

COMMISSION OF THE EUROPEAN COMMUNITIES

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COMMISSION COMMUNICATION TO THE COUNCIL

THE DEVELOPMENT OF THE EUROPEAN MONETARY SYSTEM

AND

DRAFT COUNCIL RESOLUTION

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Consideration of the system's future began in May 1979. The subject was taken up by the Commission in close consultation with the Monetary Committee and the Committee of Governors. The discussions took into consideration and were modified by developments in the Community's economic situation and by upheavals in the international environment. On several occasions there were Council declarations on the subject and in March 1980, the Commission presented the European Council with a report on the European Monetary Fund.

At its meeting on 15 February 1982, at the end of a wide-ranging debate, the Council found that a number of measures could be taken to develop the EMS in the following four areas : improving the system's mechanisms, opening up the EMS to the exterior, promoting the private use of the ECU and reinforcing convergence. On this occasion, the Council took note of the Commission's intention to put forward specific proposals, in good time for its meeting on 15 March.

The present communication is in response to that undertaking. In it, the Commission proposes the adoption of a group of measures to consolidate and develop the system; it insists on their importance by recalling the actual words of the foreword to the draft Fifth Medium-term Economic Policy Programme : "With the European Monetary System, the Community has embarked on an ambitious, albeit gradualist, venture aimed at 'stabilization and convergence. The contribution made by the system - greater certainty in economic activity, a strong incentive to keep the key economic aggregates in balance, a stimulus to policy convergence and the added weight it gives to Europe in international monetary cooperation - should be a major factor in the success of the strategy set out in the fifth programme". In other words, the Commission considers its proposed measures for developing the system to be a necessary and realistic step towards the institutional and final phase, which is still the ultimate objective of the European monetary edifice.

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The purpose of the system, clearly defined when it was launched, is to establish "closer monetary cooperation leading to a zone of monetary stability in Europe". Three years of cooperation has shown that the EMS has succeeded in stabilizing the exchange rate relationships of the participating currencies, whereas the exchange rates of the major third currencies (the dollar and the yen) and of the non-participating Community currencies have been very unstable. Altogether, five realignments of central rates have taken place, but two of them have involved one currency only; all have been made by mutual agreement in orderly market conditions, on the basis of a common procedure which has avoided competitive devaluations. Throughout these three years, exchange rate management has drawn heavily on the possibilities offered by the system's exchange rate and intervention mechanism; national monetary policies have been more closely coordinated than before and generally adapted to the requirements of the system, even though hindered by the steep rise in US interest rates, which led to a level of interest rates in Europe incompatible with the low economic activity and the scale of unemployment. The system however, has not led to a sufficient convergence of inflation rates : from 1979 to 1981, the inflation rate average rose, and the spread widened under the combined impact of the second oil shock, the soaring dollar and insufficient internal discipline as regards costs and public finance.

The successes attributable to the EMS are therefore fragile, and the object of the Commission proposals is to strengthen and consolidate the system from within so that its contribution to stability and its ability to resist outside shocks are increased.

The following proposals, which are expressed in a text based on the format of the resolution of 5 December 1978 on the establishment of the EMS do not impinge on the responsibilities of the various Member States over their monetary policies. Their implementation will stimulate the system towards its objectives and increase its contribution towards improving the general economic situation in Europe. The proposals respect the existing institutional framework and form a balanced whole, both from the view point of creditors' and debtors' rights and obligations and of the elements of solidarity and strictness on which the system has been based. Further, as demonstrated by the work undertaken in close consultation with the competent Committee, their adoption is technically possible.

A. THE ECU

The role of the official ECU as the very centre of the system should be reinforced. Also the current extension of the private use of the ECU should be facilitated and organized.

a) ECU creation and use in the system

The monetary nature of the ECU flows from its characteristics concerning : method of issue, convertibility and acceptability.

