the krone, but this was countered effectively by central bank intervention which kept the currency formally denied that a devaluation was being planned. But, with money market rates already excessively high and the current account deficit approaching some DKR 15 billion for the year as a whole, the government was running fast out of options. In late November, Copenhagen asked its EMS partners to authorise a second devaluation of the krone by 5% and this was informally approved over the telephone on 30 November 1979.[74] The devaluation was accompanied by a package which included temporary wage and price controls, increase in personal wealth and corporate taxes and a partial modification of Denmark's wage indexation arrangements.

Advocates of the EMS saw these developments as clear evidence that the EMS possessed sufficient flexibility to adapt to the economic facts of life while, at the same time, preventing disorderly fluctuations in the currency markets. Despite two devaluations in just over two months, 1979 saw more exchange rate stability in the European Community than any other year since 1972. Exchange rate variations against the ECU came on average to only 1.9%, as compared with 5.2% for the previous six years.[75] Indeed, over the next sixteen months there were no more changes in ECU central rates, a remarkable achievement when one takes into

TABLE 12

Monthly variability of nominal exchange rates against the currencies of the ERM, 1974-88.

	Snake/EMS				Non-Snake/EMS			Non-EMS				Other		
Year	DM	HFL	B/LFR	DKR	FF	LIT	IRL	UKL	DRA	PTA	ESC	USD	YEN	SFR
1974	1.37	0.48	0.83	0.64	1.53	1.69	0.78	0.71	1.93	1.66	0.49	1.93	1.42	1.70
1975	0.54	0.36	0.38	0.32	0.79	0.80	1.10	1.05	1.81	1.13	0.56	1.89	1.47	0.77
1976	1.57	0.77	0.85	0.68	1.23	3.34	2.21	2.10	0.73	1.08	1.17	0.68	1.11	1.14
1977	0.76	0.42	0.44	0.81	0.47	0.95	0.96	0.90	0.40	2.06	2.41	0.85	1.61	1.51
1978	0.77	0.58	0.69	0.57	1.40	1.03	1.38	1.32	1.82	0.79	2.08	1.84	2.50	2.87
1974-78	1.00	0.52	0.64	0.60	1.08	1.56	1.29	1.22	1.34	1.34	1.34	1.44	1.62	1.60
1979	0.37	0.32	0.30	0.93	0.23	0.64	0.50	1.72	0.96	1.51	1.07	1.13	2.20	0.64
1980	0.21	0.20	0.19	0.24	0.26	0.44	0.29	1.61	1.85	1.17	1.28	2.27	2.89	0.90
1981	0.67	0.46	0.34	0.30	0.65	0.86	0.29	2.39	0.36	0.67	0.98	3.14	2.93	1.57
1982	0.73	0.61	0.98	0.49	0.76	0.46	0.46	1.44	0.91	1.48	1.79	2.49	1.22	1.00
1983	0.51	0.18	0.24	0.37	0.50	0.48	0.38	1.99	2.55	0.98	2.16	1.89	1.64	1.18
1979-83	0.50	0.35	0.41	0.47	0.48	0.58	0.38	1.83	1.33	1.16	1.46	2.18	2.18	1.06
1984	0.24	0.10	0.22	0.30	0.08	0.46	0.22	1.06	1.31	0.77	1.25	2.70	1.62	0.83
1985	0.32	0.24	0.16	0.15	0.24	0.88	0.20	2.04	2.91	0.84	1.29	3.06	1.84	0.93
1986	0.31	0.21	0.21	0.37	0.54	0.15	0.08	2.39	1.22	0.62	1.12	2.07	1.92	1.01
1987	0.27	0.21	0.18	0.38	0.27	0.46	0.24	0.94	0.81	1.05	0.71	2.20	1.64	0.70
1988	0.15	0.16	0.10	0.26	0.24	0.29	0.16	1.18	0.43	0.67	0.23	2.03	1.18	0.44
1984-88	0.26	0.18	0.17	0.29	0.27	0.45	0.38	1.52	1.34	0.79	0.92	2.41	1.64	0.78

Source: Commission of the European Communities (1989).

account that this period coincided with the second energy crisis and the doubling of the oil price to over $30 a barrel.

The reasons for this stability were manifold: First, there were the healthy balance of payments positions in France and Italy, coupled with the large deficits in the Federal Republic (the West German current account reached a deficit of ECU 3.7 billion in 1979 and ECU 10.4 billion in 1980), at least in part the consequence of the more expansionary economic policies that Bonn had been forced to accept under pressure by its economic partners in 1978. Second, there was the strength of the dollar after the tightening and redesign of US monetary policy in October 1979. The American currency firmed up in late 1979 and the first part of 1980 and then surged ahead, appreciating by some 45% against the ECU between July 1980 and August 1981. This resulted in sizeable net sales of dollars by the European central banks, which by the middle of 1981 amounted to $32.4 billion, of which some $18.7 billion was intervention by the Bundesbank trying to halt the decline of the DM. These efforts were reinforced by parallel action by the Federal Bank of New York until the spring of 1981, when the US authorities announced that, apart from special circumstances, they no longer intended to intervene in the currency markets.

Within the EMS, the French franc was the strongest currency, pushing against its upper divergence limit on a number of occasions while the DM, reflecting the strength of the dollar, remained at its lower limit and required substantial intervention, in October 1980 and again in February 1981, to keep it within the margins. The other weak currencies in the EMS, primarily the Belgian franc and the krone, were also kept within the prescribed limits through a combination of intervention and tighter monetary policies (the discount rate was raised from

10% to 14% in Belgium and from 11% to 13% in Denmark). That an EMS realignment was actually avoided was finally also due in no small part to the continued absence of sterling from the ERM. Even before the difficulties created by the rise of the US dollar, the British currency had appreciated strongly against the EMS (it went up by 12.9% against the ECU between March 1979 and September 1980) as a result of the recession and North Sea oil and would have caused serious problems for the exchange rate structure of the EMS had it been participating at the time.[76]

Some of the economic conditions which had underpinned this welcome period of exchange rate stability in Europe began slowly to change in late 1980. The second oil price increase led to a marked deterioration in the current account of those countries which had so far enjoyed payments surpluses, while fears of a downturn in economic activity similar to that which had followed the first oil crisis of 1973-4 produced a partial relaxation of monetary conditions in several member states. Across the Atlantic, US interest rates also declined gradually through the later part of 1980 and early 1981 and the interest rate differentials began once again to favour West Germany, where the Bundesbank responded to renewed speculation against the DM in February 1981 with a severe tightening of monetary policy, introducing a special Lombard rate and raising the discount rate from 9% to 13%. The combined effect of these developments was that the dollar weakened temporarily, while the DM rose towards the top of the EMS band. At the end of March 1981, Italy requested a 6% devaluation of the lira. Although there was only minor market pressure on the current rate, which was effectively countered through central bank intervention and a rise in the discount rate from 16.5% to 19%, the Italian government thought that a devaluation was necessary to protect the competitiveness of the economy and to offset inflation differentials between Italy and the other EEC countries which were aggravated by the

second oil shock and the high degree of wage indexation in the Italian labour market. The devaluation was effected on 23 March 1981. On 10 May 1981, the leader of the French Socialists, Francois Mitterand, narrowly defeated Valery d' Estaing to be elected the new President of the French Republic. One month later, the parliamentary elections returned a strong Socialist majority and a new government was formed under Pierre Mauroy with the participation of ministers from the Communist party. The prospect of a left wing government committed to the unilateral pursuit of growth and full employment in preference to economic stabilisation and a lower inflation rate sent shivers through the exchange markets and the franc moved quickly from the top to the bottom of the EMS band, straining its bilateral limit relative to the DM and pushing hard and persistently against its threshold of divergence. For obvious political reasons, the new government did not initially request a devaluation of the franc and chose instead to rely on a mix of intervention, interest rate increases and exchange controls to maintain the current rate. These measures, however, did not prove sufficient and thus, in late September 1981, after four months of an unstable FF, the French initiated talks with the Federal Republic on a possible realignment of the FF/DM cross rate. The deal which was eventually worked out provided for a 9% bilateral change between the two currencies (the largest as yet in the EMS) and this was formally approved by ECOFIN on 5 October 1981. The DM and the Dutch guilder were revalued by 5.5%, while the French franc and (after some persuasion) the Italian lira were devalued by 3.5%.

With the French currency at a more realistic rate, attention now shifted to the overvalued state of the Belgian franc. Both in September 1979 and in October 1981, the Belgian authorities had chosen to resist calls for a devaluation of the franc, although the currency had been persistently created by the failure of negotiations to form a new government in November 1981 added to

worries on the economic front, causing the franc to breach its threshold of divergence on 10 December. Although intervention and an increase in the discount rate saved the day, these remedies could only be effective in the short run and there was renewed pressure on the currency in early 1982. In the light of the obvious lack of competitiveness of the Belgian economy at the current exchange rates, the new government of Mr. Wilfried Martens now claimed (in a complete reversal of its previous policy stance) that a devaluation was indispensable as part of a stabilisation package which also included a temporary price freeze, measures of incomes policy, a reduction in corporate taxation and a modification in the wage indexation arrangements. Although most other member states agreed that a devaluation of the franc was long overdue, there were strong objections to the size of the realignment requested (12%), as well as to a Danish request for a parallel devaluation of 7%, as again there was no immediate market pressure on the krone and other countries thought that domestic remedies to improve the competitiveness of the Danish economy had not yet been exhausted.[77] Finally, after a full day's bargaining, ECOFIN agreed on a compromise: On 22 February 1982, the BFR was devalued by 8.5% and the DKR by 3%.

During the following few months, exchange rate relationships in the EMS reverted to their normal pattern, with the DM near the top and the FF near the bottom of their prescribed fluctuation margins. In March, there was increased tension in the exchange markets, as the fundamentally different macroeconomic outlooks in the Federal Republic and France since the French presidential and parliamentary elections gradually began to translate into widening inflation differentials and diverging trends in the balance of payments. Despite a 3% increase in French money market rates relative to West Germany and the US, the imposition of exchange controls and a tightening of the 1983 budget proposals, the franc came under renewed pressure

which finally forced another realignment of EMS central rates on 14 June 1982: The DM and the guilder were revalued by 4.25%, the French franc was devalued by 5.75% and the lira was devalued by 2.75%. The bilateral change in the DM/FF cross parity was 10%, the largest in the EMS. Belgium and Denmark who had had to accept smaller devaluations than they had requested last time round did not ask to join in, despite a continued need for interventions to support the BFR.

From July 1982 onwards there was a marked relaxation of US monetary policy and the discount rate fell by 3.5 points in the second half of 1982, which led to a temporary weakness for the dollar. At the same time, the French current account slid even deeper into the red, reaching a deficit of ECU 16 billion for 1982, while West Germany reverted to a surplus of 3.5 billion. These developments generated widespread speculation in early 1983 that another realignment of the DM/FF rate would be inevitable after the West German federal elections on 6 March and there was renewed pressure in the exchange markets on the French franc, the Belgian franc and the Italian lira. This grew stronger after the West German elections and the necessitated substantial interventions by the central banks concerned, interest rate adjustments in the Federal Republic and the Netherlands and the introduction of emergency exchange controls and an increase of the discount rate by 2.5 points in Belgium. However, these were no more than temporary remedies and so, following the completion of the French municipal elections in March, ECOFIN began discussions on a new realignment. A meeting took place on the weekend of 19-20 March, but a deal did not prove possible, mainly as a result of disagreements over the precise composition of the required revaluations and devaluations which were, as always, seen to reflect a government's economic success or failure and thus carried with them different domestic political consequences. Whatever the politicians' worries, however, the

currency markets were hardly in a mood to be understanding. On Monday, 21 March 1983, there was heavy speculation against the existing parity structure, forcing some European central banks to suspend trading. Finally, on that same afternoon, the seventh realignment in the EMS was announced, one that was more comprehensive than ever before and included all currencies participating in the ERM. There was a revaluation of the DM by 5.5%, the guilder by 3.5% (the first time since the very first realignment in September 1979 that the Dutch authorities had decided not to match fully a revaluation of the German currency), the krone by 2.5% and the Belgian franc by 1.5%, as well as a devaluation of the French franc and the lira by 2.5%, and the Irish punt by 3.5%. This time, the bilateral change in the DM/FF cross parity came to 8%, bringing the cumulative change to approximately 30% over the past eighteen months.

The realignment of 21 March 1983 brought to a close the first phase of the EMS. During this period, realignments were large and frequent but they became increasingly the result of joint decision rather than be granted more or less automatically on the request of a member state. The system also proved more durable than sceptics had expected. Member states often had to accept policy adjustments to maintain the exchange rate and, when a realignment could not be avoided, they sometimes had to accept different (typically smaller) changes than what they had originally requested with no breakup in the system or the loss of any currency as had happened in the Snake. Cumulative changes in the effective exchange rate relative to EMS partners, on the other hand, had been rather large: The DM appreciated by a total of 24%, the guilder by 11%, the punt fell by 5%, the Belgian franc and the krone by 11%, the French franc was down by 14% and the lira down by 18%. In general, stability-minded countries improved their competitiveness, while high inflation countries did not achieve full accommodation for their inflation differentials and thus suffered a loss of competitiveness relative to their EMS partners.

However, the EMS band as a whole gained in competitiveness by around 10%-15%, due to the rise of the US dollar during 1981-83. Also, already in its first period, the EMS managed to avoid the misalignments that characterised those currencies which continued to float (particularly the dollar, sterling and the yen). John Williamson of the Institute for International Economics in Washington D.C. calculated that, at the end of 1984, the dollar was overvalued by 37% over all, by 50% relative to the DM and by 44% relative to the French franc.[78] Furthermore, exchange rates in the EMS appeared to move according to the underlying economic fundamentals, in contrast with floating currencies, which often experienced wildly erratic fluctuations. Thus, for example, the dollar rose in the first half of 1984, when interest rate differentials favoured the US, but continued to rise in the second half and during the early part of 1985, when such differentials were reversed. In all, though still not performing as well as its supporters might have wished, the EMS appeared to be successful in the basic task expected of it: "The EMS is doing what its architects intended - restore fixed exchange rates for about 360 days a year. Provided he picks those days correctly, a currency dealer can safely take the choicest interest rates and forget about forward cover, but it is expensive to miss the five days' scramble when realignments occur".[79]

The system did even better during its second period. Over the next twenty eight months, there were no further realignments in the EMS. There were two main reasons for this. First, the U-turn made in the economic thinking of the French Socialist government which, from March 1983 onwards, began to abandon its "Socialism in one country" attitude to the economy and, led by the Finance Minister Jacques Delors and his successor Pierre Beregovoy, embraced a more orthodox policy mix of austerity and, increasingly, economic liberalisation to respond to the serious difficulties confronting the French economy, similar to that practised in West Germany

and other countries of the European Community. Second, intra-European exchange rate stability was helped by the strength of the US dollar.[80] The American currency, which had been equivalent to ECU 0.69 at the end of 1979, climbed to over ECU 1 by the end of 1982 and continued to rise all through 1983, 1984 and the first two months of 1985, reaching a high of ECU 1.49 in February 1985. This was mirrored, as usual, by a corresponding weakening in those European currencies which are normally considered "strong". The DM and the guilder moved to the bottom of EMS band, while the French franc the krone and the punt moved near the top.

This situation was reversed in February 1985, which saw the beginning of a protracted period of decline for the dollar, which inevitably was to influence exchange rate relations in the EMS. By mid-July the DM had appreciated by 15% relative to the dollar and was once again moving near the top of the EMS band, while the Italian lira found itself under pressure at the lower end due to the rapidly deteriorating condition of the current account and the state of public finances. (The government deficit reached more than 13% of GDP and interest payments gobbled up some 20% of all public spending). The Italian government, led by Bettino Craxi, the leader of the Italian Socialists, since July 1983, had already began a determined effort to fight inflation and the uncompetitive structure of the labour market and, in 1984, sliced four percentage points off the country's wage-indexation system, the *scala mobile.* Although this measure had proved to be a success (inflation fell to 8.6% in February 1985, from 16% in 1983), there was stiff resistance to the dilution of the wage indexation arrangements and, on the initiative of the Communist Party, a referendum was organised on the issue. The positive outcome of that for the government on 9 June 1985, relieved the pressure on the lira, but, in a precautionary move to avoid a speculative build-up and to restore competitiveness, Italy requested a realignment of the

currency within the EMS which was effected on 22 July 1985. The lira was devalued by 6%. All other currencies were revalued by 2%.

The slide of the dollar continued through the summer and autumn of 1985. By August, the American currency had fallen 14% in trade-weighted terms and by almost 23% against the DM since its peak in February. The fall was seen to be long overdue in international financial circles and received approval from the G-7 conference of Finance Ministers and central bank governors, held in the Plaza Hotel, New York, on 22 September 1985, which confirmed that the world's major economies intended to achieve an orderly depreciation of the dollar and a reduction of the US trade deficit. Although Mr. James Baker, the American Secretary of the Treasury, as well as the other participants had placed strong emphasis on the gradual character of the adjustment, the admission that the US and its major partners not only were prepared to permit, but actually wished the dollar to fall naturally sent tremors through the exchange markets. On 23 September, the day after the Plaza accord, the EMS currencies appreciated by 6% relative to the dollar. In the weeks that followed, the DM and the guilder moved to the top of the EMS band, while the Belgian franc, the lira and the punt came under renewed downward pressure. In December and during early 1986, there was substantial intervention to support the Belgian franc, an increase in Belgian and Irish interest rates and the reintroduction of some previously abolished exchange controls in Italy. A realignment, however, was not expected and did not occur until after the French parliamentary elections of 16 March 1986, which produced a right-wing majority in the Assembly and a new RPR/UDF government led by Jacques Chirac.[81] Although the market reacted calmly to the unfamiliar prospect of *cohabitation* between a Socialist President and a neo-Gaullist Prime Minister, the new Finance Minister, Edouard Balladur, sought to obtain an early devaluation of the franc as part of a package which aimed to liberalise the French economy

and to improve competitiveness (since the last general realignment in March 1983, French prices had risen by 12% more than in West Germany). On 4 April, the Banque de France informed its partners in the EMS that it would no longer support the franc.[82] This created an upheaval in the currency markets, causing the DM and the guilder to cross their suspended upper intervention limits, while the franc and the punt fell bellow their lower ones. On 6 April 1986, ECOFIN meeting in Ootmarsum, Netherlands, decided on a new realignment, with effect from 7 April. The DM and the guilder were revalued by 3%, the French franc was devalued by 3%, the Belgian franc and the krone by 1% (an adjustment calculated to restore French competitiveness back to around its 1979 level). The French government followed this with a package on 9 April, which included measures intended to slow nominal wage growth and to curb the government deficit, a 5% target for the money supply (M3) for the coming year, tax cuts, the abolition of price and exchange controls as well as a program of privatisation of state-owned banks, insurance companies and major industrial concerns, similar to that successfully pursued in Great Britain by the Conservative government of Mrs. Margaret Thatcher.

Following the realignment, exchange rate relations in Europe normalised and interest rates fell in several countries as speculative pressures dissipated. Then, on 2 August 1986, the Irish authorities requested a devaluation of the punt which had not participated in the April realignment. Although there was no immediate market pressure, Dublin viewed with increasing concern the recent appreciation of the Irish currency against sterling (9% since April) and the US dollar, which threatened to make Irish products deeply uncompetitive in the two countries which between them accounted for about half of Ireland's foreign trade. The request was granted and on 4 August 1986 the punt was devalued by 8%. No further adjustments were necessary until the end of the year, when the continuing weakness of the US dollar once again put pressure on

the internal parity structure of the EMS. By early December 1986, the American currency had fallen by some 40% relative to its DM rate of February 1985. Although the dollar strengthened temporarily in the beginning of the month, the publication of figures which revealed that the trade deficit in November had been larger than expected soon reversed the trend, capital fled across the Atlantic toward the stronger European currencies (principally the DM) and the dollar fell a further 5% on its February 1985 rate, despite sizeable intervention to support it. At the same time, in France, student unrest, rail strikes and the Prime Minister's insecure and defensive handling of them undermined confidence in the government and the rate of the franc. In early January 1987, there was intense speculation in the exchange markets on an EMS realignment and the DM strained its upper limits against the franc, the krone and the punt. Despite substantial interventions and an increase of interest rates in a number of the member states, market pressure finally convinced Europe's monetary authorities that it would be pointless and damaging to try to defer the inevitable until after the West German federal election, scheduled to take place on 25 January, as this would only maximise the speculators' gains at the expense of Europe's taxpayers and central banks. Thus, on 12 January 1987, ECOFIN decided on a new realignment of EMS central rates: The DM and the guilder were revalued by 3%, while the Belgian franc was revalued by 2%. This was the last adjustment of parities in the first decade of the EMS. In the three years to the end of 1989, the continuing convergence of the member states' economic policies and a firm US dollar (helped by the G-7 Louvre accord of 22 February 1987, aimed to stabilise the American currency at its current level against the DM and the yen) contributed to a calmer situation in the exchange markets and removed the need for parity realignments between the countries of the European Community. As far as exchange rate developments were concerned, the EMS was now passing the test with flying colours!

