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The European Monetary System and the European Currency Unit

John H. Works Jr.

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Probably the most significant event in the European Economic Community in 1978 was the decision to enact the European Monetary System (EMS) in 1979.[1] During the long, technical arguments in the autumn of 1978, all nine heads of government of the European Community moved to and fro across the continent in the most intensive period of bilateral diplomacy in at least six years.[2] In fact, the efforts that went into the preparation for the EMS kept the European Commission so occupied during the second half of 1978 that it fell behind in proposing major legislation it had planned to submit.[3] The EMS could be the most significant development in the world of international finance since President Nixon officially launched floating exchange rates in 1971 by cutting the dollar free from gold.[4]

The EMS is the European Community's latest effort to come to grips with exchange rate stability as a means toward full integration and harmonization of the economies of the member states.[5] It is three steps in one towards a European central bank, a European monetary union, and a common European currency. The EMS aims to replace national control over domestic economic policy, particularly monetary policy, within the European Economic Community by multinational control. Each country will surrender a part of its sovereignty in economic affairs in return for help from, and a say in, the policies of the others.

The EMS is composed of a parity grid, a divergence indicator, and credit mechanisms. The parity grid defines the bilateral central rates[6] and the permitted margins of fluctuation on either side of these central rates. The EMS specifies a band of 2.25 percent above and below the central rates for all EMS currencies, except for the Italian Lira, which is permit-

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1. [1979] COMM. MKT. REP. (CCH), The Euromarket News, Jan. 4, 1979, at 1.
2. EUROPE, Jan./Feb. 1979, at 8.
3. [1979] COMM. MKT. REP., *supra* note 1, at 1.
4. BUSINESS WEEK, Nov. 6, 1978, at 68.
5. The United Kingdom decided not to join the EMS as a full member. However, it forms a part of the ECU, it has transferred its share of its reserves to the European Monetary Fund, and it has pledged to maintain a "stable" exchange rate. THE ECONOMIST, Mar. 17, 1979, at 74. Ireland is also a member of the EMS. The move was particularly interesting because it marked the end of the one-for-one parity between the British and Irish pounds, a relationship that had been unbroken for nearly 160 years. Wall St. J., Dec. 18, 1978, at 19, col. 1.
6. Bilateral central rates are defined by governments. Market exchange rates are those at which currencies are actually traded against one another by banks, corporations, or indirectly in foreign exchange markets. To keep market exchange rates where they want them, governments must influence their supply of and demand for their currencies by intervening directly in the foreign exchange markets.

ted a six percent band.[7] When the market rate for any currency pair reaches its limit, both central banks are obliged to intervene in participating currencies, to keep the currency within the band.[8] The system expressly provides for adjustments of exchange rate relationships between participating countries by means of changes in central rates, which are subject to the consent of all participants.[9]

The European Currency Unit (ECU) is at the heart of an alternative exchange rate mechanism to the parity grid system, called the divergence indicator. The ECU is not a true currency, but rather a "basket" of currencies, containing specific quantities of the European currencies. They are chosen according to criteria that supposedly reflect the relative size of their economies, of their intra-European trade, national productivity and quotas in support mechanisms.[10] These accounts are also subject to change by unanimous agreement of the member states. The maximum divergence represents an outer limit of permissible foreign exchange rate movement, and the EMS has fixed a "trigger" at seventy-five percent of the maximum. The divergence indicator obliges no government to take specific action, although there is a "presumption" that adequate corrective measures will be taken.[11]

The EMS also provides for credit mechanisms in order to intervene in the foreign exchange markets. Credit to support the EMS is dispersed through three mechanisms ranging from very short-term credit to medium-term financial assistance. About twenty-five billion ECU's are effectively available for credit.[12] To create an initial stock of ECU's, each member was required to deposit at least twenty percent of its holdings of dollars and gold in a "European Monetary Fund," against which it receives and equivalent amount of ECU's.[13]

In its two-year history, the EMS has performed rather well. Despite the sharp crude oil price rises, the average fluctuation of each national currency in 1979 amounted to only 1.9 percent compared to 5.2 percent during the preceding six years. That made 1979 the most stable year for EEC currencies since 1972.[14] Aside from two minor adjustments in the exchange rates in September and November 1979, there have been no other events to mar the system's operation.[15] Additionally, the New Com-

7. Wall St. J., Dec. 13, 1978, at 10, col. 3.

8. Intervention in participating currencies is compulsory when the intervention points defined by the fluctuation margins are reached. Res. No. 32/1978, Dec. 8, 1978, of the European Council, [1978] 3 COMM. MKT. REP. (CCH), ¶ 10,095.

