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Committee of Alternates



WORKING DOCUMENT FOR THE GOVERNORS' DISCUSSION OF A NEW  
EUROPEAN MONETARY SYSTEM

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On the basis of the Heyvaert Group's attached Report No. 39 and of their own deliberations, the Alternates wish to draw the Governors' attention to a number of fundamental problems in regard to which choices will have to be made in due course.

Depending on the context, these choices will be made:

- by the Governors themselves, if they consider that the matter falls within their competence;
- by the Ministers, where this is deemed appropriate by the Governors on account of the more political nature of the choice.

In view of the complexity and unfinished state of work on the project in question, it seemed preferable to the Alternates to refrain from advising the Committee of Governors at this stage to adopt any definite stance - which could have been made known to the Council of Ministers on 18th September - regarding the proposals contained in the Bremen communiqué, until the Committee itself had been able to discuss in greater detail the questions at issue. The Alternates considered that the Committee of Governors should judge for itself, in the light of the results of its meeting on 12th September, what kind of report it wished to make to the Council (ECOFIN) on 18th September.

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The Alternates would like to point out, first of all, that the object of the European monetary system is to set up a zone of stability, while fulfilling the specific requirements of durability and effectiveness. It is clear, however, that 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. While giving priority to the gradual reduction of inflation rates, the Governors consider it desirable 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 regard to all these matters.

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 commitments undertaken.

Recognition by the Council of Ministers of the characteristics and conditions described above would in itself represent an important step forward as regards the structure of the proposed new European monetary system.

#### A. THE EXCHANGE RATE SYSTEM

##### 1. Fundamental concepts:

Three fundamental concepts are conceivable for the exchange rate system; these are reflected in the choice of the numeraire and the use made of it, with the ECU being used in all three cases for:

- defining central rates,
- denominating debts and claims,
- the creation of a new reserve asset.

- (a) The intervention limits would also be defined in terms of the ECU; for the countries belonging to the "snake" arrangement the obligations arising from these limits would apply in addition to those under the "snake" expressed in terms of bilateral intervention rates.
- (b) Bilateral intervention rates would be expressed in terms of currencies, as in the "snake" ("parity grid").
- (c) The two systems would be combined to the extent that the intervention rates would be defined in terms of currencies, while the ECU would serve as an indicator of divergence from which the position of each currency and the appropriate onus of intervention and adjustment could be assessed.

The considerations to be weighed in choosing among the three concepts are outlined in the Heyvaert Group's report:

- in respect of the basket systems, pages 3-5,
- in respect of the parity grid, pages 5-6,
- in respect of the hybrid formula, page 6.

They relate to:

- (1) Certain technical aspects of the various systems, in particular,
  - the need to calculate and constantly monitor the value of each currency vis-à-vis the ECU,
  - the implications of a change in central rates,
  - the implications of the possible temporary or lasting non-participation of one or more currencies in the system,
  - the degree of automaticity in the choice of intervention currency.
- (2) The question of the symmetry of adjustment and the approach to an exchange rate policy vis-à-vis the dollar.

The distinctive feature of the basket systems is that a currency may reach its upper or lower intervention limit without another currency necessarily reaching its opposite limit. Views differ as to whether this feature (which leads to "involuntary creditors and debtors") can usefully

be turned to account to exert a certain amount of pressure, via the rules governing intervention or settlement, towards adjustment by the country whose currency has "diverged".

Furthermore, whatever basic concept is adopted, the basket to be used as numeraire could be a standard basket (like the present EUA) or an adjustable basket. The respective merits of the two formulae are discussed in the Heyvaert report (pages 4-5). It has, moreover, been pointed out that the choice of the standard basket to define the EUA in 1975 was dictated by the independent floating of several Community currencies, while the present concern is to choose a basket comprising all the Community currencies that is suited to its rôle in the European monetary system. The question also arises whether the possible effect of this choice on the other areas of use of the unit of account should be taken into consideration, bearing in mind the aim of unifying the units of account used in the Community.

Question:

With the above considerations in mind, do the Governors wish to propose to the Ministers a choice between:

- the three fundamental concepts of the exchange rate system;
- the standard basket and the adjustable basket?

Related questions:

1. Co-existence with the "snake"

Under a system with a basket-type numeraire the aim could be:

- to set the ECU margins in such a way that the intervention limits under the "snake" arrangements would hardly ever be reached ("hibernating snake"); or,
- to keep the "snake" fully operational so that its intervention rules would always come into play before those of the ECU system for the currencies concerned; or,
- to ensure a certain amount of alternation in the incidence of the intervention obligations under the "snake" and ECU systems.

Question: How is the co-existence of the ECU system, if it is adopted, and the "snake" to be conceived?

2. Graded margins:

Under an ECU system the unequal weight of the various currencies in the basket may, in the absence of compensatory provisions, lead to unequal fluctuations in the different currencies, to the disadvantage of those currencies with the lightest weighting.