In this respect the present system is less than satisfactory. Experience has proved the method of issuing the ECU not to be fully rational, and its convertibility has remained embryonic. Thus the limits imposed on its acceptability have, somewhat paradoxically, looked like a protective measure. The perspective must be reversed, so that it conforms with the role planned for the ECU in the EMS. The widest acceptability for the ECU must be sought, and the corollary must be some degree of control over the process of creating ECU and the organization of arrangements for mobilizing it.

The creation of ECU against transfers of reserves has in fact been potentially inflationary : as a result of the quarterly swpas, the 27 billion ECU created in March 1979 became almost 50 billion in April 1981, the figure has now fallen to 42 billion. Although these variations are primarily linked to the variations in the price of gold, the volume of ECU issued should be divorced from the two widely fluctuating variables, the price of gold and the dollar exchange rate, so that ECU creation can be controlled. At present, at each quarterly swap renewal, volume adjustments are made to take account of the variations in reserves held by each central bank, and value adjustments are made to take account of the variations in the ECU price of the assets transferred. An amended method would be to control ECU creation by retaining the same volume adjustments, but by applying the value adjustments to the quantities of gold and dollars transferred to the EMCF by the central banks, instead of to the amount of ECU.

Another less satisfactory possibility to dampen the effects of erratic gold price movements on the quantity ECU would be to lengthen the reference period used to calculate the average gold price from six months to two years. This would however entail the disadvantage of a difference between the price of gold on the market and that use within the system.

With the inflationary danger involved in the present method of ECU creation eliminated, the use of the ECU should be encouraged. The abolition of the ECU's present acceptance limit for settlement of operations covered by the very short-term financing would enable the debtor to clear his debt in full by using ECU. In return, the creditor should receive a higher remuneration on his net ECU position (the rate of interest should be set by the governors of the central banks at a level derived from the market levels) and be authorized to mobilize a net ECU credit position beyond 50% of its allocation; on the understanding that this mobilization possibility would not be used for the sole purpose of changing the composition of its reserves.

The above modifications to the existing rules together with those proposed concerning intra-marginal interventions (see point C (d) below) make up, in the Commission's view, a balanced package which would ensure a larger circulation for the ECU while respecting the interests of both debtors and creditors.

b) Private use of the ECU

Alongside the official ECU circuit and unconnected with it, a private ECU circuit is now developing. It is natural for operators and markets to be interested in the monetary expression of a vast economic area in the process of integration. The Community should take care of its monetary image; it should not only promote, but also monitor, and even guide this expanding private use of the ECU. Whence the importance of proposals designed to supplement the existing provisions and to encourage and control the use of the ECU on the markets.

It is important to lay down a sort of "ECU trademark" so that the term and the instrument "ECU" is used correctly by the markets. The necessary Community legislation should therefore be adopted to protect the ECU "trademark" and to define it. Such legislation would also have to set out the rules for its use, in order to ensure that the ECU is not deflected: thus, for example, prohibiting the attaching of an indexation clause to an ECU-denominated pecuniary liability would ensure that the ECU remained the instrument of stability which is its purpose. In this way the wider private use of the ECU would be solidly based.

The various Community institutions and the EIB would have to promote the widest possible use of the ECU for their accounting and their operations. Greater use of the ECU by the various Community institutions would strengthen the ECU's role on the markets.

Other steps should be taken to promote the wider use of the ECU and to make it a factor in the integration of the financial markets in Europe. First, the discriminations currently applying to the ECU in national regulations should be removed (being neither a national nor a foreign currency, it is subject to any regulation applying to either). The ECU should be given the status of a foreign currency, a privileged one. The principle of free movement within the Community of ECU-denominated capital should also be established. Finally the EMCF should be empowered to monitor ECU operations and issues.

