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European Community: Searching for Exchange Rate Stability [redacted]

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An Intelligence Assessment

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October 1982

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European Community: Searching for Exchange Rate Stability [redacted]

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An Intelligence Assessment

This paper was prepared by [redacted] of the Office of European Analysis. Comments and queries are welcome and may be directed to the Chief, Economic Issues Branch, EURA [redacted] 25X 25X

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European Community: Searching for Exchange Rate Stability [redacted] 25

Key Judgments

Information available as of 15 September 1982 was used in this report.

Establishment of the European Monetary System (EMS) by the European Community in 1979 reflected the conviction of EC leaders that stable exchange rates are necessary to further economic integration. After three years of operation, the EMS is noteworthy in at least one respect: it has remained intact with major currency participation longer than any of its predecessors. On the other hand, it has not yet produced the exchange rate stability that is its goal. The devaluation in June of the French franc within the EMS—the sixth realignment of a participating currency since the start of the system—highlights the degree of instability that remains. Moreover, member countries remain unwilling or unable to coordinate economic policies, and as a result sizable differences in inflation rates and current account balances will continue to destabilize exchange rates. Periodic currency realignments will be necessary, with another likely before the end of the year.

Changes in the dollar's value also create strains within the EMS. Although present complaints about US economic policy in part stem from the strength of the dollar, a new round of criticism would ensue should the dollar weaken appreciably. If internal pressures on the EMS become too great in the future and result in one or more countries dropping out of the system, West European leaders undoubtedly will place some of the blame on the United States. West German Chancellor Schmidt, French President Mitterrand, Italian Prime Minister Spadolini, and others have pointed to high US interest rates as a source of strain on the EMS.

To a limited extent, the EMS has influenced domestic economic policies, and as a result EMS currencies may have been kept from diverging as rapidly as they otherwise would have. The dramatic shift in French economic policy that came on the heels of the EMS realignment in June was in large part triggered by the government's desire to remain in a West European currency system, even at the expense of domestic economic and political goals.

Despite recurring rumors that the French are going to pull out of the EMS, we believe that the system will continue to hold together. The willingness of the French and Italians to take austerity measures to defend their

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currencies augurs well for the survival of the system, although occasional parity realignments no doubt will still be needed. Prospects for moving forward to the next evolutionary phase of the EMS—creation of a supranational monetary authority—are dim. Member countries, particularly West Germany, remain reluctant to hand over any responsibility for monetary policy to an EC institution.

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Steps Toward Monetary Union

Postwar plans to integrate the West European economies into a single unit have always implicitly reflected a need for a common West European currency, or at least a system of relatively fixed exchange rates. Operation of the European Community's 10-nation common market has been hampered and, in some cases, perverted by exchange rate fluctuations. [redacted]

The Common Agricultural Policy (CAP) stands out as the most obvious victim of unstable exchange rates within the Community. Although the CAP includes a centralized system of farm price supports, currency fluctuations bring about differences in prices from country to country in violation of the fundamental CAP principle of common pricing. Moreover, unstable exchange rates severely complicate internal EC agricultural trade. To offset the effects of changing exchange rates, the Community has rigged a cumbersome system of taxes and subsidies on intra-EC trade in farm products. [redacted]

The lack of fixed exchange rates also may have impaired industrial development in the Community, even though currency variations have helped to offset inflation differentials. In any case, many West European economic observers hold that stable EC exchange rates would remove some risk and uncertainty from intra-EC economic transactions and thereby increase economic efficiency and growth. Because a change in exchange rates can alter the cost of producing in one country compared with another, knowing that exchange rates will remain fixed would remove a major uncertainty affecting investment decisions. [redacted]

Although the West Europeans have generally agreed that stable exchange rates are desirable, the method of achieving that stability has generated considerable controversy within the Community. The West Germans and the Dutch usually have argued that exchange rates will stabilize when economic policies and performance in EC countries are roughly similar. On the other hand, the French, Italians, and Belgians claim that an exchange rate system is needed first to encourage governments to adopt similar economic policies. [redacted] 25

