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FROM BRETTON WOODS TO BRUSSELS: A LEGAL ANALYSIS OF THE EXCHANGE-RATE ARRANGEMENTS OF THE INTERNATIONAL MONETARY FUND AND THE EUROPEAN COMMUNITY

RICHARD MYRUS

INTRODUCTION

Exchange rates represent the price at which the currency of one country can be purchased with the currency of another.[1] These rates indirectly affect the costs of the goods, capital, and services that flow across national borders.[2] According to Joseph Gold, former General Counsel of the International Monetary Fund, "[f]or most countries, there is no single price which has such an important influence on both the financial world—in terms of asset values and rates of return, and on the real world—in terms of production, trade and employment."[3]

Orderly exchange-rate management is crucial for nations seeking to maintain stable price levels and sustained economic growth.[4] Exchange rate volatility has a chilling effect on both free trade and international investment because when exchange rates fluctuate significantly, profits become uncertain and businesses must hedge exchange-rate risks. This uncertainty diminishes the willingness of enterprises to trade with their counterparts in other countries, ultimately resulting in reduced output and fewer jobs in affected industries.[5]

During the twentieth century, the major industrial nations have participated in several systems intended to provide exchange-rate stability.[6] Of these, the Bretton Woods agreement of 1944 and, on a regional scale, the European Community's Exchange Rate Mechanism ("ERM") have come closest to maintaining exchange-rate stability.[7] These systems implemented similar exchange arrangements that functioned effectively for an extended period. Yet, in light of the recent turbulence the ERM has experienced and the Bretton Woods agreement's collapse in 1971, the

1. *See* Joseph Gold, Exchange Rates in International Law and Organization 1 (1988) [hereinafter "Exchange Rates"].

2. *See id.*

3. *Id.* (quoting Group of Thirty, The Problem of Exchange Rates: A Policy Statement 10 (1982)).

4. *See* Charles Engel & Craig S. Hakkio, *Exchange Rate Regimes and Volatility*, Fed. Reserve Bank of Kansas City Econ. Rev., Third Quarter 52, 52 (1993).

5. *See* John H. Works, Jr., *The European Currency Unit: The Increasing Significance of the European Monetary System's Currency Cocktail*, 41 Bus. Law 483, 484 n.4 (1985).

6. For an overview of twentieth century exchange-rate regimes, see generally Brian Tew, The Evolution of the International Monetary System 1945-77 (4th ed. 1988).

7. *See* Michael D. Bordo, *The Bretton Woods International Monetary System: A Historical Overview*, *in* A Retrospective on the Bretton Woods System: Lessons for International Monetary Reform 3, 3-7 (Michael D. Bordo & Barry Eichengreen eds., 1993).

two most significant post-war attempts at cooperative exchange-rate management appear to have foundered.

Most of the literature addressing the Bretton Woods agreement and the ERM focuses on the systems' respective economic performances and on issues of monetary policy.[8] Rather than examining these systems in the context of the perennial economic debate over fixed versus floating exchange rates, this Note surveys the institutional structure and historical evolution of the two systems and analyzes their legal regimes. Part I addresses the rise and fall of the Bretton Woods system. Part II examines the European Community's quest for exchange-rate stability, which culminated in the ERM. Part II then considers some of the reasons for the ERM's recent unravelling. Part III analyzes the similarities between the two systems' legal structures and argues that in addition to suffering from macro-economic problems endemic to the international management of exchange rates, each system was flawed by the lack of an adequate legal regime. This Note concludes that to achieve exchange-rate stability and monetary union, the European Community (the "Community") should forego the long transitional phase now required by the Treaty on European Union[9] and decisively adopt the European Currency Unit (the "ECU") as the common currency for those of its Member States with strong, stable currencies. The creation of a monetary union for a core of Member States would reduce overall pressure on the ERM and hasten the Community's transition to full Economic and Monetary Union.

I. The Bretton Woods System

The first multilateral charter for the regulation of the international monetary system was negotiated at the United Nations Monetary and Financial Conference held at Bretton Woods, New Hampshire in July, 1944.[10] The representatives of forty-four countries attended the Bretton Woods conference, but the agreement's principal negotiators were the United States, represented by Harry Dexter White, and the United King-

8. *See, e.g.*, Alan C. Stockman, *International Transmission Under Bretton Woods, in* A Retrospective on the Bretton Woods System: Lessons for International Monetary Reform 317 (Michel D. Bordo & Barry Eichengreen eds., 1993); The European Monetary System (Francesco Giavazzi et al. eds., 1988).

9. *See infra* text accompanying notes 193-210

10. *See* Joseph Gold, *Public International Law in the International Monetary System*, 38 Sw. L.J. 799, 805 (1984) (hereinafter "*International Monetary System*"). The Tripartite Agreement of 1936, for example, preceded the Bretton Woods agreement. According to Gold, however, the Tripartite Agreement's participants attempted to avoid giving the agreement the appearance of a compact having legal force. In general, according to Gold, the international agreements that preceded the Bretton Woods agreement constituted a haphazard pattern of short-lived exchange arrangements rather than comprehensive efforts to establish an international monetary system. *See* Gold, Exchange Rates, *supra* note 1, at 3.

dom, represented by John Maynard Keynes.[11] The final agreement reached at Bretton Woods was a compromise between the American plan, which emphasized expansion of world trade through exchange-rate stability, and the British plan, which favored increased international liquidity and sought to shield domestic economies from foreign disturbances.[12]

The international monetary instability of the interwar period greatly influenced the architects of the Bretton Woods system. The destabilizing speculation produced by floating exchange rates in the 1920s, the subsequent gold exchange standard's deflationary effects, and the competitive devaluations of the 1930s convinced the Bretton Woods participants that a new, more resilient set of monetary arrangements was essential.[13]

International adherence to pre-World War II exchange-rate systems was largely voluntary.[14] The Bretton Woods participants viewed this as a major factor in the wide-scale abandonment of these systems' exchange-rate obligations and the resort to beggar-thy-neighbor monetary practices by many nations that occurred after 1933.[15] The signatories of the Bretton Woods agreement sought to create a regime that was both sufficiently binding to deter member states' nonobservance of exchange-rate commitments and flexible enough to allow the participants to pursue independent domestic monetary and fiscal objectives.[16] In his *Proposals for an International Clearing Union*, Keynes declared: "We need an orderly and agreed method of determining the relative exchange values of national currency units, so that unilateral action and competitive exchange depreciations are prevented."[17]

The Bretton Woods conference produced the Articles of Agreement of the International Monetary Fund (the "Articles").[18] The Articles constituted a treaty providing for the Bretton Woods participants' membership

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11. *See* Robert Solomon, The International Monetary System, 1945-1976, 9-10 (1977).

12. *See* Bordo, *supra* note 7, at 32.

13. *See id.* at 81. Recent scholarship casts doubt on the accuracy of the perceived flaws of the interwar system. However, for purposes of understanding the Bretton Woods system's objectives, the perceptions of the participants, rather than the actual flaws of the interwar system, are important. *See id.* at 31.

14. *See* Stephen Zamora, *Sir Joseph Gold and the Development of International Monetary Law*, 23 Int'l Law 1009, 1013-14 (1989).

15. *See* Bordo *supra* note 7, at 28, 81. Beggar-thy-neighbor policies refer to a country's efforts to better its domestic economic performance at the expense of other countries. This is accomplished through currency devaluations or tariff policies intended to shift world demand toward domestic output. *See* Paul R. Krugman & Maurice Obstfeld, International Economics 534-35 (3d ed. 1994).

16. *See* Joseph Gold, *Strengthening the Soft International Law of Exchange Arrangements*, 77 Am. J. Int'l L. 443, 445 (1983) [hereinafter *Soft Law*].

17. John Maynard Keynes, Proposals for an International Clearing Union (1943) *reprinted in* 3 The International Monetary Fund, 1945-1965: Twenty Years of International Monetary Cooperation 20 (J. Keith Horsefield ed., 1969).

18. Bretton Woods Agreement, December 27, 1945, 2 U.N.T.S. 39, 60 Stat. 1401, [hereinafter Articles of Agreement], *as amended* April 30, 1976, 29 U.S.T. 2203, T.I.A.S. No. 8937 (entered into force Apr. 1, 1978).

in the International Monetary Fund (the "Fund").[19] The Articles' stated purposes were to promote international monetary cooperation, facilitate the growth of international trade and the attainment of high employment levels, encourage exchange-rate stability, establish a multilateral system of payments for current account transactions, create confidence in member countries by making available the IMF's resources, and minimize disequilibrium in its members' balances of payments.[20]

A. *The Par-Value System's Institutional and Legal Structure*

The Bretton Woods system departed markedly from the legal doctrine that a country's right to determine its currency's exchange rate was inherent in national sovereignty.[21] The Bretton Woods agreement acknowledged for the first time that exchange-rate policies should be subject to examination and endorsement by the international community. The Articles declared that orderly exchange-rate management was a matter of international concern, and they divided legal authority over exchange rates between the Fund and the member states.[22] To this end, the agreement established a binding system of monetary rules, including a mechanism to enforce compliance by participants and an intergovernmental organization to oversee the legal regime. Professor Stephen Zamora concludes that "the origins of international monetary law should effectively be dated from Bretton Woods . . . . The creation of the IMF was significant not just because . . . it incorporated many member countries; it was also important because of the comprehensiveness of the scheme and the limits that it placed on national sovereignty."[23]

The central feature of the Bretton Woods system's regulatory scheme was the par-value system of Article IV.[24] Under Article IV, each mem-

19. *See* Gold, *International Monetary System*, *supra* note 10, at 805.

20. Articles of Agreement, *supra* note 18, at art. I.

21. *See* Zamora, *supra* note 14, at 1009-12. Some experts have suggested that customary international law prior to Bretton Woods imposed affirmative rules and obligations on states regarding the conduct of monetary matters. Zamora, however, argues that the weight of authority supports the conclusion that states were not hindered in the conduct of their monetary affairs by customary international law. *See id.*

22. *See* Gold, Exchange Rates, *supra* note 1 at 32.

