Committee of Governors
of the Central Banks of the Member States
of the European Economic Community

(Translation)

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Draft

REPORT OF THE COMMITTEE OF GOVERNORS TO THE COUNCIL ON THE EUROPEAN MONETARY SYSTEM

In pursuance of the mandate given to it by the Council on 24th July 1978, the Committee of Governors hereby submits to the Council the conclusions of its deliberations concerning the new European monetary system that it was decided to set up at the European Council meeting in Bremen on 6th and 7th July 1978.

The Committee of Governors wishes to stress at the outset that, while a durable and effective system is a necessary prerequisite for the establishment of a zone of monetary stability in Europe, no exchange rate arrangement can make a durable contribution to the achievement of greater stability of exchange rate relationships unless it is accompanied by varied but cohesive action to scale down progressively the disparities of economic development in member countries. Thus, while giving priority to the gradual reduction of inflation rates, an effort must be made to identify procedures leading to a balanced distribution, among deficit and surplus countries, of duties and responsibilities as regards both economic growth and balances of payments. The nature of the exchange rate system adopted could play a rôle in this context.

For as long as significant disparities persist, the system must be sufficiently flexible to accommodate imbalances. It will therefore be necessary to reconcile the need for intra-Community credit facilities on a scale which allows economic and monetary policies time to take effect with the aim of maintaining a satisfactory degree of strictness in order to achieve greater stability. Similarly, steps will have to be taken to permit the adjustment at the right moment of exchange rate relationships whenever such disparities prove excessive, without, however, detracting from the credibility of the exchange rate commitments undertaken.

In view of the urgency of these matters, the Committee of Governors concentrated on decisions essential to the smooth functioning of the arrangements due to come into force at the start of the transitional period. It intends to continue its studies on the operation of the future European Monetary Fund.

The arrangements to be decided upon relate to the choice of numeraire, the exchange rate system, the credit system and the settlement system.

I. THE NUMERAIRE

The decision taken in Bremen to place the ECU at the centre of the system implies that agreement must be reached on the definition of the ECU and on its uses.

1. Definition of the ECU

The Governors consider that the definition of the ECU should correspond to that of the European unit of account (EUA) but should allow for the possibility of revision. Among the various formulae considered for possible modification of the basket, the Governors were more particularly favourable to the idea of the "revisable" basket, the composition of which would be subject to review every five years, or at the request of a country if the relative weight of a currency had changed by more than 25 per cent. since the last revision. The object of any change in the composition of the basket would be to restore a distribution of weights consistent with the economic criteria, duly updated, used as a basis for the initial determination of weights. The revision would be effected in such a way as to guarantee continuity of the value of the ECU when the composition of the basket was modified.

. Some feel that the composition of the basket should be updated in accordance with the principle suggested above even before the entry into operation of the new European monetary system. Without opposing this possibility, the Governors took note of the reservation expressed in this connection by the representative of the Commission, given the risk of disrupting efforts to harmonise the units of account currently utilised in the Community if the decision to revise the basket remained limited to the European monetary system.

2. Uses of the ECU

The ECU, thus defined, would be used:

- as a common denominator for the expression of central rates;
- as an indicator to detect divergences between Community currencies;
- as a unit in which assets and liabilities held with the EMCF (claims and debts as well as reserve assets) would be denominated.

The central rates would be expressed in the form of a fixed, but adjustable, parity between each currency and the ECU, and would be notified to the EMCF. The very nature of the numeraire, comprising a basket of Community currencies, implies that any change in the central rate of a currency would require a corresponding adjustment of the central rates of the other currencies, triggering consultations and thus satisfying the requirement of mutual agreement in such circumstances, as outlined by the European Council meeting in Bremen.

The central rates expressed in terms of the ECU would be used to determine the "grid" of reciprocal parities between currencies, and the margins of fluctuation adopted around these parities would make it possible to fix the compulsory intervention rates which would be announced to the market. However, the exchange rate system would differ from that of the "snake" through the addition of an indicator of divergence based on the deviation of the daily value of the ECU expressed in each currency from the central rate. When this deviation exceeded a certain threshold, known as the "divergence threshold" and fixed, for experimental purposes, at 75 per cent. of the maximum theoretical spread for each currency, the monetary authorities of the country in question would be presumed to have to act in such a way as to reduce or eliminate the risk of tension in accordance with the conditions outlined in the following section and in Annex 1.