Unfortunately, it did not to equally well in other respects. First, Great Britain did not join the system, although the Bank of England deposited on a voluntary basis 20% of its gold and dollar reserves with FECOM on 6 July 1979. Greece, which became the tenth member of the European Community on 1 January 1981, followed the British example and decided not to participate in the ERM. However, on the occasion of the next general revision of the currency composition of the ECU, on 17 September 1984, ECOFIN decided to include the Greek drachma in the ECU basket. Greece signed the EMS agreement on 10 June 1985 and deposited 20% of its gold and dollar reserves with FECOM on 1 January 1986. Spain and Portugal, which became members on 1 January 1986, similarly did not choose to participate in the ERM, though Spain indicated its interest in future membership. In June 1989, as part of the regular quintannual review of the EMS arrangements, ECOFIN decided to include the peseta and the escudo in the ECU basket, with effect from 20 September. Spain also announced that the peseta would join the ERM with the wider 6% fluctuation margins still used by Italy. Thus, the EMS had gained one more full member, though, on the other hand, yet another EEC country had also joined the ranks of those which did not choose (or were not able) to take part in its central mechanism, a fact which undermined the claim of the system to be seen as a true Community instrument.

It was not only in terms of membership, however, that the system performed less well than might have been hoped. Equally (if not more) worrying was the failure to deepen the content and to enhance the internal cohesion of the EMS through the kind of institutional development that would have helped it become more than a mechanism for exchange rate concertation and turned it into a *true* monetary system. Yet, the unresolved differences between the member states on institutional questions remained and put the brake on the kind of development early on

in the life of the EMS. At its Luxembourg meeting of December 1980, the European Council decided to postpone indefinitely the transition to the institutional phase of the EMS. Just two years after the Brussels resolution which established the EMS, the political leaders of Europe thus declared that the more ambitious and more interesting aspects of the system, the EMF and the potential development of the ECU into a common European currency, were matters which were too politically sensitive to be taken up seriously, especially with presidential elections in France just round the corner. Once again, the co-ordination approach to EMU had made agreement dependent on national political calendars and had precluded progress towards monetary unification in Europe.

However, the development of the EMS was not altogether halted. On 15 March 1982, the Commission presented to ECOFIN a set of proposals intended to reinforce the system.[83] The Commission's ideas included a new method of issuing official ECUs, which would not fluctuate so much with the changes in the price of gold and the US dollar, a call for the acceptance limit for ECUs offered in settlement of debt between EMS monetary authorities to be raised from 50% to 100%, as well as measures to encourage the private use of the ECU, to increase consultations and economic convergence and to improve the co-ordination of the member states' policies towards third currencies, particularly the US dollar. Although the Council was unable to accept the proposed changes at the time and referred them instead for further study, most of the elements contained in the Commission's 1982 proposals were, in fact, adopted in subsequent years. On 10 June 1985, the Committee of Central Bank Governors approved a package aimed to strengthen the EMS, which included measures intended to facilitate the general use of ECUs and enabled central banks in need of intervention currencies to mobilise ECUs held by FECOM. Also, for the first time, central banks of non-member countries as well as international monetary

institutions were allowed to become officially "other holders" of ECU.[84] Even more significant changes to the rules of the EMS were made on 12 September 1987, in two meetings of the Central Bank Governors and ECOFIN in Basle and Nyborg, Denmark, respectively. A new surveillance mechanism was created to promote greater convergence and to ensure that conflicting economic policies, which could threaten the success of the system, would be avoided. The very short term financial facility was now also made available for use in intra-marginal interventions and the prescribed settlement period was extended by one month. Finally, the acceptance limit for settlement in ECUs was raised to 100% for a trial period of two years.[85]

It was been one of the relative disappointments of the EMS that, despite these measures, the growth in the official use of the ECU had been negligible. By contrast, use of the ECU by the private sector took off during the initial period of the EMS and grew rapidly thereafter,[86] although it has never reached the level that might have been hoped. Today, most major financial instruments are available in ECU. Banks offer current and deposit accounts in ECU, there are government bonds and travellers cheques denominated in ECU, an ECU credit card and the whole spectrum of loans, from personal loans to major syndicated ones. By mid-1988, there were some ECU 34.1 billion of ECU-denominated bonds outstanding, which made the ECU the fifth most common currency for Eurobonds, behind the dollar, the DM, sterling and the yen. Total ECU assets as reported by the banking sector amounted to ECU 95 billion, while ECU liabilities came to ECU 82.2 billion. The bulk of this business was accounted for by banks in Belgium/Luxembourg, France, the UK and Italy, a fact which reflects the large differences in the treatment and the encouragement given the ECU in different member states.[87] Since 1986, the growth of the ECU market has slowed down quite appreciably and the share of the ECU in

TABLE 13

The development of the ECU market, 1982-88 (billion ECU).

	1982[1]	1983	1984	1985	1986	1987	1988[2]
ECU assets							
Banks	--	9.7	28.6	49.3	54.9	62.1	73.0
Non-Banks	--	4.7	11.2	13.9	15.8	20.3	22.0
Total	6.7	14.4	39.8	63.2	70.7	82.4	95.0
ECU liabilities							
Banks	--	10.4	27.9	49.3	53.9	60.9	73.2
Non-Banks	--	1.4	2.8	7.2	6.2	6.8	6.9
Monetary Authorities	--	0.3	0.7	1.0	1.1	1.9	2.1
Total	5.7	12.1	31.4	57.5	61.2	69.6	82.2
ECU Eurobonds	3.2	5.6	9.7	18.6	24.8	31.5	34.1

[1] Estimated

[2] The figures for 1988 are based on the available data up to the end of June.

Source: A. Lamfalussy (1989b)

TABLE 14

The role of individual countries in the development of the ECU market.

(June 1988, billion ECU)

	ECU Assets			ECU Liabilities		
Country	Bank	Non-Bank	Total	Bank	Non-Bank	Total
France	17.9	4.9	22.8	18.5	0.6	19.1
U. Kingdom	17.5	3.7	21.2	16.4	1.0	17.4
Belgium	14.0	4.1	18.1	13.0	1.3	14.3
Italy	8.8	2.8	11.6	11.5	0.5	12.0
Luxembourg	6.6	2.5	9.1	6.6	2.2	8.8
Netherlands	2.5	0.8	3.3	2.1	0.7	2.8
Germany	1.5	1.2	2.7	2.1	0.2	2.3
Other EEC[1]	1.5	0.9	2.4	2.0	0.1	2.1
Total EEC	70.3	20.9	91.2	72.2	6.6	78.8
Other[2]	2.7	1.1	3.8	3.1	0.3	3.4
Total	73.0	22.0	95.0	75.3	6.9	82.2

[1] Denmark, Ireland and Spain.

[2] Austria, Finland, Japan, Sweden and Switzerland.

Source: Constructed on the basis of data provided in A. Lamfalussy (1989b).

banks' total non-dollar Eurocurrency assets has remained stable at around 9%. Credits to non-banks amounted to ECU 22 billion in mid-1988, while deposit liabilities came to only ECU 7 billion, or 4% of non-dollar Eurocurrency deposits. The banks' net creditor position reflected the fact that the ECU market has been driven primarily by borrowing demand, particularly in Italy and France, where use of the ECU has been helped by partial exemption from exchange controls and which between them account for over half the total ECU credits. The small amount of non-bank ECU deposits on the other hand, show that the ECU's attractiveness as near-money substitute and store of liquidity has so far been quite limited. ECU deposits have been heavily concentrated in the Benelux countries, which account for some 45% of the total. Since 1986, ECU deposits have hardly registered any growth at all, which may be explained by the fact that, unlike borrowing, ECU deposits have usually been subjected to exchange controls (Italy and France) or other legal restrictions (West Germany) which, however, have now been removed or are being removed as part of the liberalisation of Europe's capital markets envisaged by the EEC's 1992 project.[88] This has led to signs of a recent pickup in the ECU market in 1989, a situation which is also paralleled by an apparent increase in the use of the ECU in foreign trade. In 1989, only 2% of European trade was invoiced in ECUs but there are encouraging signs that a growing proportion of middle-to-big European firms are switching to ECUs, or planning to do so as soon as accounting procedures allow. Similarly, an increasing number of joint ventures between East and West European firms are denominated in ECUs, while companies from as far apart as Australia and South America now engage in trade in ECUs to reduce their exposure to the gyrations of the US dollar.[89]

What then is the verdict on the first ten years of the EMS? The conclusion in the literature seems generally to be that "while the hopes of the optimists have been realised only in part,... it

has nevertheless become clear that the fears and predictions of the sceptics have not been justified".[90] Of course, the precise extent to which the EMS may be deemed a success does rather depend on how narrowly of widely one perceives the initial objectives of the system. As George Zis has pointed out, the declared aim of the EMS was to establish a zone of monetary stability in Europe and it is against this objective that the EMS has to be judged first and foremost.[91] It is clear that if the aim of the system is thus, narrowly defined, the EMS has performed better than supporters and critics alike had expected.

Monetary stability has two aspects, one external and one internal. As far as the external aspect (exchange rate stability) is concerned, the success of the EMS has been striking. Currency volatility has been progressively reduced between members, whereas it increased between non-members, as well as between members and non-members. The EMS has also avoided the gross misalignments of exchange rates which were witnessed elsewhere in the international monetary system, such as the overvaluation of sterling in 1979-81 and of the US dollar in 1981-85. Finally, parity changes within the EMS have become less automatic and have not fully compensated for inflation differentials between countries, thus providing a stimulus for the pursuit of sensible policies. "Realignments have become multilateral decisions in which accompanying domestic measures, particularly in a devaluing country, are on the agenda. In that sense, the EMS works more efficiently as a fixed-but-adjustable exchange rate system than did either the Bretton Woods one or the so-called 'snake'".[92]

With regard to the internal aspect of monetary stability (low inflation), the success of the system has been more debatable. It is one of the proudest boasts of the advocates of the EMS that, after an initial learning period, the need to maintain currency stability has prompted the member

states to pursue policies oriented towards domestic stability, which have, in turn, facilitated convergence in prices, costs and monetary aggregates at a lower level. On the other hand, it has been pointed out that, in some cases, inflation fell more dramatically in countries outside the EMS than in those inside and that, as a result, one has to be careful about attributing the reduction in the general rate of inflation in the Community to the existence of the system.[93] It would probably be a fair assessment to say that "while it may be debated whether the EMS and its constraints have been the main cause for this convergence, there is a consensus that the existence of the system has encouraged and contributed to the convergence of economic policies and developments".[94] Certainly, the worries of those critics who had argued that the establishment of the EMS with its generous facilities for financial support would prove to have inflationary consequences for the Community turned out to be ill-founded. "The EMS has not laid the ground for looser monetary policies, but rather provided a framework in which anti-inflationary policies could be pursued more effectively".[95] The system did in fact exert a strong disciplinary influence on those governments whose monetary policy diverged significantly from the average and was one of the major contributory factors behind the French Socialist government's U-turn in economic policy in March 1983.[96]

Although the creation of a zone of monetary stability was the declared aim of the EMS, however, it was never intended to be the only one. To quote from the conclusions of the presidency of the Brussels European Council, the system "should be seen as a fundamental component of a more comprehensive strategy aimed at lasting growth with stability, a progressive return to full employment, the harmonisation of living standards and the lessening of regional disparities in the Community. The European Monetary System will facilitate the convergence of economic development and give fresh impetus to the process of European

Union".[97] Taking this wider interpretation of the objectives of the EMS to view it also as an instrument of furthering the development of European integration, inevitably produces a different assessment of the relative failures and successes of the system. Convergence in prices, costs and monetary aggregates has not been matched to anything like the same extent by a similar convergence in government deficits, growth and unemployment rates or balance of payments trends and has not been reflected in a reduction of regional disparities and the equalisation of standards of living throughout the Community. Success with controlling currency instability has not been accompanied by the development of an efficient mechanism for fiscal co-ordination at a Community level, with the result that the system has, arguably, exhibited a deflationary bias which has kept European growth rates lower than they need otherwise have been.[98] It would, of course, be absurd to debit the EMS alone for the failure of the member states to accomplish more in the co-ordination of their economic policies. However, the unbalanced nature of economic harmonisation in Europe points out the unstable foundations on which the success of the system has so far been based. Currency stability and the reduction of inflation were made possible because of the other member states' willingness to follow the leader-ship of West Germany in the fight to get Europe's price level to an acceptably low level and their readiness to subject other objectives of domestic economic policy to that goal. But, as Artis has argued, success also carries within it the seeds of destruction.[99] As inflation ceases to be a major problem, so the degree of priority attached to it by the member states is bound to wane and so eventually might the monetary discipline which has underpinned the system. Begg and Wyplosz have claimed that the EMS would collapse if, for example, the fight against unemployment rather than inflation became the first priority of the member states.[100]

It is this continued reliance of the EMS on the priorities of the national governments, the failure to provide for the automatic growth and development of the system and the reluctance to set up the institutional framework which would secure and guarantee that growth that have been the main weakness of the EMS and the approach to monetary unification which underlies it. One of the early strengths of the EMS was that, unlike the Snake during its final period, it included all countries of the Community with the exception of Great Britain and she was expected to join as soon as circumstances permitted. At the end of 1989, three of the member states (Great Britain, Greece and Portugal) were still not participating in the ERM, while another two (Italy and Spain) were using the wider fluctuation margins which had originally been intended only as a temporary arrangement.[101] Thus, the EMS, behind the creation of which one of the prime motivations had been to preclude the division of the EEC into two groups as defined by membership of the Snake, was now itself the embodiment of the emergence of a two or even three-speed Community. The package of monetary measures approved in June 1985 and, even more, the 1987 Basle/Nyborg agreement may have been important reinforcements to the EMS but were hardly a substitute for the failure to develop the EMF. Finally, despite some limited progress in its use by the private sector, the ECU was way off being a truly functional common currency for Europe. In short, the EMS had proved to be a considerably successful exchange rate management system, but it was not capable or designed to achieve EMU in the European Community of the kind which had been envisaged by the Werner group in the beginning of the 1970s and to which the EEC had now returned through the December 1985 Single European Act and Project 1992.

IIIb. Facing the future.

IIIb1. Project 1992 and the Delors proposals.

On 7 January 1985, former French Finance Minister Jacques Delors succeeded Gaston Thorn as President of the Commission of the European Communities. Like Roy Jenkins in 1977, the new President made it obvious from the start that he wished to raise the political profile of the Commission and, on offering his team for approval by the European Parliament in Strasbourg on 14 January, he declared his intention to work towards a completion, by the end of 1992, of an integrated European market free of all barriers to trade and the movement of capital and individuals as specified by the Treaty of Rome, a reinforcement of policy co-ordination between the member states aimed to secure a higher level of economic growth and employment in the Community and, significantly, towards a further strengthening and development of the EMS.

Following a request by the European Council in March, Lord Cockfield, the Commissioner in charge of internal market affairs, unveiled on 15 June 1985 a plan containing some 300 directives which outlined in detail his ideas for 1992.[102] The Commission's proposals met with guarded approval in some member states (the British government, for example, strongly welcomed the creation of a single European market and the removal of controls on capital and the provision of financial services but expressed its equally strong reservations about the proposed abolition of border checks on individuals and the reduction in national sovereignty implied in the proposals related to EMU) and enthusiastic support in others (notably from West German Foreign Minister Hans-Dietrich Genscher). On 28-29 June, the European Council decided in Milan to call an intergovernmental conference to study in detail the implications of

the suggested extension in the activities of the Community, the institutional changes which might be necessary and the possible amendments to the EEC treaty required to provide the legal foundation for the establishment of an integrated European market by the end of 1992. An agreement on a reform package and a suitable wording on EMU that the British could accept were achieved at the Luxembourg meeting of the European Council on 2-3 December 1985, the resulting Single European Act (SEA) was signed by representatives of the member states in February 1986 and entered into force on 1 July 1987, after ratification by the national parliaments. Among other things, the Act provided for a new article 102 A to be inserted into the EEC Treaty, which would address the issue of co-operation in economic and monetary policy and would make specific reference to the EMS and the ECU.

Keeping strictly to the letter of SEA and wishing to maintain the political momentum which had been generated by the Act, the Commission quickly went on, in May 1986, to present to ECOFIN a specific timetable for the progressive liberalisation of capital movements within the Community and the abolition of all remaining restrictions on capital transactions by the end of 1992.[103] The Council approved the relevant directives, first in November 1986 (concerning the issue and acquisition of shares and bonds) and again in June 1988 (banking transactions and all other capital movements). In recognition of the problems which early adoption of these rules would entail for some of the weaker member states, however, the Council also authorised temporary exemptions for Ireland, Greece, Spain and Portugal, which were given more time to effect the liberalisation of their capital markets. Eight of the twelve members of the Community would abolish all remaining restrictions on the movement of capital by 1 July 1990. Ireland and Spain would do so by the beginning of 1993 while Greece and Portugal were given a further two-year extension to the beginning of 1995.

These developments generated a debate within academic and official circles as to whether the EMS, in its present form, would be capable of withstanding a complete removal of exchange controls and the creation of a fully integrated capital market throughout the Community. On the one hand, there were some who argued that the existence of exchange controls in countries like France, Italy and Belgium had been significant explanatory factors behind the success and, indeed, the survival of the EMS.[104] On the other hand, there were others who argued that, while capital controls had most certainly played a role, there is nevertheless no real evidence to support the proposition that the system would have collapsed in their absence. Exchange controls, they claimed, are rarely effective in the medium and long term and the experience of the EMS suggests that they have only been useful during periods of crisis and only if these did not last too long.[105] Given time, market operators will usually find ways to outsmart government regulators and to circumvent exchange controls and their ability to do so has progressively increased in the last decade or so with the further development of electronic and off-shore capital markets and round the clock global trading. Indeed, the spectacular rise in the private use of the ECU by comparison to its use by monetary authorities has been interpreted as yet another such case of the private sector circumventing capital controls.[106] Whatever their differences on the relative importance of the contribution of exchange controls to monetary stability in the Community in the 1980s however, there was generally no disagreement between the two sides on the fact that the adoption of SEA and the establishment of a fully integrated capital market and near-perfect capital mobility created a new situation, reduced drastically the scope for an independent formulation of monetary policy at the national level and called for a further strengthening of economic co-ordination between the member states and the development of a permanent mechanism for the management of monetary policy at the EEC level. To do

otherwise, it was claimed, would mean that the Community would "be seeking to achieve the impossible task of reconciling (1) free trade (2) full capital mobility (3) fixed (or at any rate managed) exchange rates and (4) national autonomy in the conduct of monetary policy".[107] These four objectives would, before long, turn out to be mutually inconsistent and, inevitably, at least one would have to give way. The spirit of SEA and experience with Bretton Woods, the Snake and the EMS over the past three decades dictated that it should be the last in this quartet of possible objectives which should do so. "In the long term, the only solution to the inconsistency is to complement the internal market with a monetary union".[108]

Despite continued reservations on the part of the British government, the European Council decided, at its meeting in Hanover on 27-28 June 1988, to confirm its commitment to a progressive realisation of EMU. To this purpose, it also set up a committee, chaired by Commission President Jacques Delors, to study the issue and to report to ECOFIN in good time for its conclusions to be discussed at the European Council scheduled to take place in Madrid in June 1989. The committee was made up by the President or Governor of each of the member states' Central Banks acting on a personal capacity, one more member of the Commission and three other personalities designated by common agreement by the European Council.[109]

The Delors report argued that the establishment of an EMU in Europe "would imply complete freedom of movement for persons, goods, services and capital, as well as irrevocably fixed exchange rates between national currencies and, finally, a single currency. This, in turn, would imply a common monetary policy and require a high degree of compatibility of economic policies and consistency in a number of other policy areas, particularly in the fiscal field".[110] It proposed the realisation of such a union in three discrete but evolutionary stages, though the

Committee emphasised that it saw the creation of EMU as a single process and, accordingly, the decision to embark upon the first stage should be seen as a decision to go through with the whole project. The Report was characterised by the principles of *parallelism* between developments in the economic and monetary fields and *subsidiarity*, according to which the Community should respect and encourage the existence of plurality among the member states and should only venture into those areas which could not be carried out at the national, regional and local level without adverse repercussions on the cohesion and functioning of the EMU.[111] The first stage should commence by 1 July 1990 at the latest and should encompass measures to enhance economic and monetary co-ordination within the existing institutional framework, as well as the preparation, formulation and ratification of a new Treaty which would be necessary to provide the legal foundation for a transition to the later stages of the project. In the economic field, there would be the completion of the internal market, a strengthening of the Community's competition policy and a reform of its structural funds, as well as a doubling of their resources, to make possible the pursuit of an effective regional policy and to correct structural imbalances. A surveillance mechanism would be set up to monitor economic developments in the member states and to ensure greater co-ordination in the budgetary field, with medium term orientation and precise quantitative guidelines. In the monetary field, the emphasis would be on the completion of an integrated market for financial services, the removal of all obstacles to the private use of the ECU and on achieving the participation of all EEC currencies in the EMS. The role and the functions of the Committee of Central Bank Governors would also be upgraded to facilitate co-ordination of the member states' monetary policies and consideration would be given to the question of extending the central banks' autonomy from political control. The possibility was, finally, mentioned of creating a European Reserve Fund to act as the forerunner of a future EEC central bank, although the Committee was not unanimous on this point.