23. Zamora, *supra* note 14, at 1013.

24. *See* Gold, *International Monetary System*, *supra* note 10, at 808. In addition to implementing the par-value system, the Articles of Agreement obligated participants to make their currencies convertible for current-account transactions. The Bretton Woods agreement required participants to allow nonresidents who earned currency as a result of current transactions to convert this currency into any other participating currency at exchange rates within the official margins. Except for the dollar, no major currencies were convertible at the end of World War II. Not until 1958 did the Western European nations achieve full current-account convertibility.

The Articles of Agreement also provided for creation of resources managed by the Fund which were available to help deficit members finance their payments imbalances. The Fund set a number of conditions on the use of its resources including terms related to a member's exchange system. *See* Gerald M. Meier, *The Bretton Woods Agreement—Twenty-five Years After*, 23 Stan. L. Rev. 235, 239-40 (1971).

ber, in consultation with the Fund, established a par-value for its currency either in terms of gold or the U.S. dollar.[25] The par-value system created ratios, or parities, between participating currencies. The system obligated members to intervene in their spot-exchange markets to maintain rates within one percent above or below parity with other participating currencies.[26] Each participant also agreed not to alter its currency's par-value through devaluation or revaluation, except to correct a "fundamental disequilibrium."[27] The Articles, however, failed to define this crucial term.

The key constraint that the Articles imposed on national sovereignty was the requirement that a member obtain the Fund's concurrence before making a par-value adjustment to remedy a fundamental disequilibrium. The Articles required a participant to consult with the Fund and to obtain the Fund's agreement that the proposed change was no more extensive than necessary to remedy an existing imbalance.[28] Lastly, the Articles entirely prohibited members from allowing their currency to float freely.[29] The Articles thus created a system of fixed but adjustable parities, also referred to as an adjustable peg system, designed to promote stability without imposing rigidity.[30]

Because of its massive gold reserves and strong economy, the United States eventually assumed a central role in the par-value system. The United States did not want to police its exchange markets to ensure that exchange rates for the dollar were within the margins prescribed by the Articles.[31] Prior to international adoption of the Articles, the United States had maintained a passive position with regard to exchange rates. The United States argued at Bretton Woods that inclusion in the Articles of a requirement that the United States abandon its earlier policy of non-intervention would be regressive.[32] The United States thus negotiated a provision at Bretton Woods that permitted a country to agree to undertake market purchases and sales of gold for the settlement of exchange transactions at a price equivalent to the par-value of its currency. Under the Articles, a member that agreed to this undertaking was not obligated to intervene in exchange markets to maintain margins or to take any other action on exchange rates.[33]

The United States was the only nation willing to undertake market purchases and sales of gold, and as a consequence, the dollar became the system's primary intervention currency for settling balance-of-payments

25. *See* Articles of Agreement, *supra* note 18, at art. IV, § 1.
26. *See id.* at art. IV, § 3.
27. *See id.* at art. IV, § 5.
28. *See id.* (Exchange rate realignments of less than 10% did not require the Fund's approval).
29. *See* Gold, Exchange Rates, *supra* note 1, at 51.
30. *See* Bordo, *supra* note 7, at 3-5; Gold, *Soft Law*, *supra* note 14, at 445.
31. *See* Joseph Gold, *International Monetary System*, *supra* note 10, at 809.
32. *See* Gold, Exchange Rates, *supra* note 1, at 60.
33. *See* Articles of Agreement, *supra* note 18, at art. IV.

transactions.[34] The United States, in effect, guaranteed that it would convert dollars into gold at $35 per ounce. The United States played an otherwise passive role in the Bretton Woods system. The United States did not intervene in the markets on its own behalf and, at least initially, created confidence that it would not devalue the dollar.[35] The American undertaking allowed other members to refrain from engaging in gold transactions and enabled them to hold dollars rather than gold as their reserve asset and intervention currency.[36] The arrangement benefited other Bretton Woods participants because they could earn income by investing their dollar holdings in U.S. securities.[37]

B. *Performance of the Bretton Woods Par-Value System*

From the mid-1950s to 1969, the Bretton Woods system's participants exhibited generally strong economic performance that coincided with a period of international economic growth and trade liberalization.[38] Prior to the 1969 French franc devaluation and deutschmark revaluation,[39] exchange rates remained relatively stable.[40] This stability enabled participants to reduce trade barriers without evoking criticism from domestic producers that underpriced imports were encroaching on domestic markets. In addition, because of non-inflationary American monetary policy,[41] other countries benefited from U.S. price stability simply by maintaining dollar parity.[42]

There is no clear consensus as to why the Bretton Woods agreement broke down.[43] Several problems emerged in the mid-1960s, however, that are generally accepted as having contributed to the system's collapse. First, although not intended by the Bretton Woods agreement's architects, by 1965 the dollar had assumed a preeminent position as the

34. *See* Gold, Exchange Rates *supra* note 1, at 60.

35. *See* Gold, *Soft Law, supra* note 16, at 446.

36. *See* Paul Hallwood & Ronald MacDonald, International Money: Theory, Evidence and Institutions 156 (1986).

37. *See id.*

38. *See* Bordo, *supra* note 7, at 27-28. Most European countries did not restore current account convertibility until 1958. Prior to the restoration of currency convertibility, the European Payments Union functioned as a clearinghouse for inconvertible European currencies. *See* id.

39. *See id.* at 78. The French franc was devalued by 11.1% on August 8, 1969 and the duetschmark was revalued by 9.3% on September 29, 1969. *See id.*

40. *See id.* An important exception to this stability was the sterling devaluation of 14.3% on November 18, 1967, which marked the end of sterling's role as an international reserve currency. *See id.* at 49-53.

41. *See* Alan C. Stockman, *International Transmission Under Bretton Woods, in* A Retrospective on the Bretton Woods System 317, 333-335 (Michael D. Bordo & Barry Eichengreen eds., 1993) (noting that the United States experienced 1.9% average inflation from 1962-67).

42. *See* Samuel Brittan, *Europe Will Still Need a Monetary System*, Fin. Times, Aug. 2, 1993, at 12.

43. *See* Barry Eichengreen, *Epilogue: Three Perspectives on the Bretton Woods System, in* A Retrospective on the Bretton Woods System 621, 624 (Michael D. Bordo & Barry Eichengreen eds., 1993).

system's key reserve currency.[44] In large part, the dollar's ascendancy resulted from the British pound's decline as an alternate reserve currency.[45] Subsequently, internationally-held dollar accounts, which had provided essential liquidity for the monetary system, came to exceed U.S. monetary gold reserves.[46] International confidence in the dollar as a convertible reserve asset flagged.[47] In addition, because of expansionary monetary policy, the American inflation rate began to rise, and the dollar ceased to fulfill its role as a source of international price stability.[48]

Second, narrow exchange-rate fluctuation margins proved incompatible with the increased international capital mobility that resulted from member states' relaxation of capital controls in the 1960s.[49] Increased capital mobility created an environment in which currency realignments triggered large, speculative capital flows.[50] Even the hint of an impending parity change caused turmoil in the exchange markets.[51] Monetary authorities were loathe to make necessary parity alterations and the adjustable par-value system evolved into a fixed system.[52] This de facto exchange-rate rigidity exacerbated the economic asymmetry between those countries with a balance of payments surplus and those with a deficit. In addition, asymmetry developed between the United States as the reserve currency country and the rest of the world.[53] The combined effects of these developments rendered the Bretton Woods system dynamically unstable.[54]

In early 1968, speculators who believed that the U.S. government would devalue the dollar began buying gold from the London Gold Pool.[55] In the first three months of 1968, speculators drained the Gold

44. *See* Bordo, *supra* note 7, at 47-48.

45. *See id.* at 43-44.

46. *See* Solomon, *supra* note 11, at 30-32.

47. *See* Bordo, *supra* note 7, at 55-56. By 1964, official dollar liabilities held by foreign nations exceeded the U.S. gold stock, and official holders of dollars began to fear that the Federal Reserve would be unable to maintain the dollar price of gold. A run on U.S. gold reserves thus became a destabilizing possibility. *See id.* at 56.

48. *See* Solomon, *supra* note 11, at 100-09.

49. *See id.* at 32.

50. *See* Bordo, *supra* note 7, at 82-83.

51. *See id.*

52. *See id.* at 84.

53. *See id.* at 55-56; Solomon, *supra* note 11, at 169-70.

54. *See* Bordo, *supra* note 7, at 82. In response to the Bretton Woods system's confidence and liquidity problems, the members of the IMF amended the original Articles. The First Amendment created the Special Drawing Right as an artificial reserve asset to supplement gold and take pressure off the dollar by providing an additional source of international liquidity. The First Amendment became effective in July 1969, but proved to be an inadequate solution. *See id.* at 66-68; Hallwood & MacDonald, *supra* note 36, at 158.