The desire to move toward greater exchange rate stability came to the fore in the late 1960s. At the Hague summit in December 1969, the six countries that were EC members at the time agreed to start work on the next step of economic integration, "economic and monetary union"—a concept that has been generally interpreted to mean the establishment of a supranational body to formulate EC-wide economic and monetary policies. In particular, monetary union was to be achieved by gradually narrowing the day-to-day fluctuations in the exchange rates between members' currencies. Once the exchange rates could be maintained at fixed values, creation of a common EC currency—initially slated for 1980—would be "merely technical," and an EC monetary authority would be established. By April 1971, the six EC countries had worked out the details for tightening the band of permissible exchange rate fluctuation from the ±1 percent allowed under the Bretton Woods system[1] to ±0.75 percent beginning on 15 June 1971. [redacted] 25

Before the Community could implement its plan, the fixed-rate Bretton Woods system began to break apart as the dollar came under increasing downward pressure during the spring of 1971. Unwilling to support the dollar indefinitely, the West Germans in May—followed by the Italians and the Benelux countries—floated their currency against the dollar; the French tried to maintain the parity of the franc against the dollar through capital controls. Although fixed dollar exchange rates were reestablished during

[1] Under the system worked out at a 1944 conference at Bretton Woods, New Hampshire, members of the International Monetary Fund (IMF) pegged their currencies to the US dollar, which was convertible into gold at $35 a troy ounce. IMF members were required to intervene in the foreign exchange markets whenever their currencies deviated by more than 1 percent from their par values against the dollar. [redacted] 25

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the summer, renewed pressure against the dollar in August led President Nixon to suspend convertibility of the dollar into gold, thus effectively abolishing the Bretton Woods system. [redacted]

The Smithsonian agreement of December 1971, which established a ±2.25-percent band of fluctuation of all currencies against the US dollar, provided the basis for renewed movement toward EC monetary union. Under that agreement, EC currencies could fluctuate against each other by as much as 4.5 percent if one currency was at the top of the US dollar band and another was at the bottom. In the spring of 1972, the EC Council of Ministers agreed to restrict intra-EC exchange rate fluctuations to one-half the amount allowed under the Smithsonian agreement. The Community began this joint float against the dollar, dubbed by journalists "the snake in the tunnel," on 24 April 1972; the Benelux countries restricted fluctuations between the Dutch guilder and the Belgian-Luxembourg franc to ±1 percent, creating "the worm in the snake." Within a month the United Kingdom, Ireland, Denmark, Norway, and Sweden joined the snake. [redacted]

The snake, however, quickly became a deutsche mark currency zone as it was abandoned by the United Kingdom and Ireland (on 23 June 1972), Italy (on 13 February 1973), and France (on 19 January 1974). The French rejoined the snake in July 1975 but left again after eight months. Only the countries that were most dependent economically on West Germany were willing to adjust their domestic policies sufficiently to maintain relatively fixed exchange rates against the deutsche mark. [redacted]

At the April 1978 EC summit in Copenhagen, West German Chancellor Helmut Schmidt and French President Valery Giscard d'Estaing proposed a renewed effort to establish what they called a zone of monetary stability. Schmidt and Giscard stated that some new initiative to promote economic union was needed if the Community was to expand beyond a common market. The two leaders convinced the other heads of government in Copenhagen that, in addition to the trade, investment, and growth benefits, a European Monetary System (EMS) would lend greater weight to the Community's voice in international economic affairs. By December, the details of the new system had been worked out, and the EC launched the EMS on 13 March 1979. [redacted] 25

Currency Realignments in the European Monetary System 25

13 March 1979	*Operations of the European Monetary System begin.*
24 September 1979	*The West German mark's central rate if revalued upward by 2 percent, while that of the Danish krone is devalued by 2.9 percent.*
30 November 1979	*The Danish krone's central rate is devalued by 4.85 percent.*
22 March 1981	*The Italian lira's central rate is devalued by 6.0 percent.*
5 October 1981	*The central rates of the West German mark and the Dutch guilder are revalued upward by 5.5 percent, while those of the French franc and the Italian lira are devalued by 3 percent.*
22 February 1982	*The central rates of the Belgium-Luxembourg franc and the Danish krone are devalued by 8.5 percent and 3 percent, respectively.*
14 June 1982	*The central rates of the West German mark and the Dutch guilder are revalued upward by 4.25 percent, while those of the French franc and the Italian lira are devalued by 5.75 percent and 2.75 percent, respectively.*

[redacted] 25

Structure of the European Monetary System

The European Monetary System is basically a joint float of eight EC currencies;[1] the United Kingdom declined to join the float, and Greece, the 10th EC member, has not yet been incorporated into the system. The system's prime objective is stabilization of the value of the members' currencies against one another. The Community hopes that the existence of the EMS will prod member countries to coordinate their economic policies. Economic convergence would then allow the EC to establish a centralized monetary authority, furthering the goal of eventual economic and monetary union.

