THE VIABILITY OF THE EUROPEAN MONETARY SYSTEM
A Comment on the Papers by Vaubel and Fratianni

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This is the second time in recent months I have commented on papers concerned with the European Monetary System (EMS). The first time, at a conference held in April at the Brookings Institution, the authors of most of the papers were European government officials and were strong proponents of the EMS. Therefore I felt my comments could be most constructive if I focused on my doubts about the viability of the new arrangements. As the devil's advocate, I suggested that the EMS could prove to be a shaky system--especially if the objectives motivating the European governments were poorly conceived (see Trezise, 1979).

Roland Vaubel and Michele Fratianni, as their papers show, are arch-critics of the EMS. For this audience, moreover, there is little need for me to supplement their critical comments. I am, thus, prompted to be the devil's advocate in the opposite direction from my comments at the April Brookings conference. I shall argue that Vaubel and Fratianni are excessively skeptical and that the EMS *could* prove to be more viable than they believe.

Exchange-Rate Variability: Some Analytical Background

In order to put my comments into an analytical context, I need to summarize the two dominant intellectual attitudes about variability in exchange rates and indicate my assessment of them.

The first view may be termed the *untrammeled market position;* it is widely held among North American economists and officials, but it is encountered elsewhere as well. It asserts that every nation should pursue appropriate domestic macroeconomic policies and then permit currency values to be determined in the foreign-exchange market without intervention by central banks or governments.

The second view may be labeled the *minimum variance position.* It is widely held in Western Europe and Japan, but not in those nations alone. Those holding this view emphasize the uncertainties and disruption that may be associated with exchange-rate movements and argue that governments should act to "maintain as much exchange-rate stability as possible." EMS advocates who

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identify a "zone of monetary stability' in Europe as the prime objective of the arrangements appear to take this position, at least for fluctuations of exchange rates among Community currencies.

To provide an analytical framework for evaluating these two views, imagine an open economy in which external trade is important, banks and nonbanks have significant amounts of assets and liabilities vis-à-vis foreigners, and restrictions on capital flows are not sufficiently comprehensive to prevent shifts in assets when changes occur in expectations about exchange rates and interest rates. Policy actions and nonpolicy disturbances originating abroad have more than trivial effects on the home economy, and vice versa; but, typically, the effects are greatest in the originating country. In short, imagine the situation of *intermediate interdependence.*

Make the further assumption that the primary concern of a nation's policymakers is with national objectives; e.g., with levels of employment and prices at home. Little or no welfare value is attached to developments in employment or prices abroad, except as feedbacks are perceived to affect the home economy. Policymakers consider themselves free to adjust the instruments of macroeconomic policy as they deem best. As is the case under the current Articles of Agreement of the IMF, assume that there are no binding supranational constraints on movements of exchange rates and external reserve assets.

Now, ask the question: how should the home nation's policymakers respond–in particular, should they or should they not allow the exchange rate to move–when various types of nonpolicy disturbances occur?

Consider first a boom in economic activity that originates abroad, caused by an unexpected fall in the foreign savings rate and an unexpected surge in foreign business investment. That disturbance generates *incipient* pressures on both the foreign and the home economies; market interest rates abroad tend to rise, the home currency tends to appreciate, and home interest rates tend to rise. *Actual* adjustments in financial variables depend on how domestic monetary policy is implemented at home and abroad and on the extent, if any, of exchange market intervention.

If the home country's central bank chooses to resist its currency's tendency toward appreciation, its external reserve position strengthens. Exports rise, domestic real output rises, and some upward pressure is exerted on the domestic price level. When the exchange rate is held fixed, the foreign boom is transmitted to the maximum possible extent to the home economy.

If, on the other hand, the home currency is allowed to appreciate, the adverse effects of the foreign boom on the home economy are lessened. Domestic output and prices are likely to be higher than they would be if there were no foreign boom, but by smaller amounts than if the exchange rate is held fixed.

Policymakers of the home country would thus have reason to reject exchange-rate "stability" in these circumstances. Appreciation of the home currency, while not desired for its own sake, would help to buffer domestic variables from a disturbance originating outside the home economy.