55. *See* Maurice Obstfeld, *The Adjustment Mechanism*, *in* A Retrospective on the Bretton Woods System 201, 223 (Michael D. Bordo & Barry Eichengreen eds., 1993). In 1961, the United States and the United Kingdom organized the Gold Pool to coordinate central bank intervention in the gold market. *See id.*

Pool of $3 billion in reserves.[56] In the face of this pressure, England, in consultation with the United States, closed the Gold Pool and replaced it with separate private and official market tiers.[57] The Gold Pool's monetary authorities agreed not to sell or buy gold in the private market tier. Private traders could continue to trade on the market, but government officials would allow the price of gold to rise to the market level.[58] Central banks in the official tier, however, would continue to transact with each other at the official $35-per-ounce price.[59] As a consequence of these developments, "gold was demonetized at the margin."[60] The link between the international supply of dollars and a fixed market price for gold was severed. After the establishment of the two-tier arrangement, the Bretton Woods system was on a de facto dollar standard with no market link to gold.[61]

In 1971, the United States' balance-of-payments deficit triggered an infusion of approximately thirty billion dollars into foreign reserves.[62] On May 5, 1971, the German central bank, faced with rapidly rising inflation, suspended official exchange-market operations and allowed the deutschmark to float.[63] Speculative pressure against the dollar became intense. Citing economic, political, and military considerations, the United States officially withdrew from the Bretton Woods exchange rate system on August 15, 1971.[64] President Nixon announced that the United States would no longer convert official foreign holdings into gold and would not take steps to maintain the dollar's parity as required by the Articles of Agreement.[65] According to Joseph Gold, former General Counsel of the International Monetary Fund:

> The United States had concluded that it was locked into an intolerable position in which it would not be able to achieve an effective devaluation of the dollar. . . . The United States had no hope of curing the disequilibrium in its balance of payments and restoring its lost competitiveness in international trade except by the drastic action it took.[66]

C. *The IMF Exchange-Rate System After 1971*

The Bretton Woods system ceased to function, and its participants ceased to observe the law of the original Articles when the United States withdrew its gold undertaking and suspended the dollar's external con-

56. *See* Bordo, *supra* note 7, at 70.
57. *See* Solomon, *supra* note 11, at 119-24.
58. *See* Obstfeld, *supra* note 55, at 223.
59. *See* Bordo, *supra* note 7, at 70.
60. *Id.* at 70-71.
61. *See id.* at 74.
62. *See id.* at 79.
63. *See* Solomon, *supra* note 11, at 179.
64. *See id.* at 186.
65. *See* Gold, *Soft Law*, *supra* note 16, at 447.
66. Gold, *International Monetary System*, *supra* note 10, at 816.

vertibility.[67] Following these actions, many countries abandoned their currency links to the dollar and exchange rates floated.[68] Fixed exchange rates were, however, temporarily reestablished under the Smithsonian Agreement of December 18, 1971.[69] The Smithsonian Agreement expanded the exchange-rate fluctuation margins to 2.25 percent and devalued the dollar by increasing the official price of gold to $38 per ounce.[70] The Smithsonian Agreement, although hailed by President Nixon as "the most significant monetary agreement in the history of the world," was short-lived.[71] Unable to withstand the pressures of speculative capital movements caused by an impending devaluation of the dollar, the Smithsonian Agreement collapsed in March 1973.[72]

In the wake of the Smithsonian Agreement's breakdown, efforts to stabilize the international monetary system continued. In April 1978, the Second Amendment to the Articles became effective and fundamentally altered the international exchange-rate system.[73] In contrast to the Bretton Woods system of the original Articles, the Second Amendment recognized the legitimacy of floating exchange rates and required signatories to maintain "orderly exchange arrangements."[74] The amendment marked a substantial return to national sovereignty over exchange rates.[75] Currently, each member is free to determine its currency's exchange arrangements without obtaining the agreement of the Fund or any other member country.[76] According to the Fund, "[f]or want of a better label, the present system might therefore be characterized as a discretionary and decentralized system."[77]

Although the Bretton Woods exchange-rate agreement fell short of achieving its original objectives, the Fund survived the agreement's collapse. The Fund currently monitors its members' exchange-rate policies, but the Fund's regulatory activities are now less significant than its finan-

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67. *See* Gold, Exchange Rates, *supra* note 1, at 62.

68. *See* Robert Mundell, *Panel Session II, in* A Retrospective on the Bretton Woods System 604, 607 (Michael D. Bordo & Barry Eichengreen eds., 1993).

69. *See* Solomon *supra* note 11, at 204-06. The Smithsonian Agreement, fashioned by the ministers of the Group of Ten, was an "interim" arrangement, the terms of which were in derogation of the members' obligations under Article IV. Participants circumvented this problem by agreeing that adherence to the Smithsonian Agreement would constitute compliance with the Articles of Agreement. *See* Michael H. Ryan, *The Treaty of Rome and Monetary Policy in the European Community*, 10 Ottawa L. Rev. 535, 545 n.41 (1978).

70. *See* Solomon, *supra* note 11, at 208-09.

71. Paul R. Krugman & Maurice Obstfeld, International Economics: Theory and Policy 550 (3d ed. 1994).

72. *See* Gold, Exchange Rates, *supra* note 1, at 62.

73. *See* Gold, *International Monetary System*, *supra* note 10, at 818-819.

74. Articles of Agreement, *supra* note 18, at art. IV, § 1.

75. *See* Gold, Exchange Rates, *supra* note 1, at 8-9.

76. International Monetary Fund, *The Exchange Rate System: Lessons of the past and Options for the Future*, Occasional Paper No. 30, at 3 (1984).

77. *Id.* at 40.

cial functions.[78] The current Articles require the Fund to "oversee the international monetary system in order to ensure its effective operation" and to "exercise firm surveillance over the exchange rate policies of members."[79]

D. *The Bretton Woods System's Underlying Flaws*

The original Articles created "an international organization with remarkable and unprecedented powers."[80] Nonetheless, the Bretton Woods system was plagued by several structural weaknesses. Not only was the system's monetary policy overly rigid because it deterred necessary realignments,[81] but the system's legal regime was inadequate. The Articles did not establish an enforcement mechanism that could command the loyalty of the participants or convince the private sector that the system would not be abandoned. Throughout the Bretton Woods system's life, participants frequently chose to act in their own economic best interests rather than cooperate in order to reach a Pareto superior outcome.[82] In 1971, this defect proved fatal when speculative capital flows and domestic considerations drove the United States to abandon the system.[83]

Although the Articles identified exchange rates as a matter of international concern, only a member state was authorized to propose a change in the par-value of its currency. Exchange-rate realignments ultimately remained a matter within a member state's exclusive domain.[84] The Fund could neither make a realignment proposal, nor compel a member to make a proposal.[85] The Fund's role was often limited to "rubber-stamp[ing] parity realignments."[86] At the time of the 1949 sterling devaluation, for example, Britain's Chancellor of the Exchequer informed the Fund's Managing Director that the United Kingdom intended to devalue sterling by approximately 30 percent. The United Kingdom submitted formal notification of the proposal to the Fund on September 17, 1949, and that same day, the Fund's Executive Board approved the realignment.[87]

Even when a member exceeded its authority under the Articles, the repercussions were minor. The Articles deliberately avoided labeling a

78. *See* Hallwood & MacDonald, *supra* note 36, at 171.

79. Articles of Agreement, *supra* note 18, art. IV, § 3(a-b).

80. Gold, Exchange Rates, *supra* note 1, at 37.

81. *See supra* text accompanying notes 49-54.

82. *See* Kathryn Dominguez, *The Role of International Organizations in the Bretton Woods System*, *in* A Retrospective on the Bretton Woods System: Lessons for International Monetary Reform 357, 359 (Michael D. Bordo & Barry Eichengreen eds., 1993).

83. *See* Solomon, *supra* note 111, at 182-85.

84. *See* Gold, Exchange Rates, *supra* note 1, at 48-49.

85. *See* Gold, Soft Law, *supra* note 16, at 446.

86. Francesco Giavazzi & Alberto Giovannini, Limiting Exchange Rate Flexibility: The European Monetary System 32 (1989).

87. *See id.*

member's failure to comply with exchange obligations as a "breach" or "violation."[88] If a member state failed to adhere to the central exchange-rate requirements of Article IV, that member was not deemed to be in violation of the agreement, but at most, could be held ineligible to use the Fund's resources.[89] This sanction did not deter members from disregarding their obligations. Furthermore, over the Fund's first twenty years, only five countries were officially denied access to the Fund's resources.[90] Professor Zamora observes that "the Fund has always displayed an extreme reticence to the application of legal sanctions when the rules are not observed."[91] Remarkably, the system's strongest mechanism to deter a member from floating its currency was that floating would subject the offending member to the shame that follows the breach of an international obligation.[92]

Another shortcoming of the Bretton Wood's legal regime was that the entire par-value system rested on a voluntary undertaking. The United States' commitment to exchange dollars for gold was the "primary norm" upon which all of the system's other binding obligations depended.[93] Yet, the Unites States, itself, was not bound to perform this service. By abrogating the agreement to convert dollars for gold, the United States did not technically breach its obligations under the Articles. The United States action did, however, expose the Bretton Woods system's fragility. Once the United States renounced its central role, as it was free to, the system inevitably collapsed. Furthermore, the United States blatantly disavowed its international obligations when it declared that it would not pursue measures to maintain the dollar within the margins required by the Articles. Despite this transgression, the Fund made no attempt to levy sanctions against the United States[94]

II. The European Community's Exchange Rate Mechanism

Until the early 1970s, the Bretton Woods agreement furnished the basis for the European Economic Community's currency arrangements.[95] The Bretton Woods system's increasing instability and the European currency realignments of the late 1960s prompted the first Community steps toward an autonomous exchange-rate mechanism.[96] For those within

88. *See* Gold, Exchange Rates, *supra* note 1, at 46.
89. *See* Zamora, *supra* note 14, at 1017 n.39.
90. *See* Eichengreen, *supra* note 43, at 641.
91. Zamora, *supra* note 14, at 1017.
92. *See* Gold, *Soft Law*, *supra* note 16, at 446.
93. *See* Gold, Exchange Rates, *supra* note 1, at 60.
94. *See* Zamora, *supra* note 14, at 1017.
95. *See* Giavazzi & Giovannini, *supra* note 86, at 8.
96. *See* Jacques van Ypersele & Jean-Claude Koeune, The European Monetary System: Origins, Operation and Outlook 32-33 (1984). *But see* Peter Coffey, The European Monetary System: Past, Present and Future 6-8 (1984) (suggesting that the causal link between the Bretton Woods collapse and Community efforts to establish an exchange rate was minimal).

the Community faced with the task of fashioning a replacement for the Bretton Woods system, however, the European Economic Community Treaty ("EEC Treaty") provided little guidance.[97] When the EEC Treaty entered into force in 1958, the six original Member States[98] already were participating in the Bretton Woods par-value system and the European Payments Union.[99] The EEC Treaty's drafters perceived these arrangements to be so solid that they devoted little attention in the EEC Treaty to monetary policy matters.[100]

Despite the EEC Treaty's extensive and exacting obligations in many areas,[101] it contained only limited commitments regarding monetary policy coordination. The EEC Treaty required Member States to pursue high domestic employment levels, price stability, and equilibrium in their national balance of payments.[102] In addition, the EEC Treaty called upon each Member State "to maintain confidence in its currency."[103] These general obligations reflected the Community's desire to avoid prolonged internal and external imbalances in Member States' economies. The EEC Treaty's drafters feared that Member States would attempt to correct external imbalances through trade restrictions and currency devaluations,[104] which would impede Community efforts to ensure free movement of goods and services between Member States.[105] Despite the importance of stable exchange rates, however, the Community could not easily discipline a Member State that pursued a monetary policy inconsistent with the EEC Treaty's objectives. The EEC Treaty provided no

97. Treaty Establishing the European Economic Community, Mar. 25, 1957, 298 U.N.T.S. 3, *as amended* by Single European Act, O.J. L 169/1 (1987) [hereinafter EEC Treaty].