The second stage of EMU would only begin when the new Treaty had come into force and would see a thorough revision of the existing institutions and the creation of new ones. The new institutional framework would work towards the eventual adoption of collective decision-making by majority rule, monitor and analyse macroeconomic developments in the Community and would gradually assume operational responsibilities, though ultimate control over policy would still remain in the hands of the national governments. In the economic field, the measures taken during the first stage would be evaluated and, where necessary, reinforced. In the monetary field, a European System of Central Banks (ESCB) would be established to take over the functions of FECOM and the Committee of Central Bank Governors. The ESCB would be committed to the objective of price stability and would be responsible for the formulation and implementation of monetary and exchange rate policy and the management of foreign reserves. It would have a federal structure, would be independent from political control by national governments or other Community institutions, to which it would have a comparable status, and would submit an annual report of its activities to the European Parliament and the European Council. The ESCB would consist of the ESCB Council (made up by the Governors of the Central Banks and the members of a Board appointed by the European Council), which would be responsible for the formulation of monetary policy in the Community, the ESCB Board, supported by its own staff, responsible for the overseeing and the implementation of this policy and national central banks which would execute daily operations in the accordance with the decisions of the ESCB Council. During the second stage, the ESCB would start on the process of transition from co-ordinating national monetary policies to the determination and execution of a common policy at the Community level and on the transfer of decision-making authority which this transition entailed. Depending on the progress made with economic convergence and any specific provisions in the new Treaty, the ESCB could also narrow the margins of

fluctuation within the ERM in preparation for the irrevocable locking of parities envisaged to take place during the final stage.

The third stage would see the completion of the process towards EMU in the European Community. In the economic field, the Council of Ministers, in co-operation with the European Parliament, would be invested with the authority to take binding decisions on the macro-economic and budgetary policies of the member states, to make structural transfers and to impose policy conditions to the extent required for the successful operation of the union. The Community would also begin to play its full part in the process of international policy co-operation. In the monetary field, exchange rates would now be irrevocably locked, national foreign reserves would be pooled and the ESCB would take over the responsibility for the formulation and implementation of a common monetary policy at the union level, the management of reserves and any exchange market interventions that might prove necessary. The transition to a single currency would also be effected during this final stage.

Seen in the light of the Community's past experience with EMU, there is no doubt that the Delors report represented a substantial advance over both, the Werner plan and the EMS. Like the Werner plan and unlike the EMS, the report was a blueprint for a complete transformation of the European economy leading to full EMU, not just (or mainly) a mechanism for the management of semi-fixed exchange rates. But, unlike the Werner plan, which was forced by political disagreements to be at all precise only about the contents of the first stage and became hazy on what followed thereafter and, in particular, the nature of the final stage and the path to get there, the Delors Committee understood the importance of agreeing above everything on a crystal clear description of what complete EMU entailed and setting out in an unambiguous way

the specific steps that would be required and the implications for the process of policy-making and for national sovereignty. The strategy suggested in the report was based on the kind of parallelism which was truly necessary in order to progress in a balanced fashion towards the realisation of both the economic and the monetary aspects of EMU and not on compromises based on the lowest common denominator, as the Werner plan had been. The report gave due attention to the linkages which exist between monetary union and other areas of economic integration and included specific provisions aimed to deal with the aggravation of regional and structural disparities which might result out of a transition to full EMU. It also included a mechanism for co-ordination in the budgetary field, which had been conspicuously absent from the EMS. Institutional questions, on which the EMU project of the 1970s had finally floundered, were not skipped but were faced head on and, still more significantly, were given the kind of solutions which did truly derive from the experience gained so far in both the successes and the failures of previous ventures towards EMU. Hence the insistence in the report that the envisaged ESCB be fully independent from political control at either the national or the Community level (there is a strong correlation in Europe and elsewhere between the degree of independence of the Central Bank and the level of inflation),[112] or that the process towards EMU should be seen as indivisible and so the second stage should only be embarked upon when a new Treaty had come into force, to provide the legal foundation for EMU, which the Treaty of Rome even as amended by SEA could not do, and to signify the member states' determination to complete the journey to the final stage.

In fact, just about the only weakness of the Delors report, *though it is a crucial one*, was that, like the schemes which preceded it, it was based on the co-ordination approach to EMU and, thus, it failed to establish an "automatic" mechanism for the development of the system. In

practical terms, this meant that the report saw exchange rate unification as a *prerequisite* to monetary union and ruled out the establishment of a common currency at an early stage and until exchange rates had been, first, irrevocably locked. It also meant that once again the process towards EMU in the Community would be government-driven rather than the market-driven. In this, the strategy of the Delors report was similar to that of the Werner plan and the EMS and, as a consequence, was beset by the same unnecessary problems and costs of economic harmonisation and exposed to the same political risks. Indeed, looking back at the Werner plan, one cannot fail to notice the several similarities that exist between that and the Delors report[113] and even though, as a result of greater convergence and experience with floating currencies, the new proposals were obviously more in tune with current political reality in Europe, there was little in the report to guarantee that the process towards EMU would not be halted when it reached the institutional stage, as had happened to both the EMU project and the EMS. With unanimity required for a new Treaty and Great Britain firmly opposed to a diminution of national sovereignty, the strategy advocated in the report ran, at the very least, the risk of a British veto. In that case, the cause of EMU could only be advanced if the other eleven felt passionately enough about the issue to conclude a separate treaty outside of and in parallel with the normal framework of the EEC. If that were to happen, the British would no longer be fully involved in decisions which would crucially affect the future course of the European Community. Despite considerable irritation generated through the years over the issue of the British contribution to the EEC budget and over Mrs. Thatcher's often provocative stance on European affairs, there is little doubt that some (though not all) of the member states would frown on any such development, while the loss to the Community of one of its four larger members would be a serious blow, not only to the cause of EMU but also to the general economic and political cohesion of Europe.

Political reactions to the Delors report in the Community ranged over the whole spectrum, from outright support to thinly-veiled condemnation. In April 1989, the European Parliament gave its approval to the proposals and suggested that 1995 should be adopted as the deadline for the completion of EMU. Two months later, on 26-27 June, the Madrid European Council decided to adopt the recommendations of the Delors report and instructed the competent bodies of the Community to take the necessary steps for the launch of the first stage by 1 July 1990 and to carry out the preparatory work for the organisation of an intergovernmental conference which would take place once the first stage had begun and would lay down the timetable and policy measures to be followed for a transition to the later stages. The British Prime Minister, Mrs. Thatcher , once again noted her reservations about the whole process.[114]

Although Britain had signed the SEA, had been one of the leading advocates for the creation of a single market and the liberalisation of capital services and had gone along so far on EMU, the position of the British government was fundamentally different to that of the others and was likely to remain so for at least as long as the current resident of 10 Downing street continued to be Mrs. Margaret Thatcher. For, although other member states, in particular West Germany and Holland, had some reservations about the details of EMU and about the speed of its implementation, British objections went deeper and concerned the very nature of the final objective, especially in relation to the supranational aspects of the proposals. Indeed, progress had been at all possible so far as a result of a curious balancing act which consisted of finding forms of words which London would find acceptable and which permitted the further examination of the issues involved while not committing the British government firmly to the project. Mrs. Thatcher had emerged from the Luxembourg meeting of the European Council on 3 December 1985 (just after such a compromise wording on EMU had saved the day and made

possible a final agreement on the SEA) saying: "It doesn't change anything. If it did, I wouldn't have agreed to it".[115] The British position became clearer in the months which followed the publication of the Delors report and its adoption in Madrid. London claimed that the proposals made good sense only as far as the measures envisaged for the first stage and that to proceed further into institutional reforms and a transfer of economic and political economy authority from national governments to the Community would only be feasible within the context of a wider political union which was code for saying that, in British eyes (or, at any rate, in those of the Prime Minister), the whole idea was daft.

It is one of the ironies of the history of monetary unification in Europe that this negative attitude which Britain adopted towards the EMS and EMU not only was not monolithic (such things rarely are), but it reflected the opinion of just a small minority of the public and the political establishment of the country. For, although there was genuinely more scepticism over the issue in Britain than in the other member states, a decade of EMS success, during which the predictions of the critics had been demolished, had led to an ever growing consensus that Britain was losing out by not participating in the system. The Treasury, the Foreign Office, the three opposition parties, the CBI, the TUC, the Bank of England, as well as a majority of the City of London, the academic community, the general public and even the Conservative party and the Cabinet, all thought that Britain should join the EMS. The Chancellor of the Exchequer in particular, Mr. Nigel Lawson, believed that a continued absence of sterling from the ERM would inevitably deprive Britain of the chance to influence the future course of economic and industrial policies in Europe, would threaten the long term pre-eminence of London as Europe's leading financial centre and, in the meanwhile, it contributed to higher interest rates (an uncertainty premium) *and higher inflation* in Britain than in the rest of the Community. He therefore

elected to run an unofficial sterling policy, based on shadowing developments in the EMS and keeping a stable rate relative to the DM, but this led him to a long semi-public squabble with the Prime Minister who, influenced by her economic adviser Sir Alan Walters, was against participation in the EMS and against any form of pegging the exchange rate. In the end, Mr. Lawson had enough. On 26 October 1989 he resigned his position, thus depriving the government of the services of a highly-regarded and innovative Chancellor who had enjoyed a good relationship and the confidence of the City of London. Mr. John Major took over at the Treasury. Over the following month, sterling fell by 6%.

With regard to its attitude to EMU, France stood at the opposite end of the spectrum from Great Britain. Like Commission President Jacques Delors who had once been his Finance Minister, the French President, Francois Mitterand, wished to push ahead quickly towards the implementation of EMU in the European Community and thought that the need to reinforce the EEC by doing so had now become even more urgent as a result of the recent cataclysmic developments in Eastern Europe. The second half of 1989 and early 1990 saw the unthinkable happen across the once thought inviolable iron curtain. In the space of a few months, Communist regimes throughout Eastern Europe and the political, social and economic order on which they were based collapsed like dominoes under the watchful eye of the Soviet Union, with the tolerance and, sometimes, even the tacit encouragement of its President, Mikhail Gorbachev. Hungary led the way towards a pluralist multi-party democracy, Solidarity, the once-banned trades union found itself winning elections and forming a new government in Poland, Vaclav Havel, an once-dissident playwright became President of Czechoslovakia, all-powerful ex-Communist party leaders Todor Zhivkov and Erich Honecker were removed from office in disgrace, arrested and committed for trial on charges of corruption and treason in

Bulgaria and East Germany and the Romanian despot Nicolae Ceausescu was tried and shot by an army firing squad on Christmas day 1989, in a sad parody of even elementary military justice. The climax of the upheaval came on 9 November 1989, when the Berlin wall, the long-hated symbol of oppression and the division of Europe into two military camps, began to come down, thus at last opening the way for a free and democratic continent and for the reunification of Germany within its 1945 frontiers.

It was these developments which prompted President Mitterand to press even harder for an early realisation of EMU in the later part of 1989. The French President did not see EMU just as an economic arrangement, but also as a means of binding Europe together politically and making sure that a reunited Germany would continue to play its full part in the European Community. Helmut Kohl, the present West German Chancellor, and his Minister for Foreign Affairs, Hans-Dietrich Genscher, could probably be relied upon, the French thought, to share that view, but this could not be said with the same amount of confidence about the likely SPD Chancellor-candidate for the next federal elections, Herr Oscar Lafontaine, the current Premier of Saarland. With the outcome of the German elections difficult to predict, President Mitterand therefore wanted to crown the French presidency of the EEC of the second half of the year by setting a date, at the forthcoming Strasbourg meeting of the European Council on 8-9 December 1989, for an intergovernmental conference, which would meet before the German election, scheduled to take place in early December 1990, and would start drafting the treaty changes necessary for a move to the later stages of EMU, so that these would be ratified by the end of 1992.[116]

Within West Germany, France's urgency to move ahead with EMU was matched by that of the Foreign Minister, Hans-Dietrich Genscher, who also thought that events in Eastern Europe

called for a radical strengthening of the links which bound together the nations of the European Community and expressed his agreement with the ambitious timetable suggested by the European Parliament for the completion of EMU, even though a speedy transition to the later stages might lead to the establishment of a two-tier Europe.[117] In striking resemblance to the 1975 Tindemans report,[118] Herr Genscher argued that the EEC ought to press on with the implementation of EMU and those member states which felt that their individual circumstances did not allow them to participate from the outset should be kept fully involved in the discussions on the development of the project and join later, as soon as conditions were right. On the other hand, there was a number of influential personalities who advocated a more cautious approach to EMU and thought that the Strasbourg summit of the European Council was too early to set a date for an intergovernmental conference on the issue. Among these were the President of the Bundesbank, Karl-Otto Pohl, the Finance Minister, Theo Waigel, and Count Otto Lambsdorf, Chairman of the FDP and Herr Genscher's party colleague. An early dash towards EMU, they argued, not only ran the risk of a two-tier Community and of a British veto, but was bound to fail unless those details of the project which had not been clarified by the Delors report were sorted out first. Should, for example, large member states have equal or larger representation than small ones in the board of the ESCB? Should decisions be taken by simple or qualified majority? And since national Central Bank Governors would sit at the board of the ESCB did the independence of the new institution require prior arrangements to ensure more autonomy from political control for the national central banks as well?

To those technical considerations came to be added others of a political nature. On the one hand, the West German government wished to avoid any rash commitments which might in any way impede the course of a reunification with East Germany. On the other hand, the centre-

right coalition faced electoral worries, not only from a rejuvenated SPD, but also as a result of the rise of the far-right Republicans who sniffed at the EEC and would attempt to portray an early deal on EMU as a sell-out on national sovereignty, German interests and the DM. Among the other member states, West German reservations about the pace of implementing the Delors report were shared fully by the Dutch, while Italy and the smaller member states came generally in favour of the line taken by France and the Commission, even though it was clear that at least some of them would be unable to participate straight away. The stage was now set for a compromise and one was indeed found at the Strasbourg summit of the European Council, on 8-9 December 1989. Federal Chancellor Helmut Kohl came down on the side of his Foreign Minister and agreed that an intergovernmental conference on EMU would be convened in December 1990, just after the federal election, to begin work on a new EEC treaty. In return, President Mitterand agreed to a declaration which made reference to the German people regaining "unity through free self-determination.... placed in a context of European integration".[119] Mrs. Thatcher remained unrepentant in her objections, though she spoke almost warmly about the EMS, if only to contrast it with, in her opinion, the more inflationary and politically divisive EMU.

Two more recent developments must be briefly mentioned before we leave this section on the current state of affairs regarding the progress of EMU in the European Community. First, France abolished all remaining capital controls in December 1989, six months ahead of schedule. Second, 5 January 1990 saw the latest realignment in the EMS (the first for three years) effected in order to accommodate recent upward pressures on the DM. With the West German economy already growing rapidly, the Bundesbank grew anxious that a combination of the DM25 billion of income-tax reductions announced by the federal government, the influx of

refugees from East Germany and excessive wage claims (IG Metal, the country's biggest trade union, had tabled a demand for a 9% pay increase and a cut in the working week to 35 hours) could easily result in higher prices and took strict measures to stamp out inflationary expectations before they could take hold. West German interest rates were pushed up at a time when, across the Atlantic, the US Federal Reserve was easing American monetary policy which led to the DM enjoying a favourable interest rate differential relative to the dollar for the first time since 1976. As if this were not enough, however, on 4 January 1990, the Bundesbank intervened heavily in the exchange markets to push the American currency below the DM 1.70 mark, which had long been assumed to be the unpublished lower limit agreed at the G-7 Louvre accord of February 1987. The rapid appreciation of the DM created, as always, pressures within the parity structure of the EMS and led to a number of currencies being pushed towards their lower intervention limits and to an interest rate increase in France. With some estimates, however, pointing out that, in purchasing power parity terms, the DM was already slightly overvalued and having only recently succeeded to almost eliminate the inflation differential with West Germany as a result of its *franc fort* policy being closely aligned to Frankfurt policy, the Banque de France resisted the Bundesbank's persistent calls for a general realignment in the EMS. So, finally, it was only Italy which devalued against its EMS partners on 5 January 1990 although there had been no immediate market pressure on the current rate of the lira. To effect the desired adjustment of around 4%, the lira was devalued by 3.01% against the ECU, while all other EMS currencies were revalued by 0.7%. At the same time, as a contribution towards EMU, the Italian government abandoned the wider 6% margins of fluctuation and adopted instead the narrow 2.25% band, as had originally been intended in the EMS agreement. The wider margins of fluctuation continued to be used for the time being by the Spanish peseta.[120]

IIIb2. Where do we go from here?

When work started on the final draft of this study a few months ago, the prospect that the European Community would proceed on the basis of the Delors report to achieve full and permanent EMU looked very uncertain indeed. After all, experience would suggest that the EEC has been here before on a couple of occasions with the EMU project of the early 1970s and the EMS and, both times, despite the proclaimed commitment of the national governments to the success of the enterprise, the final result did not quite match the expectations and the high hopes vested upon it at the outset. There was a continuous reduction of content from the Werner plan to the DM-dominated zone of monetary stability which the Snake developed into, as there was a continuous reduction of content from Roy Jenkins's Florence speech to Bremen, to Brussels and to the actual reality of the EMS. It may be that this process of downgrading and compromise is an inevitable and anticipated part of political reality, but it is equally true that the end result was substantially less than what was needed in order to achieve EMU in Europe. So, despite being a considerable advance on earlier schemes, are the Delors proposals, even before that process of reduction. The implementation of the proposals is still dependent on political discretion and there is no automatic, crisis-proof mechanism to ensure an eventual transition to the later, troublesome institutional stages. Indeed, some of the arguments between national governments which surfaced during the later part of 1989 over the degree of economic harmonisation and convergence that would be necessary before such a transition could be contemplated, or over the precise functions, status and composition of the proposed ESCB, in some ways recalled the controversy between the "Economists" and the "Monetarists" of the early 1970s.

Then, events started happening at a dizzy pace. Within a few months, the Communist order in Eastern Europe collapsed like a house built of playing-cards, while the rapid disintegration of the East German economy and a daily exodus to the West of some 3,000 people brought forward the prospect of German reunification within a time-span which made even the once-thought ambitious plan Chancellor Helmut Kohl had submitted to the Bundestag on 28 November 1989 seem hopelessly reserved and out of date.[121] Arrangements were now being made for direct talks between Bonn and the new government that would emerge from East Germany's free election, scheduled to take place on 18 March 1990, for the quick establishment of an economic and monetary union and there was the likelihood that the federal election due in December would be turned into an all-German one and that a united Germany would be in place before the end of the year.

