



ORAL REPORT BY THE CHAIRMAN OF THE COMMITTEE OF GOVERNORS

Further to its earlier analysis in preparation for the Council meeting on 18th September, and bearing in mind the Council's discussions, the Committee of Governors continued its studies in order to determine more precisely the essential elements on which the new European Monetary System should be based.

The Committee directed its attention in turn to the kind of basket that might be adopted as numeraire for all the functions that unit will be called upon to perform, the composite formula for combining the parity grid and the indicator of divergence based on the ECU, and the reciprocal credit arrangements that should come into operation at the same time as the new system.

The Governors are not yet in a position to make comprehensive proposals on these questions, which are of crucial importance for the shape of the new European Monetary System, on the one hand because differences of opinion still exist among them and on the other because the close links between the various aspects of the system make it difficult to consider certain options in isolation. For this reason the Committee has asked the Chairman to present a second oral report to the Council on the progress made so far, pending the submission of a written report at a later date describing in detail the common views it has been able to form.

I. THE TYPE OF BASKET

While considering the respective merits of the standard basket and the adjustable basket the Governors had mentioned the possibility of a compromise solution in the form of a basket that would be neither as rigid as the standard basket nor as volatile as the adjustable basket.

Accordingly, they outlined a so-called "revisable" basket which would differ from the standard basket in that it would incorporate a procedure for review and possible revision and would differ from the adjustable basket in that central rate changes would not automatically affect the composition of

the basket. This would only be reviewed at intervals of between three and five years or when a currency's weight had changed significantly, for example by more than 25 per cent., since the weights had last been fixed. The purpose of any revision of the basket's composition as a result of such a review would be to restore an appropriate relationship between the weight structure of the basket and the pattern of the underlying weighting criteria, duly updated.

The Governors felt that a revisable basket with the properties described above might be a useful concept for defining the ECU numeraire. They intend to formulate an opinion on the choice of a suitable basket for the ECU once the other essential elements of the system have been more clearly defined.

## II. FORMULA FOR COMBINING THE TWO INTERVENTION SYSTEMS BASED ON THE PARITY GRID AND ON THE ECU (BASKET)

The Governors examined the underlying principles and operation of this formula, concentrating primarily on the alternative concepts with regard to the potential implications of the ECU-based indicator of divergence.

### 1. Underlying principles and operation of the combined formula

The underlying principles and operation of the combined formula are relatively straightforward and raise no obstacles from a technical point of view; they may be summarised as follows.

The ECU would be used, in the same way as the EMUA in the present "snake" arrangements, to express each currency's central rate. The grid of reciprocal parities between currencies would be derived from these central rates and would form the basis for defining the bilateral intervention limits, which would be the only rates announced to the market.

For each currency in the system the operation of the ECU indicator of divergence would rest on the attainment of a specific spread, known as the threshold of divergence, between the ECU's current rate and its central rate (initial value) in the currency in question. It should be possible to establish realistic divergence thresholds irrespective of the currencies'

weights in the ECU basket, of the (wider) fluctuation margins that some countries might adopt or of the ECU concept chosen (standard, adjustable or revisable basket). In a number of particular situations, such as the non-participation of one or more currencies in the intervention system, certain adjustments would have to be made if the ECU indicator of divergence were to retain sufficient value.

## 2. Implications of the ECU-based indicator of divergence

The crossing of a currency's divergence threshold, possibly for a specified period which would show that the divergence was more than transitory, should in principle trigger corrective action by the central bank in question. This action would as a general rule take the form of intra-marginal interventions in the currencies of certain other participants in the exchange rate system. The central bank concerned would, however, have the option of calling for concertation with the other central banks participating in the system in order to consider the desirability of such interventions and of any other steps that it or its partners could take in the light of the factors causing the divergence.

Such a formula would imply that all the central banks participating in the exchange rate system would have to agree that, as soon as their currency came close (e.g. closer than 0.25 per cent.) to a bilateral limit it could be used for interventions without prior concertation.

The extent of such agreement could be limited to, for example, the equivalent of one-quarter of the quotas under the short-term monetary support arrangements. This ceiling could be substantially higher if special terms, chiefly designed to ensure greater symmetry of adjustment, were applied to the financing and settlement of the liabilities and claims resulting from interventions by a divergent creditor or debtor.

At all events, to function smoothly the new monetary system would require concertation more directly geared towards a co-ordinated exchange rate policy, which means that it should be conducted at a sufficiently high level for decision-taking. The scope of concertation could, if necessary, be extended beyond the area of exchange rate policy, notably when the deviation between a currency's market and central rates reached a certain scale or persisted for a certain length of time.

### 3. Adjustment of short-term Community credit arrangements

As it noted at the meeting of the Council of Ministers on 18th September 1978, the Committee of Governors continued its examination of the structure, scale and duration of the credit facilities that would be required for the European exchange rate system to function smoothly during the transitional period, that is, until the European Fund is established.

In order to allow the new system to be set in motion rapidly, the expansion of credit facilities should be based largely on the institutional machinery that already exists, adapted as necessary.

The duration of the short-term credit facility should be sufficient to allow for a reversal of the debtors' situation. To this end, the very short-term financing facility and short-term monetary support combined might be extended to fourteen to fifteen months, against ten and a half months at present. Details of how this extension would be apportioned between the two mechanisms are still to be worked out.

The volume of short-term credit facilities should be large enough to safeguard the credibility of the exchange rate system, but not so large as to fuel inflationary propensities.

The Governors examined various proposals, all of which are based on an overall Community credit system of some ECU 25 billion. They noted, however, that, depending on how this overall amount is viewed, the scale of the expansion of credit facilities can vary very substantially.

Without prejudice to the decisions to be taken in the area of medium-term financial assistance, where any enlargement would probably take some time to implement, the Governors consider that the bulk of the increase in Community credit facilities for the transitional period should be allocated to short-term monetary support.

The form in which short-term monetary support might be expanded depends on:

- whether the overall amount is seen in terms of the financing commitments of creditors or the availability of credit to debtors;
- the respective priorities given to quotas, which may be drawn on virtually automatically, and rallonges, whose use is more discretionary;

It was pointed out that, within a new European monetary system essentially based on intervention in Community currencies, short-term monetary support would more often be used as an extension of financing already granted at very short term than as a means of reconstituting reserves to cover third currency needs. Since both financing and settlements would be based on ECU-denominated assets, short-term monetary support could be activated without calling upon all the central banks other than the beneficiary to provide financing, and the creditor quotas and rallonges might be discontinued.

In view of the importance and complexity of the questions to be resolved, the Governors have agreed to pursue their examination in greater depth before submitting a definitive report to the Council at an early date.