98. The six original signatories to the EEC Treaty were Belgium, the Federal Republic of Germany, France, Italy, Luxembourg, and the Netherlands. *See id.* at Preamble.

99. Prior to 1958, the European Payments Union functioned as a clearinghouse for inconvertible European currencies and performed some of the functions of a foreign exchange market. *See* Krugman & Obstfeld, *supra* note 15, at 538.

100. *See* Economic and Monetary Union: Implications for National Policy-Makers 8 (Klaus Gretschmann ed., 1993); Roger Henderson, European Finance 32 (1993); Gold, Exchange Rates, *supra* note 1, at 188 n.4.

101. The EEC Treaty gave the Community the status of a sovereign governmental entity with lawmaking competence in numerous spheres of economic activity. The EEC Treaty created obligations and rights constituting a legal order that bound the Member States and prevailed over both conflicting national and public international law. *See* George A. Bermann et al., Cases and Materials on European Community Law 166-242 (1993).

102. *See* EEC Treaty *supra* note 97, at art. 104.

103. *Id.*

104. *See* Hans Smit & Peter E. Herzog, 3 Law of the European Economic Community: A Commentary on the EEC Treaty (Matthew Bender) 3-679 to 81. Prolonged disequilibrium in a country's balance of payment threatens the stability of that country's currency and may produce domestic pressure for trade restrictions or competitive devaluations. These pressures may be exacerbated by high domestic unemployment and inflation. For an explanation of the concepts of internal and external balance, and their influence on monetary policy, see Krugman & Obstfeld, *supra* note 71, at 523-54.

105. *See* Giavazzi & Giovannini, *supra* note 86, at 7; Ryan, *supra* note 69, at 536-37.

legal sanctions for a Member State's noncompliance[106] and stipulated only that Member States and their central banks should "co-ordinate their economic policies."[107]

In addition to broad monetary-policy goals, the EEC Treaty included one article that expressly addressed exchange-rate management. Article 107 obligated each Member State to "treat its policy with regard to rates of exchange as a matter of common concern" and included the EEC Treaty's only enforcement provision relevant to exchange-rate policy.[108] If a Member State altered its exchange rate in a way that "seriously distort[ed] the conditions of competition," Article 107 empowered the Commission[109] to authorize other Member States to take necessary, temporary counter-measures.[110]

By requiring Member States to treat their exchange-rate policies as a common concern, Article 107 obligated each state to consider its exchange-rate policy's effects on other Member States. Article 107, however, neither denied a Member State the right to change its currency's value unilaterally nor required a state to consult with the Community before taking action.[111] In *Compagnie d'Approvisionnement de Transport et de Crédit S.A. and Grand Moulins de Paris S.A. v. Commission*,[112] the Court of Justice[113] narrowly construed Article 107 by declaring, "[i]t is clear from Article 107 that it is for each Member State to decide upon any alteration in the rate of exchange of its currency under the conditions laid down by that provision."[114] The Advocate-General advanced the same interpretation[115] in *Schlüter v. Hauptzollamt Lörrach*[116] and *Rewe-Zentral AG v. Hauptzollamt Kehl*,[117] regarding Member States' rights to float their currency. The Court of Justice concurred and held that the obligations imposed by Article 107 were limited to treating exchange rates as a matter of common concern.[118]

106. *See* Smit & Herzog, *supra* note 104, at 3-684, 3-690.

107. *See* EEC Treaty, *supra* note 97, at art. 105. To promote cooperation between Member States, article 105(2) created the Monetary Committee, which was empowered to review Member States' monetary and financial policies. *See id.*

108. *See id.*, art. 107(1). Articles 102a-109 of the TEU have replaced Chapter 3 of the EEC Treaty.

109. The Commission is the Community's executive body and has primary responsibility for ensuring that the EEC Treaty's provisions and secondary legislation are observed. *See* Bermann et al., *supra* note 101, at 57-60.

110. EEC Treaty, *supra* note 97, art. 107(2).

111. *See* Smit & Herzog, *supra* note 104, at 3-694.12(6).

112. Joined cases 9 & 11/71, 1972 E.C.R. 391.

113. The Court of Justice of the European Communities has exclusive final jurisdiction to interpret Community law. *See* Bermann et al., *supra* note 101, at 69-69.

114. *Compagnie d'Approvisionnement*, 1972 E.C.R. at 406.

115. *See* Opinion of Advocate-General Roemer delivered on 11 July 1973, 1973 E.C.R. 1163, 1170-71.

116. Case 9/73, 1973 E.C.R. 1135.

117. Case 10/73, 1973 E.C.R. 1175.

118. *See Schülter*, 1973 E.C.R. at 1160-61; *Rewe- Zentral*, 1973 E.C.R. at 1194.

A. *The European Community's Transition from the Bretton Woods System to the Exchange-Rate Mechanism*

During its first decade, the Community did not need to regulate Member States' monetary policies extensively because the international monetary system functioned adequately.[119] Except for the French franc devaluation in 1958, and the Dutch florin and the deutschmark revaluations in 1961, intra-Community exchange rates were relatively stable prior to 1969.[120] Although the Community entertained the possibility of greater monetary-policy coordination, it pursued this goal primarily through studies and reports rather than binding measures.[121]

The first comprehensive efforts to fill in the EEC Treaty's monetary-policy gaps culminated with the Werner report in 1970.[122] The Werner report proposed a stage-by-stage plan to establish an Economic and Monetary Union.[123] In order to coordinate economic policies, the report included suggestions about Member States' fiscal policies, deficit financing, tax policies, and financial markets.[124] In the monetary sphere, the report called for the progressive narrowing of Community exchange-rate fluctuation margins beyond those that the IMF Articles required.[125] The report envisioned that Community exchange rates eventually would become irrevocably fixed.[126] The report also proposed the creation of a Community organization to provide financial assistance to Member

119. The EEC Treaty created the Monetary Committee of the European Community comprised of two representatives from each Member State, one appointed by the Member State's central bank, the other by its Treasury. In May 1964, the Council of Ministers adopted a system of compulsory consultation for Member States prior to exchange rate changes. *See* Council Decision 64/301 of May 8, 1964 on cooperation between Member States in the field of monetary relations *reprinted in* European Communities, Monetary Committee, Compendium of Community Monetary Texts 12 (1979) [hereinafter Compendium]. In addition, the Council of Ministers created the Committee of Central Bank Governors whose purpose was to hold consultations and exchange information regarding credit, money, and foreign exchange markets. *See* Council Decision 64/300 of May 8, 1964 on cooperation between the central banks of the Member States of the European Economic Community *reprinted in* Compendium.

120. *See* Ryan, *supra* note 69, at 544.

121. *See* van Ypersele & Koeune, *supra* note 96, at 35-37. In 1968, the Commission Memorandum to the Council on Coordination of Economic Policies and Monetary Cooperation within the Community, referred to as the Barre Plan, proposed that exchange-rate parity changes be subject to the preliminary agreement of the Member States. The Barre plan also suggested that the Community examine the possibility of eliminating fluctuation bands between Member State currencies. Lastly, the Barre Plan recommended that the Community establish a system of monetary support for Member States. *See id.* at 37.

122. *See id.* at 40-41.

123. *See id.* at 38. The possibility of Economic and Monetary Union was first broached at the European Summit of The Hague in December 1969, by German Chancellor Willy Brandt. Economic and Monetary Union entails, among other things, that major economic policy decisions be taken at the Community, rather than the national level, and that the Community adopt a single currency. *See id.*

124. *See id.* at 36-39.

125. *See id.* at 40.

126. *See id.*

States and facilitate coordinated monetary action.[127] The Werner report's emphasis on both economic and monetary measures reflected a compromise between those within the Community who favored gradual harmonization of economic policies and those who argued that rapid harmonization in the monetary field was the best way to compel Member States to coordinate their policies.[128] In March 1971, the Council of the European Communities adopted the Werner report's basic scheme.[129] The international monetary crisis that culminated with the United States' withdrawal from the Bretton Woods system in August 1971, however, thwarted the Community's plan for Economic and Monetary Union.[130]

Because of the Bretton Woods system's breakdown and the subsequent enactment of the Smithsonian Agreement's broad exchange-rate fluctuation margins, the Community implemented an exchange-rate system to provide increased intra-Community currency stability. Under the Smithsonian Agreement the exchange-rate spread between two currencies potentially could reach nine percent if one of the currencies moved to its ceiling against the dollar and the other currency moved to its floor. Because the Community could not tolerate such wide fluctuations, it adopted the "snake agreement,"[131] which became operational in April 1972.[132]

Under the snake agreement, Member States maintained the Smithsonian Agreement's 4.5 percent fluctuation margin in relation to the dollar, but agreed to reduce their currency deviations to 2.25 percent against other snake currencies.[133] The snake agreement was technically an agreement between the Member States' central banks and was not a binding Community act.[134] Nonetheless, because the central banks entered into the snake agreement at the Council's behest,[135] the snake agreement is considered the Community's first coordinated effort to establish an exchange-rate mechanism.[136]

The snake agreement's effectiveness was short-lived. The dollar's con-

127. *See* Manuel Guitian & Massimo Russo et al., *Policy Coordination in the European Monetary System*, IMF Occasional Paper No. 61, at 6 (1988).

128. *See id.*

129. *See* Resolution of the Council and of the Representatives of the Governments of the Member States of March 22, 1971, on the attainment by stages of economic and monetary union in the Community *reprinted in* Compendium, *supra* note 119, at 25.

130. *See supra* text accompanying notes 62-65.