At the heart of the EMS is the European Currency Unit (ECU), an accounting unit made up of a basket of nine EC currencies[2] (see table below). In exchange for 25 billion ECUs, the central banks of the EMS countries alloted 20 percent of their foreign exchange and gold reserves to the European Monetary Cooperation Fund (FECOM). The Fund primarily acts as a clearinghouse for swap transactions between members' central banks. The FECOM also manages short-term loans of reserves to the member countries.

The EMS joint float is a "parity grid" arrangement that includes a "divergence indicator" to signal potential problems. The grid is set up so that each currency may deviate from its parities against any other currency by no more than 2.25 percent (6 percent for the Italian lira). The divergence indicator, on the other hand, is calculated as a deviation from each currency's central rate against the ECU.[3] If a currency's exchange rate goes past the divergence indicator, the EMS countries "presume" that the country with the diverging currency will take appropriate action, such as adjusting its monetary or fiscal policies. Although action is not required, the government must explain to the other EMS countries if it chooses not to act. Action is required if a currency reaches its limit on the grid. At that point, the EMS central banks are expected to intervene in exchange markets to maintain the integrity of the band. Realignments of the central rates occur when the member countries agree that the old parities can no longer be supported.

[1] Belgium and Luxembourg maintain a monetary union, with both currencies equal in value; thus, the Luxembourg franc does not float separately.
[2] The ECU is defined as made up of 0.828 West German deutsche mark, 1.15 French francs, 0.0885 British pound, 0.286 Dutch guilder, 109 Italian lire, 3.66 Belgian francs, 0.217 Danish krone, 0.00759 Irish pound, and 0.14 Luxembourg franc.

[3] The divergence indicator for each currency equals 0.75 × (the allowable margin of fluctuation) × [1—the weight of the currency in the ECU). For the deutsche mark, the indicator is 0.75 × 2.25 × (1—0.33) = 1.13 percent].

EMS: Central Rates [a]

	West German Mark	French Franc	Dutch Guilder	Belgian Franc [b]	Italian Lira	Danish Krone	Irish Pound
ECU	**2.334**	**6.614**	**2.580**	**44.97**	**1,350**	**8.234**	**0.691**
West German mark		2.773	1.102	19.10	561.5	3.453	0.290
French franc	0.353		0.390	6.799	204.2	1.245	0.105
Dutch guilder	0.905	2.564		17.44	523.4	3.192	0.268
Belgian franc [b]	0.052	0.147	0.057		30.03	0.183	0.015
Italian lira	0.002	0.005	0.002	0.033		0.006	0.001
Danish krone	0.283	0.803	0.313	5.462	164.0		0.084
Irish pound	3.378	9.571	3.733	65.08	1,954	11.92	

[a] After the 14 June 1982 realignment. Columns are expressed in their respective national currency units.

[b] The parities for the Luxembourg franc are the same as those for the Belgian franc because of the Belgium-Luxembourg monetary union.

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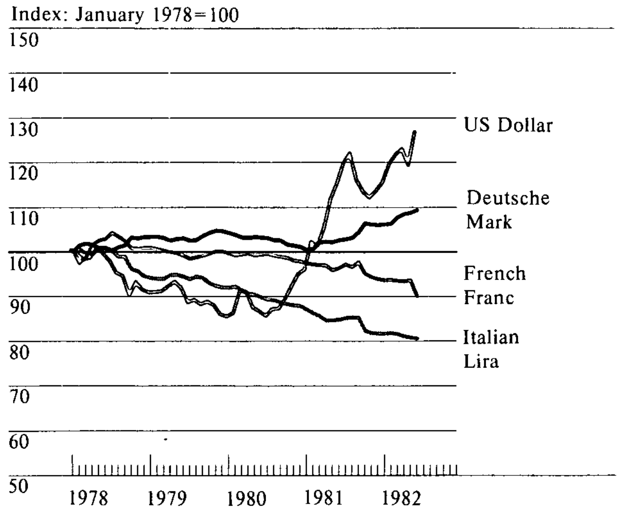
Table 1
Selected Countries:
Consumer Price Inflation