These developments and the need to fight off any neutralist tendencies and to keep Germany fully involved in the West brought about a new urgency to the way the European Community looked upon its internal affairs. Suddenly, member states and personalities who had previously balked at certain aspects of EMU were now pushing for faster progress and the 1995 deadline for the completion of the whole process, which the European Parliament had called for, seemed less Quixotic than had appeared to some in the beginning. France accepted the inroads to national sovereignty which would be an inevitable part of full EMU and Guido Carli, the Italian Treasury Minister who was expected to be the President of ECOFIN during the second part of 1990, and would thus be crucially placed to affect the path the Community would chart towards EMU, seemed to have abandoned his former scepticism of European monetary ventures and made it clear that Italy would push for a quick adoption (probably within 1991) of the treaties necessary to proceed beyond the first stage and that the question of German reunification and/or

monetary union should not be allowed to stand in the way.[122] There was also speculation that the intergovernmental conference which was scheduled to take place in December would now be brought forward to July and even rumours that the British Chancellor of the Exchequer, Mr. John Major, intended to bring sterling into the EMS, possibly in April and no later than in June 1990. Experience would suggest that, under normal circumstances, reliance on the discretion of the national governments, a packed electoral calendar in Europe, disagreements over those elements of the Delors report which were left unspecified and the daily unfolding of momentous events on the world stage would combine in some measure to block decisive progress. But, clearly, circumstances are *not* normal and *there is* a different political feel behind the displayed urgency of the Community to achieve the long-awaited breakthrough to EMU. Experience alone suggests it will not succeed. But, in these extraordinary times when the Berlin wall lies scattered around an amazed world in small pieces of souvenir rock and when the Soviet Union itself is now well down the road of being transformed into a Western-style presidential democracy, who is to say?

Certainly, there still remain a number of issues over which conflicts may potentially arise and which may yet scupper the achievement of EMU in Europe. One of these is the still unresolved question of the precise status, structure and responsibilities of the proposed ESCB. Speaking in Paris on 16 January 1990, Bundesbank President Karl-Otto Pohl made it clear that a new European monetary institution would only be acceptable to low-inflation countries like West Germany if it could guarantee a comparable degree of monetary stability to that already provided by their own national Central Banks. To achieve this, the ESCB would have to be given a legally independent status and be free from political control at the national or the Community levels, as well as a legal mandate and responsibility to maintain the fight against

inflation as an over-riding objective. Not surprisingly, Herr Pohl's blueprint for the ESCB is for a Bundesbank writ large. The new institution should be given total control of monetary policy and in particular the monopoly of money creation. The members of the ESCB board should be appointed on long term contracts (say eight years) which cut across national electoral cycles. Finally, since the Governors of the national Central Banks would participate in the ESCB Council, to guarantee the ESCB's freedom from political pressure would require that national Central Banks should also become fully independent of their respective governments.[123]

Although the main thrust of Herr Pohl's views is also shared by the Dutch, other member states feel less easy about some of his specific recommendations. Disagreements exist, for example, on whether the ESCB should be granted sole responsibility for the conduct of intervention in the currency markets. West Germany and Holland think it should, as such intervention can have a sizeable effect on the money supply. France and Great Britain, on the other hand, argue that exchange rates have a wider effect on domestic economic policy and, thus, currency market intervention should be left to the national governments. By way of compromise, Italy has suggested that ECOFIN should determine the general direction of exchange rate policy and the ESCB should then be left to decide day-to-day policy and to effect such interventions as deemed necessary. Similarly, there is a difference of emphasis between the member states on the question of the goals of the ESCB. Italy and France may share the West German and Dutch view that the fight against inflation should be a prime objective of the new institution, but they think it should not be the only one and that the promotion of economic growth and employment should also count for something. Finally, on Central Bank independence, Sr. Carli, the Italian Treasury Minister and a former Governor of the Banca d' Italia, argues that it is unrealistic to expect that members of the ESCB Council will not take their governments' views into account

when called upon to decide ESCB policy and totally impractical to make every member state change its laws and tradition on the way it appoints its Central Bank Governor to provide independence from political control.[124]

Another issue over which progress towards EMU in the European Community might stumble is the insistence of the Delors report that exchange rate union must *precede* monetary union, that is to say that the irrevocable locking of parities is prerequisite for the establishment of a common currency. Like the Werner plan, the Delors report is *wrong* to say that a single currency is not strictly necessary for the creation of EMU. To start with, the maintenance of separate currencies, even at fixed parities, entails transaction costs which are completely eliminated by the transition to a single currency. More seriously though, the fact is that, as long as separate currencies continue to exist, the exchange markets will *not* be convinced about the irreversibility of the arrangement. (Both the Werner and the Delors reports do, in fact, concede this when, in a self-contradictory fashion, they say that, to demonstrate this irreversibility and for political and psychological reasons, the transition to a common currency must occur as soon as possible after the irrevocable locking of parities).[125] After all, there have been times in the past when a *de facto* state of virtual fixity of exchange rates was taken for granted, most notably in the period between 1961 and 1968 and, for all intents and purposes, in the three years from January 1987 to January 1990. This, however, did not prevent the eventual eruption of the 1968-9 monetary crisis or the devaluation of the Italian lira on 5 January 1990, while the Bundesbank has been calling for some time now for a more general realignment in the EMS. It is true that increased co-ordination of monetary policies, the convergence of inflation rates in the Community and the acceptance of the monetary overlordship of the Bundesbank by the other member states may have convinced the financial markets that currency realignments are not as likely and, when they

do take place, they will not be as large as they once were. Exchange risk, however, has not been completely eliminated and this is reflected in the existence of interest rate differentials between the member states (Italian rates are, at present, four percentage points higher than West German ones).[126] If the financial markets considered the DM and the lira to be virtual substitutes, capital would flow between the two countries until interest rates were equalised. This, of course, would then give rise to a quite different problem, for it would deprive the Banca d' Italia of the ability to raise interest rates to bring down inflation to West German levels (at present around 3%, compared to Italy's 6%), with the result that inflation differentials would eventually rupture the parity structure of the system and lead to an inevitable realignment.[127]

These problems would be further aggravated by the complete liberalisation of capital movements in the Community. France abolished all remaining exchange controls in December 1989 and Italy has already got rid of most of hers without experiencing the severe capital outflow that was feared by many economists. However, when the final such controls (the restriction on Italians to open a foreign bank account) are removed, such outflows will undoubtedly materialise, unless Italy takes action to cut its penal rates of withholding tax on domestic deposits, currently set at 25-35%.[128] The situation becomes even more complicated when one takes into account that three of the Community currencies do not currently participate in the ERM, one other uses the wider 6% margins of fluctuation and that, whether or not sterling joins the ERM in the near future, there is not yet any serious suggestion that the Greek drachma or the Portuguese escudo might do so too. On the contrary, Greece and Portugal (together with Ireland and Spain) have been exempted from the obligation to abolish capital restrictions by 1 July 1990 and this has pushed further into the future the date when the exchange rates of those currencies might be irrevocably locked to the others within the ERM.

Clearly, even forgetting the possibility of a British veto, any endeavour to speed up the implementation of EMU in the Community along the lines of the Delors report runs the risk of creating a two (or even three) speed Europe and of generating political friction between its stronger and its weaker members. And, with the economic effects of the envisaged pan-German monetary union and political developments in Eastern Europe still uncertain, it could be that, if national governments choose to adhere literally to the letter of the report, that exchange rates must be irrevocably locked before a transition to a common currency can be contemplated, then the Community might yet have to wait a long time to get beyond a decent system of exchange rate management, to full EMU.

There are two main alternatives to the co-ordination approach to EMU which underlies the Delors report. The first one is the "big leap" transition to a single currency and a European Central Bank mentioned by M. Edouard Balladur, the French Finance Minister, in late 1987.[129] Roland Vaubel has argued that such an "apocalyptic solution", as Theo Peeters once called it,[130] would imply substantial adjustment costs and could only be implemented in the aftermath of a massive crisis which had transformed the normal attitudes of politicians and the public.[131] Thus, despite these being extraordinary times, it does appear very unlikely that such a solution would be politically acceptable at present. There is, however, a second, more credible alternative to the approach used in the Delors report, though it is one to which governments have failed so far to give due attention. This is the establishment, at an early stage, of a fully functional parallel currency which would be allowed to circulate in competition with national monies and which would provide a transition to a single-currency EMU through an automatic process, the pace of which would not be dependent on political discretion but would be determined instead by those most affected by it, that is in the market place.

The Delors Committee did, in fact, briefly examine this option, but rejected it (not surprisingly, given the predominance of national central bankers in the Committee's composition) on the grounds that a parallel currency would complicate the already difficult task of co-ordinating national monetary policies and that an additional source of money creation without a precise linkage to economic activity will have inflationary consequences for the Community.[132] It is, of course, ironic that the more powerful of the early versions of a European parallel currency advanced in the mid-1970s, the "All-Saints' Day Manifesto", was put forward precisely in order to combine monetary unification with monetary reform aimed to *reduce* the level of inflation in the Community,[133] and it is a fact that the disadvantages that are supposed to burden the parallel currency proposal are shared to at least a comparable degree by the co-ordination approach approved by the Delors report, which is flawed by many more besides. It is not, for example, all that clear as yet exactly how the transition from co-ordinating national monetary policies to the formulation and implementation of a single Community policy will be effected, how a "precise linkage to economic activity" will be maintained during this transitional stage, how the transfer of authority from national governments to the ESCB will be managed or on what criteria and by what method binding targets for national budget deficits will be decided and enforced.[134]

The truth is that many of the supposed problems with the establishment of a European parallel currency simply do not exist in the stronger versions of the proposal, technical solutions *have* been suggested for most of those problems which do exist, the uncertainties and ambiguities that do remain are far fewer with this kind of strategy than with any other (save for other "automatic" but crude solutions such as a return to the gold-standard) and that the reluctance of Europe's national governments to embrace the idea is explained partly by the fact that "the full logical

implications of this approach were never drawn up at the official level"[135] and partly, to the extent that they were, less by the shortcomings of the proposal itself than by their own unwillingness to cede control over the levels of economic policy and the political power it entails. Indeed, such are the advantages of the parallel currency approach to monetary unification that it had continued to attract a large number of economists,[136] despite the fact that the Community had already embarked on a quite different path towards EMU, which effectively rules out a proper examination of this strategy at the official level, at least for the time being.

To be successful in the task of displacing national monies and achieving a single-currency EMU, a parallel currency must fulfil three conditions: First it must be politically feasible, to a degree sufficient to ensure its acceptance and implementation by Europe's national governments. Second, it must be able to compete favourably with national monies as a transaction currency (the transaction costs and exchange risk involved in its use must be low). Third, it must be able to compete with national monies as an investment currency (the net yield of assets invested in it, taking into account interest rates as well as exchange rate developments, must be comparable to that of assets denominated in national currencies).

There are two main types of parallel currency that could be realistically adopted by the European Community and, naturally, each fulfils these conditions to a different extent. On the one hand, there is the basket ECU as currently defined within the EMS, issued and controlled initially by the EEC's national Central Banks and, eventually, by a European monetary institution. On the other hand, there is the option of establishing an independently defined ECU, possibly equipped with some guarantee relating to value or exchange risk, issued and controlled by a European Central Bank from the outset. The first variant would be more acceptable politically, for the

basket ECU is already a well-embedded feature of the European financial scene and its adoption as a parallel currency would not involve any dramatic transfer of authority from national governments and Central Banks to Community institutions, at least at the early stage. However, being a weighted average of the national currencies, the basket ECU cannot, by definition, be superior to *all* of these, either as a transaction or as an investment currency. In the best of cases therefore, the adoption of the basket ECU as Europe's parallel currency will lead to an asymmetrical displacement of those national monies that are weaker than itself and, by the same process of currency competition, to its own eventual displacement by the stronger Community currencies, unless national governments take active measures to discriminate in favour of the ECU to compensate for its inability to compete with all national currencies unaided.[137] Political pressure, of course, might come to the rescue (once most national currencies have been displaced by the ECU, the governments of the countries concerned would probably, for both economic reasons and for those related to national pride, push for the abolition of all remaining national monies and a transition to a common-currency EMU), but to rely on this would contradict the original intention (and the greatest advantage) of the parallel currency approach, that the transition to a common currency be independent of political discretion and be determined instead freely by the market. Thus, if the basket ECU were deemed to have the best chance of being accepted by the national governments, a more intelligent version of it is required and one such version has, in fact, been proposed.[138] According to this proposal, the weight of each national currency in the basket would be regularly adjusted to reflect its share in the EEC's aggregate money supply. As the ECU displaced the weaker national currencies they would drop out of the basket, until eventually there would remain only one national currency which would be identical to the ECU. This proposal seems to provide the second best way of achieving EMU in Europe through the adoption of a parallel currency.[139]

The alternative to this is an independently defined parallel currency (for want of a better name we will continue to call this the ECU) which would be equipped with a value or exchange risk guarantee. As we have already seen in the previous chapter, many versions of this concept were put forward round the mid-1970s.[140] The version which appears to combine the most advantages and which this study recommends is a parallel ECU designed and run in such a way as to be able to match, in terms of price stability, the least inflationary of the Community's national currencies (usually, but not always, likely to be the DM).[141] Parallel ECUs would be issued in a way that would be linked to the expected growth of aggregate GDP in Europe so as to avoid the "dual coverage" that could result from the simultaneous circulation of both ECUs and national currencies, and its supply would be regulated with the above-mentioned operational goal in mind by a European central monetary institution (let us call it the ESCB), which would possess a legal status of independence from political control at either the national or the Community levels, and a legally binding commitment to price stability, along the lines advocated by the President of the Bundesbank, Karl-Otto Pohl.[142] The proposed parallel ECU would be a fully fledged currency from the beginning, with notes, coins and the whole spectrum of financial instruments available in it and would circulate side-by-side with each national currency in its own territory as legal tender, an arrangement which would confer upon it the status of a domestic currency (as opposed to the foreign currency status which the present ECU enjoys) and would establish an effective dual standard within each member state.

Designed to be superior to all national currencies (at least equal with the best in terms of value and likely to involve lower exchange risk and transaction costs across Europe than any of them) and avoiding national rivalries, such a parallel ECU would become very attractive, both as a

transaction and as an investment currency (in fact, the only aspect of normal monetary use that would be discouraged by the value guarantee would be borrowing in ECU) and would quickly provide a pan-European and world standard for foreign trade and investment. However, it would also, before long, challenge and eventually displace national monies from their home territories and this, together with the early transfer of monetary authority from national control to a central Community institution, would make national governments less willing to accept this version than other, less radical (and less effective) ones. It must be remembered though that, if one is to take seriously the national governments' professed commitment to achieve an EMU and their recent approval of the Delors report, then they have already compromised with the idea of eventually surrendering monetary sovereignty and abolishing national currencies within a relatively short time-span, some say within five years. The establishment of a parallel ECU of the kind proposed here is not aimed at any different objective. It is rather a different, more secure, more painless and more effective way to get from here to there!

The benefits which the European Community would expect to derive from the establishment of a viable, independently-defined ECU would be very substantial indeed. First, a transition to full EMU would be achieved in an automatic and gradual way which would avoid the economic and political disadvantages of the co-ordination approach. Progress towards EMU would not be subject to the ups and downs in the political fortunes of personalities and national governments, but would advance freely and at a pace determined by Europe's real need for it, avoiding in the process the complications of an intermediate stage of exchange rate unification and minimising the transitional costs to full monetary union. (In what was probably a conservative estimate, the Catherwood Report estimated the anticipated economic benefits from such a union to be in excess of ECU 30 billion a year).[143] Second, a unification strategy based on a parallel ECU of

this kind, if coupled with other appropriate measures (we will return to these below), would have a better chance of avoiding the division of the Community into an inner hard core of well-integrated economies and a more loosely associated periphery lagging behind, and the political friction which might emerge in this way. A parallel ECU would also answer many of the criticisms of those who object, or are hesitant about the whole idea of EMU: Mrs. Thatcher would find it a lot harder to oppose a strategy which is based on free market choice and which would be designed from the outset to outperform all member states, and certainly Great Britain, in terms of price stability. So, assuming that the questions of ESCB independence and of its commitment to low inflation are satisfactorily resolved, would the Deutsche Bundesbank. Finally, a parallel ECU would avoid national monetary rivalries and would ensure that a reunited Germany would continue to play its full part within the European Community and the West. At the same time though, unlike what could well happen with some other strategies towards EMU, notably the co-ordination approach espoused by the Delors Report, the quick adoption of a common currency and the transfer of monetary authority to a central Community institution would reduce the danger that a reunited German economy would dwarf and dominate the others to an even greater extent than the Bundesbank already dominates the EMS. Put simply, if Berlin, Frankfurt and the DM are not going to have unilateral control over the economic destiny of Europe, it will be because that destiny will be determined at the Community rather than the national level and because a common European currency will itself dominate and eventually displace the DM.

On top of these internal advantages, the adoption of a parallel ECU would entail a number of external benefits for the European Community. For a start, it would be a lot easier to conduct an effective external policy towards the dollar on the basis of a single currency rather than through

the co-ordination of twelve or more separate national policies. Being designed to be equal or superior to all national currencies, the ECU would also become the focus of trans-Atlantic capital movements during periods of dollar weakness, reducing the upward strain on the DM and relieving the pressure on the internal parity structure of the EMS which results from asymmetrical inflows of capital to the national currencies during such periods and which has often in the past caused exchange rate crises and realignments within the system. An attractive, fully fledged and widely available ECU, backed by a fully integrated European capital market, would provide an alternative to the dollar to the international economy and would foster a development of economic and monetary relations within the Western alliance based on partnership and mutual understanding, rather than on an outdated hegemony which is no longer legitimate and has often in practice been irresponsible.[144]

Partly because of the size and diversity of its domestic economy and, even more, because of the unchallenged position of the dollar in the international monetary system, the US has been able to enjoy (and exploit) a unique freedom to manage its own and world economic affairs in an almost unilateral fashion, unrestricted by external financial constraints. This has allowed the US government to avoid unpopular measures such as higher taxation, budget cuts or the implementation of a sensible energy policy and enabled the American public to go on a spending binge which has turned the richest nation on earth from largest creditor to largest debtor within the space of less than a decade. President Ronald Reagan's new brand of economics led to a massive increase of the budget and the balance of payments deficits, to a dramatic rise and then an equally dramatic fall of the dollar and to high interest rates which, combined with exchange rate developments, exacerbated the world's debt problem and brought a number of developing countries down to their knees and the world financial system within a

hair's breadth from collapse. The emergence of an alternative to the dollar through a strong and successful ECU would help avoid a repetition of this experience and would lead to a more balanced management and development of the world's economic affairs, which would be beneficial for American taxpayers tomorrow, as well as for everybody else. The parallel ECU would quickly become an alternative (and possibly more reliable) standard for international trade and investment and eliminate the dislocating influence of total dependence on a gyrating dollar on the world economy.

Finally, the ECU would be useful in relation to future economic developments in Eastern Europe. Over the next decade or more, there is bound to be a spectacular explosion of economic activity as the ex-Communist half of the continent and, probably, the Soviet Union itself gradually shed the stifling influence of state control and an oppressive political creed on the initiative and the enterprise of their citizens. Much of this economic activity will be financed by loans and grants in dollars and DM. The development of a parallel ECU would make it possible for a common European currency to top them both, an arrangement which would have obvious economic and political advantages and would prepare the way for a closer relationship between the European Community and these countries in the future. Economic forecasters widely expect the next half-century or so to be the Pacific nations' golden age. It is not too late to start working to make sure it will be Europe's too.