Question: Under an ECU system would this imbalance be offset by adopting graded margins so as to restore the symmetry of nominal exchange rate fluctuations and thus of the intervention burden?

2. Apportionment of the onus of intervention

Whatever choice is made between the various basic concepts of the exchange rate system, it will be necessary to decide on how the onus of intervention in Community currencies and third currencies should be apportioned.

(1) In Community currencies

The relevant considerations are to be found in the Heyvaert Group's report (pages 11 and 12).

Question: Is it accepted that interventions in Community currencies should be more systematic and diversified even if the currencies in question have not reached the intervention points (in nominal terms or vis-à-vis the ECU) that had been disclosed to the market?

(2) In third currencies

The Governors have already reached agreement on the co-ordination of intervention policies in third currencies, as reflected in the following terms in their Report to the Council of 9th December 1975:

"(a) The "snake" central banks will be justified in refraining from making dollar interventions which should be carried out under the arrangement of 12th March 1975 when such interventions would either obstruct greater cohesion within the "snake" or might give rise to mandatory interventions in European currencies.

- (b) Even if they were to make for greater cohesion within the "snake", interventions in dollars that would accentuate that currency's trend instead of merely limiting its fluctuations shall in principle be subject to prior concertation.
- (c) Certain difficulties might be partially resolved by resorting to interventions in "snake" currencies within the margins.
- (d) Central banks with floating currencies will, if need be, have the possibility of defending their currencies by intervening also in strong "snake" currencies, particularly when the dollar is falling. Such action shall be the subject of ad hoc arrangements.
- (e) To improve co-ordination of the action envisaged, particularly in the event of pronounced movements on the exchange markets, more frequent ad hoc concertation will be arranged."

However, this agreement had scarcely any effect on action at central-bank level.

Question: Are existing arrangements in this field adequate or should new guidelines be drawn up, having regard, inter alia, to the new features of a system based on the ECU?

## B. THE EUROPEAN MONETARY FUND

### 1. Programme of action

The setting-up of the European Monetary Fund will undoubtedly take as long as foreseen in the Bremen communiqué, given the scale of the political, legal and technical problems that have to be resolved.

Question: Should the application of all the provisions relating to the European Monetary Fund be postponed until all the conditions for its establishment have been fulfilled or could these provisions be carried into effect gradually as follows:

- The EMCF structure, adapted as necessary for the immediate implementation of an intervention system, would be used as a starting-point;

- the EMCF would subsequently undergo a more fundamental reorganisation so as to exploit all its potentialities from the point of view of the Community;
- finally, the EMF would be set up and the arrangements concluded or to be concluded would be consolidated within its framework, which would involve, in particular:
  - (i) the Community-wide collectivisation of risks attached to assets contributed to the Fund;
  - (ii) the actual depositing of national currencies as the basis for administering Community credit;
  - (iii) the development and use of the ECU?

## 2. The transitional phase

The entry into operation of the transitional phase will be hampered by legal difficulties, at both national and Community level, in the early stages. Pending the resolution of these difficulties, claims and liabilities arising from interventions and requiring recourse to very short-term and short-term credit facilities would be denominated in ECUs and entered in the books of the EMCF.

The settlement of these facilities would be effected in accordance with the rules currently in force within the EMCF, that is to say by means of the creditor country's currency or through the transfer of reserve elements by the debtor country.

To clarify the nature of the legal problems arising from the implementation of a system involving the creation of ECUs against contributions of reserves and their use in intra-Community settlements, decisions will have to be taken on the following points:

- recourse to the "swap" technique for the creation of ECUs against contributions of reserves;
- the choice between creating ECUs against dollars and gold or, experimentally, against dollars only for the equivalent of a fixed proportion - say, 20 per cent. - of gross holdings of the assets contributed;

- the choice between systematically depositing with/withdrawing from the EMCF 20 per cent. of any central-bank purchase/sale of dollars and allowing a certain amount of flexibility in these adjustments while ensuring both a sufficiently ready convertibility into dollars of assets in ECUs and a regular supply of dollars to the Fund in line with the growth of reserves;
- the right to use assets in ECUs as legal tender in intra-Community settlements and the obligation on central banks that have accumulated assets in ECUs to surrender a portion against their national currency or against other reserve assets.

### 3. The credit system

To ensure the proper functioning of the new exchange rate system from the transitional period onwards, substantial short-term credit facilities should be made available, as foreseen in the Bremen communiqué.

Questions: Do the Governors consider that this provision should be implemented, wholly or partly, in the form of:

- an extension of the duration of unlimited very short-term financing?
- an expansion of the arrangements for automatic renewal of such financing?
- an expansion of the amount and duration of short-term monetary support?

What form of access to the enlarged credit facilities should be open to countries that have temporarily opted out of the intervention obligation?