Percent change over previous period

	1978	1979	1980	1981	First-Half 1982
United States	7.7	11.3	13.5	10.3	7.2
European Monetary System					
Belgium	4.5	4.4	6.7	7.6	8.4
Denmark	10.1	9.6	12.3	11.7	10.5
France	9.3	10.6	13.5	13.3	13.9
Ireland	7.6	13.2	18.2	20.4	19.9
Italy	12.4	15.7	21.2	18.7	16.1
Luxembourg	3.1	4.6	6.3	8.1	8.7
Netherlands	4.1	4.2	6.5	6.7	6.7
United Kingdom	8.3	13.4	18.0	11.9	10.2
West Germany	2.7	4.1	5.5	5.9	5.6

[redacted]

Selected Currencies: Change Against the European Currency Unit



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Middling Results

The EMS has had little success so far in achieving long-term exchange rate stability—its primary goal. Since the system began operating, EMS parities have been realigned six times, mostly because differences in inflation rates and current account balances among the member countries have not narrowed (see table 1). Two of the three realignments in the past year occurred because French inflation was continuing at about 13 to 14 percent while price increases in other EC countries were slowing. Moreover, the international financial community considered Mitterrand's economic policies as inflationary and expected these intra-EC price trends to continue for some time. Even before the most recent realignment on 14 June, the lack of long-term stability alarmed Bundesbank President Otto Poehl, who warned in several speeches that frequent exchange rate changes were threatening the EMS by eliminating the major reason for its establishment. [redacted]

Although a 1981 study by the EC Commission maintains that interventions in the foreign exchange markets under the EMS have reduced day-to-day fluctuations in exchange rates, an examination of the evidence casts doubt on even this limited claim. The average daily fluctuation of most EMS currencies as measured against the European Currency Unit (ECU) has not lessened substantially since establishment of the system. Based on a calculation of the standard deviations [2] of the percent changes of the major currencies against the ECU, only the West German mark, the Italian lira, and the Irish pound are more stable than in 1978 (see table 2). [redacted]

Impact of the Dollar

Shifts in the dollar exchange rate have made stability harder to achieve for the EMS. Any substantial change in the value of the US dollar—up or down—therefore leads to West European criticism of US economic policies. Carter administration policies came under sharp attack from West European leaders for having contributed to the slide in the dollar's

[2] The standard deviation is the amount of variation from an average within which two-thirds of the observations occur. For example, two-thirds of the daily percent changes in the value of the Belgian franc against the ECU during 1978 were ±0.057 percent or less. Less volatile currencies have smaller standard deviations. [redacted]

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Table 2
Selected Countries: Exchange Rate Volatility [a]

	1978	13 March–23 Sep 1979	24 Sep 1979–29 Nov 1981	30 Nov 1979–22 Mar 1981	23 Mar 1981–4 Oct 1981	5 Oct 1981–20 Feb 1982	21 Feb 1982–13 Jun 1982
European Monetary System							
Belgian franc [b]	0.123	0.080	0.090	0.199	0.106	0.320	0.075
Danish krone	0.084	0.101	0.075	0.198	0.086	0.078	0.070
French franc	0.138	0.142	0.089	0.053	0.148	0.061	0.232
Irish pound	0.122	0.170	0.063	0.165	0.079	0.077	0.078
Italian lira	0.111	0.067	0.085	0.128	0.182	0.074	0.057
Dutch guilder	0.075	0.073	0.072	0.059	0.107	0.071	0.084
British pound	0.122	0.202	0.339	0.222	0.228	0.174	0.140
West German mark	0.080	0.076	0.040	0.071	0.084	0.064	0.085
US dollar	0.252	0.127	0.100	0.268	0.338	0.253	0.259
Japanese yen	0.246	0.379	0.092	0.304	0.335	0.228	0.122
Swiss franc	0.359	0.119	0.085	0.138	0.233	0.185	0.161

[a] Standard deviation of the day-to-day percent changes in exchange rates against the ECU between realignments. Larger numbers indicate greater volatility.
[b] Includes the Luxembourg franc.

