THE EUROPEAN MONETARY SYSTEM – WILL IT REALLY BRING MORE MONETARY STABILITY TO EUROPE?

BY

PIETER KORTEWEG*

1 INTRODUCTION

In March of 1973, after a series of exchange rate crises, the Bretton Woods system of fixed parities finally collapsed. Apart from the currencies in the European snake-arrangement, exchange rates between currencies became unpegged and free to move. Six years later, in March of 1979, after summit meetings in Bremen and Paris, the nine nations of the European Communities (EC) finally launched their new European Monetary System (EMS) aimed at creating a European zone of monetary stability. The period between March 1973 and March 1979 has been marked by substantial exchange rate variability between the currencies of the U.S., Japan, and the EC countries.

Exchange rate variability presents those active in international trade and payments with risks which under a fixed exchange rate system are assumed by the monetary authorities. More exchange rate variability means greater unpredictability of the external purchasing power of currencies and thus more exchange rate risks. Prevention of exchange rate risks implies information and transaction costs. These risks and costs might hamper world trade and payments, thereby adding to stagnation. The EMS was established to reduce the risks and costs that result from exchange rate instability and to insulate the EC economies from the instabilities of the dollar. To that end a grid of parities has been fixed between the EC currencies (with the exception of the pound sterling) which is sustained by an extensive system of financial assistance. In addition, a new European reserve asset, means of payment and unit of account has been created for use among central banks, the European Currency Unit (ECU), which

* Professor of Economics, Erasmus University, Rotterdam. This article is a slightly revised version of a paper prepared for the third meeting of the Shadow European Economic Policy Committee (SEEPC), held May 28–28, 1979, in Paris. In writing it I have greatly benefitted from the many discussions I had with my colleague Dr. Roland Vaubel, and from his writings on the subject, as well as from those of Professors Paul de Grauwe and Theo Peeters of the University of Louvain (see the references).
it is hoped will become a competitive one with existing European currencies and the dollar as an international means of payment.

It is readily agreed that stable exchange rates are favourable to world trade and welfare. This by no means implies, however, that world trade and welfare will be favourably affected when exchange rates are forced to be stable by decree. Fixing exchange rates by decree and keeping them fixed through supporting interventions in the exchange market raises two interrelated issues: One issue has to do with the underlying causes of exchange rate movements. Exchange rates are determined by real and nominal factors, changes in which may be either transitory or permanent. Fixing exchange rates by decree will contribute to their stability only if changes in these determinants are transitory. If, however, the determinants of exchange rates have permanently changed, fixed exchange rates lead to a build-up of inflationary or deflationary tensions that will eventually blow them apart, as witnessed by the history of the Bretton Woods system of fixed parities. A second issue has to do with the fact that in market economies one cannot fix both price and quantity. Specifically, by fixing the rate at which a currency is exchanged against foreign currencies, a country has no choice but to let the market determine its stock of money and international reserves and, consequently, its price level. Exchange rate stability through fixing thus generally means price level instability. Fixing the external purchasing power of a currency leaves its internal purchasing power variable. And it is not clear at all why stable exchange rates should be preferable to stable prices.

In what follows we shall attempt to evaluate the EMS and the chances of its success in achieving a zone of European monetary stability. In order to do so, we shall first give an outline of the past record of monetary instability. Following that, we shall briefly discuss the structure of EMS, its principles and design. We are then ready to consider the questions of whether an EMS would have produced exchange rate stability during the 1970's if it had replaced the Bretton Woods system right after its break-down and whether it will indeed create a European zone of exchange rate stability for the 1980's. Finally, we shall review some other options open for approaching monetary stability in Europe.

2 THE PAST RECORD OF MONETARY INSTABILITY

It is generally agreed that a country's price level mirrors the speed at which that country produces money relative to the speed at which it produces output. If money is produced persistently faster than output, it loses its purchasing power through inflation. Likewise, it is generally agreed that a country's exchange rate vis-à-vis foreign currencies mirrors the speed at which that country produces money per unit of output relative to the speed at which its trading partners