Consider next a boom that begins at home in response to an unexpected surge in consumption and investment spending by the home country's residents. The incipient pressures on financial variables now include tendencies for the home currency to depreciate and for market interest rates to rise at home and abroad.

If the central bank holds the exchange rate stable, the external reserves of the home country fall. Domestic output and employment rise, and prices are under upward pressure. But as imports rise, some of the expansionary impetus of the home boom is transmitted abroad through the current account of the balance of payments.

If the exchange rate is permitted to depreciate, however, less of the expansionary impetus is transferred abroad. Depreciation of the home currency tends to reinforce the excess demand created by the initial disturbance in goods markets at home; for example, it causes a rise in import prices relative to those for domestic goods and makes export goods more competitive, thereby leading both indigenous and foreign residents to switch expenditures away from foreign to domestic goods. The disruptive effects of the disturbance are therefore confined more to the home economy because of the depreciation of the home currency. From the point of view of the nation's policymakers, exchange-rate variability in these circumstances can be an *inferior* alternative to exchange-rate stability, at least over a short to medium run.

As a third illustrative type of disturbance, consider an unexpected change in asset preferences in which private investors, foreign or domestic, decide to increase the proportion of home-currency assets in their portfolios. The incipient pressures on financial variables in this case include tendencies for the home currency to appreciate, for home market interest rates to fall, and for foreign interest rates to rise.

If there is no central bank intervention in exchange markets and the home currency thus appreciates, native and foreign residents switch expenditures away from domestic to foreign goods, imports rise, and exports tend to decline. The net result is an unanticipated and unwanted tendency toward contraction in domestic output and prices. (The contractive result is unambiguous if the central bank keeps domestic interest rates from falling while it allows the home currency to appreciate.)

If, however, exchange market intervention is carried out to prevent the exchange rate from changing, the external reserves of the home country increase, but there is no unwanted impact on output and prices (at home or abroad). In effect, the exchange market intervention accommodates the private sector's shift in asset preferences at the existing interest rates and exchange rate by means of offsetting changes in central bank balance sheets.

For this case of an autonomous change in private asset preferences, therefore, both the home economy and the foreign economy are better off with exchange market intervention that keeps the exchange rate unchanged.

A similar evaluation can be conducted for still other types of disturbances. When this is done, the result of the entire analysis is to lead one to an eclectic view about exchange-rate variability. Such an analysis shows that the variability of the external value of a nation's currency facilitates adjustment to some types of nonpolicy disturbances but aggravates the adverse consequences of others. (An analogous conclusion applies to policy "mistakes," i.e., macroeconomic policy actions that turn out in retrospect to have been undesirable.) Hence it is sometimes desirable for exchange rates to fluctuate; at other times, stability is advantageous. As an analytical matter, neither the untrammeled market position nor the minimum variance position is sound. And it is inappropriate to set either the presence or the absence of exchange-rate stability as a goal of national macroeconomic policy. The traditional choice between fixed rates and flexible rates is an artificial one that policymakers do not have to, and should not, make. The proper approach is a discretionary one–managed fixing or managed floating, with "managed" being the key word.

The existence of uncertainty about disturbances and about how economies work does not essentially change the preceding conclusion. It is true that the home policymakers cannot know, at the time they make decisions, just what types of disturbances may be the predominant nonpolicy forces influencing the home economy. It is equally true that policymakers have only poor models of how national economies function and can predict only imperfectly how nonpolicy disturbances and their own policy actions will affect their ultimate target variables. The existence of these uncertainties is a cogent reason for avoiding a "fine tuning" approach to policy decisions, where fine tuning involves aggressive instrument manipulation that considers only the expected values of the impacts of disturbances and policy actions and ignores their variances and covariances. But policymakers have *some* information about the current state of the economy and *some* knowledge of how the economy works. And they continue to receive new data, including new data about the home economy's relationships with the rest of the world. An efficient approach to policy decisions in the face of uncertainty requires policymakers to make the best, cautious use of the information and knowledge available to them. In any case, a careful analysis of uncertainty cannot justify a rule approach to policymaking – and, in particular, cannot justify *either* the minimum variance position *or* the untrammeled market position about exchange-rate variability.