The establishment of a European parallel currency will not, of course, by itself guarantee that this will happen. For although such a currency may turn out to be a necessary condition for the successful implementation of full EMU in the Community, it is certainly not a sufficient one. An EMU involves more than the establishment of technical rules for the liberalisation of

markets or the elimination of currency unpredictability in daily economic relations and touches upon almost every aspect of the economic, social and political life of the nations of Europe. The Delors Committee examined these interconnections between EMU and other areas of activity only in a limited way, partly because such issues are heavily political and so lay outside the task of the Committee to suggest a path for the implementation of *EMU* by stages and possibly because the Committee did not wish to burden EMU with other, not immediately related elements which some member states might find objectionable and which might thus prejudice the chances of a successful drive toward EMU in the Community. This study suffers from no such limitations or inhibitions. What follows, therefore, is a brief and by no means exhaustive look at some of those issues which, though not always part of what is normally understood to be included in the concept of EMU, nevertheless have a bearing upon the course of monetary unification in Europe.

The first of these issues, rarely mentioned though frequently alluded to in the literature, is defence. Europe cannot expect (and will not deserve) to be treated as an equal partner by the US in economic and monetary relations as long as it is unwilling to take upon itself the primary task of providing for its own defence. Economic and political independence cannot be divorced from the question of political responsibility. If Europeans do not wish military insecurity to be used, as it has often been, to bend them to America's will, if they wish to develop a truly independent European monetary personality, if they wish to participate more effectively in the management of world economic affairs and if they wish to see a substantial reduction of the American budget deficit, they cannot take it for granted that the US will continue to spend a part of that deficit to pay for Europe's defence. History certainly does seem to be presenting Europe with a golden opportunity. The recent improvement in the relations between East and West, the arms-cutting

deals between the super-powers and a likely collapse of the Warsaw Pact have already diffused tension and should make the task of establishing a credible but unprovocative European defence policy significantly easier and cheaper to effect. Such a policy would also ease the worries of the Eastern European nations, some of whom may view the prospect of German reunification with alarm.

A second, and more obvious, interconnection is the one between EMU and the Community budget. Even taking on board the principle of *subsidiarity*, it does seem unlikely that a monetary union can operate successfully given the present level and distribution of EEC funding from the centre. The implementation of EMU will in all probability exacerbate regional and structural disparities in the Community as a result of differential standards of productivity between a weak periphery and a vibrant centre, the elimination of the ability to counter this through devaluation, an exodus of skilled labour to the more prosperous areas, a growing tendency towards equalisation in welfare provision to all, an upward push in wages through trades unions pressure for national or union-wide contracts, and other "demonstration effects" in the more backward areas.[145] Clearly, if EMU is to operate smoothly and political friction avoided, the EEC budget has a significant role to play. Indeed, as Sir Gordon Richardson once correctly observed, "the greater one's vision of monetary integration within the Community, the more clear should it be that the Community budget should perform the same kind of functions as are taken for granted in the budget of a national state".[146] The European Council appears to recognise this fact and, at its meeting of February 1988, it decided to strengthen and reorganise the Community's regional and structural policies and to double the amounts available to the ERDF and the Social Fund to ECU 14 billion. This, however, though a step in the right direction, is still grossly inadequate to provide a proper response to the very real repercussions

that EMU will entail for the countries of the periphery, especially when compared with the large aggregate benefits which are expected to result from it. The Cecchini Report estimated the direct gains arising from the establishment of the single market to be of the order of ECU 216 billion in 1988 prices.[147] Clearly, if the poorer areas of the Community are not to contribute more to these gains than they benefit from them, the EEC could and should do more to help. However, with one specific and important exception mentioned below, any assistance provided should not take the form of income subsidisation to offset inequalities in standards of living, or locational incentives which often turn out to be ineffective. All such aid extended from the Community's structural funds should aim instead to "equalise production conditions through investment programmes in such areas as physical infrastructure, communications, transportation and education so that large-scale movements of labour do not become the major adjustment factor. The success of these policies will hinge not only on the size of the available financial resources, but to a decisive extent also on their efficient use and on the private and social return on the investment programmes".[148]

Naturally, this criterion of efficient use should not be confined only to funds which might be allocated to the Community's institutions in the future. It must equally apply to those resources which are already available, and here there is clearly ground for improvement. It is a ludicrous situation that the EEC spends some two-thirds of its annual budget on a price support system in the CAP which directs only part of the money spent on the goal it is intended to accomplish (that of providing an adequate standard of living for Europe's farming communities) and wastes another significant part on middlemen, storage for unwanted food surpluses, subsidised exports to the Eastern bloc (the cost of which is bound to rise as Eastern European farms, free from the constraints of state control, increase production and world prices fall) and the bureaucratic

administration of an overcomplicated mechanism of green currencies and MCAs which is likely to be abolished with the eventual transition to a single-market single-currency Europe and which has in the meanwhile frequently become a target for systematic fraud and abuse. With the opportunity of its adoption of EMU, the Community would do well to reconsider whether the instrument still serves the objective and, possibly, move away from the current system of *price support* to a system of *income support* for its farming community, administered by the centre and topped up, where special circumstances so dictate, by direct transfers from national governments to their own farmers. Such a change would lower food prices for the rest of the population, depress further the rate of inflation in Europe, give a boost to poor food-exporting nations in the third world, cut down on inefficiency and release precious resources which could be put into far better use to reduce regional and structural imbalances and to promote greater convergence between the member states of the Community.

This care to spread the benefits of EMU and the developments related to it to the widest possible part of the population must characterise the approach of the EEC to the subject throughout. EMU must not be allowed to be seen as a matter of concern only to the financial community or to the big multinational corporations. There are very real gains to be obtained from the establishment of a single market and the eventual transition to a common currency in terms of faster growth, lower unemployment and a better standard of living for most people in the Community, as well as less tangible benefits of a political and symbolic nature, such as the development of a European monetary personality or the gradual emergence of a diverse, plural but closely-knit political entity at the European level that would command a weight in world affairs well beyond the capabilities of separate national governments. It should be the task of the Community's institutions to bring to the foreground these benefits of EMU, to fire the public's

imagination and to transform the politicians' perceptions of the issue (and the electoral calculations connected with it) to the degree necessary for them to overcome their customary inhibitions to the surrender of sovereign economic power and to give real priority to the achievement of EMU.

There are no apologies needed if this brief account of the interconnections of EMU with other areas of economic and political activity reads a little like a roll-call of all that has to be done in Europe (or at least what someone of a "European" or federalist persuasion might argue has to be done). At a time when there is obviously a fair political wind behind the project, it is in any case preferable to overstate these interconnections and the difficulty of the tasks which will have to be accomplished to maximise the chances of a successful implementation of EMU, than to understate them and have the whole process grind to a halt later for want of a proper analysis of its full implications, as happened in the 1970s with the EMU project. Money is highly political and has linkages with most aspects of life. This is why EMU is so important and it is why it has been so hard to implement. And, if the pursuit of EMU points to the need for further integration in other, adjacent fields and introduces a Community element into areas which may have been thought to be the preserve of national authority, it is because EMU *does in the end lead inescapably towards a political union too.* It would be nonsensical to believe that a dramatic transformation in the economic fortunes of Europe, such as EMU is expected to bring about, can occur without serious repercussions in the political field. Those who support the implementation of EMU in the European Community should not permit the issue to be portrayed as a "Trojan horse" for the achievement of a united Europe by stealth. There is no stealth whatsoever about it. The search for EMU is not only an economic matter, it is a full frontal attack on the citadel of national sovereignty and a vital part of the quest for a fully-integrated and politically united

Europe, though it does not (and should not) aim to stifle plurality and diversity in the Community, nor does it (or should it) result in the creation of an overcentralised European superstate.

Naturally, the linkage between EMU and political union is not a simple or an one-way affair. Paul de Grauwe has stressed the historical role of central government action in establishing a particular currency as the accepted means of payment and has therefore concluded that political integration is required for the achievement of EMU in the Community (rather than be just a consequence of it).[149] This is also the position of the British government which has long argued that the pursuit of EMU makes sense only within the context of a wider political union. This issue raises questions as to whether and to what extent are additional measures necessary during the *transition* to EMU to maximise its chances of success. Does EMU, for example, really require integration in the fiscal field as well, including binding targets for national budget deficits, as the Delors Report suggests? Or, does the implementation of EMU and the transfer of economic authority from national to Community institutions require constitutional changes in the EEC and the upgrading of the democratic control mechanisms and the role of the European Parliament to compensate for the loss of democratic accountability through national parliaments? Most analysts tend to offer affirmative answers to these questions. There are some, however, who are concerned to minimise the extent of the practical steps necessary for a transition to full EMU. Tommaso Padoa-Schioppa, for example, has argued that it takes less than is usually thought to capture the *substance* of a monetary union. It would not be necessary to abolish the outward symbols of national monetary sovereignty, such as separate currency denominations, banknotes and national Central Banks. Such an arrangement would require no more "tolerance" than is needed to let, say, the Bank of Scotland issue pound sterling today. Nor

would there be any need to unify the fiscal policies of the member states, provided that national governments were obliged to finance deficits through the open capital market rather than through the printing press.[150]

Whether or not one accepts this relatively "minimalist" version of EMU does, of course, depend partly on one's vision of it and whether one perceives the balance of advantage to lie with the preservation of the symbols of national sovereignty or with the emergence of a new "European" reality. It also depends crucially on the choice of strategy adopted to achieve EMU. The unification of fiscal policy, for example, is much more important for the co-ordination approach to EMU which sees exchange rate unification as a precondition for monetary union, than it is for the parallel currency approach, which avoids the complications connected with exchange rate unification and relies instead on the free market for the implementation of EMU. Either way, whatever the dictates of political acceptability and whether the *outward* symbols of national monetary sovereignty are preserved or abolished, the fact is that the effective pursuit of full EMU requires substantially more than the establishment of technical rules for the co-ordination of national monetary policies or procedures for the maintenance of fixed exchange rates. To take this fully on board may burden any potential initiative towards EMU with implications which were not evident from the start and reduce its "realistic" chances of being pursued to its logical conclusion. But then, the history of monetary unification in the European Community to date suggests that the development of EMU has not been a matter of choice but one of necessity. And so it is that, to put it in Peter Ludlow's words, "the advocates of 'adventurous ideas' will almost certainly in the long term prove to have been the true realists".[151]

IIIc. Conclusion.

Throughout the history of monetary unification in the European Community, national governments have chosen to pursue EMU through a strategy based on the co-ordination of their economic policies and on the progressive narrowing of fluctuations between their currencies through the maintenance of an adjustable peg. Bretton Woods demonstrated that such a system will work effectively only under conditions of a responsible and legitimate hegemony or, failing that, if the participants are prepared to sacrifice a substantial measure of national autonomy and to subjugate their individual economic and political objectives, methods and priorities to the dictates of the system by agreeing to a common determination of economic policy at the Union level.

The European currency Snake proved just how difficult it is to achieve in practice the required degree of co-ordination, even within a relatively well-integrated and homogeneous geographic, economic and political entity such as the European Community. The Snake was based on the neofunctionalist approach to European integration. However, international monetary relations refused to conform to the expectations of neofunctionalist theory, for monetary affairs were from the outset viewed by national authorities as an issue of "high politics" and stubbornly refused to be turned into a "welfare politics" matter instead. Neofunctionalism and the Snake were not adequately equipped to deal with such a situation and were clearly incapable of dealing with the impact of dramatic political actors such as General De Gaulle on the integration process.[152] Nor was there much scope in the co-ordination approach which underpinned the Snake for dealing adequately with the influence of national electoral calendars, party-political expediency, shifts of political influence between different factions of the same government, coincidence and chance,

in short all those elements which experience has shown to have played such a crucial role in the history of monetary unification in Western Europe. The Snake was gradually divorced from the EMU project, it lost its function as an instrument for the promotion of further integration in the Community and was reduced to a much more limited (though still important) mechanism for the preservation of a zone of monetary stability centered round the DM, within which those conditions shown by Bretton Woods to be necessary for the smooth operation of such a system could be met.

Much the same reasoning explains both the relative successes as well as the limitations of the EMS. Despite the economic preponderance of West Germany in the European Community, no single member state dominates Europe to anything like the extent to which the US dominated the world economy in the two decades following the second world war, or to which the Federal Republic dominated the mini-Snake after 1973. However, due to a number of both external and internal factors (the experience of floating currencies, the oil crises of 1973-74 and 1979, stagflation, destabilizing American international financial policies in the late 1970s, the general reduction in world inflation during the 1980s, the requirements of further integration in the Community as specified by the 1985 SEA and the success of the mutual consultation and co-ordination mechanisms fostered by the Snake), after an initial learning period, national governments proved both capable and willing to subject their other economic and political objectives to the goal of achieving a low level of inflation in Europe and to align their monetary policies to that of the German Bundesbank. In a sense, the hegemony of a policy objective was able to substitute for the absence of a hegemonic power as such in the Community. Although, as a result, the EMS has been very successful in terms of achieving a high degree of monetary stability within the EEC however, the inherent limitations of the co-ordination approach have

prevented a resolution of the conflicts related to the development of the institutional framework and the transfer of decision-making authority required to progress towards the implementation of full EMU in Western Europe.

Regrettably, the European Community has been able or willing to learn from this experience only to a limited extent. The Delors report which underlies the latest drive towards EMU in the Community may be a considerable improvement over both the EMU project of the 1970s and the EMS, but is still based on the co-ordination approach to monetary unification which sees exchange rate union as a necessary precondition for monetary union, and is therefore handicapped by the economic and political perils of that approach. There is a number of factors (orderly world monetary conditions, the gradual emergence of a single European market, developments in Eastern Europe and the necessity to anchor a reunited Germany firmly within the West, the fervour with which France is currently pushing the idea of EMU, the general reformist mood of many of the member states towards the Community and the highly political, motivated and effective stewardship of the European bureaucracy by the EEC Commission President Jacques Delors and his cabinet) which make it quite *possible* that the EEC will succeed this time where it has twice failed before. Exactly how possible, will depend on how strictly national governments will decide to take the stipulation that exchange rates must be irrevocably locked before a transition to a common currency can be contemplated, as well as on the length of time that will be allowed to elapse in between. In any case, the Community will, at some point, have to make the *qualitative* leap from the co-ordination of twelve or more separate national monetary policies to the formulation and implementation of a common monetary policy at the Union level, and from the maintenance of stable exchange rate relations between national monies to the establishment of a single, fully fledged, common currency. It is one of the

contentions of this study that this transition would be made substantially easier, and that the benefits to be derived from a common currency would be maximized, if the EEC decided to avoid the economic and political risks, costs and uncertainties of the co-ordination approach and pursued instead the objective of EMU through the early introduction of a fully functional parallel currency.

There are certainly still many issues over which progress towards EMU in the Community might potentially stumble. The recent resurgence of inflation in some member states, continuing disagreements over institutional questions, the rather imprecise nature of the transitional second stage of EMU as this is envisaged in the Delors Report, the rapid pace of political change in Eastern Europe, the uncertain effects of the forthcoming German monetary union and the possibility that a reunited and newly-confident Germany, preoccupied with its own internal affairs, will have second thoughts about the wisdom of burdening itself simultaneously with the additional complications which the pursuit of EMU in the Community entails, all introduce an element of unpredictability which defies theoretical analysis or prediction and makes pure reliance on the lessons of the past not quite appropriate to what is unmistakably, and in some ways *dramatically*, a different situation. Equally certainly though, the past holds lessons about the economic interrelationships and the political dynamics of the EMU process in Europe which the EEC can only ignore at its peril. All those who genuinely wish the Community success with the achievement of EMU (as the writer does) and even those of us who believe that Europe has, once again, chosen the difficult way and have recommended a different approach, would hope that this is going to be one time when the conventional wisdom embodied in the strategy of the Delors Report will finally come good and that the future will prove the skeptics to have been overcautious. If not, and it does after all turn out to be the case that monetary union cannot be

brought about by decree, then the politicians should give the markets their say. For, if anything, current economic and political realities make the successful implementation of EMU in Western Europe more important and indispensable today than it has ever been before.

So far, the Community appears to be well on course for the desired destination. It now seems fairly certain that some agreement on a second stage of EMU will emerge from the intergovernmental conference due to start in Rome in mid-December 1990. The immediate challenge facing the participants in that conference will be to negotiate a new monetary constitution which will be adequate to meet the future needs of the economic and political development of the Community in the longer term and which will include a clear provision for the rapid creation of a common European currency. Beyond this, there are other tasks which may have less of an obvious (or direct) connection to EMU but are no less vital for that. This study has already argued that, as an integral part of its attempt to facilitate the adoption of EMU and make it economically feasible and politically acceptable, the Community should (i) aim to assume responsibility for Europe's own defence, (ii) rethink its approach to the structural and regional imbalances between, as well as within, the member states and iii) look again at the whole area of its finances, the size and distribution of the EEC budget, the relative priorities assigned to different economic sectors and whether or not these are best served by existing policies or whether some measure of reform could be fruitfully undertaken, as well as for ways to improve efficiency in the use of the available resources, at whatever level these may be.

Looking further ahead, the successful adoption of EMU in the Community will also require the member states to take a number of measures to iron out other anomalies which are either likely to result from monetary union, or which may already exist but will be exposed to a greater extent

than ever before by the establishment of a single currency. For, although this study (as its very title explicitly declares) is itself concerned with *monetary* union and though it is the issues of a common European currency and a European Central Bank which are likely to draw most of the attention (and the controversy) over the following year or so, it would be a serious mistake for the Community to focus solely on the "M" and to neglect the "E" in EMU. The emergence of a single currency and the progressive determination of monetary policy at the Union level will take away from national governments the opportunity to manipulate the money supply and the exchange rate. The maintenance of a satisfactory level of domestic economic activity and the preservation of balance of payments equilibrium will now depend even more clearly on sound fiscal management, the structural and institutional health and modernity of the economy concerned and on a number of *microeconomic* factors which the Community should aim to foster with a resolute effort to remove friction and imperfections from the workings of the single European market.

To this purpose, the Community should aim to strengthen its industrial and taxation policies: Further measures should be taken to eliminate hidden subsidies, non-tariff barriers to trade and discrimination on national grounds and the current mechanisms and provisions which already exist for the achievement of these objectives should be reinforced. Further progress must be made with the establishment of common trading and industrial standards, or (as has become increasingly the practice in later years) towards the harmonization and mutual acceptance of each other's national standards by all the member states. The Community must examine very carefully the degree to which it would be helpful to implement *positive* measures to guide and to aid the progress of specific sectors of European industry into the twenty-first century, to help reorganize and rationalize declining sectors, anticipate developments in, and direct increased

national and Community resources towards, the growth-sectors of the future (such as informatics, telecommunications etc.) and act expeditiously to apply these measures in a way that will answer the, very often justified, opposition from the affected member states and that will iron out the short-term anomalies which are inescapably going to be produced. The Community should also aim to harmonize the rates of indirect, money market, company and personal taxation, to approximate as far as possible the conditions of free and fair competition and to create a productive economic environment and a truly common market in people, goods, services and capital.

Naturally, to achieve all this will not be easy and certainly will not come about quickly. Nor is it the case that the removal of imperfections in market conditions, or even the application of some positive integration measures such as are described above, will by themselves be sufficient to ensure a share of the benefits of EMU for all the member states of the Community. For, though it is certain that, in the longer run, the removal of friction and market imperfections and the eventual establishment of EMU will lead to an increase of *aggregate* welfare in the Community, it is also virtually certain that, in the shorter run and unless the thinking of the political leaders of Europe changes dramatically (something highly unlikely), the positive results, for what and how long they are worth, will be rather of a symbolic or a psychological nature, and that the more tangible, *economic* positive results might be vastly outweighed by negative ones for a good deal, perhaps even a majority, of the peoples of the Community. And this for two reasons: First, for the reasons we have outlined earlier in this study, despite the gains in *aggregate* welfare, it is certain that, as far as the *individual* actors of the system and the between them division of these gains are concerned, reality is far from the conditions of perfect competition and thus, in the absence of corrective action, some member states will tend to benefit disproportionally from the

establishment of full EMU, while others might not benefit that much and might even lose. Second, given the insistence of the member governments on the co-ordination approach to EMU, we can expect during the next few years a further effort towards the "equalization" of the economic policies of the member states, in both the fiscal and the monetary fields. This will naturally mean the adjustment of the policies of the weaker, more unstable member states to approximate those of the stronger, more stable ones, particularly West Germany. And while this may not be a bad thing at all in the longer term and from the point of view of economic logic alone, it does inescapably mean that over the next few years we will witness an increase in the hardship suffered by a few at least of the peoples of the Community, including notably a sharp rise in unemployment. As a result, the problem of a division between a rich North and a poor South which plagues the international economic system but which, to a smaller degree, also already exists today within the Community, might gradually acquire dangerous dimensions and might have serious repercussions for the process towards EMU.

