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The European Monetary System and the International Exchange Rate System 1/

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I. Introduction

The present paper is not an attempt to deal in either a systematic or programmatic way with the position of the European Monetary System (EMS) within or vis-à-vis the international exchange rate system, but instead discusses rather pragmatically some thoughts on this subject. The section immediately following examines the experiences with the EMS, taking into account its special features, with a view to answering the question whether and to what extent these experiences are applicable to the international exchange rate system. In a further section, the relaionship of the EMS to the U.S. dollar, the most important currency of the international exchange rate system, and the question of a common dollar policy of the EMS central banks are addressed.

II. Experiences with the EMS and the International Exchange Rate System

1. Particular features of the EMS

There is no need to describe here in detail the structure and functioning of the EMS: this has already been done at length a number of times. 2/ Nonetheless, some particular features of the EMS that are important in this context should be mentioned briefly. The EMS is not simply a regional Bretton Woods System (BWS), although it has been described as such on numerous occasions. Unlike the BWS, it has no

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1/ This is the English version of a paper, prepared in German, for a seminar on "Monetary Stability and Economic Growth" organized by the International Monetary Fund in cooperation with the Austrian National Bank in Baden, Austria, on October 11-14, 1983.

2/ See, e.g., IMF Survey, March 1979, Supplement; Deutsche Bundesbank, Monthly Report, March 1979; Commission of the European Communities, The European Economy, July 1979; International Monetary Fund, Occasional Paper No. 19, The European Monetary System: The Experience, 1979-82, Washington, May 1983, by Horst Ungerer, with Owen Evans and Peter Nyberg.

common central point. Even leaving aside fluctuation margins that are wider than those that existed in the BWS, EMS exchange rates are set less rigidly than were those in the BWS. There, they could be changed only in case of a "fundamental disequilibrium." The original text of the IMF Agreement required consultation with, and the "concurrence" of, the IMF. Although the EMS belongs to the area of monetary policy, it reaches beyond this and involves clearly a dimension of European or, in other words, integration policy. The goal of "greater stability at home and abroad" 1/ was considered important to the healthy economic development of the participating countries, and furthermore it was hoped that such stability would provide new impetus for further progess in the economic integration of the European Economic Community (EEC) and improved convergence of economic developments, not only in the short term (equilibrium-oriented) but also, as referred to in the Preamble to the EEC Treaty, in the long term (growth-oriented). Although the EMS was not mentioned expressly in the Resolution of the European Council of December 5, 1978, the EMS was also seen as an important step toward a currency union and thus toward closer political cooperation. We may assume that, at least in some circles, there existed the expectation that the EMS and the emphasis laid on exchange rate stability would also have a positive effect on the operation of the common agricultural policy of the EC.

2. The Present International Exchange Rate System

What does the international exchange rate system into which the EMS was introduced look like today? It is often said that it is actually more of a "nonsystem" than a system, because there existed no binding rules and no clearly established relations. In fact, the present system has no clear orientation points such as gold or the U.S. dollar. Nonetheless, this line of argument is not completely convincing. Article IV of the amended IMF Agreement includes, it is true, only very vague principles for setting exchange rate policy; these require extensive interpretation and contain no clear, unambiguous rules of conduct. It is also true that in the present system not all currencies are based either on fixed exchange rates or on free floating; instead, various exchange rate regimes exist side by side and a clearly defined center is absent. We have, then, a multicurrency system in which a number of centers of gravity exist, and in which relationships and groupings, while in permanent flux are nevertheless clearly defined, not so much in the sense of legally binding rules but of economic interdependence. The present exchange rate system reacts like a system of linked pipes to exogenous and endogenous impulses; it requires observation, assessment and response by appropriate measures. In principle, matters were the same in the BWS, because it too was a system in which equilibrium was not attained automatically. In the present system, groups of currencies arrange themselves around those centers of gravity, forming the dollar zone, the EMS (plus the other European currencies oriented toward it), the franc zone. Although no

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1/ Resolution of the European Council of December 5, 1978 on the establishment of the European Monetary System and related matters.

other currencies are associated with the Japanese yen, for many countries this does not limit the yen's importance; accordingly, the yen is included in the currency basket of a number of countries. Under the IMF classification only eight currencies are considered to be "freely floating," among them, however, such important currencies as the U.S. dollar, the Canadian dollar, the pound sterling, and the Japanese yen.