If private-sector expectations are given proper attention in the analysis, does the preceding conclusion still stand? I believe it does. Policymakers can get into serious trouble if they ignore private-sector expectations of policy decisions and if they do not try to incorporate those expectational phenomena into their policymaking model. Because policymakers in practice have paid too little attention to expectations, such authors as Lucas (1976), Sargent and Wallace (1976), and Kydland and Prescott (1977) have been right in focusing attention on them. An emphasis on expectations, however, does not logically require policymakers to adopt simple rules for policy decisions, for either domestic macroeconomic policy or external monetary policy. In particular, an emphasis on private-sector expectations of government actions does not provide a convincing justification for a single nation wanting to adopt either the simple rule of perfectly flexible exchange rates or the simple rule of perfectly fixed exchange rates.

As a broad guideline for national policy, then, policymakers should avoid an unqualified commitment to "stability" of exchange rates, *and* they should avoid an unqualified commitment to "flexibility." The appropriate approach to exchange market policy is a cautious, discretionary differentiation of decisions in accordance with the current and prospective circumstances of the national economy and the global economy.[1]

With appropriate modifications to suit the institutional circumstances, an analytical framework of the sort I have sketched out here is the right context in which to assess the prospects for the success or failure of the EMS--including, especially, its detailed provisions governing exchange relationships among the currencies of the EEC countries.

Possible Motives for Establishing the EMS

An important part of any assessment of the EMS must address the *objectives* that could have prompted the European governments to make the Bremen declaration, in July 1978, to negotiate the Council resolution of December 1978, and to start the EMS off in March 1979. At least three broad objectives can be distinguished that might have played a role.

First, proponents of the EMS may have wanted to foster exchange-rate stability virtually as an end in itself. That motive, for example, seems to lie behind the proclaimed desire of some proponents to establish a "zone of monetary stability in Europe."

A second objective may have been to facilitate the achievement of the national economic goals of the individual European Community countries. Some proponents, for example, may believe that the EMS will make it easier to keep national price levels under control or to promote higher and more stable levels of national employment. Individuals or governments supporting the EMS for this second reason could place exclusive emphasis on national goals and, hence, give no weight to the idea of greater European economic integration or political unity.[2]

Finally, a third objective–the hastening of the economic and political integration of Europe–may have motivated some of those advocating the EMS. The greater integration may have been perceived as an end in itself, perhaps because of the political consequences with which it is thought to be associated.[3]

In my view, conclusions about the likely viability and longevity of the EMS should partly depend on the relative importance of these objectives in the minds of European government officials and, hence, on the supporting actions that will or will not be taken to advance the differing objectives.

Suppose that European politicians are motivated primarily by the first objective (exchange-rate stability for its own sake). Or, somewhat less simplistically, suppose that proponents of the EMS have argued for its adoption out of a combination of the first two motives. In other words, suppose they believe that exchange-rate stability will, in itself, help advance such national macroeconomic objectives as the dampening of inflation. What verdict should one have if these hypotheses are an accurate description of the motives of European governments? In this case–as Vaubel, Fratianni, and I would all agree–it would be appropriate to interpret the initiation of the EMS as an experiment little different from earlier efforts at European monetary unification. The EMS would be based on views that are no more durable than those incorporated in the earlier Barre and Werner reports or in the agreement establishing the snake in the tunnel. The situations and interests of the individual EC countries can easily be so divergent, and various economic disturbances can create circumstances with such divergent consequences, that it is preferable for *some* EC countries to hold exchange rates steady but preferable for others to let them vary.[4] A temporary convergence of short-run national interests in promoting exchange-rate stability under "fair weather" conditions would have disguised fundamental differences in national interests. With such shaky foundations, the EMS would be likely to run into trouble in future years when the weather becomes stormy.