The operations of the EMCF would henceforth be denominated in terms of the ECU instead of the EMUA (European monetary unit of account). [The exchange guarantee attached to very short-term financing would thus be modified]; claims and debts in respect of short-term monetary support would also be denominated in ECUs. The assets created as a counterpart to the contributions to the EMCF of gold and dollars would represent "reserves in

ECUs"; however, the swap technique proposed for contributions during the transitional period would mean that the risk attaching to assets transferred in this way to the EMCF would be left with the various central banks.

II. THE EXCHANGE RATE SYSTEM

The stabilisation of exchange rates on which the creation of a zone of stability depends must be based on a durable and effective system. In the Governors' view, this system should incorporate three elements designed to reinforce each other mutually: the fluctuation limits determined by the parity grid and the margins adopted around these parities; the presumption to act associated with a currency's crossing the divergence threshold based on the ECU; the co-ordination of policies vis-à-vis third currencies.

1. The parity grid and the margins

Like the "snake", the exchange rate system would involve compulsory intervention rates fixed on either side of the reciprocal parities. At these rates, interventions would be undertaken on an unlimited scale in the markets concerned through the sale of one or more strong Community currencies against the purchase of one or more weak Community currencies.

As far as the present member countries of the "snake" are concerned, the margins of fluctuation would remain unchanged at 2.25 per cent. on either side of the reciprocal parities. The Governors propose that the option for the other countries of applying wider margins, at least in the initial stage, should be exercised on the understanding that such margins may not exceed 4 per cent. on either side of the reciprocal parities and may not result in the creation of more than two bands of fluctuation in the new European monetary system.

2. The effects of the divergence threshold based on the ECU

The Governors consider it useful to add to the exchange rate system a mechanism for detecting divergences, the object of which would consist essentially in triggering the action necessary to prevent or check tension or a risk of tension in the Community band or bands.

The presumption to act which would be associated with crossing the divergence threshold is analysed in Annex 1 in terms that are acceptable to most of the Governors. They all believe that the proposed consultations in the event of a confirmed divergence could make a useful contribution towards the adoption of appropriate measures and the stability of the exchange rate system. It is recognised that such consultations would have to be held at levels of responsibility enabling adequate decisions to be adopted.

While the views of the Governors still differ as regards the emphasis to be laid on diversification of interventions as the primary objective of the proposed presumption to act, /the Committee is prepared to recommend, in view of the flexibility of the arrangements envisaged, that the system should be implemented on an experimental basis in accordance with the guidelines set out in Annex 1, in the traditional spirit of co-operation among central banks/.

3. Co-ordination of policies vis-à-vis third currencies

While closely linked with whatever action is recommended in regard to the indicator of divergence, the co-ordination of exchange rate policies vis-à-vis third currencies remains a highly desirable objective even in the absence of tensions or divergences in the Community band.

The Governors consider that in this field close concertation among them and, if necessary, with the issuing authorities of the third currencies concerned would make it possible to co-ordinate the action taken. While there can be no question of pursuing a common policy with a view to stabilising the rates of a third currency, it is nonetheless desirable to avoid applying incohesive national policies in respect of interventions in third currencies.

III. THE CREDIT SYSTEM

The Governors have sought the most appropriate ways and means of implementing the desire expressed at the meeting of the European Council in Bremen to increase the potential for intra-Community credit in connection with the exchange rate system and, in particular, to provide substantial short-term credit facilities.

In this regard the Governors have considered the possibility of modifying the structure of short-term monetary support in such a way that credit would be provided not through central-bank financing but by creating assets in ECUs against the deposit of national currencies. Although this idea aroused considerable interest among the Governors, some doubted whether it would be possible in the time available to resolve the legal problems that such an innovation was bound to pose and expressed reservations regarding the volume of assets in ECUs that a central bank might have to accumulate unless an acceptance limit were set. The Governors therefore agreed to propose for the immediate future that the support mechanisms be expanded in their present form pending solution of the problems to which implementation of a revamped system would give rise.