The problem with the present international exchange rate system thus lies not so much in the fact that the majority of currencies are not subject to an (self-imposed) exchange rate regime with certain implied rules, but rather in that the most important currencies fluctuate vis-à-vis one another. As a result, many countries with close trade and financial ties to more than one country with an important currency often confront a dilemma in their exchange rate policy. Requirements for maintaining domestic monetary stability can, for example, conflict with those of international competitiveness if the geographical distribution of imports and exports does not coincide. The difficulties with major currencies (a group of currencies in the case of the EMS) fluctuating against one another are the main reason for the repeated calls for a "reform" of the international exchange rate system and even for a conference modeled on Bretton Woods; such calls reflect the belief that it would thus be possible to arrive again at a system with universally fixed or unambiguously determined exchange rates. A particular cause of complaint is that the present system exercises no disciplinary pressures for a better coordination of economic policies and therefore fails to lead to more convergent economic developments. Furthermore, the present system provides no guarantee that exchange rates are attuned to the evolution of "fundamentals." The results are said to be misalignments stemming from massive overshooting, both over the short and the long term, persistence of "incorrect" exchange rates or even trends that run counter to the evolution of fundamentals. In this context, it is frequently overlooked that exchange rates are simply prices that bring the supply and demand for foreign exchange into balance, irrespective of whether supply and demand arise in connection with trade, service, or financial transactions. There is reason for believing that financial transactions are of considerably greater magnitude than trade or service transactions and are therefore a more important factor in determining exchange rates. Financial transactions often move in one direction only while transactions in trade and services tend to compensate for one another, and a sudden reversal of direction is not conceivable. Furthermore, financial transactions react much more quickly to changes of such data as interest rates, economic forecasts, or political events. In addition to fundamentals, relative interest rates thus play a very important role in determining exchange rates: perhaps we should get used to the idea of considering interest rate relations, too, as fundamentals. Another factor is the--unquantifiable--effect on capital flows of reactions and expectations in both the political and economic spheres. No "reform" of the international exchange rate regime, no matter how conceived, can alter the influence of these factors on exchange rates. Any attempt at reform would have to begin precisely with these factors, i.e., with the formulation and sequence of decisions and developments not only in the areas of monetary and economic policy but in the last analysis also in the general political arena. It is obvious that such a task would go far beyond institutional and technical changes in the monetary field. Another "solution"--of quite a questionable nature--would be once again to abolish, to a large extent, free capital movements. In this context, it is interesting to note that the IMF Agreement scarcely addresses problems of capital movements and that the BWS began to falter at the time when, in addition to the dollar's destabilization (and in part caused by it), relatively large capital movements, particularly of a short-term nature, assumed ever greater importance.

After these general observations, a number of important aspects of the EMS will be examined, with a view to determining the extent to which the experience with the EMS provides a point of departure for efforts to improve or change the international exchange rate system.

3. Exchange Rate Variability

Since the inception of the EMS, the variability of the nominal and real exchange rates of EMS currencies 1/ among themselves has decreased markedly, compared both to the pre-EMS period and, during the same period, to currencies that are not participating in the EMS. This occurred despite several central rate changes within the EMS. The same can be observed for those European currencies that are strongly oriented toward the EMS, such as the Austrian schilling, the Swiss franc, the Norwegian krone and the Swedish krone. 2/ The central rate changes in the EMS, by and large reflected changes in fundamentals, although speculation and capital flows have influenced the timing of the most recent realignments of exchange rates. One interesting example for taking into account the evolution of fundamentals and not yielding to strong market pressure was the deutsche mark which was not devalued in October 1980 and February 1981. On the other hand, attempts to resist the development of fundamentals and to avoid an exchange rate adjustment by using monetary and foreign exchange policy measures proved unsuccessful over the long run. A change in the exchange rate usually occurred a few months after the initial period of strain. 3/ Short-term overshooting was halted in the EMS by the intervention obligation of the system, with, interestingly, the maintenance of narrower margins within the bands by some countries exerting an additional beneficial effect. In the longer run, overshooting and misalignments (or, in other words, market pressure on exchange rates contrary to or in excess of the trend indicated by fundamentals) were avoided because the market was convinced of the authorities' determination and ability to defend what they considered correct exchange rates or to sustain an exchange rate trend considered to be correct.