131. *See* van Ypersele & Koeune, *supra* note 96, at 42. This system is referred to as the snake agreement because, when graphically depicted, the value of a Member State's currency approximated a sinoidal curve as it fluctuated above or below its pegged rate. *See* Bermann et al., *supra* note 101, at 1195.

132. *See* Resolution of the Council and of the Representatives of the Governments of the Member States *reprinted in* Compendium, *supra* note 119, at 30; van Ypersele & Koeune, *supra* note 96, at 41.

133. *See* Peter Ludlow, The Making of the European Monetary System 2-4 (1982).

134. *See* Smit & Herzog, *supra* note 104, at 3-585 to 86.

135. *See* van Ypersele & Koeune, *supra* note 96, at 41-42.

136. *See* Works, *supra* note 5, at 491; IMF Occasional Paper No. 61, *supra* note 127, at 7 n.14.

tinued instability disrupted its operation, and the 1973 oil crisis, which created severe balance-of-payments problems for the Member States, made it difficult for them to maintain their exchange-rate parities.[137] The Member States' lack of commitment to the snake agreement and an insufficient understanding of the need to shift authority to Community institutions compounded the external economic problems that beset the agreement.[138] In 1973, the snake agreement's participants decided to let their currencies float against the dollar.[139] By 1976, three of the four major participants had left the snake agreement and allowed their currencies to float.[140]

B. *The European Monetary System*

From 1973 to 1977, the Community's plans for monetary-policy coordination remained moribund.[141] They were revived, however, by Roy Jenkins, President of the Commission, in a 1977 speech in which he proposed European monetary integration as the best way to promote economic growth and combat the inflation and unemployment then plaguing Europe.[142] Responding to Jenkins' suggestion and motivated by the desire to increase independence from the United States in monetary matters, German Chancellor Helmut Schimdt and French President Giscard d'Estaing launched the idea of a European Monetary System ("EMS").[143] After a period of intense bilateral negotiations, the European Council[144] approved the Franco-German initiative and adopted a

137. See Krugman & Obstfeld, *supra* note 71, at 567-69.

138. *See* Henderson, *supra* note 99, at 34; Works, *supra* note 5, at 9-10.

139. *See* Van Ypersele & Koeune, *supra* note 96, at 43.

140. *See id.* The snake's original members were the Federal Republic of Germany, France, Holland, Belgium, Luxembourg and Italy. The U.K. joined briefly in 1972 and by 1976, both France and Italy had abandoned the system. According to Tommaso Padoa-Schioppa, "it might be said that, during the snake period, each major member country pursued its own economic objectives without much regard for whether they were compatible with those of its partners and, when this produced strains on the exchange rate, the deficit countries, one by one dropped out of the system." Tommaso Padoa-Schioppa, Money, Economic Policy and Europe 60-61 (1985) *quoted in* Gold, Exchange Rates, *supra* note 1, at 194 n.78.

141. The Community took some steps during this period, but the role of the Community with regard to monetary policy remained consultative and few precise policies were implemented. The Council decision of February 18, 1974, superseded an earlier declaration of the Council and strengthened Article 107's concept of "common concern" by creating a duty of consultation for Member States. The Council decision provided that any Member State intending to change or discontinue its currency's parity or central rate must initiate a prior consultation with the Community. *See* Gold, Exchange Rates, *supra* note 1, at 139.

142. *See* Works, *supra* note 5, at 10.

143. *See* Gold, Exchange Rates, *supra* note 1, at 142. *See generally* Peter Ludlow, The Making of the European Monetary System 63-85 (1982) (describing the political maneuvering by Chancellor Schmidt and President d'Estaing prior to the Bremen Summit).

144. The European Council coordinates the Community's long-term policy and is the Community's principle forum for considering structural changes. The European Council is comprised of the heads of state or government of the Member States and meets regularly two or three times a year. *See* Bermann et al., *supra* note 101, at 55.

resolution establishing the EMS.[145]

1. Institutional Structure of the EMS

The EMS was intended to "create a zone of monetary stability in Europe," based on close monetary cooperation and coordinated exchange-rate management between the Member States.[146] The architects of the EMS also envisioned that, within two years, the system's arrangements and institutions would be consolidated in a European Monetary Fund responsible for overseeing the system's loans and developing a common monetary policy for the Community.[147] The plans for creation of the EMF, however, did not come to fruition.

The EMS is comprised of three principal elements: the European Currency Unit ("ECU"), the Exchange Rate Mechanism ("ERM"), and a system of credit facilities for financing Member States' exchange-market interventions.[148] The ECU is a composite unit of account, or basket, comprised of specified amounts of each Member State's currency.[149] A Member State's economic strength determines the weight accorded to its currency.[150] Establishing the ECU as Europe's single currency is a goal of the EMS;[151] however, at present, the ECU anchors the ERM. The ECU serves as a numeraire, or standard of value, for the ERM, a basis for the divergence indicator, and a unit of account for Member States' exchange-rate interventions.[152]

The primary component of the EMS is the ERM, which is comprised of the parity grid and the divergence indicator.[153] To create the parity grid, each Member State established a rate for its currency expressed as the price of one ECU in terms of that currency.[154] This value remains fixed and represents the currency's central rate.[155] The ratio of any two

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145. *See* Works, *supra* note 5, at 492.

146. Extract from the conclusions of the Presidency of the European Council of July 6-7, 1978 *reprinted in* van Ypersele & Koeune, *supra* note 96, at 121.

147. *See* van Ypersele & Keoune, *supra* note 96, at 61.

148. *See* Henderson, *supra* note 99, at 35.

149. *See* Council Regulation 3180/78 of Dec. 18, 1978, changing the value of the unit of account used by the European Monetary Cooperation Fund *reprinted in* Compendium, *supra* note 119, at 133, (defining the ECU and specifying the amounts of currencies that comprised it). ECU weights remain fixed but are subject to review every five years or if the weight of any currency changes by 25%. *See* Resolution of the European Council on the Establishment of the European Monetary System and related matters, Dec. 5, 1978, § 2.3 *reprinted in* Compendium, *supra* note 119, at 40 [hereinafter "Resolution"].

150. *See* Smit & Herzog, *supra* note 104, at 3-587.

151. *See* Resolution, *supra* note 149, § 1.4.

152. *See id.* § 2.2.

153. *See* Henderson, *supra* note 99, at 34-36; *See also* Jean-Jacques Rey, *The European Monetary System*, 17 Common Mkt. L. Rev. 7, 19 (1980) (describing the Resolution's goal of stabilizing exchange rates).

154. *See* Resolution §§ 2-3, *supra* note 149, at 40-41; Giavazzi & Giovannini, *supra* note 86 at 33.

155. *See* Resolution §§ 2-3, *supra* note 149, at 40-41; Giavazzi & Giovannini, *supra* note 86, at 33.

ECU central rates constitutes a bilateral central rate, which also remains fixed.[156] Bilateral central rates provide reference points against which countries and investors can measure market exchange rates, which are the rates at which currencies are actually traded. The bilateral central rates of all the participating currencies form the ERM parity grid. Under the ERM's intervention rules, each participating central bank agrees to maintain its currency's market exchange rate with other participating currencies within a fluctuation band around the bilateral central rate.[157] A margin of 2.25 percent above or below each set of bilateral rates establishes the permitted range of fluctuation for market exchange rates.[158] Under this system, whenever two currencies reach their bilateral limits, both states must take steps to close the gap between the currencies. To this end, "[t]he central bank of the strong currency purchases in its exchange market the weak currency, which is at the lower intervention limit, while the central bank of the weak currency sells in its exchange market the strong currency, which is at the upper intervention limit."[159]

In addition to this intervention requirement, the ERM agreement implies that a Member State should intervene in certain situations although its currency is still within the margins.[160] The divergence indicator, the ERM's second element, provides the basis for intra-marginal intervention in exchange rates. When a Member State's currency reaches seventy-five percent of the maximum allowable 2.25 percent divergence from its ECU central rate, that currency is at its divergence threshold.[161] The divergence indicator, in effect, signals that a member's currency has deviated from the average behavior of all the EMS currencies as embodied by the ECU. The Member State should then intervene in exchange markets with a number of other currencies in order to bring its currency into alignment with the ECU central rate. The rationale behind the divergence indicator is that a currency may be strong or weak against all others, thus exceeding its central-rate threshold of divergence without exceeding any bilateral limits. The divergence indicator, unlike the parity grid, does not require a Member State to intervene, but the ERM agreement suggests that a Member State should take necessary ameliorative measures.[162]

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156. *See* Resolution § 3, *supra* note 149, at 40; Giavazzi & Giovannini, *supra* note 86, at 33.

157. *See* Agreement of 13 March 1979: Between the Central Banks of the Member States of the European Community Laying Down the Operating Procedures for the European Monetary System, Preamble *reprinted in* Compendium, *supra* note 119, at 55 [hereinafter Central Bank Agreement].

158. *See id.* Member States not originally participating in the ERM are permitted to maintain 6% margins "which must be progressively reduced as soon as economic conditions permit." *Id.*

159. Gold, Exchange Rates, *supra* note 1, at 153.

160. *See* Resolution § 3.5, *supra* note 149, at 41.

161. *See id.* § 3.5; Works, *supra* note 5, at 497.

162. *See* Central Bank Agreement § 3.1, *supra* note 157, at 55 (describing calculation

To facilitate performance of Member States' ERM intervention obligations, the EMS includes a system of settlement and credit mechanisms administered by the European Monetary Cooperation Fund ("EMCF").[163] The ERM's primary credit source is the Very Short-Term Financing Facility ("VSTF"), which provides funds, in the form of ECUs, for interventions by Member States that lack adequate reserves and whose currency has reached the marginal limit.[164] Under the VSTF, each participant must provide an unlimited line of credit to other participants. A borrower is entitled to any amount of currency needed to finance required intervention in exchange markets or to cope with temporary balance-of-payments difficulties.[165] The VSTF provides loans for up to ten weeks with an automatic three-month renewal.[166]

2. Legal Structure of the EMS

Four Community instruments established the EMS and continue to provide its operating parameters. Foremost among these instruments is the European Council's Resolution of December 5, 1978, on the Establishment of the European Monetary System (the "Resolution"), which delineates the functions of the ECU, the ERM, and the short-term credit mechanism.[167] The Resolution also limits Member States' monetary policy autonomy by classifying currency realignment decisions as multilateral agreements rather than sovereign acts by individual states.[168] The Resolution states that a Member State that desires to change its central rates, in other words to realign its currency, must engage in negotiations with the ERM's other participants and the Commission.[169] Furthermore, a Member State's central-rate adjustment requires the other participants' mutual agreement.[170]

Although the Resolution reflects the Member States' intentions to collaborate in the monetary-policy field and outlines a system for attaining stable exchange rates, the Resolution's value as a legally binding agree-

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of the divergence threshold and extolling all members to consider the failure of any state to participate).