B. CONVERGENCE

On an annual average over the last three years, and expressed in national currencies, movements of costs and prices in the countries participating in the EMS have diverged substantially : consumer price rises range from 5.6% to 16.3% and variations in the relative unit costs of labour range from - 14.5% to + 32.7%. What is more, the deviations from the mean are increasing. It is true that these movements would have been even more unfavourable without the EMS, but the persistence of these divergences imperils the very nature of the system. The measures to strengthen the system would be useless if they too did not contribute to the convergence of economic and monetary policies.

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All dimensions of economic policy should be considered from the view-point, of their contribution to convergence towards stability. It is clearly a long and difficult exercise. This goal should always be borne in mind when economic policies are formulated. Some concrete decisions should to be taken at Community level and be implemented rapidly. The main objective should be to arrange for policies to be concerted more actively :

- a) by the regular discussion of the national intermediate monetary policy targets, and the level of interest rates, in relation to their compatibility with the economic policy objectives pursued in common, without however affecting essential national responsibilities especially those of the central banks;
- b) by enumerating the economic and monetary policy measures and instruments which are incompatible with the proper functioning of the EMS, the use of these should be avoided;
- c) by establishing the principle of the free movement of ECU-denominated capital, and by reconsidering the restrictions on movements of capital currently authorized under safeguard clauses;
- d) by improving the application of their economic policies by Member States. The results and means of these will be assessed by reference to a set of comparative indicators and to objectives laid down by common agreement; in the event of significant difference between these, the Commission should make full use of the existing consultation and recommendation procedures.
- e) by establishing a mutual information and monitoring procedure on the balance of payments situation and the external indebtedness of the Member States; in this context, an assessment could be made of the desirability of early recourse to Community financing.

C. EXTERNAL RELATIONS OF THE SYSTEM

In the field of international monetary relations, the Community lacks the organization needed for it to play the role asked of it as one of the poles of the developing multiple reserve currency system. As a result, it is handicapped in the dialogue with the authorities responsible for the major third currencies, the dollar and the yen, at a time when such a dialogue is essential in order to promote the orderly evolution of the international monetary system.

The cohesion of the system might not withstand the repetition of shocks comparable to those caused, in the last two years, by the sudden and erratic changes in US interest rates (which have doubled) and the dollar exchange rate (which has appreciated by over 50% against the major European currencies). Circumstances demand a common attitude to third currencies - particularly the dollar - and an expression of this by Community bodies.

Actions in four areas could be foreseen :

- a) Reinforcing the regular consultations should be proposed to the US and Japanese authorities. The various Community bodies (Council, Commission and specialist committees) should take part in these consultations. These would provide a regular forum, with periodicity to be decided, for an exchange of views on financial and monetary problems of common interest. The procedure should also be able to be activated when the situation on the foreign exchange market appeared to be unrelated to the underlying economic data - i.e. manifestly outside the limits that economic likelihood would suggest - or when interest rate differentials caused excessive and undesirable strains on the Community's money and financial markets.

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- b) The Community monetary authorities should encourage the American and Japanese monetary authorities to participate in meaningful cooperation on exchange and interest rates. The US authorities in particular should be invited to abandon their *laissez-aller* exchange rate and interest rate policy. Also discussions with the US authorities should be started with a view to replacing the existing network of swaps between certain Community central banks and Federal Reserve Bank of New York by a single credit line between the latter and the EMCF. This would provide tangible evidence of European determination to avoid appearing disunited from the United States point of view.
- c) The coordination of Community central banks' interventions in third currencies should be improved. The central banks should make regular and frequent common assessments of the ECU's exchange relationships, paying regard to the average level of interest rates desirable in the Community. Their intervention policy should be based on this assessment.
- d) With the same objective in view, it is important to organize the use of Community currencies in intra-marginal interventions. At present, a central bank's use of a Community currency for intervention inside the margins is subject to the good will of the central bank whose currency is requested. Interventions are instead made in dollars and this often has the effect of emphasizing an undesired movement of the US currency or of undermining the coherence of the participating central banks' attitudes towards that currency. Alternatively, if no intervention is made inside the margins, the currency under threat slides until it reaches its bilateral margin, at which point the intervention amounts may be far greater than those that would earlier have been necessary to reverse the trend.