This problem of a North-South divide may be further exacerbated by the prospects for further enlargement of the Community. The last two rounds of enlargement, in 1981 and 1986, brought into the EEC Greece, Spain and Portugal, three southern states of a Mediterranean outlook, which went a long way towards balancing geographically, economically and psychologically what had been until then a rather north-oriented grouping of nations. The next round of enlargement, however, might do just the opposite.

So far, there are four countries which have already officially applied to join the Community: Turkey in April 1987, Austria in July 1989 and Cyprus and Malta in July 1990. Another eight might reasonably be expected do so in the next few years: Switzerland, Sweden, Norway,

Finland, Iceland and the more economically advanced countries of Eastern Europe, Hungary, Poland and Czechoslovakia.

Of the countries which have already applied, Austria does not seem to present any particular problems, as its economy and its political system seem to be on a par with those of the more developed member states of the existing Community. Therefore, despite some doubts concerning the country's "neutral" status, the Austrian application has been welcomed by the Commission and has received strong and outspoken support from among the member states.

Concerning the other three applicant countries, the Commission views Turkey's application as rather premature, expressing serious doubts about the state of Turkey's economy and democracy, particularly over the question of human rights, while serious difficulties remain over the applications of the two other countries, given, on the one hand, the continuing Turkish occupation of almost 35% of Cyprus and the unresolved political problems which go with the status of the country as a divided island, and, on the other, the smallness of the Maltese economy.

As concerns the countries which can be reasonably expected to apply in the near future, it is rather doubtful that the three East European states will be ready to join the Community before the turn of the century. On the contrary, were they to apply, it is likely that Switzerland and the Scandinavian countries would present a case very similar to Austria's, which in many ways they resemble. (The doubts over the inclusion to the Community of "neutral" states would be intensified with the Swiss, Swedish and Finnish applications, but there is in any case already a precedent in the Community with the membership of "neutral" Ireland and, anyway, the whole

question of defence and neutrality will have to be looked again right from the basics in what undoubtedly is now a wholly different political situation, following the collapse of communism in the Soviet Union and the very probable disintegration of the Eastern military bloc).

As to the question of timing, the official line of the Commission is that new applications cannot be considered until at least 1993. The completion of the single market, EMU and internal constitutional reform in the Community must come first. Some member states, headed by Italy, tend to oppose this self-imposed time limit. Others, headed by France and the Netherlands, support the Commission. In this, the debate going on within the Community bears an uncanny similarity to the "deepening versus enlargement" debate of the late 1960s, at the time of the Hague summit which launched the EMU project (the battle lines, the main arguments and even the protagonists seem to be very much the same).

Whether or not the 1993 time limit is observed however, it is quite reasonable to expect that, by around the middle of the decade, Austria and two or three other northern industrial countries will have augmented the current Community of Twelve to a Community of Fifteen or Sixteen and that, in its composition, its character, its ethic, its mentality, its internal organization and its economic outlook and practice, this will be a more austere, utilitarian, "northern" Community than it has ever been before. It will also, of course, be a *richer* Community, one which will have at its disposal greater means for decisive action to combat regional inequality between, as well as within, the member states. But, at a time when economic policy is likely to be tightened and unemployment is likely to be rising in the North as well as in the South, it will require real statesmanship and political imagination on the part of Europe's leaders, as well as great self-discipline and real improvements in the efficiency of use of the available resources by the

recipient member states, if the Community is to avoid a substantial economic and political rift and if it is not to disintegrate into a Europe of two or more speeds.

A future enlargement of the Community, for all its undoubted benefits, will also bring into sharper relief than ever before (and complicate the solution of) the problems which already exist with the institutional framework of the Community and the day-to-day management of its affairs. From the camps of both, the Community's most enthusiastic supporters and its most vehement opponents, the Community's current institutional setup has long been justly criticized for an apparent lack of democracy in the way that even major decisions, which will affect significantly and for a very long time the lives of ordinary Europeans, seem to be taken with little or no consultation of the wishes and opinions of the very people who are going to be affected, or even their elected representatives in the national parliaments.

This would probably have been acceptable (at least for the first of these camps) if there had been instead some kind of provision for an alternative mechanism of *direct* democratic control of the Community's institutions by the peoples of Europe. As things currently stand, however, the view is gradually taking hold among the ordinary citizens of the Community that more and more of the important decisions are taken by a distant, impersonal and rather soul-less collegium of Eurocrats, with their own sense and criteria of what is best for Europe and its peoples, but with little regard to those peoples' views, cultural or political multiplicity and variability or to factors of national importance. Which, in turn, is not helped by the usual practice of the member states (with the possible and partial exception of the Benelux countries and the office of the President of the Commission) of sending to Brussels and Strasbourg a larger than expected proportion of honourably-retired, illustrious political "have-beens" and aspiring younger politicians and rather

fewer politicians of the current national first-rank, to serve in the Commission and the European Parliament.

This mater of a "democratic deficit" in the operation of the Community leads to the conclusion that one of the important (if, of necessity, secondary) questions that the forthcoming inter-governmental conference would be well advised to address is how to balance the diminution of national control over economic policy, which EMU entails, with some provision of democratic control of the process at the Union level. And this, in good neofunctionalist logic, points to the need for a further reinforcement of the standing and the role of the European Parliament.

Beyond the issue of *legitimacy*, however, there is also an equally important, and so far equally unanswered, issue of *efficiency*. A future enlargement of the Community will necessitate drastic and far-reaching measures to simplify the institutional framework of the Community and to establish more efficient procedures for economic (and other) decision making. Among such measures to be taken could be a reduction of the size of the European Commission (with the number of Commissioners from the larger member states being reduced to one rather than the current two, rotating Commissioners from the smaller member states etc), a rethinking of the size and national distribution of the European Parliament, a move towards greater use of qualified majority voting for issues not considered of vital national importance, greater practical application of the principle of subsidiarity in the everyday management of the Community's affairs and such like.

All this, no doubt, amounts to a quite long and difficult list of "musts". Yet, the fact that all these issues are currently the subject of serious discussion in the Community, shows what is

different about this latest drive for EMU and why it might well succeed where previous ones failed. Indeed, only a few years back, it would have seemed quite ridiculous to suggest that full EMU and the establishment of a common currency in the European Community could be achieved by the middle of the 1990s and that not only Euro-enthusiasts or the European Parliament, but also high-ranking national politicians and national governments would confirm, apparently quite seriously, this to be a credible objective and would expend considerable effort for its achievement. Political realism then appeared to dictate that what was best in the circumstances was a far more cautious, less ambitious approach. But then, as Roy Jenkins said in his Florence speech in 1977: "We must not only do what is best in the circumstances. We must give our people an aim beyond the immediately possible. Politics is not only the art of the possible but, as Jean Monnet said, it is also the art of making possible tomorrow what may seem impossible today".[153]

NOTES AND REFERENCES

INTRODUCTION

1. There have been many different criteria suggested in the literature on what does constitute a viable currency area. By reason of geography, economic interdependence, similarity of political structures and outlook and the degree of integration achieved so far, the European Community would meet most, but not all of them. For a comprehensive survey of the literature on optimum currency areas see Y, Ishiyama (1975) and E. Tower & T. D. Willett (1976).

2. For a historical account of the progress towards EMU in the European Community see L. Tsoukalis (1977), R. Hellmann (1979), D. C. Kruse (1980) and P. Ludlow (1982). For a theoretical analysis of the various aspects of monetary integration see the literature on optimum currency areas (references as above) and, among many others, B. Balassa (1975), CEC (1973), (1976a) and (1977a), R. N. Cooper at al, (1982), W. M. Corden (1977), P. De Grauwe (1976) and (1989), Federal Trust for Education and Research (1972) and (1974), J. C. Ingram (1973), H. G. Johnson & A. K. Swoboda (1973), L. B. Krause & W. S. Salant (1973), D. T. Llewellyn (1980), G. Magnifico (1973), R. I. McKinnon (1979), J. R. Presley & G. E. J. Dennis (1976), M. T. Summer & G. Zis (1982), A. K. Swoboda (1973) and R. Vaubel (1978b).

3. For a comprehensive study of these alternative strategies see R. Vaubel (1978b).

4. Vaubel calls this the *centralisation* strategy, a name I find misleading and inappropriate and which I will not be using in this study. See R. Vaubel (1978b), pp. 13-15.

5. In T. Peeters (1982), p. 11.

6. In R. Triffin (1979a), p. 71.

7. See L. Tsoukalis (1977), pp. 170-171.

8. See B. J. Cohen (1977), pp. 3-5 and various relevant publications of the Commission of the European Communities.

CHAPTER I: THE COLLAPSE OF BRETTON WOODS

1. See J. Williamson (1979), pp. 21-22.

2. See section Ic3, below.

3. In J. Williamson (1979), p. 22.

4. The "fire extinguishers" were established in the period 1961-64 and included, together with the Gold Pool, the Group of Ten, the General Agreement to Borrow, the Roosa bonds and various swap agreements. See R. Triffin (1966), p. 249.

5. In R. Crossman (1976), p. 583.

6. See B. Klein (1978), pp. 74-78.

7. At the same time, a system of border taxes was introduced to insulate the French agricultural market, thus avoiding the increase in domestic farm prices which would have otherwise resulted from the devaluation of the franc.

8. In C. A. Coombs (1976), p. 206.

9. In R. Solomon (1977), p. 179. To these it was intended to impress, this sounded very similar to the West German government's declaration of two years earlier (9 May 1969),

that the existing parity of the DM was "valid for eternity". See M. E. Kreinin (11971), p. 146. The "eternity" had lasted for three-and-a-half months (to 24 September, when the market was closed)! Why should the dollar fair any better?

10. In R. Solomon (1977), p. 181.

11. In R. Solomon (1977), p. 186.

12. Ibid.

13. See R. Triffin (1960).

14. See W. Safire (1975), p. 506.

15. See R. Solomon (1977), pp. 212-213.

16. See O. Emminger (1977), pp. 27-31.

17. See C. A. Coombs (1976), pp. 204-220.

18. See H. Brandon (1973), p. 225. Also C. A. Coombs (1976), p. 246 and R. Solomon (1977), p. 185.

19. The Baltimore Sun, 15 July 1971. The Christian Science Monitor, 16 July 1971.

20. This is when parity adjustments were allowed under the rules of Bretton Woods, though the precise meaning of the phrase was left unspecified. See the IMF articles of agreement, article IV. 5(a).

21. See chapter IIIa1 below.

22. See R. Z. Aliber (1969) for a fuller exposition of this argument. The demand-determined hypothesis was supported by the President's Council of Economic Advisers (then under the chairmanship of Paul McCracken) and by the dollar standard school.

23. See J. Williamson (1977), pp. 30-43.

24. Indeed, it would have been difficult for the American government, even had it been willing (which it was not), to reverse its policy on this matter. Congressional approval was required in order to change the price of gold and at the time, Henry Reuss and his powerful subcommittee could still be counted upon to kill at birth any proposal to that effect in the House.

25. See J. Williamson (1977), pp. 30-43.

26. Ironically, only five months after General De Gaulle's press conference of 4 February 1965, which marked the beginning of the gold war, US Treasury Secretary Henry Fowler indicated a U-turn in American international monetary policy by supporting the

idea of a Composite Reserve Unit (CRU), a version of which had been persistently advocated by French Finance Minister Valery Giscard d' Estaing during 1963-64.

27. For an account of French international economic policy and its relation to wider foreign policy issues, see E. A. Kolodziej (1974).

28. Williamson (1977), p. 78.

29. See R. I. McKinnon (1969), E. Despres, C. P. Kindleberger and W. S. Salant (1966), C. P. Kindleberger (1967), L. B. Krause (1970), G. Haberler & T. D. Willett (1971) and W. Fellner (1972).

30. That this is a correct description of what really happened in the 1930s has, of course, been disputed. See S. E. Rolfe and J. L. Burtle (1974), pp. 13-55.

31. The term "openness" has been used in the literature to describe various different economic concepts. Here, the world is used to express the relative importance of foreign trade to a country's GNP.

32. Whether the dollar standard proposals were an intermediate step on the way towards greater exchange rate flexibility is rather difficult to determine, as the school included in its ranks advocates of both fixed and flexible exchange rates.

33. See C. A. Coombs (1976), pp. 204-205.

34. In those days, it was still widely believed that flexible exchange rates could insulate the domestic economy from external interference and thus provide independence of monetary action.

35. In J. Williamson (1977), pp. 40-41.

36. This crucial weakness of the Bretton Woods design will be discussed in more detail in section Id3, below.

37. John Connally, for example, is quoted to have referred to a British conversion request of $3 billion. See W. Safire (1975), p. 506. As we have seen, the amount involved in the deal between the Fed and the Bank of England in fact came to only a quarter of that, or $750 million.

38. Ironically, in his 1960 campaign for the presidency, Richard Nixon had claimed that if John F. Kennedy was elected the dollar would have to be devalued! The dollar was, indeed, devalued in the end, but in Richard Nixon's presidency (though, to be fair, the policies of his Democratic predecessors were, at least in part, also responsible).

39. In R. Gilpin (1975), p. 40-41.

40. The Japanese Yen did not return to convertibility, under Article VIII of the IMF Charter, until 1964.

41. It is important here to emphasize the word "effective". For, strictly speaking, a proper dollar standard was never really established at all. On the contrary, because of the continued lack of commitment on the part of the American authorities to domestic stabilization (and, therefore, to maintain the rate of the dollar) until the end of the decade, as well as the unhalted relative decline of the US economy during the 1970s and a variety of other factors, the dollar's predominance in the world economy gradually became less absolute, though it did, and does, remain by far the most important international currency.

42. For a complete analysis of hegemony as an organisational principle for the international monetary system, see B. J. Cohen (1977), pp. 221-253.

43. In R. Vaubel (1979), p. 17.

44. See B. J. Cohen (1977).

45. In B. J. Cohen (1979), p. 36.

46. See j. Williamson (1971), p. 8.

47. In R. I. McKinnon (1974), p. 4.

48. In D. P. Calleo (1976b), p. 50. This belief goes back a long time. In chapter XXVII of his "Principles of Political Economy and Taxation", back in 1817, David Ricardo wrote: "Experience ... shews that neither a state nor a bank ever had the unrestricted power of

issuing paper money, without abusing that power". See P. Sraffa (1951). Incidentally, Ricardo also recommended the same solution to this problem that was eventually arrived at in Bretton Woods. He goes on to say: "... in all states, therefore, the issue of paper money ought to be under some check and controul; and none seems so proper for that purpose, as that of subjecting the issuers of paper money to the obligation of paying their notes, either in gold coin or in bullion".

49. In R. A. Mundell (1975), p. 36.

50. See J. Rueff (1961).

51. See R. Z. Aliber (1977a), pp. 35-43.

52. See C. P. Kindleberger (1969), pp. 11-15 and (1967), pp. 6-7. See also R. A. Mundell (1969), p. 643.

53. See B. J. Cohen (1977), pp. 228-229. These proposals might have worked in a world where everywhere shared their proponent's kindly instincts with regard to the future of the international monetary system, but that was certainly not the real world in the late 1960s and early 1970s.

54. In E. Mandel (1972), p. 114. See also E. Mandel (1970).

55. In J. B. Crotty and L. A. Rapping (1975), pp. 798-799. It is interesting to compare this view with the one expressed by Roland Vaubel (quoted above; see note No. 43). Both

refer to the "n-1 problem" and, though in very different terminology, come to a strikingly similar conclusion: A fixed parity system will work best under conditions of hegemony.

56. In D. P. Calleo (1974), p. 62.

57. See B. J. Cohen (1974), pp. 113-120.

58. In R. Gilpin (1975), p. 43.

59. The establishment of a two-tier market for gold, the dollar standard proposals, the suspension of the convertibility of the dollar and the subsequent official US reform outline in the C-20, can all be viewed as different stages of this defensive reaction of the US to the threat to the privileges it enjoyed under Bretton Woods.

60. See J. Williamson (1979), p. 25.

61. Monetary systems can be classified as "automatic" or "non-automatic", depending on whether or not they require external regulation to operate efficiently. In "automatic" monetary systems, adjustment (and, if so designed, monetary integration) takes place without constant need for political decisions, either by the nature of the system or through the market. Examples of such a system are the classical gold standard, a system of free (and unmanaged) flexible exchange rates and a "parallel currency" type of arrangement, such as we will examine later on.

62. In C. P. Kindleberger (1967), p. 1.

63. Whether the particular rules agreed should be made public and the degree of flexibility built into the system are points of dispute among international monetary economists. For an interesting contrast of views on these questions, see S. Katz (1979).

64. Quoted in R. Triffin: "Comments" in R. A. Mundell and J. J. Polak (1977), p. 166.

65. See chapter IIa3.

66. For a more complete account of the positions of the European countries, see D. C. Kruse (1980), pp. 93-100.

67. Ibid.

68. "Congressional Record", 21 September 1971, pp. H8611-8615, and 1 October 1971, pp. S15619-15621. See R. Solomon (1977), pp. 196-197.

69. See R. Hellmann (1979), p. 6.

70. As Robert Solomon has suggested, it was always unlikely that the French President, Georges Pompidou, would have allowed his Finance Minister, a potential political rival, to settle in Rome, when he had the chance to do the job (and take the credit) himself during his forthcoming meeting with President Nixon, scheduled for mid-December.

71. See note on table 1.

72. See table 1.

73. New York Times, 19 December 1971.

74. It has, of course, been argued, in defence of American monetary policy, that nobody *wanted* to do anything about it (i.e. that these dollars were willingly held). No doubt, this is partly true. A proportion of the dollars circulating in the world economy was willingly held by foreign public and private sectors. But, the persistent efforts to establish a dollar substitution account (and the US' equally persistent opposition to it) clearly indicated that a lot of them were not. Furthermore, if the American authorities truly believed that the dollar overhang was in fact willingly held, they would not have objected to the restoration of convertibility, for under those circumstances there would have been no threat to the gold stock in Fort Knox. Needless to say, the proposition was never put to the test and the rest of the world was not given the opportunity to express their wishes.

75. See, for example M. Willms (1972), p. 18.

76. The "effective" exchange rate takes into account movements in the rates of other currencies, weighted so as to reflect the importance of these currencies in a county's foreign trade.

77. Professor Manfred Willms of Kiel University argued that this was because the Smithsonian negotiators had taken the exchange rates of early 1971 (which were already grossly misaligned) as the starting point of the negotiations, rather than those prevailing in the market in the period preceding the conference. See M. Willms (1972).

78. As calculated by the US Federal Reserve staff. See R. Solomon (1977), p. 210.

79. We will return to the J-curve in chapter IIIa1.

80. See chapter IIa3.

81. See D. C. Kruse (1980), pp. 113-116.

82. Hansard, 21 March 1972.

83. See C. A. Coombs (1976), pp. 224-225.

84. Ironically, it was Helmut Schmidt, who had led the fight against Schiller within the German government who, barely nine months later, was steering his country's financial affairs on precisely the path advocated by his predecessor, towards a European joint float and the establishment of a world-wide system of floating exchange rates.

85. Shultz's move from the Bureau of the Budget to the Treasury at this time of uncertainty in the international monetary system was very significant in view of his well-known sympathy for flexible exchange rates.

86. See C. A. Coombs (1976), pp. 226-227.

87. See J. D. Aronson (1977), pp. 104-105.

88. The figure was later corrected to show an improvement, which continued over the following period. See C. A. Coombs (1976), p. 228.

89. New York Sunday Times, 4 February 1973.

90. Statement of foreign economic policy, by US Treasury Secretary George P. Shultz, 12 February 1973.

91. It must be pointed out, in George Shultz's defence, that he was merely stating openly what, in effect, had been the US' international financial position for a long time!

92. This was not just the initial response to the freeing of the exchange rate. By June 1973, the lira had depreciated another 10 percentage points relative to its Smithsonian level and, after a brief recovery, slid further down in the wake of the energy crisis of late 1973.