[redacted] 25

value. The rise of the dollar since 1980 has brought more recent US monetary and fiscal policies under fire. [redacted]

High US interest rates, on top of sizable US current account surpluses, have helped the dollar to appreciate nearly 50 percent against the ECU since the start of 1980 (see figure). Because the share of imports priced in dollars and the importance of imports in the economy vary among EMS countries, the domestic price effects of a change in the dollar differ. Thus, the Netherlands, where imports priced in US dollars equal 16 percent of GDP, is more heavily affected than France, whose dollar-denominated imports equal only 6.5 percent of GDP. Differences in inflation rates among the countries, therefore, can be aggravated by the unequal impact of the dollar appreciation. Changes in the dollar exchange rate can also lead to changes in each country's balance of payments. [redacted]

The West German attempt to stabilize the dollar/deutsche mark exchange rate also has put pressure on the EMS currencies. Since the dollar began appreciating in 1980, the Bundesbank has kept interest rates high to support the deutsche mark. Higher interest rates strengthened the mark against other EMS currencies, forcing some of the other EMS countries in turn to hike their interest rates as they tried to maintain currency parities (see table 3). [redacted] 25

Constraints on Policies

Although the EMS has yet to bring about a convergence of economic policies among the participants, the system undoubtedly has resulted in national policies that are less divergent than otherwise would be the case. The French austerity program announced immediately after the recent realignment provides a prime example. Perhaps even more important, the shift in

Table 3
Selected Countries:
Real Money Market Rates [a]

Percent

	1978	1979	1980	1981	First-Half 1982
United States	0.23	−0.10	−0.14	6.08	7.20
European Monetary System					
Belgium	0.73	3.57	4.52	3.86	3.52
Denmark	5.32	3.03	4.63	3.07	6.10
France	−1.32	−1.56	−1.65	2.00	2.06
Ireland	0.82	0.27	−2.83	−6.86	−6.24
Italy	−0.91	−3.84	−4.03	0.90	4.78
Netherlands	2.14	4.83	3.63	4.31	2.20
United Kingdom	−4.60	0.19	−1.90	1.39	2.92
West Germany	1.00	2.59	4.04	6.21	4.13

[a] Short-term interest rates minus the consumer price inflation rate.

[redacted]

French policy shows the degree to which Paris has thus far been willing to go to maintain a viable West European currency system. [redacted]

After taking office in the spring of 1981, France's Socialist government boosted the minimum wage, increased transfer payments and other government spending, and accelerated money supply expansion in an attempt to speed up economic growth. At the same time, other EMS countries were still following relatively restrictive monetary and fiscal policies. Although French GNP growth did pick up, the price was continued high inflation and a larger current account deficit. The concurrent nationalization program encouraged capital to leave France. [redacted]

As a result, the franc began to weaken against the other EMS currencies. Since the Socialist victory, Paris has spent more than $8 billion in reserves supporting the franc. When the EMS realignment and the austerity program were announced in June of this year, Banque de France had only a one-month foreign reserve cushion. The new French economic program is designed chiefly to cut the 14-percent inflation rate by reducing the budget and social insurance deficits, freezing wages and most prices, and slowing money supply growth. Without the French commitment to the EMS, Mitterrand could have continued his inflationary policies longer than he did by either letting the franc slide in value or applying stringent capital controls. [redacted]

Politically, we believe that Mitterrand would find withdrawal from the European Monetary System as embarrassing as Giscard found withdrawal from the snake, especially if Italy could remain in the system. The French President probably would come under severe attack by the opposition for abandoning efforts to preserve the franc's value. Moreover, the press and the opposition parties would remind the public of Mitterrand's past pledges of strong support for EC institutions. Recently the government announced that it was raising $4 billion in international capital markets to bolster reserves. Economically, participation in the EMS allows Paris to point to external obligations as a reason for taking unpopular deflationary measures. Nevertheless, we think that Mitterrand probably would be willing to take France out of the EMS if he believed that continued participation was harming long-term French interests. [redacted]

The influence of the EMS on other EC countries' policies has been more subtle. The smaller countries have long adopted economic policies aimed at maintaining stable exchange rates with their major economic partners. Thus, the Dutch and the Danes tend to follow economic policies compatible with those of the West Germans, while the Belgians and the Luxembourgers attempt to maintain a balance between the West Germans and the French. For their part, the Italians have made only minor policy adjustments in response to developments in other EMS countries. Although the Italian austerity program announced on 31 July may in part be a consequence of Italy's participation in the EMS, Rome claims that the primary purpose of the new measures is to bring down a sizable government budget deficit to slow inflation. [redacted]