1. <u>The volume of credit</u>

An increase in the volume of credit facilities raises the problem of allocation between medium-term financial assistance, which is not the direct responsibility of the central banks, and short-term monetary support (it being agreed that very short-term financing should remain unlimited in amount). The relationship between the two mechanisms is further complicated by the length of time that, in the opinion of some Governors, would be required to implement any increase in medium-term financial assistance.

Assuming that the overall amount of credit facilities should be ECU 25 billion, which is generally accepted as the intention of the European Council in Bremen, the Governors have examined various ways of dividing the total between the short and medium-term support mechanisms, several different approaches based either on the volume of financing commitments or on that of the credit effectively available, and a variety of combinations of relative increases in the quotas and rallonges under the short-term monetary support arrangements.

The Governors have not yet been able to draw any final conclusions from this examination. /However, it did appear that, provided medium-term financial assistance were suitably increased within a sufficiently short space of time, a compromise between the ideas expressed might lie in maintaining the existing relationship between quotas and rallonges within the short-term monetary support mechanism but increasing the amount of credit effectively available under this arrangement from ECU 5.8 billion to around ECU 15 billion. The quotas and rallonges would accordingly be multiplied by approximately 2.6/ (see Annex 2).

2. The duration of credit

The Governors are in agreement in proposing that the maximum combined duration of automatic very short-term financing and short-term monetary support should be extended from 10-11 months to 14-15 months.

As long as the present structure of short-term monetary support remains unchanged, this total duration would be divided as follows: the initial maturity of unlimited financing would be extended by one month, thus increasing its duration to 60 days from the end of the month. The facility providing for the automatic three-month renewal of this financing for an amount not exceeding the debtor quota under the short-term monetary support arrangement would remain unchanged. The maximum duration of short-term monetary support would be increased to three periods of three months.

/One central bank, however, maintained its reservations about extending the duration of the initial very short-term financing to 60 days from the end of the month./

3. Other provisions

The short-term and very short-term credit facilities would remain unchanged in all other respects. The interest rate for very short-term financing would thus remain equal to the arithmetic mean of the discount rates applied by the participating central banks and the interest rate for short-term monetary support would continue to be set by the Governors as and when support was granted.

/Some central banks, however, would like special provision to be made with regard to the duration of credit or interest rates in order to alleviate the burden on debtor central banks in connection with interventions carried out in their currencies against a "divergent" strong currency./

IV. THE SETTLEMENT SYSTEM

From the beginning of the transitional period the settlement system should be based on the use of assets in ECUs created as a counterpart to the contributions of gold and dollars to be made to the EMCF.

The Governors have considered the method of creating ECU assets, their potential uses and their properties.

1. The creation of ECU assets

During the transitional period functional simplicity should be a major consideration in the formulation of solutions to the problems raised by the creation of assets in ECUs against reserve contributions.

With this aspect in mind, it is proposed that initial contributions should be confined to assets in gold and dollars, as indicated in the guidelines laid down by the European Council in Bremen. Each central bank would contribute to the EMCF an amount of gold equal to 20 per cent. of the weight of its gold holdings, together with either 20 per cent. of the dollar equivalent of all its other gross reserves or, as some would prefer, 20 per cent. of its gross dollar assets only (see Annex 3).

Each central bank would be credited with the ECU equivalent of its contributions. The conversion rate in the case of the dollar would be the market rate; in the case of gold, the Governors have examined a number of possible formulae, all designed to establish a conversion rate close to and derived from market prices.

The Governors feel that for the transitional period the creation of ECU assets against gold and dollar contributions should take the form of three-month swaps renewable indefinitely. The risks attaching to the contributions, whose composition would vary widely, would thus continue to be borne by the individual central banks. At a later date, when procedures are being worked out for the European Monetary Fund, consideration might be given to the definitive transfer of reserve assets to the Fund and a consequent Community-wide pooling of risks.