Consider, now, a less simple-minded hypothesis about the objectives of European governments. Suppose that the primary aim of the EMS is to facilitate better achievement of national macroeconomic objectives, but to do so through more "ordered management" of exchange rates, *including* such prompt changes in the parity grid among Community currencies as may be desirable from time to time. One cannot so easily fault this view of the EMS as an espousal of the minimum variance position about exchange-rate variability; to the contrary, this view admits the desirability of managed variability. Furthermore, if it should turn out that changes in the EMS parity grid can take place fairly promptly (before great tensions have been allowed to build up) and if the negotiations can be handled in an increasingly orderly way, then one could reasonably have a less cynical view about the likely durability and longevity of the EMS. The EMS could become not a commitment to any given parity grid, but a commitment to a process for collectively managing an "adjustable peg" arrangement, where the presumption is strong that the pegs *are* periodically adjusted.

Next, consider the hypothesis that the hope for greater progress toward European integration is a major driving force behind the EMS experiment. The implication of this supposition is that European governments will be willing, not only in fair weather but even in foul, to sacrifice national goals to a somewhat greater extent than in the past and to move the Community's interests as a whole up the scale of priorities relative to national interests. One variant of the view that integration should get a higher priority than in the past would be a "Europeanist" strategy of the sort propounded by Jean Monnet. Such a strategy, you will recall, relies on an *apparently* technical initiative in the monetary field to catalyze greater integration (see, for example, Nye, 1973); however, it does not simultaneously involve direct steps to foster greater convergence in nations' domestic macroeconomic policies. What verdict should one reach about a Europeanist strategy of this sort? The appropriate verdict is skepticism, in my view. If European policymakers seek to bring about greater integration among their heterogeneous economies solely by trying to stabilize their currencies vis-à-vis each other, the attempt seems certain to be abortive. As long as more basic differences in national objectives, behavior patterns, and institutions remain, the means (exchange-rate stability) will have to be abandoned long before the end (greater integration) has been accomplished.

Finally, consider a view about the objectives of European governments that attributes to them a blend of the objective of promoting integration and the objective of using an adjustable peg system to facilitate national goals. Suppose, in particular, that the Community nations intend to give European integration a higher political priority and that they plan to institute complementary direct measures to try to bring about more convergence of domestic economic policies. Suppose, in addition, that the EC governments plan to use changes in the parity grid, promptly and fairly frequently, whenever political pressures or divergent national interests make it infeasible for the time being to force the convergence of domestic policies any further. Without doubt, this blend of objectives and intentions is ambitious. It presupposes considerable political will to promote integration, especially the convergence of domestic policies, and it presupposes agile policymaking about exchange rates. This ambitious agenda, however, is not an absurd one. And it is not obvious to me that the agenda is analytically flawed (at any rate in its economics). Furthermore, when Europeanist politics and economics are blended in this way, the result is an untidy but not altogether unpalatable concoction. In a way, the situation is a bit like Samuel Butler's view on life: "To live is like to love; all reason is against it, but all healthy instinct is for it." European integration—some of it, but not yet too much of it—may be similar. Economic reason scarcely gives it a ringing endorsement. But all healthy political instinct may be for it.

Does this last characterization of the objectives underlying the inauguration of the EMS accurately describe the motives of politicians and civil servants who agree to launch the EMS? For some European politicians, almost certainly not. European politicians have varying motives and are capable, no less so than government officials on this side of the Atlantic, of confused analysis. Some, perhaps many, may be guilty of the simple-minded espousal of a zone of exchange-rate stability in Europe for its own sake. But I am also sure that there are some influential Europeans who do have a sophisticated blend of objectives in mind, something along the lines I have just described.

What I have said up to this point is background—I hope helpful background—for evaluating the Vaubel and Fratianni papers. I propose now to turn to several specific points about the arguments in the two papers. These points concern details, yet they also illustrate my general theme that Vaubel and Fratianni have failed to give the EMS a sufficiently sympathetic evaluation.

Vaubel's Criticisms of the EMS Exchange-Rate Arrangements

Vaubel is highly critical of the ECU as the centerpiece of the EMS exchange-rate arrangements. In his view, the ECU is merely the old European unit of account "now applied in fields in which it cannot serve a useful purpose."