163. *See* Council Regulation 3181/78 of Dec. 18, 1978, relating to the European Monetary System *reprinted in* Compendium, *supra* note 119, at 53, arts. 1-2. The EMCF is composed of members of the Committee of Presidents of the Central Banks of the Member States and one member of the European Commission. The EMCF is empowered to "receive monetary reserves from the monetary authorities of the Member States and to issue ECU against such assets." *Id.* at art. 1. To establish initial reserves, the central bank of each participant contributed 20% of its gold reserves and an equal amount of its dollar holdings to the EMCF. In return, participants received ECUs to be used to settle debts arising from intervention obligations. *See id.* art 1-2; Works, *supra* note 5, at 890; IMF Occasional Paper No. 30, *supra* note 76, at 5.

164. *See* Giavazzi & Giovannini, *supra* note 86, at 37-38.

165. *See* Henderson, *supra* note 99, at 37-39.

166. *See id.* at 37.

167. *See* Resolution *supra* note 149, at 40.

168. *See* Gold, Exchange Rates, *supra* note 1, at 142.

169. *See* Resolution § 3.2, *supra* note 149, at 41.

170. *See id.*

ment is unclear.[171] Under Community law, European Council resolutions are not binding.[172] In addition, the Resolution cites no specific EEC Treaty provisions as the source of the Member States' obligations under the EMS.

In apparent recognition of its non-binding character, the Resolution itself requests that the Community institutions pass legislation and that the Member States' central banks conclude agreements to implement the EMS.[173] The Resolution's declaration that the system should "be based on adequate legislation at the Community as well as the national level"[174] also reflects the European Council's awareness that the Resolution was legally ambiguous. Lastly, the Community did not include the Resolution in the Official Journal, which publishes all legally binding Community documents.[175]

In response to the Resolution's request to implement the EMS, the Member States' central banks adopted an agreement "laying down the operating procedures for the European Monetary system" (the "Central Bank agreement").[176] The Central Bank agreement is generally regarded as the legal instrument that gives the EMS its operational effectiveness.[177] With two notable exceptions, the Central Bank agreement reiterates the procedures and obligations set forth in the Resolution. The Central Bank agreement omits the requirement that Member States consult with and obtain consent from other participants before revaluing their currency.[178] The agreement also does not require Member States to intervene based on the divergence indicator.[179] Although the Central Bank agreement reproduced much of the Resolution and referred to it several times, the agreement was between the central banks only and not between the Member States acting within the formal Community structure.[180]

171. The Conseil Constitutionnel of France, for example, addressed the Resolution's legal value and concluded that the Resolution was only a political declaration with no legal effect. *See* Rey, *supra* note 153, at 10 n.8. Rey nonetheless argues that the Resolution is a legally binding Community agreement. *See id.* at 10. *See also* Luca Radicabi di Brozolo, *Some Legal Aspects of the European Monetary System*, 63 Rivista di Diritto Internazionale 335 (1980) (arguing that the EMS consists only of a set of contractual relationships); Bull. EC 1985-18, at 11-12 (proposing that Article 107 of the EEC Treaty be amended to explicitly incorporate the EMS).

172. *See* Pieter Ver Loren Van Themaat, *Some Preliminary Observations on the Intergovernmental Conferences: The Relations Between the Concepts of a Common Market, a Monetary Union, an Economic Union, a Political Union and Sovereignty*, 28 Common Mkt. L. Rev. 291, 296 (1991).

173. *See* Resolution § 6, *supra* note 149, at 42-43.

174. *Id.* § 1.4.

175. *See* Smit & Herzog, *supra* note 104, at 3-615.

176. Central Bank Agreement, *supra* note 157, at 55.

177. *See* International Economic Law Documents, II-E-1, at 2 (CCH 1989) *available in* WESTLAW, I.E.L. Library.

178. *See* Rey, *supra* note 153, at 10.

179. *See id.*

180. *See* René J.H. Smits, *Some Aspects of the Monetary Law of the European Community*, 2 Legal Issues of European Integration 39, 73 (1980); Smit & Herzog, *supra* note

In addition to the steps taken by the European Council and the central banks, two Community institutions acted to establish the EMS. The Council of Ministers increased Medium-Term Financial Assistance, changed the European Monetary Cooperation Fund's ("EMCF") unit of account to the ECU, and authorized the EMCF to take steps to receive monetary reserves from the Member States and to issue ECUs for exchange-rate intervention.[181] Pursuant to the Council's instructions, the Board of Governors of the EMCF issued decisions adopting the Central Bank agreement.[182] Although the EMCF serves the limited function of recording transactions arising under the Community's short-term credit facilities and the ECU reserve mechanism, and has no staff of its own, the EMCF's decisions were significant because they constituted the EMS's only official Community acknowledgement.[183]

3. Modification of the EMS Legal Structure

In 1987, the Community took several steps to strengthen the EMS. In addition to numerous other modifications of the EEC Treaty, the Single European Act added a new chapter entitled "Cooperation in Economic and Monetary Policy."[184] Article 102a, the only article in the new chapter, explicitly referred to the European Monetary System and called upon Member States to increase monetary cooperation and to "respect the existing powers" in the field of monetary policy.[185] Although this reference to the EMS in the EEC Treaty enhanced the status of the EMS, Article 102a did not expressly acknowledge the system's binding nature and stopped short of formally incorporating the system's requirements into the EEC Treaty.

The Basle-Nyborg Agreement, also of 1987, modified the EMS through amendment of the 1979 Central Bank agreement. Community finance ministers meeting in Nyborg, Denmark and the Committee of Central Bank Governors meeting in Basle, Switzerland agreed to permit increased currency movements within the ERM's fluctuation margins.[186] In addition, the agreement liberalized the availability of financing for in-

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104, at 3-616. *But see* Rey, *supra* note 153, at 11-12 (suggesting that the Agreement merely provided the necessary technical implementation for the binding Resolution).

181. *See* Smit & Herzog, *supra* note 104, at 3-615.

182. *See* Board of Governors Decision 12/79 of March 13, 1979 and Decision 13/79 of March 13, 1979 modifying the very short-term and short-term monetary support arrangements respectively *reprinted in* van Ypersele, *supra* note 96, at 135-37; Smit & Herzog, *supra* note 104, at 3-616.

183. *See* Smit & Herzog, *supra* note 104 at 3-615 to 16.

184. EEC Treaty, *supra* note 97, at art. 102a.

185. *Id.* The Single European Act also cited Article 236 as the basis for further development in the monetary policy field thus ensuring that the Community could take no further steps regarding monetary union without formally amending the EEC Treaty. *See* Francis B. Jacobs, *The European Parliament and Economic and Monetary Union*, 28 Common Mkt. L. Rev. 361, 366 (1991).

186. *See* Smit & Herzog, *supra* note 104, at 3-619.

tramarginal intervention by Member States.[187] Lastly, the agreement emphasized central-bank manipulation of short-term interest-rate differentials, rather than currency realignments to abate destabilizing capital flows.[188] The Basle-Nyborg agreement's goal was to deter speculative capital flows by providing more flexibility for the system and enhancing intra-marginal corrective measures. The agreement reflected the Community's desire "to foster exchange rate cohesion within the EMS"[189] and was perceived as a major step forward in collective Community responsibility.[190]

In 1987, Community interest in Economic and Monetary Union experienced a revival.[191] This was followed, in 1989, by the Delors Report on Economic and Monetary Union in the European Community.[192] The report outlined a three-stage process for the Community to achieve union and contained the nucleus of the plan eventually adopted in the Treaty on European Union ("TEU").[193] The Intergovernmental Conference on Economic and Monetary Union convened in December 1990, to consider the Delors report and formally develop the plan for Economic and Monetary Union.[194] The Intergovernmental Conference's work was finalized at the Maastricht summit and signed on February 7, 1992.[195] After surviving challenges to its adoption in France, Denmark, and Germany, the TEU became effective on November 1, 1993.[196]

As part of the sweeping changes enacted by the TEU, Article 3a declares that the Community shall adopt irrevocably fixed exchange rates leading to a single currency.[197] In addition, Articles 102a through 109 of

187. Prior to the Basle-Nyborg agreement, intra-marginal intervention required the consent of the central bank issuing the currency used in the intervention. The Basle-Nyborg agreement eliminated this consent requirement and made the VSTF more accessible to Member States. *See* Niels Thygesen, *Towards Monetary Union in Europe — Reforms of the EMS in the Perspective of Monetary Union*, 31 J. Common Mkt. Stud. 447, 460 (1993).

188. *See id.*

189. Committee of Governors of the Central Banks of the Member States of the European Economic Community, press communique, Sept. 18, 1987 *reprinted in* Horst Ungerer et al., *The European Monetary System: Developments and Perspectives*, International Monetary Fund Occasional Paper No. 73, 87 (1990).

190. *See* Henderson, *supra* note 99, at 37.

191. *See* European Update: Economic and Monetary Integration, 1991 WL 11671 (D. R. T.) § 1 (1991).

192. *See* Smit & Herzog, *supra* note 104, 3-625 to 26.

193. *See infra* note 197.

194. *See* Bermann et al., *supra* note 101, at 16. A second Intergovernmental Conference on Political Union was convened simultaneously. *See id.*

195. *See id.*

196. *See European Union*, Financial Times (London), Nov. 1, 1993 at 15.