1/ Throughout the paper, the term "EMS currencies" is applied to those currencies which participate in the exchange rate mechanism of the EMS, i.e., the EC currencies except the pound sterling and the Greek drachma.

2/ See International Monetary Fund, Occasional Paper No. 19, p. 9.

3/ Occasional Paper No. 19, p. 5 and Table 1.

In the worldwide context, such a choice, among, for example, the deutsche mark, the U.S. dollar, the Japanese yen, or the pound sterling would be far less clear. Also, economic and monetary influences are far more strongly overlaid by political influences than in the EMS. This has been repeatedly revealed over past years in connection with various international political crises (e.g., Poland, Afghanistan, the Middle East), as well as by domestic political developments. Another reason is that financial markets within the EMS have a very different degree of development and are not equally open to capital movements across national borders. In view of the relatively advanced degree of development and the liberalization of financial markets in the Federal Republic of Germany, movements of capital within the EMS may not be as easy as those between the deutsche mark and the dollar. 1/ Another factor that affected the average exchange rate variability is that central rate changes often failed to trigger immediate changes in market rates, or, these latter were considerably less pronounced than the changes in central rates. Strong swings in market rates were therefore absent.

Seen in this light, the greater stability of exchange rates in the EMS is, in essence, a result of factors that do not exist, or exist to a far lesser degree, in a worldwide context. Among these is also the authorities' determination to uphold, for reasons both of monetary and stability policy ("hard currency policy") and integration policy, the official central rates, as far as possible and justifiable. An important role undoubtedly was played also by the fact that a definite "stability hierarchy" existed among the small number of currencies participating in the EMS and that the medium-term problems of the EMS countries with respect to unemployment, industrial structure, and growth prospects are fairly similar while differing clearly from those of the U.S. economy (more dynamic, less vulnerable) or of the Japanese economy (relatively strong growth and a more modern structure).

4. Convergence

The concept of convergence, which has become fashionable in recent years, and which in part simply replaced concepts such as coordination or harmonization, is somewhat vague and is frequently used to mean very different things. No attempt will be made here to define in more detail the concept of convergence--this has already been tried elsewhere. 2/ It will be merely pointed to the important distinction between a convergence of policies and a convergence of developments, and the possibility that convergent economic developments may well require divergent, although compatible, policies. In addition, it is assumed that, for the EMS, convergence means domestic monetary developments that result in relatively stable costs and prices. Such convergence--it is argued--is an important, perhaps even the decisive, condition for greater exchange rate stability and is therefore a basic prerequisite for long-term balanced growth and for greater integration of the European economies. Whether the convergence

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1/ See also International Monetary Fund, Annual Report 1983, p. 51.
2/ See International Monetary Fund, Occasional Paper No. 19, p. 10.

of nominal variables actually leads to the long-term convergence of real variables--industrial structure, productivity, employment and living standard--is not easily proved. A "conflict of convergences"--or, in other words, a conflict between short-term and long-term objectives--is conceivable, if in economies with different economic and social structures stable nominal exchange rates and stable costs and prices are simultaneous goals, and monetary policy is aimed at both. This can adversely affect investment and with it the structure of the economy as well as growth. The debate on convergence has thus far devoted insufficient attention to this question.

The self-interests of the EMS countries and their common interest in integration may explain why in the early years of the EMS--although original aspirations were undoubtedly not met--yet wider divergence of economic developments could nonetheless be prevented; and, even more, why since about 1982 clear indications of convergence of economic policies (i.e., orientation toward common objectives), could be noted. One can reasonably assume that the various stability-directed measures in the areas of incomes, monetary and financial policy in Denmark, Belgium, France, even--if only to a limited extent--in Italy, would not have come into being without the EMS and the interest in its continued existence, or that these would have been more limited in scope or much slower in coming. Whether the convergence presently emerging will ultimately be enough for a satisfactory perfomance of the EMS is another question.