I do not believe that Vaubel has made a convincing case for the prosecution. Take, for example, his point about the ECU as a numéraire for parities. He correctly points out that parities in the EMS cannot be changed unilaterally (because any bilateral adjustments in the parity grid have to be expressed as parity changes in terms of the ECU in such a way as to leave the ECU's external value unchanged) and, hence, can only be adjusted after multilateral negotiations and unanimous agreement. Vaubel sees this feature solely as a complication and a defect. A proponent of the EMS with the Europeanist blend of objectives I described earlier can view this necessity for collaboration and multilateral agreement as a positive good-indeed as one of the key features of the EMS that promotes collective decisionmaking and greater political integration.[5]

Vaubel's paper contains a number of criticisms of the "divergence indicators" based on the ECU. Although his analysis is interesting, at several points his criticisms are inappropriate.

For example, he points out that the divergence indicators create the presumption of adjustment action by a "deviant" country regardless of the direction in which it deviates, and, hence, that "the divergence [indicators]... [favor] assimilation of inflation rates toward the Community average" rather than the lowest inflation rate for any member. That point is, of course, true. But is it, as Vaubel believes, a telling criticism of the divergence indicators? In the minds of its more sophisticated proponents, the function of a country's divergence indicator is to give a presumptive indication of when the country is deviating from the Community average-*and not to do more than that.* One reason that the indicators are presumptive, instead of mechanical triggers requiring action, is precisely to avoid boxing the Community into an average experience when agreement exists that the average experience is undesirable. It is thus much too strong to say, as Vaubel does, that the divergence indicators are "designed to punish excellence in the fight against inflation and to reward mediocrity." The most difficult circumstances for policymaking in the Community, however, are situations in which it is *not* possible to obtain full agreement on what the Community average ought to be. For those difficult cases, the divergence indicators may be able to play a marginally helpful role, given their limited objective of defining behavior that deviates from the average.

Vaubel speaks of the "principle of individual (policy agent) responsibility" and asserts that the divergence indicators dilute or even deny this principle in exchange-rate matters. I do not even understand this principle as applied to exchange rates.[6] And I certainly cannot get excited about the divergence indicators as a threat that undermines it. If the divergence indicators are not intended to do anything more than identify behavior different from the average, it is unreasonable to find fault with them for failing to accomplish something they are not designed to do.

In another of his criticisms, Vaubel complains that the divergence indicators may fail to "flash" in certain situations when two countries deviate from the average in opposite directions. He also argues that the indicators do not work in a symmetric way in such situations (for example, a "small" country gets pushed earlier to its divergence threshold); this asymmetry in his view is "arbitrary discrimination." These points made by Vaubel are technically correct.

Again, however, Vaubel wishes to apply a standard of judgment to the divergence indicators that their sophisticated proponents did not intend. If the function of the divergence indicators is merely to identify (presumptively) deviant behavior of the individual countries from the Community average, Vaubel's complaints are somewhat beside the point.[7]

One point that Vaubel does not mention could possibly be a "technical flaw" in the calculation of the divergence indicators. The ECU values of currencies, and hence also the maximum divergence spreads and the divergence thresholds, depend on an *arithmetic* weighted average calculation rather than a *geometric* weighted average. For circumstances in which exchange rates deviate substantially from the base-period values used in constructing a weighted average, it can be shown that arithmetic averages lead to awkward asymmetries that are avoided by the use of geometric averages. I have not examined this problem carefully in the context of the EMS arrangements, but I surmise that it could have some quantitative significance after the EMS has been in operation for several years.

I sympathize least of all with Vaubel's complaint that a government's policy reactions are "indeterminate" if its divergence indicator does flash. Vaubel seems to agree with Peter Oppenheimer (see Vaubel's note 30) that the indicator is a "joke" because a flashing indicator does not obligate a country to take policy action. But at most, surely, a sensible indicator of this sort should be only presumptive. It is impossible to specify *ex ante* a set of ideal policy responses applicable to all situations in which a divergence indicator may flash. And why should the presumptive aspect of the indicators be accused of increasing policy uncertainty and destabilizing expectations? The relevant uncertainty issue is whether this set of arrangements increases uncertainty relative to other arrangements. Some sizable uncertainty exists under *any* procedures for altering exchange rates. If rigid rules for changing the parity grid were announced, substantial uncertainty would exist about whether and when the rules would be abandoned. It is relevant to observe here that the Belgian authorities have said that they found the flashing of the divergence indicator helpful in 1979 in creating a domestic political climate supportive of their policy actions.