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The use of Community currencies for intra-marginal interventions would conform to the spirit of the system if it were specified that a central bank intervening inside the margins was presumed to be able to do so in Community currencies with access to the very short-term financing when its currency crossed the divergence threshold (lowered to 50% for wider band currencies) or when the difference of its bilateral rate vis-à-vis another participant was more than 85% of the permitted fluctuation margin. The central banks of currencies used for interventions would for their part have the right of refusing the continued use of their currencies if such use were causing problems for their internal monetary policy. Nevertheless, the dollar would continue to be used for intra-marginal interventions in cases where, by use of this currency, the cohesion of the EMS could be maintained and, at the same time, an undesirable movement of the dollar in relation to the EMS could be acted upon.

Determined action in line with the above could allow the Community the degree of autonomy necessary for it to be able to react, in a unified and coherent way, to tensions from the outside which have a large and excessive effect on European interest rates.

The EMS is at present a closed system in which only the central banks of certain Member States participate, whereas the Community is open to the outside world. Opening it to third countries in the spirit of the European Council of Brussels and giving them access to ECU would extend the system's zone of stability and increase the possibilities for using and mobilizing ECU.

Central banks of countries which seek to have special economic and financial ties with the European Communities should be authorized to acquire ECU freely from the participating central banks, and the EMCF should be empowered to create ECU for them on the same conditions as those for the participants, i.e. against reserve transfers in the form of swaps. But first, agreements would have to be concluded specifying the terms and conditions for acquiring, mobilizing and restituting ECU.

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The adoption of the measures proposed above to develop, strengthen and consolidate the EMS is technically feasible. While they respect the institutional framework, they represent a necessary step forward for the system. In devising them, care has been taken to preserve the balance between the principles of strictness and solidarity inherent in the system, and the measures form a whole in which the component parts reinforce each other.

Following the method employed when the EMS was set up in December 1973 the Council decisions or guidelines could be the subject of a resolution. A draft resolution based on the suggestions of this communication is attached.

DRAFT COUNCIL RESOLUTION

Development of the European Monetary System

1. Introduction

- 1.1. At the Council meeting of 15 March 1982, the ministers of economics and financial affairs of the Member States examined the Commission's communication on strengthening of the European Monetary System and listened to reports on this subject from the chairmen of the Monetary Committee and Committee of Central Bank Governors.
- 1.2. The Council confirms its determination to continue strengthening the system until its transition to the institutional stage at the appropriate time. It agreed to keep under review the work in the transition to the final stage of the system and the creation of the European Monetary Fund already undertaken by the Commission and the competent committees.
- 1.3. The Council is determined to move forward towards establishing the final phase of the system by adopting the following provisions and measures.

2. The ECU

- 2.1.1. At the next quarterly swap, the base volume of ECU will be set at 40 (1) billion. This base volume will remain until the end of the present period of swaps.

During this period, quarterly value adjustments will relate to the quantities of gold and dollars transferred to the EMCF by the central banks. Volume adjustment will continue to be made according to the existing system.

A new base volume will be fixed when the decision is to be taken on the renewal of the swap system (15 March 1983).

Alternatively, the reference period to be used for gold valuation will be extended to two years.

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(1) This number corresponds approximately to the amount of ECU which would be created if the existing rules were applied at the start of the next swap period (April 1982).

- 2.1.2. The acceptance limit on ECU is raised to 100 %.
- 2.1.3. The remuneration of ECU net credit positions will be fixed by the Central Bank Governors on the basis of market exchange rates.
- 2.1.4. Any participant whose net positive position has exceeded 50 % of its ECU allocation may, on demand, mobilize these ECU against dollars for the duration of the existing period of swaps. Mobilization should not be done for the sole purpose of changing the composition of reserves.