This can, however, be contrasted with the observation during the same period of a far greater convergence of nominal variables among the United States, the United Kingdom, Japan, and Germany. Does this not prove that convergence can also occur without the constraint of a common exchange rate system or the influence of integration considerations? In this regard, one could argue that a greater convergence of price developments (because that is what actually occurred) obviously does not suffice to achieve more stable exchange rates: greater convergence or compatibility of budgetary and monetary policies, particularly interest rate policy, is indispensable. Additionally, the convergence of the nominal variables in these four countries is to a large degree the result not of common and deliberately coordinated actions but of a favorable, perhaps somewhat coincidental, constellation of election results. While a stability-oriented policy was followed consistently over many years in Germany and Japan, the situation might have been different in the United States and the United Kingdom had the election results been different. Nonetheless, this is not to deny the existence of a similar trend in general economic thinking in a number of important industrial countries.

While in the EMS convergence toward stability is called for not only with reference to monetary policy but also to integration policy, in a worldwide context, the situation is different. Only if the governments that are in power perceive efforts to attain stability as clearly within their own--one is tempted to add short-term--monetary policy interests (frequently defined in terms of domestic policy) is such a policy pursued;

other determining factors play scarcely any role. It can hardly be assumed that a worldwide system of stabilized exchange rates (e.g., using target zones), and the institutions charged with its supervision, would exert sufficient pressure to bring a government to act contrary to what it feels are the interests of the country. The chance of achieving in this way the convergence necessary for the proper functioning of a system of fixed exchange rates appears smaller globally than within the framework of a small group of countries with strong common political interests. It may be, in addition, that the already mentioned conflicts between different objectives--whether they are real or perceived is irrelevant--may occur more frequently and be more pronounced on a worldwide scale than in the more similarly structured countries of the EMS.

5. Changes in Official Exchange Rates and Other Questions of Institutional Operation

At the start of the EMS, the fear was frequently expressed that the necessary exchange rate adjustments would not be undertaken in a timely fashion or to the extent necessary. After more than four years of experience with the EMS, it can be noted that these fears were exaggerated. Central rate adjustments were, on the whole, undertaken in a timely fashion (with perhaps one exception), to the appropriate extent and in the right direction. They have, however, increased in magnitude and frequency, and since mid-1981, they have not escaped troublesome side-effects. This has led to suggestions to eliminate the need for common decisionmaking in exchange rate adjustments and to introduce a kind of crawling peg in place of relatively large adjustments in irregular intervals. In my view, these suggestions are mistaken. To leave the decision solely with the particular national authorities would eliminate the healthy pressure from the other participating countries to avoid insufficient as well as excessive adjustments and--perhaps even more important--to take simultaneously stabilization measures. The latter speaks also against the introduction of a crawling peg: the pressure to make domestic adjustments that is inherent in the system would be significantly reduced, and the possibility of making use of the shock effect of a relatively large exchange rate adjustment for implementing a stabilization policy would not exist. It is interesting in this context that the large central rate adjustments of the last two years in the EMS were the first to be accompanied by domestic adjustment measures. Whether the avoidance of speculative profits, which are nearly bound to occur in large and perhaps somewhat delayed adjustments, is always more important than the opportunity to reorient more fundamentally economic policy is at least open to question.

Globally, an exchange rate system such as that of the EMS, in which all exchange rates are related to one another, is probably impossible. A common fixed point such as the dollar or the SDR would probably be necessary. Choosing the SDR might result in difficulties similar to those discussed in the early phase of discussions about the creation of the EMS, when a system of intervention based on the European Currency Unit (ECU) was under consideration. 1/ Exchange rates would be linked to the SDR, but intervention would have to be undertaken in actual currencies, i.e., chiefly in U.S. dollars. But this would be very close to a system based solely on the dollar. Such a system would assign the dollar a role very similar to that under the Bretton Woods System: exchange rate adjustments would be decided unilaterally, and the United States would have to accept such decisions more or less passively. If the dollar were weak, the problem of the accumulation of large, unwanted dollar reserves would occur again, unless the United States intervened in other currencies, obtained the necessary credits to do so, and made the necessary domestic adjustments. Common decisionmaking, as practiced in the EMS is also difficult to imagine in a worldwide context. Were, for example, the authority for making such common decisions given to the Executive Board of the IMF, it is doubtful whether in this body (which does not have the political weight of ministers, as in the case of the EMS) could exact the same pressure for appropriate exchange rate changes and their combination with the appropriate domestic adjustment measures. In addition, multilateral realignments of exchange rates would be significantly more difficult to implement. The principal objections to a global system of fixed exchange rates are, however, not primarily institutional, but exist, as noted above, with regard to the problems of convergence and the factors which determine exchange rates.