I do not want to be misunderstood. I am not suggesting that the divergence indicators are the most marvelous invention since the wheel. I am merely arguing that they may be marginally useful in national and Community-wide discussions of macroeconomic policies and that they deserve a more sympathetic evaluation, given their limited objectives, than Vaubel has provided.

Fratianni's Criticisms of the EMS Reserve-Settlement Arrangements

I shall now turn briefly to Fratianni's criticisms of the ECU and the reserve-settlement aspects of the EMS, in particular the European Monetary Cooperation Fund (EMCF) and its intended successor the European Monetary Fund (EMF). Fratianni argues that these institutional arrangements are not well designed to enhance the development of the ECU as a parallel currency and do not represent a significant innovation with respect to the goal of achieving monetary union in the European Economic Community.

Fratianni has some incorrect perceptions of how the General Account and the SDR Account operate in the International Monetary Fund (IMF), and those misperceptions seem to be one reason why he reaches too pessimistic a verdict about the possible evolution of the EMCF and EMF. For example, he states that the IMF General Account "does not create international reserves." In reality, reserve positions in the IMF *are* created (temporarily) when the IMF permits borrowing countries to draw on their credit tranches; the creditor nations report the IMF reserve positions as part of their international reserve assets and may use them as readily as their other reserve assets.

Furthermore, Fratianni's description of the SDR account in the IMF is seriously inaccurate. His comments are not consistent with the accounting treatment which national governments and the IMF employ for SDR allocations and uses; more important, his description is not analytically correct. Initial allocations of SDR, despite Fratianni's assertion to the contrary, are treated as the creation of owned reserves. The SDR account is not merely a "credit line facility." And the reconstitution requirement was lowered even further in 1979 (from 30 percent to 15 percent). A large number of countries have run down their holdings of SDRs, using them de facto as an owned reserve asset. Some important problems with the SDR do exist because its effective rate of interest (earned by net accumulators and paid by net users) is set well below an average of short-term market interest rates.[8] But those problems do not negate the fact that SDRs are reserve assets and that reserve creation takes place when they are allocated.

Fratianni's misperceptions about the IMF carry over, I believe, into his analysis of the EMCF and the EMF. As presently envisaged, the EMF is not merely a "credit-line facility." Fratianni's insistence that the EMF be an "asset-transforming institution" is puzzling and unclear to me; in any case, I do not see how the present arrangements inhibit the EMCF and EMF from evolving into a full-scale reserve-pooling and reserve-creating institution for the Community. Reserve pooling of (what are for Europe) "outside" reserve assets -- gold, SDRs, and dollars -- has already begun in a significant way, including an upward revaluation of the gold holdings. Further progress along those lines will require resolution of difficult issues analogous to those presently being considered in connection with an IMF-sponsored Substitution Account. But those issues arise in connection with any set of institutional procedures for reserve pooling. Creation of "inside reserves" within Europe through Community institutions (where inside European reserves are assets for one EC nation that have a counterpart reserve liability for another) could, in principle, proceed in several ways, including those criticized by Fratianni. The alternative accounting procedures are not intrinsically important, and disagreements about them are not likely to be the most important obstacles to further evolution. The "assets" on the balance sheet of the EMF associated with inside reserve creation could be securities of the European governments, some other assets denominated in European currencies, or even (as in the SDR Account of the IMF) a set of contingent understandings about procedures to be followed in the event of liquidation. In any case, when the accounting cosmetics are stripped aside, the key analytical and political issue is the nature of the conditionality restrictions associated with the use of ECU created as inside reserves.

None of us can now foresee whether the EEC governments will be able to agree, in March 1981 or at a later date, on operational provisions for inside-reserve creation in the EMF and, if so, on what the conditionality terms may be. It is equally difficult to predict what the incentives may be for private-sector transactors and investors to begin to denominate some of their intra-European assets and liabilities in ECU. But I fail to see how such an evolutionary process is blocked or greatly impeded by the institutional arrangements currently envisaged for the EMF. In my view, Fratianni does not make a convincing case for his pessimistic prognosis.