197. *See* Treaty Establishing the European Community, 1 C.M.L.R. 573, 589 (1992). The changes to the EEC Treaty made by the TEU are incorporated into the new Treaty Establishing the European Community [hereinafter EC Treaty], which supersedes the EEC Treaty. Some parts of the TEU, however, are not incorporated into the EC Treaty. Those parts of the TEU that are not incorporated into the EC Treaty are available at 1 C.M.L.R. 719 (1992).

the EEC Treaty, which addressed economic and monetary policy, have been replaced.[198] The TEU assigns specific dates for the beginning of each of three stages culminating in union.[199] The TEU acknowledges that stage one, which emphasizes increased Community policy coordination and the elimination of restrictions on the free flow of capital, has already begun and sets January 1994, as the beginning of stage two.[200] Stage two's principal feature is the creation of the European Monetary Institute ("EMI"). In the future, the EMI's role will be to strengthen monetary cooperation between Member States by issuing non-binding opinions and recommendations on Community monetary policy.[201] The EMI will also prepare the framework for the European System of Central Banks and the European Central Bank, which will both become effective during the third stage.[202]

Stage three will begin in 1997, if the "Council, meeting in the composition of Heads of State or of government," determines that a majority of Member States has complied with the convergence criteria for membership stated in the TEU.[203] Included among these criteria is the requirement that a Member State observe the normal fluctuation margins provided by the exchange-rate mechanism for at least two years without devaluing its currency against any other Member State's currency.[204] In addition, a country must comply with requirements for its inflation rate and fiscal policies.[205] If a majority of countries has not complied by the first deadline, stage three will automatically begin in January 1999 and will include only those countries that meet the convergence criteria at that time.[206] The TEU thus provides for the possibility of a two-speed system in which a core of Member States would form a union that others could join later.[207]

Full monetary union is to be established at the beginning of the third stage.[208] The European System of Central Banks, headed by the European Central Bank, will be created and will decide all Community mone-

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198. *See* EC Treaty, Title VI: Economic and Monetary Policy, 1 C.M.L.R. 573, 636 (1992).

199. *See* EC Treaty, 109j, *supra* note 197, at 652-53.

200. *See European Update*, *supra* note 191, § 2.3.1.

201. *See* EC Treaty, art. 109f, *supra* note 197, at 648.

202. *See id.*

203. EC Treaty, art. 109j, *supra* note 197, at 653.

204. *See id.*

205. *See id.*; M.J. Artis, *The Maastricht Road to Monetary Union*, 30 J. Common Mkt. Stud. 299, 303 (1992).

206. *See* EC Treaty, art. 109j, *supra* note 197, at 653.

207. *See* Artis, *supra* note 205, at 305.

208. *See* EC Treaty, Art 109l, *supra* note 197, at 654-55. The TEU contains a special derogation for the United Kingdom exempting it from the obligation to participate in the third stage of EMU. *See* TEU Protocol on Certain Provisions Relating to the United Kingdom of Great Britain and Northern Ireland *reprinted in* George Bermann et al., European Community Law Selected Documents 191-93 (1993). Denmark also received a similar derogation. *See* Protocol on Denmark *reprinted in* Bermann et al., European Community Law Selected Documents 194 (1993).

tary issues and manage Member States' official reserves.[209] Exchange rates will become irrevocably fixed at the start of the third stage, and the Community will substitute the ECU for all participating member currencies.[210]

C. *Exchange Rate Stability under the ERM*

From its inception in 1979 through March 1983, the ERM experienced seven exchange-rate realignments.[211] During that period, significant disparities existed between the participants' economic policies, and their economies' inflation rates varied correspondingly.[212] As a result, frequent currency realignments were necessary to maintain the ERM's central rates.[213] In 1983, a consensus emerged among the ERM participants that economic policy should focus on combatting inflation. Member States' economic performance began to converge, and from 1983 to 1987, there were only two major realignments.[214] During the third phase, from 1987 to 1992, there were no realignments.[215]

During the 1980s, Germany emerged as the ERM's anchor because of the deutschmark's strength.[216] The deutschmark was Europe's strongest currency because of the Bundesbank's commitment to controlling domestic price levels.[217] Until recently, European countries tied their currencies and interest rates to the inflation-resistant deutschmark in an effort to control their own domestic inflation. According to Pieter Ver Loren Van Themaat, former Advocate General at the Court of Justice:

> Particularly since the liberalization of financial services and capital movements . . . any increase or reduction of interest-rates by the German Central Bank as market-leader . . . is immediately (often within minutes) followed by the many central banks of other Member States who deem it to be of vital interest for their own monetary policy to follow the market-leader.[218]

In part because of the ERM's smooth functioning during the 1980s, much of the Community enjoyed a period of growth and stability.[219] The EMS is also credited with assisting traditionally inflation-prone Member States' economies converge toward Germany's and the Nether-

209. *See European Update*, *supra* note 191, § 2.3.3.
210. *See* EC Treaty, art. 109l, *supra* note 197, at 655.
211. *See* Horst Ungerer et al., *The European Monetary System: Recent Developments*, International Monetary Fund Occasional Paper No. 48, 11 (1986).
212. *See* Smit & Herzog, *supra* note 104, at 3-682 to 83.
213. *See id.*; International Monetary Fund Occasional Paper No. 48, *supra* note 211, at 11.
214. *See* International Monetary Fund Occasional Paper No. 48, *supra* note 211, at 32-34.
215. *See* Organisation for Economic Co-operation and Development, *National Financial Markets*, 53 Financial Market Trends 10, 15 (1992) [hereinafter OECD report].
216. *See id.* at 16.
217. *See id.*
218. Van Themaat, *supra* note 172, at 296.
219. *See* Smit & Herzog, *supra* note 104, at 3-621.

lands' low-inflation performance.[220] Had it not been for the ERM's resilience in the years after 1982, the Community probably would not have had the confidence to pursue plans for Economic and Monetary Union.[221]

D. *Breakdown of the ERM*

On September 13, 1992, the first ERM realignment in five years occurred when Italy devalued the lira by 7%.[222] Three days later, the ERM suffered a major crisis. The United Kingdom exhausted massive sterling reserves[223] and raised its base interest rate from 10% to 12%, and then to 15% in a failed effort to support the pound's exchange rate with the deutschmark.[224] The United Kingdom and Italy then suspended their membership in the ERM.[225] In addition, Spain devalued the peseta by 5%, and both Spain and Ireland instituted exchange controls. On November 23, Spain and Portugal further devalued their currencies by 6%.[226]

A period of relative tranquility followed the events of "Black Wednesday."[227] On August 2, 1993, however, in the wake of intense speculative attacks on several ERM currencies, the remaining participants agreed to expand the ERM's fluctuation margins to 15% above or below parvalue.[228] Meeting in Geneva on October 8-9, European Community economic and finance ministers acknowledged that plans for Economic and Monetary Union would have to proceed at a much slower pace than planned and that the 15% fluctuation margins would remain in place indefinitely.[229]

Speculative pressure against overvalued currencies was the proximate

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220. *See id.*

221. *See id.* at 603.

222. *See* Neill Nugent, *Editorial: The Treaty on European Union: Looking Rather Different Twelve Months On*, 31 J. Common Mkt. Stud. 1, 4 (1993).

223. Estimates are that the UK expended the equivalent of 25% of its total foreign exchange reserves in its failed attempt to support the pound. *See* Kathleen Hays, *European Monetary Union Now Up in the Air*, Investor's Business Daily, Sept. 18, 1992, at 1.

224. *See* Geoffrey Bell, *The Collapse of EMU*, International Reports, Sept. 18, 1992, *available in* LEXIS, News Library.

225. *See* Nugent, *supra* note 222, at 4.

226. *See id.*

227. Klaus Gretschmann et al., *The European Monetary System: The Geography of Economics Versus the Politics of Money?*, *in* Economic and Monetary Union: Implications for National Policy-Makers 45 (Klaus Gretschmann ed., 1993).

228. *See* Thygesen, *supra* note 187, at 447. Although the Community expanded the ERM's official exchange-rate fluctuation bands, the duetschmark and the Dutch guilder maintained their 2.25 percent fluctuation bands throughout the crisis and the Danish krone and French franc returned to their narrow bands as of December, 1993. *See* Financial Times, Feb. 7, 1994, at 1 *available in* DIALOG, FTF file; Lionel Barber, *Denmark Calls for Return to Narrow ERM*, Financial Times, February 15, 1994, at 2; Alice Rawsthorn, *Paris Shrugs Off Industry Gloom*, Financial Times, Dec. 24, 1993, at 2.

229. *See* Daily Report for Executives, Oct. 13, 1993, § A at 196 (BNA) *available in* LEXIS, Nexis library, 1993 DER 196 File.

cause of the ERM's collapse.[230] According to many experts, the underlying shock that precipitated the recent volatility in the exchange markets was the cost of German unification and the German government's unwillingness to finance this cost through normal budgetary measures.[231] While other Member States were mired in recession, the Bundesbank pursued an anti-inflationary policy based on high interest rates.[232] In order to maintain exchange-rate parity with the deutschmark, these countries were forced to increase their interest rates to levels that were unsustainably high in light of these countries' slow economic growth and high unemployment.[233]

International currency speculators correctly determined that several ERM currencies were overvalued and that Member States, principally the United Kingdom and Italy, would be forced to accept devaluation.[234] Because of their lack of confidence in these currencies and in the ERM's ability to maintain Member State discipline, speculators shifted their holdings from the overvalued currencies to the deutschmark, thus precipitating a crisis. The Danish rejection of the TEU in June 1992 and the possibility that France might not ratify the TEU cast further doubt upon the Community's ability to progress toward fixed exchange rates and prompted investors to shift their holdings to the stable deutschmark.[235] According to the Organisation for Economic Cooperation and Development, "market participants were confronted with a one-sided exchange rate risk, and felt that they had little to lose and might realise major gains by reducing their positions in the currencies under pressure . . . ."[236]

The growth of the international currency market and the Community's removal of restrictions on the movement of capital rendered Member States' reserves inadequate to compensate for the flows of "hot capital" that investors channeled into deutschmarks.[237] Professor Alan Walters, former advisor to Margaret Thatcher, explained:

> Since everyone found it profitable to borrow and sell pesetas etc, the only buyers were the central banks and they soon ran out of marks in attempts to maintain the exchange rate. Such is the weight of footloose money that sloshes around world markets that the defense was

230. *See* Thygesen, *supra* note 187, at 447-48.