It has frequently been discussed whether a multilateral intervention system would be useful in the worldwide context. Ignoring for a moment the fact that even in the framework of the EMS, no more than approximately half (or fewer) of interventions occur in participating currencies, the efficient management of such a system would entail many difficulties. Close cooperation--presently successfully practiced in the EMS and stemming from the "snake" period--among the central banks concerned would be necessary. This would be extremely complicated, because of the large number of participants but also for technical reasons, such as international time differences. Even more difficult than those problems of coordination (which are already dealt with, albeit on a limited scale and restricted more or less to an exchange of information, in the framework of telephone concertation among the most important of the world's central banks) would be questions of financing and the granting of short-term credits for intervention purposes. In this area, too, a feeling of political solidarity undoubtedly plays some role in the EMS.

When the EMS was designed, a certain amount of attention was devoted to the divergence indicator. It was perceived as an important innovation and was praised as an instrument for implementing greater convergence together with a more symmetrical distribution of the adjustment burden. In fact, apart from bringing about certain interest rate policy measures, the indicator has not played an important role. This is partially attributable to the fact that its operation was restricted and distorted

1/ See International Monetary Fund, Occasional Paper No. 19, p. 15.

by the absence of the pound sterling from the EMS exchange rate mechanism and by the larger fluctuation margins of the Italian lira. In addition, because of the way it was designed, the indicator could only have worked toward a convergence of nominal variables, such as prices, on an average level. While this would have meant greater symmetry, it would have been in conflict with the objective of achieving greater domestic monetary stability.

III. The EMS and the U.S. Dollar

The U.S. dollar continues to be the most important transaction and reserve currency in the international monetary system, and the relationship between the dollar and the EMS currencies therefore merits particular attention. Virtually all European countries, as well as a number of non-European countries that have close economic ties with both the United States and the EMS countries, are strongly affected by it. The EMS countries themselves stand in the shadow thrown by the U.S. economy and therefore depend greatly on the exchange rate relationship between the dollar and their currencies.

When the EMS was founded, there was much talk of the European currencies breaking away from the dollar. Greater independence from unforeseen changes in U.S. monetary policies and the establishment of a European monetary "identity" were offered in part as important reasons for founding the EMS. In Germany there was also the expectation that the EMS would shield the deutsche mark somewhat against the dollar; this expectation was based on the assumption that capital flowing out of the dollar in search of investment would be spread over a number of EMS currencies, and that possible sharp rises in the deutsche mark could thus be moderated. From the outset, both expectations were probably unrealistic, or at least greatly exaggerated. Because of the close economic interdependence of the European countries and the United States, every marked change in the cyclical position or in fiscal and monetary policies of the United States is having a strong effect on the European economies and therefore on exchange rates. Ironically, were European monetary policy to have an even more pronounced "identity," e.g., as a result of limiting exchange market intervention exclusively to EMS currencies, without compensating dollar intervention, the European currencies would be brought into an even more direct relationship to economic and monetary developments in the United States and even greater fluctuations in the dollar exchange rate would result. Again, the only "solution" would be to use wide-ranging capital controls to insulate the European currencies.

The hope that the EMS would shield the deutsche mark to some extent was also probably rather unrealistic. The deutsche mark, because of its relative stability and the breadth of its financial market, is the only alternative reserve currency within the EMS; it has also maintained its position within the EMS as the most stable of the major EMS currencies.