The initial creation of ECUs would be followed at set intervals by adjustments to maintain the desired relationship between the overall volume of ECU assets and the volume of other reserve assets. Procedures for these adjustments, which should constitute a simple means of responding to the desire expressed in Bremen that ECU assets should move in line with reserve changes resulting from purchases and sales of dollars, will have to be worked out but must be compatible with the rôle of ECU assets in intra-Community settlements.

2. The use of assets in ECUs

If they are to rank with other categories of reserve instruments, assets in ECUs will have to be endowed with comparable properties, notably as far as usability is concerned.

The main function of ECU assets will be in the settlement of liabilities arising in the context of very short-term financing. Accordingly, the debtor country should have the option of departing from the principle that repayment must be effected in accordance with the composition of its reserves if it wishes to use a larger ECU element or, indeed, only ECU assets in settlement.

It should also be possible to use ECU assets to buy convertible currencies, in particular dollars, in case of need. Mobilisation for this purpose could take the form of dollar swaps with the EMCF itself or voluntary transfers between central banks.

3. Properties of ECU assets

The Governors are of the opinion that all ECU-denominated assets held by a central bank either as a result of very short-term financing or in the form of claims under short-term monetary support or reserves corresponding to contributions of gold and dollars should be treated uniformly from the point of view of remuneration.

This would be possible if two provisions were implemented: the first would be to charge the central banks a custody fee in respect of their gold contributions so as to give the EMCF a return on the gold comparable with that on investment of the dollar contributions. The second would be to pay interest on the ECUs on the basis of the average return obtained by the EMCF on its dollar investments, the gold contributions and its ECU-denominated claims.

Throughout the transitional period the central banks' ECU assets would be tied to forward commitments equivalent to their contributions of reserve assets. At the end of the transitional period the swaps would be unwound, for which purpose those central banks that no longer held a corresponding amount of ECU assets would either repurchase ECUs from the central banks that had accumulated them against settlement on the traditional basis of the Basle Agreement, or surrender to the new European Monetary Fund the gold and dollar assets constituting the counterpart of the swaps according to the rules of the new system.

THE OPERATION OF THE INDICATOR OF DIVERGENCE BASED ON THE ECU

The indicator of divergence based on the ECU would operate under the conditions described below.

1. The normative significance of the "divergence threshold"

(a) When a currency exceeded the divergence threshold, there would be a presumption that the monetary authorities concerned would take action.

This presumption would not be based on an imputation of "abnormality" in the behaviour of the divergent currency but would be aimed at the early detection of a risk of tension in the European monetary system, owing to a currency's tendency to diverge from the others.

The presumption thus proposed would be open to discussion; it could be invalidated by sound arguments put forward in the concertation procedure. The nature of these arguments is examined in Section 2 of the present note.

It should be noted at the outset that in order to invalidate this presumption it would not be sufficent or necessary to prove that the origin of the tension was unconnected with the situation of the divergent currency or was attributable to the situation of other, even non-divergent, Community currencies: instead, it would be necessary and adequate to show that action on the part of the monetary authorities responsible for the divergent currency would be inadvisable from the point of view of the stability of the European monetary system.

(b) The action deemed expedient when the divergence threshold was exceeded would consist, first of all, in diversified interventions in the exchange market.

Nonetheless, intervention would not take precedence over other measures designed to eliminate or check the divergence. Other measures, such as changes in monetary policy, the regulation of capital movements, fiscal or budgetary action, or an adjustment of the central rate might also be considered. From the point of view of timing, however, intervention in the market could, generally speaking, be implemented more rapidly than other measures and would enable the expediency of applying less easily reversible instruments to be tested if the divergence were a temporary one. It should be noted that intervention itself is not automatic, since it must be administered in "doses". There would be no obligation to "maintain" a bilateral rate as long as the compulsory intervention point had not been reached.

If, however, the intervention commitment seemed too mechanical, it might conceivably be delayed until the crossing of the divergence threshold had been confirmed by five consecutive days of "divergence". The delay could be used to trigger consultations.