231. *See* Samuel Britain, *Europe Will Still Need a Monetary System*, Financial Times, Aug. 2, at 12 (1993); Bermann et al., *supra* note 101, at 1197 n.1.

232. See Andrew Scott, *Developments in the European Community Economies*, J. Common Mkt. Stud., August 1993, at 87, 88.

233. *See Europe's Monetary Future: From Here to EMU*, Economist, Oct. 23 1993, at 25.

234. *See* Scott, *supra* note 232, at 89-90.

235. *See* OECD report, *supra* note 215, at 13.

236. *Id.* at 10.

237. *See Europe's Monetary Future*, *supra* note 233, at 26; Rich Miller, *Policy-makers vs. Speculators: More Battles Ahead*, Reuter Community Report, Sept. 21, 1992, *available in* LEXIS, News Library.

brief, futile and expensive.[238]

The destabilizing impact of portfolio shifts moved Jacques Delors, President of the European Commission, to suggest the possible re-implementation of capital controls. According to Delors, "Cars are free to drive but they are subject to traffic rules. I can see no reason why at an international level, we should not study means of limiting monetary traffic."[239]

E. *Underlying Causes of the ERM's Breakdown*

Asymmetry between the Member States' economies played a decisive role in the ERM's disintegration.[240] Most informed observers, however, take the view that the ERM's problems were also a consequence of deep-rooted weakness in the system.[241] One aspect of this weakness that has received relatively little attention is the ERM's flawed legal structure, which proved infirm in two important regards. The ERM's legal foundation is ambiguous, and it created an inadequate commitment mechanism to govern Member States' exchange-rate management. These flaws undermined the ERM's credibility and led investors to challenge the Community's resolve to maintain stable rates.

1. The ERM's Ambiguous Legal Foundation

The EEC Treaty contained only limited obligations regarding exchange rates and did not provide an exchange-rate regime for the Member States.[242] In addition, the EEC Treaty did not give any Community institution the authority to require that a Member State maintain or change its exchange rates.[243] The EEC Treaty included no system of exchange-rate management, in part, because at the time the Member States adopted the EEC Treaty, they were participating in the Bretton Woods system. This lack of specific exchange-rate requirements was, however, also a reflection of the Community's inability to enact a comprehensive, joint monetary policy. Jacques van Ypersele explains:

> The agreement on forming a customs union among the [original members] had been laboriously obtained . . . . If the supporters of tighter integration had tried to go beyond what had been obtained, by demanding more specific commitments on positive integration and economic policy coordination, they would have run the risk of destroying even the consensus that was attained.[244]

238. Alan Walters, *The Fatal Flaws of that System*, Sunday Times (London), Aug. 1, 1993, *available in* WESTLAW, INT-NEWS Library.
239. *Regulating the EC's Monetary Traffic*, Fin. Reg. Rep., Sept. 1993, *available in* WESTLAW, INT-NEWS Library.
240. *See* OECD report, *supra* note 215, at 13.
241. *See* Nugent, *supra* note 222, at 4.
242. *See supra* notes 95-118 and accompanying text.
243. *See supra* text accompanying notes 167-183.
244. van Ypersele, *supra* note 196, at 34.

A similar lack of will on the part of the Member States was evident in the creation of the EMS. The foundation of the EMS, and the ERM in particular, rested upon shadowy instruments of uncertain legal nature. Tommaso Padoa-Schioppa observed:

> The EMS was conceived and created outside the normal Community procedures. It is not, perhaps, a praiseworthy feature, but it is a reality. . . . [T]he bones of the system were negotiated and prepared by a small group of personal representatives of some, but not all the Community countries, completely outside the normal channels, and in spite of the lack of enthusiasm of technicians and several central banks.[245]

The EMS was essentially the product of bilateral political efforts between France and Germany adopted by the central banks, rather than a reflection of firm Community commitment to exchange-rate management. Although the Community could have amended the EEC Treaty or cited Article 107 as the basis for its exchange-rate system in 1978, it chose instead to implement the ERM through far less direct measures.[246] It is clear, as Professor Rey points out, "that the EMS was not intended to serve as a model of legal drafting and institutional consistency."[247]

2. The ERM's Lack of a Commitment Mechanism

In addition to its ambiguous legal origin, the ERM failed to establish a legal regime sufficient to persuade participants and currency investors that the Member States would not abandon it. According to Niels Thygesen, former member of the Delors Committee on Economic and Monetary Union, "[i]t was obvious that the starting point in the EMS was one in which monetary authority rested ultimately in national hands."[248] If a Member State failed to pursue a policy consistent with the ERM's goals, other Member States could not easily implement legal sanctions. Because a Member State's obligations regarding exchange rate modifications were not contained in formal Community agreements, neither a Community institution, nor a Member State seeking to enforce the ERM, could resort to the Court of Justice.[249] Most significantly, participation in the ERM was not mandatory, and those Member States that did participate could leave the system at any time.[250] Lastly, the ERM did not provide for an institution with authority to oversee exchange-rate policy. The ERM thus established soft rules for exchange-rate management and an even softer system for administering those rules. According to *The Economist*, "[t]he ERM was not rigid enough—because, once pressure to devalue mounted beyond a certain point . . . governments did

245. Tommaso Padoa-Schioppa, *Lessons for the European Monetary System*, 2 Banca d'Italia, Economic Bulletin 67 (1986) *quoted in* Gold, Exchange Rates, *supra* note 1 at 19.
246. *See* Smit & Herzog, *supra* note 104, at 3-591.
247. Rey, *supra* note 187, at 29.
248. Thygesen, *supra* note 187, at 467.
249. *See* Smit & Herzog, *supra* note 104, at 3-694.12(8).
250. *See* Smits, *supra* note 180, at 68.

in fact have the option of giving in."[251]

III. Common Weaknesses in the Legal Regimes of the Bretton Woods System and the ERM

The Bretton Woods system and the ERM instituted similar fixed but adjustable exchange-rate arrangements. Furthermore, the ERM's legal regime did not go significantly beyond the original obligations that the Bretton Woods agreement imposed. Although the ERM established the preservation of exchange rates as a joint obligation between the Member States,[252] neither the Bretton Woods system, nor the ERM markedly diminished their participants' sovereignty over monetary policy. Both systems lacked authority to enforce their participants' compliance and relied on nonspecific requirements to establish discipline.

The chief practical deterrent to breach in the Bretton Woods system and the ERM was the international shame that would follow a participant's abandonment of the obligation to maintain fixed exchange rates. This safeguard neither convinced international investors of the systems' credibility, nor stopped participants from leaving when domestic economic conditions made it advantageous for them to do so.[253]

The history of the Bretton Woods agreement and the ERM suggests that in order to endure, an exchange-rate system must be capable of forcing its participants to cooperate when their short-term economic interests would be better served through independent action. Even when all members of an exchange-rate system understand that cooperation will lead to the Pareto superior outcome, they will be unlikely to forgo the benefit of independent action unless they are convinced that the other participants are committed to the system. Confidence in the system cannot be maintained unless the system, itself, includes a legal regime sufficient to deter members from acting unilaterally. As long as participants retain the option of devaluing their currency the incentive for unilateral action remains, and the system's integrity is compromised. Unless participants are willing to make a commitment to a strong legal regime by relinquishing sovereignty over domestic monetary policy, any future exchange-rate system is destined to meet the same fate as the Bretton Woods agreement and the ERM.

Technically, the ERM is still functioning, but a viable Community exchange-rate system is not a realistic possibility in the near future.[254] Nonetheless, because both the Community's single market, and the TEU's plan for Economic and Monetary Union require exchange rate stability, the Community probably will endeavor to resurrect the ERM. "Arguably," according to the Economist, "the EC cannot remain a sin-

251. *Europe's Monetary Future*, Economist, Oct. 23, 1993, at 26.
252. *See supra* text accompanying notes 169-72.
253. *See* Smit & Herzog, *supra* note 104 at 3-621.
254. *See supra* notes 227-29 and accompanying text.

gle market if its currencies are free to fluctuate against each other."[255] Monetary union requires a long transitional period with a resilient exchange-rate mechanism. Member States, however, have shown little willingness to enact an exchange-rate arrangement that undermines their control over domestic monetary policy.

An alternative to the current ERM would be for a segment of the Community to adopt the ECU as its single currency in the near future. Disparities between the Member States' economies make a single currency for the entire Community unlikely. The ERM, however, could be bifurcated with the strong-currency Member States adopting a single currency, while maintaining the present ERM with respect to the other Member States.[256] This would be consistent with the spirit of the TEU, which already provides for a two-tier system to begin in 1999 in the event that all Member States do not meet the convergence criteria.[257] A rapid move to a common currency would eliminate the need for a narrow-band ERM and enable the Community to avoid a drawn-out stage prior to monetary union during which the ERM would be tested severely by markets that are now aware of the Community's lack of resolve in maintaining exchange rates.

CONCLUSION

In light of the fate that befell the Bretton Woods system, it is not surprising that the ERM collapsed. The history of these two systems suggests that semi-fixed, exchange-rate arrangements will not endure in a period of high capital mobility unless the arrangements include commitment mechanisms sufficient to establish the system's credibility with both the participants and the international currency markets. As Horst Ungerer, formerly of the Bundesbank and the IMF, observed, "Ultimately, the underlying question is one of a willingness to surrender sovereignty to common . . . institutions and to share in a common decision-making process."[258] The Bretton Woods system and the ERM were founded on legal regimes that did not have the full commitment of their participants. They remained sound during ordinary times, but they could not survive an extraordinary shock. When faced with a crisis, their voluntary nature proved fatal.

255. *See Europe's Monetary Future, supra* note 232, at 26.

256. *See* Walter Goldstein, *Europe After Maastricht: A Premature Treaty*, Foreign Affairs, Winter 1992/93, at 127; *Europe's Monetary Future, supra* note 232, at 27; Bermann et al., *supra* note 101, at 1203.

257. *See* Bermann et al., *supra* note 101, at 1202.

258. Horst Ungerer, *Europe—The Quest for Monetary Integration*, Finance and Development, Dec. 1990, at 17.