9. *Id.*

10. Carreau, *Vers Une Zone de Stabilité Monétaire: la Création du System monétaire Europeen au Sein de la CEE*, REVUE DU MARCHÉ COMMUN, Sept. 26, 1979, at 413.

11. *See* note 8 *supra.*

12. MONETARY REPORT OF THE DEUTSCHE BUNDESBANK, Mar. 1979.

13. *See* note 8 *supra.*

14. THE ECONOMIST, Mar. 8, 1980, at 56.

15. The finance ministers of the EMS raised the value of the Deutsche Mark two percent against six other EMS currencies and five percent against the Danish Krone in the first

munity Instrument (NCI or the Ortoli Facility), was officially instituted by a decision of the European Council on October 16, 1978.[16] It was decided to allow less prosperous member states to borrow a maximum of five million ECU's for a period of five years, divided into annual installments of one million ECU's, and to allow member states a three percent interest rate subsidy. The first loans from the resources of the NCI were signed in Brussels on December 17, 1979, and were made to Ireland, Italy, and the United Kingdom. The loans are for investments in energy schemes, water and sewerage infrastructures, and road and telecommunication improvements.

The concept of a European monetary system is neither new nor novel. Informal arrangements linking European currencies have existed in one form or another since the beginning of the twentieth century, and more formal arrangements have existed since the Second World War. In fact, one of the ultimate goals of the European Economic Community, which came into existence on January 1, 1958, was the attainment of a European Monetary System. But one of the fundamental obstacles in examining the Articles of the Treaty of Rome relating to monetary policy is the very limited nature of the commitments they contain in contrast to other often exacting obligations of other sections of the Treaty. Article 107 is the only treaty provision relating directly to foreign exchange rate policy.[17]

The EMS is a sign that Europe's slow march toward greater economic unity has not yet been arrested. By tying their currencies together and by creating a new reserve unit, the Europeans may hope to build a new global monetary order composed of three currency blocs: the dollar, the ECU, and the yen.[18] In addition, a common currency, which will undoubtedly become attractive to others for private transactions and official reserve purposes, might enhance Europe's bargaining strength in international monetary discussions. To do this, the ECU would have to move from its present status as an accounting unit, designed to help the eight members maintain a reasonably stable exchange rate system, and into the

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realignment of the six-month old EMS, on September 24, 1979. Wall St. J., Sept. 24, 1979, at 4, col. 1. The second realignment of the EMS currencies took place on November 30, 1979, when the Danish government devalued its krone by five percent against the other currencies of the EMS. BULL. EUR. COMM. (CCH), Nov. 1979, at 30.

16. O.J. EUR. COMM. 298, Oct. 25, 1978.

17. Article 107 provides:

> Each member state shall treat its policy with regard to rates of exchange as a matter of common concern. If a member state makes an alteration in its rate of exchange which is inconsistent with the objectives set out in Article 104 and which seriously distorts conditions of cooperation, the Commission may, after consulting the Monetary Committee, authorize other member states to take for a strictly limited period the necessary measures, the conditions and details of which it shall determine, in order to counter the consequences of such alternatives.

Treaty Establishing the European Economic Community, Mar. 25, 1958, 298 U.N.T.S. 57.

18. LE NOUVEL OBSERVATEUR, Mar. 12, 1979, at 44.

hands of commercial banks. From there it would not be a large step for the ECU to become real money. It would, however, be a considerably larger step for it to become a world-wide reserve currency. The development in the past fifteen years of various units of account (official ones like the Special Drawing Rights of the International Monetary Fund, and a number of privately computed ones) for such purposes has not been particularly encouraging; acceptance has been slow and halting on the whole. Yet, the possibility cannot be ruled out that after a certain lead-in period the ECU might do better.

Though timely exchange rate adjustments will be required to make the EMS work in the medium term, over a longer period the ambition is to move forward to a system requiring fewer and fewer adjustments and eventually into a ture monetary union. Real progress toward that goal will require a very considerable harmonization of economic policies, of which the coordination of monetary policy will be paramount. The real bar to European economic integration is the fact that the currencies of the member states are still not fully convertible with each other. The strength of Western Europe as a political and economic entity depends upon their ability of member states to perceive common problems and to act together toward their solution, and to create in a concrete way a factual solidarity among them to establish common bases for their economic, social, and political development. In view of the instability in the world economy, it seems that full economic and monetary integration in Western Europe will remain a long-term aim, rather than a practical consideration in the 1980's.

John H. Works, Jr.