A central bank anxious to avoid being compelled to undertake intra-marginal interventions because its currency would then exceed the divergence threshold could also initiate preventive or optional "advance" consultations if its currency was approaching the threshold (for instance, when it had covered 80 per cent. of the distance between the central rate in ECUs and the divergence threshold).

(c) As the object of intervention would be both to check the divergence and to alleviate the burden on currencies in opposite positions, the idea of diversification of interventions is very important.

This concept implies that the interventions necessary when the divergence threshold was exceeded would not normally be effected solely in the currency at the other limit of the band. They would also be effected in dollars and/or in other Community currencies unless the use of these currencies was inadvisable on other grounds.

When the bilateral intervention limits were reached, the action which the central bank whose currency had crossed the divergence threshold was presumed to take would not be the intervention itself, which would in any case be compulsory, but diversification of the choice of intervention currencies with a view to lightening the burden on the currency furthest removed.

2. Motives for and limits to exemption

When a central bank was presumed to have a duty to intervene, the intervention might be inexpedient for reasons relating either to the behaviour of the divergent currency itself or to that of the intervention currencies likely to be used.

As regards the divergent currency, intra-marginal intervention might be inadvisable on the grounds

- either of market strategy: in the event of a speculative wave, intra-marginal intervention is useless. Exogenous events (electoral period, strikes, etc.) can increase the likelihood of such movements; it would be possible to exempt the central bank concerned from the presumption in favour of intervention even before the divergence threshold was reached;

- or of monetary policy: in this case, it is not so much the act of intervention as the volume of intervention that counts. However, if the central bank whose currency was divergent refused to adjust its monetary policy with a view to reducing tensions in the European monetary system and if it emerged in the course of concertation that an adjustment of other countries' monetary policy in the opposite direction was also ruled out, the need for an adjustment in the central rate would become more likely.

As regards the intervention currencies, action in the market might be deemed inadvisable owing to:

- the absence of Community currencies in the opposite "border zone";

- attainment of the ceilings set on the amount of interventions that might be made in the currencies located in the border zone;

- factors discouraging use of the dollar (danger of accentuating an undesirable spontaneous tendency, risk of interventions in the opposite direction, etc.).

These motives for exempting from the intervention obligation a central bank whose currency was divergent might be countered by other considerations possibly lending force to the presumption in favour of diversified interventions.

This would be the case, in particular, in the event of tensions in the Community band between a divergent currency and a non-divergent currency;

- if, assuming that the divergent currency was a strong one, the non-divergent currency at the other limit had, on the basis of the movement recorded on the preceding days vis-à-vis the dollar or the SDR, nevertheless been appreciating;

- if, assuming that the divergent currency was a weak one, the non-divergent currency at the other limit had, on the basis of the movement recorded on the preceding days vis-à-vis the dollar and the SDR, nevertheless been depreciating.

In such situations, when the divergent currency was clearly exercising a "pull" on the whole of the Community band, interventions in third currencies would have to be undertaken by the central bank whose currency was divergent, as a rule in the same proportion at least as interventions in Community currencies, unless other adjustment measures, notably the adjustment of the central rate of the divergent currency, were adopted.

3. Community currencies in the border zone

The central banks whose currencies were located in the border zone would have to agree in the course of concertation to their currencies being used in interventions by others, up to the fixed ceiling.

This would no longer be a presumption but an obligation necessary to create a pool of utilisable resources for the central banks whose currencies were divergent. The annex to the Bremen communiqué having expressed a clear preference for interventions in Community currencies, the lightening of the burden imposed on the central bank whose currency was at the intervention point would imply using other currencies which were not at the intervention point.

The ceiling placed on these interventions could be expressed in proportion to the quota under the short-term monetary support arrangements; any intra-marginal intervention effected would "break into" the ceiling for a period of three months.

4. Persistent divergence

The Belgian proposal provides for compulsory consultations among monetary authorities in the event of a persistent divergence for a fixed period.

This period might be set, for example, at fifteen days of divergence in any three months (comprising about sixty working days). The object of these consultations would be to consider all adjustment measures that might be undertaken by the country whose currency was divergent or by other countries with a view to assuring the stability of the European monetary system.

Annexes 2 and 3 will be dispatched tomorrow