93. The Commission's proposals for the establishment of FECOM had been published on 24 January 1973. See chapter IIa3.

94. This link was well justified in view of the fact that Britain still accounted for more than half of the country's foreign trade.

95. See chapter IIa3.

96. See chapter IIIa1.

97. See R. Hellmann (1979), pp. 37-39.

98. This Colombo had left to take the considerably less important post of Minister responsible for United Nations affairs, in order to demonstrate his low opinion of the center-right coalition government which had been formed following the parliamentary election of May 1972.

99. This characterization refers, of course, to the relative importance of those currencies which were floating in the international economy, as measured by, say, the proportion of world trade or output accounted for by countries with floating currencies. For, in purely numerical terms, the fact was (and is) that the overwhelming majority of currencies remained pegged to one or another of the major currencies, a basket etc. with only a handful of twenty or so currencies daring to go it alone.

100. See O. Emminger (1973) and (1977), pp. 36-46.

101. See J. Williamson (1977), pp. 44-51 and T. D. Willett (1977), pp. 7-10.

102. Stephen Marris has provided a full account of the various factors which, together with the expected bureaucratic delays, induced governments to try to avoid, or at least

postpone, parity changes for the longest possible period. See S. N. Marris (1970a) and (1970b), pp. 13-35.

103. See R. N. Cooper (1971).

104. See T. D. Willett (1977), p. 14.

105. For the most authoritative and influential study of the inter-war period see R. Nurkse (1944). See also note No. 30, above.

106. See J. M. Keynes (1935), pp. 67-74 and H. D. White (1933), chaps. 12-14.

107. In J. M. Keynes(1943), p. 72.

108. Ibid, p. 74.

109. Ibid, p. 73.

110. In L. Rasminsky at al, (1972), pp. 38-39.

111. The other side of this argument, of course, is that, given the factors discouraging prompt parity adjustment and with the heat taken off them, governments might become more inclined to sit it out and delay taking some sort of corrective action even further. This question touches upon the discussion of "stabilizing versus destabilizing speculation", to which we will return in chapter IIIa1.

112. In J. Williamson (1977), pp. 46-47.

113. See R. Solomon (1977), pp. 213-214.

114. See T. D. Willett (1977), pp. 2-14 and O. Emminger (1973), p. 7.

115. In O. Emminger (1973), p. 10.

116. In A. F. Burns (1972).

117. Ibid.

118. In Dr. Burn's defence, it must be pointed out that this statement is perfectly consistent in a world of floating currencies on which American minds were already set (though, of course, these remarks were made while the adjustable peg was still alive).

119. In F. Lutz (1943), p. 19.

120. Supporters of floating rates naturally point out that, even after 1973, currencies have rarely been allowed to fluctuate freely, but have been "managed" by monetary authorities (a practice usually referred to as "dirty floating").

121. In R. Nurkse (1944), p. 189.

122. In A. Cairncross (1973), p. 13. For an account of the gradual intensification of exchange controls in the European Community during the early 1970s, see L. Tsoukalis (1977), pp. 131-136.

123. In T. D. Willett (1977), p. 12-14.

124. The perceived success of the system (and the wide-spread desire for more orderly conditions in the exchange markets) was clearly demonstrated by the increasingly frequent political calls, more than a decade after its final breakdown, for "a new Bretton Woods" to deal with current economic difficulties.

125. Quoted in Walter Trautmann (1967), p. 1502. The counter-argument to this is, of course, that it was *precisely* because the external disequilibrium was so small, relative to the size of the domestic economy, that the US should have found it easier than most other countries to maintain both internal and external balance and thus its membership of a fixed-parity system. Such a criterion for participation in a currency area was, indeed, suggested by Peter Kenen in 1969 (though it was contradicted by other proposed criteria in the literature on Optimum Currency Areas). See P. B. Kenen (1969) and Y. Ishiyama (1975).

CHAPTER II: THE "SNAKE"

1. See L. Yeager (1976), pp. 382-384 and P. Coffey & J. R. Presley (1971), pp. 3-5.

2. The OEEC became the Organisation for Economic Co-operation and Development (OECD) in September 1961.

3. See table 2. The Greek drachma was devalued once again by 50% in 1953. Owing to pressures on the balance of payments, the French franc was also devalued in 1957 and again at the time of the dissolution of the EPU, in December 1958.

4. A maximalist version of monetary union would include such elements as a common currency, common budgetary policy, common internal and external monetary policy, pooling of reserves, a European Central Bank etc. which go way beyond the scope of the Treaty of Rome.

5. See CEC (1978), article 104.

6. Ibid, articles 107 and 103.

7. Ibid, articles 6 and 105.

8. Ibid, articles 67. 71 and 106.

9. Ibid, article 108.

10. See L. Tsoukalis (1977), p. 53.

11. See CEC (1962).

12. See M. Camps (1967), p. 2.

13. See Official Journal of the European Communities, 22 April 1964 and 21 May 1964. See also D. C. Kruse (1980), pp. 17-18.

14. Following balance of payments problems in 1968-69, the franc was devalued on 8 August 1969. "*Prior*" consultations with regard to this devaluation took place on August 10! See CEC (1970a).

15. Barre, speech to the European Parliament, 9th February 1970. Quoted in B. Balassa (1973), p. 96.

16. See J. Pinder (1969), pp. 145-146.

17. Ibid.

18. See P. G. Taylor (1979), pp. 8-12.

19. To put this absence in context, one must keep in mind, however, that in 1957 most of Europe's currencies still remained inconvertible, Triffin's "Gold and the dollar crisis"

had yet three years to appear and it would not be until another eight years until the first visible cracks to the Bretton Woods design would begin to show. Under the circumstances, the continuation of a general regime of fixed but adjustable exchange rates may thus have been taken very much for granted and a specific mention in the Treaty considered superfluous.

20. See L. Tsoukalis (1977), pp. 56-57.

21. See S. Strange (1976), pp. 270-275.

22. See statements by Herr Erhard in G. R. Denton (1967), p. 17.

23. See CEC (1969).

24. Ibid.

25. See chapter Ic1.

26. See CEC (1969).

27. ECO/FIN had approved the first medium-term economic policy programme on 11 April 1967.

28. Ironically, it was Italy not France, who first made use of the resources provided by the EEC's financial aid mechanism a few years later.

29. See chapter Ic1.

30. The extent to which the French government saw its advocacy of monetary integration as, among other things, a tactic to prevent, or at least to delay, Britain's admission to the Community is unclear. For, there were signs that even General De Gaulle may have changed his mind during his last year in office and softened his opposition to the participation of the British. See U. Kitzinger (1973), pp. 44-45. The General may, in fact, have begun to realize the advantages of having Great Britain in the EEC as a counterweight to the growing economic (and thus inevitably political) might of West Germany, which had been openly and forcefully exhibited during the Bonn G-10 monetary conference of November 1968. During the Hague summit the French did insist, however, that "deepening" of the Community must *precede* "enlargement", whereas other countries, led by West Germany, advocated a simultaneous advance on both fronts.

31. In L. Tsoukalis (1977), p. 90.

32. Though the Barre Plan also contained proposals for the harmonization of indirect taxation, which were not part of the "Monetarist" position and was closer to the "Economist" on the question of transfer of authority to European, central institutions, which France rejected in favour of intergovernmental decision making.

33. See chapter Ic3.

34. In CEC (1970b), p. 9.

35. See CEC (1970c).

36. In H. Tietmeyer (1971), p. 419.

37. See "Official Journal of the European Communities", 27 March 1971 and "Report of the Committee of Governors of the Central Banks of the EEC", Annex No. 5 of CEC (1970b). With regard to implementation, the various component measures of the resolution of March 1971 met with different fortunes. The monetary measures and most of those relating to policy co-ordination were, indeed, speedily enacted. On the other hand, the establishment of a Regional Fund was only agreed in 1974, while measures concerning the harmonization of capital markets, company and indirect taxation and such like were not followed up at all.

38. Known, at the time, as the Ansiaux Committee, after its chairman, the Governor of the Belgian National Bank.

39. See chapter Ic2.

40. The Directive, which was in complete contrast to those adopted in 1960 and 1962, confirmed and extraordinary turnabout in Community thinking in the face of monetary crisis, and the emergence of a belief, even among economically "liberal" countries like

West Germany, that some degree of exchange control was unavoidable under the circumstances, in order to deal effectively with the problem of speculation.

41. See chapter Id2.

42. See R. Hellmann (1979), pp. 34-35.

43. See chapter Id2.

44. Ibid.

45. Italy had initially shared the reservations of the other "Economist" states, West Germany and the Netherlands, about the early creation on such a Fund.

46. For a more detailed account of the negotiations of 11-12 March 1973, see R. Hellmann (1979), pp. 37-40, chapter I note No. 98.

47. See R. W. Russell (1977), p. 80.

48. In D. C. Kruse (1980), p. 138.

49. Ibid, pp. 135-145.

50. The average dollar rate of the EUA through this period fluctuated around $1.25 - $1.36/EUA ($1=0.73-0.80 EUAs). Thus, the European loan was worth over 50% more than the American one.

51. See CEC (1974b).

52. The Economist, 2 March 1974 and 6 September 1975. See also S. W. Black (1977), pp. 48-58.

53. See D. C. Kruse (1980), pp. 149-158.

54. Le Monde, 3 May 1974.

55. The Community apparently never learnt that lesson. It repeated the very same mistake in the early 1980s, when a growing convergence of economic views and a strong dollar made for fairly harmonious monetary conditions in Europe. Once again, national government remained pre-occupied each with their domestic affairs, the "European" element was downgraded and the chance was wasted not only to make decisive new progress in monetary integration but even to realize decisions already agreed to, such as the establishment of the European Monetary Fund.

56. In CEC (1975a), p. 4.

57. In D. C. Kruse (1980), p. 194.

58. Ibid, pp. 206-213.

59. See R. Morgan (1974), p. 173 and S. Strange (1976), pp. 270-275. In April 1967, as part of this process, the President of the Bundesbank, Karl Blessing, had to offer a written assurance to the American authorities that West Germany would temporarily abstain from converting its unwanted dollar holdings into gold. The threat of a withdrawal of US forces was reportedly used (unsuccessfully as it turned out) during the Bonn G-10 monetary conference of November 1968, to put pressure on the West German government to revalue the DM. See Die Zeit, 22 November 1968. Two and a half years on, in May 1971, US Secretary of the Treasury John Connally once again linked defence issues with the weak state of the dollar and demanded that the Europeans should bear a larger part of the cost of their own defence. See chapter Ic2. In April 1973, the US Secretary of State, Dr. Henry Kissinger, attempted to put this idea on a more formal basis and proposed a "New Atlantic Charter" whose aim was to reassert American leadership in the Western Alliance and to establish a direct link between monetary reform, trade and a redistribution of the financial burden of defending the West. See I, Smart (1973). The disproportionate share of total defence expenditure born by the US has been habitually blamed ever since by American politicians for the occasional difficulty confronting the US economy, as has been witnessed in recent years in connection with the US budget and balance of payments deficits.

60. The CAP was the one important exception. For a full exposition of neofunctionalism see E. Haas (1958) and (1964), L. N. Lindberg (1963) and L. N. Lindberg & S. J. Scheingold (1970). It is important here to note that the neo-functional strategy called

for a transfer of authority to *supranational* institutions, whereas in the process towards EMU outlined in the Barre plan most of those agencies which would assume some of the responsibilities formerly in the province of national governments would be *intergovernmental* ones, especially during the early stages. However, the essential element of the neo-functional strategy remains the idea of spill-over, where integration in one field leads to solve problems on a common basis rather than in isolation from one another. The development of a Community framework for the discussion of economic policy that was achieved in the Snake may not have always produced immediate results but proved invaluable for the future course of monetary unification in the European Community.

61. I do not wish here to minimize the difficulties. *There were* instances where the positions of the members states were clearly incompatible such as, for example, in their antithetical attitudes towards the US. In the main, however, the economic and political advantages of a simultaneous advances in both fields would tend to vastly outweigh the disadvantages, which principally had to do with complications of timing correctly the implementation of the various elements of EMU.

62. In CEC (1970b), p. 23.

63. Also this distinction does not contradict the statement made above that, on the whole, national authorities' perception of the national interest was in basic accord with public opinion in their respective countries. The fact is that international monetary negotiat-ions tend to be of a highly secretive and technical nature and in a number of instances it

is doubtful that there existed sufficient knowledge, interest or expertise beyond a narrow inner circle for a "public" opinion to be formed. Thus, on many crucial occasions for the development of EMU in the Community, decisions were taken and modified on criteria quite unrelated to any fundamental national characteristics of the member state in question and more on the grounds of narrowly defined political interests.

64. The SPD vote went up from 39.3% to 42.7% while that of the FDP fell from 9.5% to 5.8%. The CDU/CSU vote had held remarkably well given that the party had been in government since 1949, dropping from 47.6% to 46.1%, while the neo-Nazi NDP scored 4.3 %. See T. Prittie (1979), p. 153.

65. This deal had also helped to elect Gustav Heinemann of the SPD over the CDU's Gerhard Schroder as President of the Federal Republic by just six electoral college votes in March 1969. See ibid, p. 151 and E. Mende (1972).

66. It is, of course, likely that the CDU would have been *forced* to revalue the DM anyway after the election. The fact is, however, that there was a distinct difference between the two parties on this matter and on the subject of European monetary union.

67. See P. Galante (1969).

68. See L. Tsoukalis (1977), pp. 104-111.

69. For an exposition of the characteristics of these schools of thought as they have been applied in the theory of European integration, see ibid, pp. 19-30.

70. Ibid, pp. 170-171.

71. For a detailed account of the work of the C-20, see J. Williamson (1977), pp. 60-181 and R. Solomon (1977), pp. 235-266.

72. See US Government Printing Office (1973). A similar idea was contained in the plan submitted by Lord Keynes in 1943, which had also included a proposal for a new international currency, the bancor. This had been motivated by the fear that the US, which had emerged from World War II as the dominant economic power, would run perennial surpluses and so deprive the rest of the world of much needed liquidity. In the C-20, there was once again an attempt to restrain surplus nations by focusing attention on the level of international reserves but, in marked contrast with the times of the Keynes Plan, American officials now viewed the US as a chronically deficit country. There was no proposal, of course, for an international currency. This need had been met, in theory at least, by the SDR. More significantly though, the US was opposed to anything that could present a threat to the de facto dollar standard which had been achieved with the official end of convertibility in August 1971.

73. For a fuller discussion of these viewpoints, see chapter Ic3 above.

74. In C. J. Morse (1974), pp. 186-189.

75. As with the question of the exchange rate system and the other elements of reform, there were various shades and strengths of opinion amongst the Europeans, though there was a general agreement on basic objectives, motivated by a shared dislike of the American determination to impose a dollar standard.

76. Although West Germany possessed the largest gold holdings of all the EEC countries in absolute terms, these accounted for a smaller proportion of total reserves than in the case of other member states.

77. See The Economist, 27 January 1973.

78. See R. Solomon (1977), p. 304.

79. There were two such gold auctions by the US Treasury on 6 January and 1 July 1975. Then followed an interval of almost three years, to 23 May 1978, when gold sales were resumed by the Carter administration.

80. Sales of gold by the IMF began on 2 June 1976 and continued on a regular basis. Despite indirect (and illegal) purchases by the Central Banks of France and Switzerland, the combined sales of gold by the US and the IMF had a depressing effect on the price of gold which sunk temporarily to just $103.50 in August 1976.

81. The restitution of part of the IMF's gold to its former owners would be accomplished within four years, starting in January 1977.

82. See The Economist, 6 September 1975.

83. An agreement enabling Central Banks to pledge gold as security to obtain finance for balance of payments purposes had been reached in principle during a dinner of the G-10 at the Watergate Hotel, Washington D. C., in June 1974 and approved soon after by the C-20. In accordance with this, a loan of $2 billion, secured by gold, was agreed between the Bundesbank and the Banca d' Italia on 5 September 1974, following a meeting in mid-August between Federal Chancellor Helmut Schmidt, Finance Minister Hans Aped and Bundesbank President Karl Klasen, with their Italian counterparts, Mariano Rumor, Emilio Colombo and Guido Carli, at Bellagio. See R. Hellmann (1979), pp. 137.

84. On 25 August 1976, Chirac had been replaced as Prime Minister by Raymond Barre, who blamed his predecessors for the relative economic decline of France. Relations between Chirac and the President and his government deteriorated steadily and, despite the long-standing alliance within the center-right ground of French politics between the neo-Gaullist RPR and the loose federation of parties in the UDF supporting the President, Chirac was noticeably cool towards Giscard's campaign for re-election in 1981.

85. See IMF Survey, 19 January 1976, p. 20. For reactions to the Jamaica agreement see E. M. Bernstein et al (1977).

86. See Bulletin of the European Communities, 9-1974.

87. The idea of trying to place the burden of adjustment on the diverging currency, rather than merely on the weakest one, by measuring deviations against a weighted average, found partial acceptance late in the EMS, though again it was the bilateral parity grid which remained dominant in that system. The other important element of the Fourcade plan, the idea of a common policy toward the dollar, although generally thought to be a necessary feature for the success of any European scheme, unfortunately has never overcome the practical and political objections to it.

88. In CEC (1975a), p. 1.

89. Ibid.

90. Ibid.

91. See CEC (1976b).

92. Ibid.

93. See S. C. Kolm (1976).

94. See C. J. Oort (1979). The target zone proposal in its original name of "reference rate" proposal first appeared in the literature in W. Ethier & A. I. Bloomfield (1975). See also J. Williamson (1975a) for additional elements intended to give real teeth to the scheme.

95. The idea of an objective indicator which would trigger off a process of consultations on police co-ordination was later taken up by the creators of the EMS in the establishment of an indicator of divergence.

96. See CEC (1977b).

97. See J. van Ypersele de Strihou (1978).

98. In J. Pinder (1981), p. 548. See also chapter IIb2 above.

99. See Federal Trust for Education and Research (1972). Also, CEC (1973), R. A. Mundell (1973a) and (1973b) and G. Magnifico (1973).

100. See CEC (1975).

101. See CEC (1976a), pp. 23-34.

102. See B. Balassa (1976), p. 306.

103. See R. Triffin (1975). This is similar to the definition of the unit of account employed during the 1950s in the EPU, to the creation of which Robert Triffin was a crucial contributor.

104. See CEC (1976a), pp. 29-31.

105. See G. Basevi et al (1978). For a full analysis of the proposal see M. Fratianni & T. Peeters (1978).

106. Milton Friedman has suggested that, in a sense, a common currency system is actually closer to a *flexible* exchange rate regime than to one of national currencies linked by fixed exchange rates. "The basic fact is that a unified currency and a system of freely floating exchange rates are members of the same species, even though superficially they appear very different. Both are free market mechanisms for inter-regional or international payments ... On the other hand, national currencies linked by pegged exchange rates, ... controlled and manipulated by governmental bodies either through and adjustable peg or day-to-day market operations, are also members of the same species. Both are interventionist standards". In M. Friedman (1968), pp. 271-272. The prevailing opinion at the time was, though, that from an operational point of view there is very little difference between a common currency system and one wherein exchange rates are fixed. See, for example, R. Triffin (1860), p. 141, C. P. Kindleberger (1968), p. 517 and R. I. McKinnon (1963), p. 717. According to Mundell, a common currency area is "a domain within which exchange rates are fixed". In R. Mundell (1961), p. 657. Even Tsoukalis in 1977, with the benefit of hindsight and the reasoning contained in the manifesto and the supporting literature, continues to adhere to the traditional view: "From a technical point of view, it is not a matter of interest whether the currencies of the member countries, which form part of the monetary union, are retained or whether they are replaced by a new common currency". In L. Tsoukalis (1977), p. 32.

107. See G. Basevi et al (1978), p. 39.

108. See H. Christie & M. Fratianni (1978), p. 22.

109. See G. Basevi et al (1978), pp. 39-43.

110. Ibid, p. 37.

111. For a comprehensive study of the economics of currency competition and the issues involved in the introduction of a European parallel currency, see R. Vaubel (1978b).