Bonn has made few, if any, policy adjustments because of its EMS membership. With its relatively low inflation rate and usual current account surplus, West

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Germany normally has had the strongest currency in the EMS. As a result, the government in Bonn, and even more so the Bundesbank in Frankfurt, believe that other EMS members should adopt policies emulating the West German example. As the Bundesbank stated in its 1981 *Annual Report*, the EMS countries "will have to make even greater efforts to achieve more economic harmony on the basis of the highest possible degree of price stability"; West Germany has had the lowest inflation rate of any EC country each year since the EMS was established. [redacted]

Prospects

Although we believe the EMS will hold together, continued realignments will be necessary, and another one is likely before the end of the year. The French and Italian austerity programs and the June realignment will not be sufficient to stabilize exchange rates over the next few years. The fall of the Spadolini government in early August has delayed timely implementation of some austerity measures. Econometric simulations using CIA's Linked Policy Impact Model suggest that the realignment and the new French and Italian austerity programs, if implemented as announced, will not be sufficient to stabilize EMS currencies through 1983:

- In *France*, the current account would improve by $1.2 billion in 1982 and by $3.4 billion in 1983, and the GNP growth would be shaved about 1 percentage point this year and next; inflation would barely be affected, however, remaining above 12 percent through 1983 if wage-price controls are not continued—Paris maintains that these restrictions are only temporary.

- The *Italian* current account would improve by about $1 billion in 1982 and $2 billion next year. The Italian austerity program would almost eliminate GNP growth this year but would have only a slight effect on growth in 1983. By shaving demand through higher taxes and lower government spending, Rome would trim inflation by about 0.4 percentage point in 1982. There would be hardly any change in 1983 from what would have occurred without the program.

- *West Germany* would remain little affected by the EMS realignment and the French and Italian austerity programs. Because the decline in import prices for goods from France and Italy would offset the drop in export volume to France and Italy, the substantial current account surplus would not significantly change this year. In 1983, when the lagged effects in the other countries would have taken hold, the current account surplus would fall by only $700 million. Inflation is expected to remain at roughly 4 percent through 1983. 25

The difference in inflation rates between France and Italy on one side and West Germany on the other is likely to remain about 10 percentage points through 1983 [redacted] The growing West German current account surplus and a continuing French deficit will compound the difficulty of maintaining the present EMS parities. [redacted] 25

Movement toward the next evolutionary phase of the EMS, creation of a European Monetary Fund (EMF) that would have supranational monetary authority, appears likely to remain blocked for the near future. When Chancellor Schmidt and President Giscard originally broached the idea of the EMS, they called for the EMF to start operations by 1981. The EMS members are little closer to this objective today than four years ago. In the spring of 1982, EC finance ministers refused to agree on minor procedural adjustments to EMS policy coordination because economic conditions were so divergent that more than procedural changes were needed to improve the system's overall performance. The ministers met again in August to consider expanding the scope of the EMS by giving the European Monetary Cooperation Fund responsibility for intervening against third-country currencies, but no progress was made. In a recent interview in *Sparkasse* magazine, West German Finance Minister Manfred Lahnstein ruled out any institutional change in the EMS until the member countries cooperate to develop more complementary economic policies. [redacted] 25

Expanding the role of the ECU, such as making it available for use as an international reserve currency and for private transactions, also is unlikely in the

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near future. Converting the ECU from simply an accounting unit into an actual international currency would require the creation of an issuing authority such as the EMF. 25

The EMS will continue to serve as a rallying point for West European criticism of US economic policy. Until EMS members are better able to coordinate their own economic policies, changes in the value of the dollar will destabilize the EMS. Although today's complaints against the United States focus on the strength of the dollar, a new round of criticism will ensue should the dollar weaken. If internal pressures on the EMS become too great and lead to one or more countries pulling out of the system, West European leaders undoubtedly will place some of the blame for the system's demise on the United States. In any event, continuing policy conflicts between the United States and EMS members over exchange rates are likely to remain a sore point in the US-EC relationship for some time to come. 25