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

(Translation)

14th September 1978

ORAL REPORT TO THE COUNCIL BY THE CHAIRMAN OF THE COMMITTEE OF GOVERNORS

In pursuance of the mandate given to it by the Council, the Committee of Governors has attempted to define what might be the essential characteristics of the European monetary system that it has been agreed to establish. Adopting as a working basis the conclusions of the Presidency and the annex published at the close of the European Council meeting in Bremen, as well as the conclusions reached by the Council (Economic and Financial Affairs) on 19th June and 24th July 1978, the Committee of Governors initiated the necessary preliminary technical studies, the results of which have been set out in a report by the experts which has been circulated to the central banks and Treasuries.

In view of the preliminary nature of their discussions and of the need for complementary studies, the Governors consider it preferable, at this stage, that an oral report be presented to the Council of Ministers on the position reached so far, in particular with regard to the numeraire and the exchange rate system. The Governors have also agreed that more detailed opinions concerning the reciprocal credit machinery and the European Fund will be submitted to the Council subsequently, at its meeting on 18th October next.

The Committee of Governors notes, firstly, that the European monetary system that has as its goal the establishment of a zone of greater exchange rate stability must be structured in such a way as to be both durable and effective. Secondly, it points out that the disparities in member countries' general economic conditions which are likely to persist for quite some time require the system to be sufficiently flexible to accommodate them. Thirdly, it notes that the new exchange rate arrangement linking all the Community currencies will have to include a system of intra-Community credit facilities which, while allowing economic and monetary policies time to take effect, also retains a degree of constraint commensurate with the pursuit of stability.

In their discussions the Governors have focused on the three main issues of the numeraire and the exchange rate system, the reciprocal credit machinery and the European Fund.

I. NUMERAIRE AND THE EXCHANGE RATE SYSTEM

The Governors note that the numeraire must perform a threefold function:

- constituting the basis of the exchange rate stabilisation system;
- determining the value of liabilities and claims resulting from interventions effected on the foreign exchange market in order to ensure that the agreed fluctuation margins are respected;
- fixing the value of the assets in ECUs to be created by the European Fund.

The first priority is therefore to establish the characteristics of the numeraire in the light of their implications with regard to these three functions.

The first fundamental question that arises in this connection is that of the composition of the numeraire. Should it as a matter of principle include the currencies of all Community member countries or only those that participate in the exchange rate system?

The Governors are unanimous in agreeing that, for the second and third of the functions mentioned above, it is essential that the numeraire embrace all the currencies of the Community.

As far as the first of these functions is concerned, the Governors are thus far divided: some of them are in favour of applying the intervention margin to a basket-type numeraire and consider that the basket should include all the Community currencies, irrespective of whether or not they participate in the intervention system; others favour the establishment of bilateral intervention limits between all the participating currencies, using the parity grid mechanism. The latter alternative would avoid the difficulties arising from the non-participation in the exchange rate system of one or more Community currency. The ECU basket could, in this case, still be used to establish the central rates on which the parity grid was based and, more important, as an indicator of a currency's divergence, since the ECU basket represents a cross-section of currencies.

The Governors are at all events unanimous in emphasising the importance of devising a system in which the currencies of all the member countries can participate on a lasting basis. It will therefore have to be able to survive during the necessarily long process of convergence of fundamental policies, which, moreover, could be assisted by steps taken on other fronts.

The <u>second question</u>, which is related to the first, concerns the choice to be made between the standard basket (EUA in its present definition) and the adjustable basket. Despite the preference expressed by some Governors for the standard basket, it seemed that, by virtue of its rigidity, a numeraire of this type might, following changes in central rates, give rise to politically unacceptable distortions; it might also, in the event of the temporary non-participation of a currency in the intervention system, raise problems to which no fully satisfactory solution could be found. The Governors therefore looked into the question of whether a basket that was revisable under certain agreed circumstances might not provide a solution acceptable to all. Such a basket would not be quite as volatile as the adjustable basket nor as rigid as the standard basket. The procedures for revision would have to be considered very carefully so that all the implications were fully appraised. The Committee of Governors has entrusted the task of studying these procedures to a group of experts, and will, therefore, shortly be in a position to state its views on the subject.

The <u>third basic question</u> examined concerns the co-existence of the present "snake" arrangement with the new system that would be set up. At this stage, the Governors are of the opinion that the members of the "snake" should be able to continue fulfilling their commitments under that arrangement and that consequently the new exchange rate system should be organised in such a way as to enable the two exchange rate systems to co-exist for as long as is deemed appropriate. The problem of co-existence would disappear if it were decided to base the new intervention system on a parity grid.

II. RECIPROCAL CREDIT ARRANGEMENTS

At this stage of their work, the Governors do not feel they are in a position to express a clear-cut and final opinion on the structure, scale and duration of the credit arrangements that would be required for the new European monetary system to function smoothly. They are examining this matter in the context of their study of the European Monetary Fund and in the light of the possible characteristics of the exchange rate system.

It is clear, however, that the European Monetary Fund cannot be set up at short notice, i.e. by the time the exchange rate system is introduced, whereas that system will require substantially larger credit facilities than those existing at the moment. It follows that during a transitional period the monetary system would have to operate on the basis of enlarged credit arrangements which would be incorporated in the Fund later, when the new institution has been established and entrusted with the task of granting and administering the arrangements for reciprocal financial assistance.

The Governors are going to examine more closely the need for an expansion of credit facilities, particularly as far as the very short-term and short-term facilities that fall within the competence of the central banks are concerned. The Committee of Governors has agreed to report to the next meeting of the Council on the conclusions it reaches concerning the possibilities of adapting the existing credit arrangements. A similar study should be carried out with regard to medium-term assistance, since it is essential to reach agreement on the overall structure of the enlarged intra-Community credit system before the exchange rate machinery comes into operation.

III. THE EUROPEAN MONETARY FUND

As indicated in the annex to the Bremen communiqué, two years at the latest after the entry into operation of the monetary system, the existing arrangements and institutions are to be consolidated in a European Monetary Fund.

To ensure that the fullest advantage is taken of this period in terms of resolving the numerous political, legal and technical problems raised by the creation of a new Community institution, the Governors consider that it would be desirable, in the light of any proposals that might be made by the Commission in this regard, to specify as soon as possible the nature and functions of the Fund as it should be in the final stage.

The way in which the creation of assets in ECUs develops subsequently will necessarily hinge on the answers that are given to these questions. Depending on the concept that is adopted, this may or may not involve a genuine Community-wide collectivisation of the risks attached to contributions of reserve assets.

The Governors feel that a preliminary phase could be initiated within a relatively short time, provided that certain conditions are fulfilled. For instance, the contribution of reserves to the Fund leading to the initial creation of ECUs should not involve transfers of ownership or an implicit redistribution of assets among central banks (formulae such as deposits or swaps might be contemplated). It would also be advisable during the transitional period to make use of the European Monetary Co-operation Fund, adapted as required by the introduction of the new intervention and settlement system.

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The Committee of Governors is continuing its work on the European monetary system with a view to submitting to the Council of Finance Ministers at its meeting in October a more detailed analysis and more definitive views on the basic questions or options arising out of the introduction of a new system which have not been described in today's interim oral report.