112. See F. A. von Hayek (1976) and (1978). Note, however, that Hayek himself was in favour of intercirculation of national and private currencies in the Community and saw this as a way to defeat inflation, whereas he did not believe or indeed wish that adoption of his proposals would lead to monetary union. Also note that, in recommending a solution through free market competition, Hayek had reversed his own previous opinion on the subject: "To rely on the spontaneous forces of the market to supply whatever is needed for a satisfactory medium of exchange ... is not only politically impracticable today but would probably be undesirable if it were possible". In F. A. von Hayek (1960), p. 324.

113. Gresham's law, popularly expressed, states that "bad money" drives "good money" out of circulation. It had its origin in the time of bimetalism, when it was reasonable to expect that if two currencies of unequal metal value were to circulate side by side, the currency with the lower metal content would be used as money in normal transactions,

while the one with the higher value content would gradually disappear to be melted down or hoarded. The principle first appears in the comedy "Frogs" by the ancient Greek comic poet Aristofanes. The term "Gresham's law" was coined in 1858 by the English economist Henry D. McLeod and popularised by William S. Jevons and other advocates of monometalism. See R. Vaubel (1978b) for the conditions under which Gresham's law is likely to apply.

114. See G. Basevi et al (1978), p. 41.

115. Ibid, pp. 39-40.

116. See B. Klein (1978), pp. 69-80.

117. See D. Laidler (1978), pp. 54-62.

118. See R. Vaubel (1978c), pp. 116-122.

119. See B. Balassa (1976), p. 303.

120. For details of the Fourcade Plan and other countries' reactions to it, see chapter IIb4 above.

121. The European Council was instituted in December 1974 on the initiative of President Giscard d' Estaing of France and comprised of the heads of government (or state) of the countries of the European Community.

122. Quoted in Agence Europe, 18 December 1974.

123. On 18 February 1974, ECO/FIN approved the proposals on the harmonization of policy instruments, economic policy co-ordination and the creation of an Economic Policy Committee contained in the Commission's package of 15 November 1973 and thus, the EMU project was deemed to have passed into a second stage.

124. The Schuman Plan of 9th May 1950 was the basis for the creation of the European Coal and Steel Community (ECSC) in April 1951.

125. This was clearly a case where Giscard the politician and Giscard the Frenchman got the better of Giscard the financial expert: The setting of a lower initial rate for the franc would have possibly avoided the embarrassment of having again to depart after an interval of only eight months. Even if there had been a temporary upward pressure on the franc at a lower rate, a degree of intervention by the Banque de France would have probably sufficed to keep the currency within the snake's limits, French reserves would have increased and the domestic economy could have been expanded on the cheap, and certainly would have been none the worse given the fact that the government seemed to want a degree of expansion anyway and was about to start taking measures to that effect.

126. It must be noted though that none of the governments concerned expressed themselves any objections to Switzerland's membership of the snake.

127. For more detail on these negotiations see R. Hellmann (1979), pp. 50-57.

128. The Phillips curve is named after the Australian economist A. W. Phillips who in a famous article in 1958 demonstrated a relation between the wage rate in British industry and the level of unemployment. See Phillips (1958). This was later extended to arrive at the hypothesis that there is a trade-off between the level of unemployment and inflation and that, by the use of traditional Keynesian demand-management methods, national governments could choose any particular combination between the two that suit their needs. As with measures of the money supply, which appear to behave themselves *until* they are adopted as targets, the Phillips curve seemed to fit very well the available evidence for the period from the middle of the 19th century to the middle 1960s, but then, as faith in it grew, its explanatory and predictive power collapsed in the inflationary climate of the 1970s. See J. R. Presley & G. E. J. Dennis (1976). Still, just as the curve had been written off as irrelevant from the policy formation viewpoint, it began once again to fit the facts in the less inflationary environment which developed from the early 1980s onwards.

129. See D. C. Kruse (1980), pp. 224-230.

130. Le Figaro, 12 February 1976.

131. It has been written that the French decided to take the franc out of the snake *because* of this refusal of the Benelux countries to participate in the general realignment Fourcade had asked for. See R. Hellmann (1979), p. 60. However, this does not appear to be the

case, for the French decision to pull out was in fact made known *before* the Benelux Ministers returned to announce their decision. See C. Oort (1979), p. 197.

132. The Community loan facility had been proposed by the Commission on 16 September 1974 and approved in principle by ECO/FIN on 18 November 1974, but it was not until February 1975 that the questions of the available amount, time span and other technicalities were finally settled.

133. See R. Hellmann (1979), pp. 104-108.

134. Sunday Times, 24 October 1976.

135. See R. Hellmann (1979), pp. 99-104.

136. Ibid, pp. 108-121.

137. For an analysis of the crawling peg see J. Williamson (1965).

138. See N. Thygesen (1979b), pp. 12-24.

139. Ibid.

140. Ireland was, of course, a special case because of the one-to-one link of the Irish pound with sterling.

CHAPTER III: THE EUROPEAN MONETARY SYSTEM

1. See R. Jenkins (1977), pp. 6-7.

2. Those proponents would, of course, argue that flexible exchange rates were never given a true chance due to continuous government interference in the operations of the free market and that it was, therefore, this practice of "dirty floating" that proved to be a relative disappointment not flexible exchange rates themselves.

3. In R. Jenkins (1977), p. 10.

4. See CEC (1977b).

5. In R. Jenkins (1977), p. 15.

6. Ibid.

7. See H. A. Poniachek (1979).

8. See chapter IIb3.

9. For an overview of the theory and evidence on the Mundell-Laffer ratchet hypothesis, see M. Goldstein (1977).

10. See chapter IIb5.

11. See A. Lamfalussy (1979b), p. 43.

12. See M. Friedman (1953a), pp. 175-177.

13. See A. Lamfalussy (1979b), pp. 44-45.

14. For an analysis and contrasting views on the VC hypothesis see S. I. Katz (1979).

15. In this way the VC hypothesis provides part of the answer to the logical problem posed by Friedman. Overshooting and speculation would tend to change the equilibrium rate of the currency itself in the longer run and become, in effect, self-justifying.

16. The suspicion implied (with ample reason) by the advocates of the more extreme versions of the VS hypothesis is that governments would in fact attempt to accommodate these inflationary pressures as long as possible in order to avoid the political cost of deflation and unemployment, even though the problem could only get worse in the longer run. This can be seen as a further argument for the view that monetary policy should be run by a Central Bank independent from political control, according to a clearly defined criterion of monetary stability.

17. For the degree of wage indexation in the member states of the European Community during the middle 1970s, see CEC (1977a), Annex 18.

18. See R. J. Ball, T. Burns & J. S. E. Laury (1977), CEC (1977a) and a brief summary of the latter in N. Thygesen (1979d), pp. 138-155.

19. Bulletin des Presse und Informationsamptes, 8 February 1977.

20. See P. Ludlow (1982), pp. 64-69.

21. See K. Kaiser (1978), pp. 83-110.

22. The Economist, 6 August 1977.

23. See chapter IIb5.

24. See Newsweek, 23 July 1977.

25. The German Chancellor, being politically to the right of his party and being constantly harassed by the SPD's left wing, seems anyway to have been more at ease dealing with conservative leaders abroad. Apart from his excellent personal relationship with President Giscard d' Estaing, who was himself leading a center-right coalition in France, Herr Schmidt seems to have got on better with Republican Gerald Ford and the British Conservative Prime Minister Margaret Thatcher than with Democrat Jimmy Carter and Labour Prime Minister James Callaghan, both of whom came from political parties whose economic and social philosophy was, at least in conventional political terms, closer to Herr Schmidt's own SPD.

26. See P. Ludlow (1982), p. 66.

27. The SPD vote fell from 45.8% to 42.6%, while that of the CDU/CSU went up from 44.9% to 48.6%. The Social Democrats' coalition partners in Bonn, the FDP, scored almost 8%, easily surpassing the 5% constitutional limit they had to overcome to qualify for seats in the Bundestag.

28. See T. Prittie (1979), pp. 215-240.

29. Frankfurter Allgemeine Zeitung, 30 April 1977.

30. In P. Ludlow (1982), p. 33.

31. The Guardian, 20 October 1977.

32. These reactions may have also been influenced by questions of personal pique. Roy Jenkins was critical of the "bureaucratic" way in which the Commission had operated in the past and had made no secret of the fact that he did not consider Herr Haferkamp suitable for the job (an opinion which was shared by many others) and had indeed tried to prevent his reappointment, only to be overruled by Helmut Schmidt.

33. In P. Ludlow (1982), p. 74.

34. See T. Prittie (1979), pp. 215-218.

35. According to Herr Schmidt himself, apart from the evident success of Mr. Jenkins' tactics, he was also influenced in this decision by the memoirs of the father of the European Community, Jean Monnet, which he had read only recently. See P. Ludlow (1982), p. 63.

36. The Guardian, 21 December 1978.

37. Mr. Callaghan may have been offended (arguably with some justification) by the fact that, whereas it was obvious that the West German Chancellor had already discussed his plans in some detail with the French President and Mr. Roy Jenkins, he had chosen to leave him totally in the dark when the British Prime Minister had visited Herr Schmidt in Bonn on 12 March for a private meeting to discuss the international economic situation.

38. For a comprehensive and authoritative account of the negotiations which led to the creation of the EMS, see P. Ludlow (1982).

39. See CEC (1979b).

40. Le Monde, 13 July 1978.

41. See tables 6 and 7.

42. At the limit, if a currency reached a weight of over 50%, it would never be exposed as the diverging currency. A proposal by the Bank of England to establish constant

currency weights in the ECU was summarily rejected by the Bundesbank as a recipe for a "Community of inflation".

43. See p. Ludlow (1982), pp. 163-164.

44. See table 8.

45. See table 9 and section IIIa3 below.

46. The EPC had been set up in 1974 and had taken over the responsibilities of the Short-Term Economic Policy Committee, the Medium-Term Economic Policy Committee and the Budgetary Policy Committee.

47. Hansard, 29 November 1978.

48. Britain also gave notice of its intention to keep sterling as close as possible to the fluctuation limits agreed for the other currencies. The absence of sterling from the ERM nevertheless necessitated a number of technical rules to avoid the complications to the intervention mechanism and the system of currency weights employed, created by the independent flotation of the pound. See J. van Ypersele & J. C. Koeune (1988).

49. See table 4.

50. See action IIb6 above.

51. The human aspect of neofunctionalism has scarcely been mentioned in the literature.

52. See P. Ludlow (1982), pp. 19-21.

53. See section IIb5 above.

54. Such credits could then be automatically extended for three months and converted into monetary support under the provisions of the STMS, for amounts up to the maximum quota of the country concerned.

55. These are the special border levies and rebates used to shelter domestic agricultural prices from the effects of currency movements on the intervention prices set by the CAP. Ironically, they had been introduced for the first time in response to the 11.1% devaluation of the French franc in August 1969!

56. In P. Ludlow (1982), p. 273.

57. See G. Pridham & P. Pridham (1981), p. 183.

58. See P. Ludlow (1982), pp. 198-205 and 281-828. As it turned out, these hard-line tactics in the end backfired on the Gaullists. In the European elections in June, the UDF topped the poll with 27.6%, the Socialists were second with 23.6% and the RPR came fourth with only 16.3%, behind the Communists' 20.6%.

59. The gold portion of these reserves was valued according to the average of the prices recorded at the two daily London fixings during the six months prior to valuation. The dollar portion was valued according to the market rate two working days prior to the valuation date. Quarterly adjustments are made to ensure that each of the participating Central Banks maintains at least 20% of its gold and dollar reserves deposited with FECOM. See CEC (1979a), p. 76.

60. See J. Godeaux (1989), p. 193.

61. In R. Triffin (1979b), p. 67.

62. In N. Thygesen (1979c), p. 112.

63. See CEC (1979c), p. 95.

64. In L. Spaventa (1982), p. 275.

65. See G. D. Baer (1979).

66. For the mathematical proof of the following propositions see L. Spaventa (1982), pp. 262-273. See also J. Salop (1981) and J. J. Rey (1982).

67. See Deutsche Bundesbank (1979), pp. 13-14.

68. See N. Thygesen (1981).

69. In D. C. Kruse (1980), pp. 251-252.

70. See table 10.

71. The Bundesbank had previously expressed the opinion that the BFR had been brought into the EMS at too high an initial level.

72. See D. C. Kruse (1980), pp. 249-251.

73. See N. Thygesen (1984), pp. 265-267.

74. See D. C. Kruse (1980), pp. 252-254 and N. Thygesen (1984), p. 267.

75. For the average monthly exchange rate variations throughout this period, see table 12.

76. As it was, the strong appreciation of sterling and, to a lesser extent, the lira which saw not bound by the narrower fluctuation bands, pulled the ECU upwards and made the DM appear artificially weak. To overcome this statistical difficulty, it was decided that, if the pound rose more than permitted by the upper limits of the ERM, the extra increase would not be taken into account when calculating the thresholds of divergence.

77. The Belgian request for a devaluation also created problems for the BLEU as Luxembourg happened to enjoy lower inflation and a healthier balance of payments and thus needed a currency devaluation far less than Belgium did. See N. Thygesen (1984), p. 270.

78. The Economist, 5 October 1985.

79. The Economist, 22 March 1980.

80. The connection between stability in the EMS and the movements of the US dollar has been underlined in F. Giavazzi & A. Giovannini (1986), pp. 460-463 and in M. Sarcinelli (1986).

81. The RPR and UDF together scored around 44% of the vote, the Socialists 32% and the PCF and the National Front 10% each.

82. See H. Ungerer et al (1986), p. 15.

83. See CEC (1982). For a comprehensive look into the various proposals to reform the EMS in the period 1979-81, see J. van Ypersele & J. C. Koeune (1988).

84. The BIS became the first such holder on 14 January 1986. See S. Micossi (1985), pp. 405-424, and H. Ungerer et al (1986), p. 8.

85. See CEC (1989). For a fuller discussion of the Basle/Nyborg agreement, see L. Dini (1988).

86. See R. S. Masera (1987b).

87. See tables 13 and 14.

88. See A. Lamfalussy (1989b), pp. 201-203.

89. See the Economist, 13 January 1990.

90. In H. Ungerer et al (1986), p. 1. For excellent surveys of the large literature assessing the EMS, see D. Gros & N. Thygesen (1988) and F. McDonald & G. Zis (1989).

91. See G. Zis (1984), pp. 45-72.

92. In D. Gros & N. Thygesen (1988), p. 32.

93. See P. de Grauwe (1987) and S. Collins (1988).

94. In H. Ungerer et al (1986), p. 1.

95. Ibid, p. 25.

96. See J. Sachs & C. Wyplosz (1986).

97. In CEC (1979d), p. 94.

98. See P. De Grawe (1987).

99. See M. J. Artis (1988), p. 115.

100. See D. Begg & C. Wyplosz (1987).

101. As we will see in the following section, Italy adopted the narrow ±2.25% fluctuation band on 5 January 1990.

102. See the Economist, 22 June 1985.

103. See CEC (1986b).

104. See M. J. Artis (1988), K. Rogoff (1985) and F. Giavazzi & A. Giovannini (1986).

105. See C. Wyplosz (1988), p. 96 and F. McDonald & G. Zis (1989), pp. 193-196.

106. See M. D. Bordo & A. J. Schwarz (1989), p. 16.

107. In T. Padoa-Schioppa (1988), p. 373.

108. Ibid, p. 376.

109. The three experts selected for this purpose by the European Council were Messrs. Niels Thygesen, Professor of Economics at the University of Copenhagen, Alexandre Lamfalussy, General Manager of the BIS and Miguel Boyer, President of Banco Exterior de Espana. From the Commission came Mr. Frans Andriessen, the Commissioner for foreign affairs.

110. In CSEMU (1989), p. 17.

111. See ibid, pp. 17-18. A similar idea, though with a less fancy name, existed in Roy Jenkins' Florence speech, in October 1977.

112. See M. Parkin (1978), pp. 172-187, and the Economist, 10 February 1990.

113. The erroneous idea that a single currency is not strictly necessary for the creation of a full EMU is common to both the Werner and the Delors reports. See CEC (1970b), p. 10 and CSEMU (1989), p. 19. So is the insistence that exchange rate union must precede monetary union. The Council Resolution of 22 March 1971, which set the EMU project in motion, also states that "the elimination of fluctuation margins of rates of exchange and the irrevocable fixing of parity rates ... are indispensable conditions for the creation of a single currency". In CEC (1971), I, 2. For a reappraisal of the Werner report, see G. D. Baer & T. Padoa-Schioppa (1989).

114. Over the following few months, Mrs. Thatcher was also to find herself in a minority of one on the questions of the Social Charter and the reform of the EEC constitution, as proposed by the Commission and the European Parliament.

115. In the Economist, 7 December 1985.

116. See the Economist, 28 October 1989.

117. See the Economist, 13 May 1989.

118. See CEC (1976b) and section IIb4 above.

119. In The Economist, 16 December 1989.

120. See The Economist, 13 January 1990.

121. See The Economist, 2 December 1989.

122. See The Economist, 17 February 1990.

123. See The Economist, 20 January 1990 and 10 February 1990.

124. See The Economist, 17 February 1990.

125. See CEC (1970b), p. 10 and CSEMU (1989), p. 19.

126. See The Economist, 27 January 1990.

127. This worry, that the EMS would drive interest rates too low in Europe's high inflation countries and jeopardize their efforts to attain price stability was the main argument in the advice given by Sir Alan Walters to Mrs. Thatcher against sterling's participation in the system.

128. See The Economist,17 February 1990.

129. See D. Cobham (1989), p. 211.

130. In T. Peeters (1982), p. 11.

131. See R. Vaubel (1978b).

132. See CSEMU (1989), p. 33. For an account of some the options considered by the Delors committee and their perceived drawbacks, see K. O. Pohl (1989), pp. 139-146.

133. See G. Basevi et al (1972) and section IIb4 above.

134. For suggestions on these and other issues, see A. Lamfalussy (1989a) and (1989c), N. Thygesen (1989a) and 91989b), J. de Larosiere (1989) and C. A. Ciampi (1989).

135. In D. Gros & N. Thygesen (1988).

136. Support for the idea of currency competition and/or the establishment of the ECU as a parallel currency has been expressed in, among others, R. S. Masera (1987), P. Allen-Reynolds (1989), R. Vaubel (1989), M. D. Bordo & A. J. Schwartz (1989) and A. Steinherr (1989). The British Chancellor of the Exchequer, Mr. Nigel Lawson, was also preparing a British alternative to the Delors report, based on the idea of competition between the national currencies. After his departure from the Treasury, the paper was presented to the Brussels ECO/FIN meeting of 13 November 1989 by his successor, Mr. John Major, but the idea was never developed further.

137. See. K. O. Pohl (1989), pp. 142-143.

138. See R. Vaubel (1989) and A. Steinherr (1989).

139. For criticisms of this proposal, see D. Cobham (1989), pp. 212-213.

140. See section IIb4.

141. The indexation proposal contained in the 1975 All Saints' day manifesto, see G. Basevi et al (1975), is even stronger in terms of price stability (and for that reason it appeared more attractive in the high-inflation mid-1970s than it does today when inflation seems to be under control), but it may be an overkill which could make the chances of an eventual adoption of the parallel currency approach in Europe even more remote than they are at present.

142. Given the objections of some member states to Herr Pohl's proposals, The Economist has suggested that, in the way of a compromise, the new ESCB could be based on the example of the Nederlandsche Bank, instead of the bank in the Community, is nominally under the political control of the finance ministry but there are such legal safeguards for the independent management of monetary policy (including the possibility of toppling the government) that no government has dared yet risk ordering the bank to pursue one kind of policy rather than another. For more details, see the Economist, 10 February 1990.

143. See F. Catherwood (1988).

144. Legitimacy and responsibility, as we have seen, are the tow conditions for the successful exercise of hegemony. See section Ic4 above.

145. For the effects of EMU on regional disparities within the Community, see J. Williamson (1975), M. F. Doyle (1989) and J. Delors (1989b).

146. In G. Richardson (1979a).

147. See P. Cecchini (1988).

148. In CSEMU (1989), p. 23.

149. See P. De Grauwe (1989b).

150. See T. Padoa-Schioppa (1988), pp. 377-380.

151. In P. Ludlow (1982), p. 299.

152. See T. Peeters (1982), L. Tsoukalis (1977), pp. 170-173, and D. Cobham (1989), p. 210.

153. In R. Jenkins (1977), p. 16

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