The real reason why the deutsche mark's role as a reserve currency has not increased the tensions in the EMS to the extent originally feared is that the dollar has been markedly stronger during the life of the EMS than in the preceding years. At most, it is possible to determine that with a commensurate interest rate differential and with unchanged nominal exchange rates in the EMS in the short run, e.g., for the period immediately following an adjustment of the central rates, capital would temporarily have sought investment in EMS currencies other than the deutsche mark, normally after it had been invested in deutsche mark before the exchange rate realignment. Had the deutsche mark continued to be strong vis-à-vis the dollar over the last four years, there would certainly have been pressure for its appreciation, with consequent tensions in the structure of EMS exchange rates. If it would have been possible to deflect somewhat the pressure on the deutsche mark to other EMS currencies, other difficulties in areas such as exports and employment would have cropped up, and these would themselves have ultimately led to tensions in the EMS.

Because of the problems attributed to U.S. monetary policies, and because of the direct effect of these policies on exchange rates for European currencies, there are repeated calls for a common dollar policy or for the adoption of a common position toward the dollar. The idea here is not so much fixed exchange rates for the dollar as it is "target zones," and "probability zones" for exchange rates or an intervention policy that would be coordinated from the outset. Quantitative guidelines for dollar interventions and the multilateralization of bilateral swap lines with the Federal Reserve Board of New York have also been suggested.

Given the present circumstances, a common dollar policy for the EMS countries is difficult to imagine. In this regard, the question of whether there exists a European Monetary Fund is largely irrelevant. Two basic conditions must be met before a common dollar policy can be developed and implemented. Firstly, such a policy can effectively be implemented only in accordance with the United States. Given the present position of the U.S. authorities on intervention, which are prepared to undertake intervention only in case of significant disruptions of the exchange markets, the first condition remains unmet. The other condition involves weighing the various interests and priorities of the EMS countries that touch on the dollar exchange rate. But that is a highly political issue. These problems cannot be solved on the basis of institutional arrangements or compromises within the more narrow, technical framework of exchange rate and monetary policies. Instead, agreement on basic questions of the balance of payments, financial policies and overall stability policy is required.

Economic relationships between EMS countries and the United States vary greatly. Foreign trade structures show geographical and sectoral differences, and financial transactions vary in significance. Even the dependence, in the energy field, on imports priced in dollars is less pronounced for the Netherlands (excluding the United Kingdom, not presently a full EMS member). One could also point to the varying degrees of interdependence in the field of foreign policy. In the area of exchange policy per se, the unique role of the deutsche mark as alternative reserve currency creates special problems for domestic liquidity management in Germany. It is therefore understandable that the German authorities have raised the strongest objections to attempts to use institutional arrangements to move toward a common dollar policy. In this regard, the situation with respect to the deutsche mark has changed. Whereas originally, at least in some circles, it was hoped that the EMS could ease the special interdependence of deutsche mark and dollar, it has now become apparent that it is precisely this interdependence that stands in the way of a common dollar policy.

It has been pointed out a number of times that in fact an EMS dollar policy exists. While this was not a policy agreed on in advance, it was ultimately, the dollar policy of the Deutsche Bundesbank. The natural consequence of the deutsche mark's importance in the framework of the EMS and the international exchange rate system is that the Bundesbank's dollar transactions have a very strong impact on the relationship between the dollar and the EMS currencies. The Bundesbank, making use of the numerous contacts and coordination mechanisms of the central banks, strives to avoid acting contrary to the interests of other EMS participants. To conclude, however, that the Bundesbank alone determines the relationship between the dollar and the EMS would be a simplification. The Banca d'Italia, for example, intervenes almost exclusively in dollars, sometimes with considerable sums, and the Banque de France has undertaken large-scale dollar interventions on a number of occasions. Such interventions affect the supply of dollars in exchange markets and thus the dollar exchange rates for third currencies. They are undertaken before the currencies in question reach their intervention limits vis-à-vis other EMS currencies, thereby preventing these limits from being reached, which would trigger interventions in EMS currencies.