Concluding Summary

As I hope these examples have indicated, it is at least possible to come up with a view of the EMS less jaundiced than the verdicts of Vaubel and Fratianni. In particular, the EMS *could* turn out to be more than a mere adjustable peg system supported by somewhat liberalized credit facilities. The alternative perspective I have been outlining gives considerably greater emphasis than do Vaubel and Fratianni to the objective of further political and economic integration in Europe; it acknowledges more than they do that some further progress may be made toward promoting convergence of domestic economic policies; and yet it also explicitly acknowledges the importance of prompt, orderly adjustments in the parity grid.

If effect, Vaubel and Fratianni conclude, flatfootedly, that the EMS merits the verdict of Samuel Johnson on second marriages. A second marriage, asserted Johnson, is merely the triumph of hope over experience. And indeed, it ought to be a sobering thought for European politicians that the EMS is a second marriage for the Italian lira – and a *third* marriage for the French franc.

The counterview I have espoused here – partly as the devil's advocate, but also because I believe it deserves a better hearing – is more akin to the outlook summed up in the remark made to a young woman by Benjamin Jowett, the classics scholar who was for many years the master of Balliol College, Oxford. "You must believe in God, my dear," asserted Jowett, "despite what the clergymen say." I do not deny that the EMS invites some skepticism. But I also do not rule out the possibility that one should believe in its viability despite what we economists are prone to say about it.

Notes

1. For a more detailed analysis of the points summarized in these background comments, see Bryant (1980a, 1980b).

2. Roland Vaubel's paper seems to place primary emphasis on the goal of dampening inflation, and his judgments about the EMS may derive from an exclusive concentration on this second type of motive for establishing the EMS. Vaubel is apparently willing to condemn the EMS if it has any effect in raising the inflation rate in Germany. He does not make it clear how many kudos, if any, he would give the EMS if it could be shown that it would reduce the Italian and French inflation rates more than it would increase the German rate. But in any event, Vaubel seems to accept the performance of policymakers in achieving national goals, especially in reducing inflation, as the appropriate standard for judgment. (See, for example, his concluding comment that it is the "quality" rather than the "equality" of policy performance that should be used to judge the success of the EMS.)

3. Fratianni mentions European monetary union often enough in his paper, and with sufficiently favorable overtones, to lead the reader to suspect that he regards it as a worthy objective. To be sure, Fratianni argues that the EMS will not promote monetary union. But he nonetheless appears to share the objective.

4. For example, if a wage explosion occurs in France, it is better for France in the short run to keep the franc-Deutsche mark exchange rate unchanged, thereby sharing the disturbance with Germany as much as possible. For Germany, the disturbance is fenced out to the greatest possible extent when the Deutsche mark appreciates against the franc.

5. Article 107 of the Treaty of Rome requires that "each Member State handle its policy regarding exchange rates as a problem of common interest.' Triffin correctly points out (see Trezise, 1979, pp. 67-68) that the adoption of the ECU as a common denominator for parities gives, for the first time, an operational significance to this provision.

6. If two nations have differing ultimate policy objectives, if the policy actions of both nations affect the exchange rate between their currencies, and if there is only one exchange rate instead of two, which nation has policy "responsibility" for the exchange rate?

7 I am puzzled by Vaubel's emphasis on the asymmetry point (see his appendix) for another reason. He concentrates on the hypothetical case where two currencies approach their intervention points vis-à-vis each other, while all other Community currencies remain in the middle at the Community average; for him, this is the appropriate case on which to base assessment of the divergence indicators. But if the purpose of the divergence indicator for a single country is to measure deviations of that single country from the Community average, it seems at least as appropriate to calculate the maximum divergence spread and the divergence indicator in the manner now used in the EMS.

8. These problems were mitigated somewhat in 1979 when the interest rate on SDRs was raised from 60 percent to 80 percent of the weighted average of short-term market interest rates in the five member countries with the largest financial markets.

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