It can be assumed that EMS central banks generally examine their dollar transactions for their possible effects on other EMS currencies, or, at least, that they attempt to avoid transactions that are not consistent with one another. It does not, however, appear to be always the case that possible problems raised by the choice between intervention in EMS currencies and in dollars and the effect on the international exchange rate structure have always been sufficiently taken into account. Intervention in dollars is not always undertaken solely with the object of directly influencing the relationship of a given currency to the dollar, but often primarily to influence relationships among exchange rates within the EMS, while the effects on the exchange rates for third currencies are of secondary importance. This is explained, among other things, by the fact that a number of EMS countries deliberately strive for narrower margins for their currencies than those allowed in the EMS (this applies particularly to Italy, with its relatively wide margins of $\pm$ 6 percent for the lira, compared to margins of $\pm$2 1/4 percent for all other EMS currencies). In addition, other EMS currencies are not made automatically available for purposes of intramarginal intervention, and very short-term financing under the EMS agreement does not apply to such intervention. At the same time, EMS central banks may only hold other EMS currencies as working balances in limited amounts. The possible consequences for the international structure of exchange rates of the choice of intervention currency by the EMS central banks explains the particular interest outside countries and the IMF have in the operation of the EMS and in the intervention policies of EMS central banks.

The difficulty of establishing a common dollar policy for the EMS in advance does not mean that there are no ways of adequately taking into account the importance for the EMS and the international exchange rate system of the relationship between the dollar and the EMS. There is another factor in addition to the problem of consistency of dollar transactions by EMS central banks within the EMS and the consequences of such transactions on third countries. It is quite conceivable that a more active policy of intervention by the U.S. authorities and closer cooperation between the United States and the EMS countries in this area could have a smoothing effect on exchange rate developments. Although it was admitted above that the problems of overshooting and misalignment have a different dimension in the European than in a worldwide context, there are signs that the market perceives exchange market intervention as signalling both the exchange rate developments the authorities consider desirable and realistic and their determination to work toward them.

The decisive problem affecting the relationship between the dollar and the EMS is ultimately, just as it is in the EMS, the achievement of greater convergence and consistency of policies and developments. The last one or two years have revealed that the convergence of inflation rates is not enough. Instead, it is necessary to strive for greater compatibility among the broader objectives and measures of economic, fiscal, and monetary policy. The absence of a common interest in integration and the implicit willingness to balance conflicting interests, as it exists among EMS countries, makes this task significantly more difficult.

IV. Concluding Remarks

The foregoing considerations have been an attempt to show that the achievements in terms of exchange rate stability and convergence recorded thus far in the EMS--modest as they may be compared to original expectations--can be largely attributed to particular features of the EMS. It would be a mistake to conclude from the experience of the EMS that the same could be expected at the global level from a return to a system of fixed, but adjustable exchange rates: the political and economic conditions are too different.

Returning to a system closely modeled on the Bretton Woods System has, of course, hardly been suggested. Rather, ideas and suggestions have tended in the direction of establishing institutionally more stable exchange rate relationships and setting more clearly defined obligations to intervene in order to guarantee these. In this respect, the concept of "target zones" is of particular interest, despite the frequent lack of clarity about methods for their determination, their possible magnitude, or the accompanying obligations to intervene. 1/ Attempts to formulate such target zones or an intervention policy that is set in advance--and, possibly, defined by rules--for the relationship of the EMS currencies to the U.S. dollar (representative here of all the more important non-EMS currencies) would face many difficulties. Apart from questions of technique or of monetary policy in the narrow sense, the political willingness and ability to make the necessary compromises and to stick by the resulting agreements and commitments are of particular importance.

Nonetheless, some possibility of achieving greater cooperation and coordination in intervention policy, within the EMS as well as between the EMS and the United States, appears to exist. In the longer term, however, any coordination of intervention between EMS and third countries, whether ambitious or modest, would fail without a wide-ranging understanding on the compatibility not only of monetary policy, but also of other areas of economic policy, which might touch on other important areas of foreign and domestic policies.

1/ For recent and more detailed proposals see: John Williamson, "The Exchange Rate System," Institute for International Economics, (Washington DC, September 1983); H. Johannes Witteveen, "Developing a New International Monetary System," lecture before The Per Jacobsson Foundation, (Washington DC, September 25, 1983).