2.2. Private use of the ECU

- 2.2.1. The ECU will be the subject of a basic Community text which will lay down its characteristics and the way in which it is used.
- 2.2.2. The ECU will have the status of a foreign currency in all Member States. National monetary authorities will permit the financial institutions under their control to open accounts and carry out operations in ECU. ECU bond issues will be the subject of a Community mutual information procedure.
- 2.2.3. Indexation clauses will not be permitted to apply, apart from by exception, to claims, values or prices expressed in ECU.
- 2.2.4. The various Community institutions, and the EIB will be invited to do the same, shall, with the active collaboration of the Member States, undertake to promote the widest possible use of the ECU in the areas for which they are responsible; in particular :
 - the ECU will be progressively used for borrowing and lending operations as far as is compatible with its sound establishment on the financial markets, the object in view being for it to account for a similar proportion of such operations as do those national currencies which are most used;
 - Community institutions' accounts in national currencies will, in principle, be replaced by accounts in ECU;

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- the financial rights and obligations of these institutions will, as far as possible, be denominated and settled in ECU.

3. Measures to develop convergence

- 3.1. The actual conduct of the economic policies of Member States must be assessed, as regards its results and its methods, by reference to the objectives laid down by common agreement. The Commission is invited, in this context, to make full use of the existing consultation and recommendation procedure.
- 3.2. The Council of Ministers ECO/FIN will regularly discuss, on the basis of a report by the Monetary Committee and the Committee of Governors, the intermediate monetary targets and the level of interest rates in the Community countries in the light of their compatibility with the objectives of economic policies. Where the intermediate monetary targets are concerned, the discussion will take place at least once a year during the fourth quarter.
- 3.3. Measures which are incompatible with the proper functioning of the EMS must be avoided. The Council will, on a proposal of the Commission, draw up a list of measures which impede current transactions; implementation of such measures will be prohibited, in the absence of a decision made at the Community level and for a limited period.
- 3.4. Except for derogations granted under the Treaty, there will be free movement of ECU denominated capital. Liberalization of other capital movements currently subject to restrictions will be sought through an examination of the restrictions in force.
- 3.5. A mutual information and monitoring procedure will be established on the balance of payments situation and the external indebtedness of the Member States, in line with the suggestions of the Monetary Committee of October 1980. Early use of Community credit will be encouraged when it is complementary to a policy aimed at external balance.

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4. Organization of the exterior aspects of the system

- 4.1. The competent Community institutions will propose to the US and Japanese authorities that their regular discussions on monetary problems of common interest should be reinforced. These consultations should also take place when the foreign exchange market appears to be unrelated to the underlying economic data - i.e. where rates are obviously outside the limits that economic likelihood would suggest - or when interest rate differentials cause excessive and undesirable strains on the Community's money and financial markets.
- 4.2. The European authorities will continue to request the United States to abandon the principle of not intervening on the foreign exchange markets. Cooperation with Community central banks will be facilitated by the establishment of a single credit line between the FED and the EMCF.
- 4.3. Coordination of Community central banks' interventions in third currencies will be increased. Interventions will be based on a common assessment of the ECU's exchange relationships and bearing in mind the average level of interest rates desirable in the Community.
- 4.4. When a currency crosses its divergence threshold (lowered to 50 % for wider band currencies) or when the difference of its bilateral rate is more than 85 % of the maximum permitted fluctuation margin against another participating currency, the central bank of the currency in question is presumed to be able to intervene in Community currency and to have access to the very short-term financing. The issuing central banks of currencies used for interventions have the possibility to refusing the continued use of their currency if this causes problems for their internal monetary policy. Nevertheless, the dollar will continue to be used for intra-marginal interventions in cases where, by use of

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this currency, the cohesion of the EMS can be maintained and, at the same time, an undesirable movement of the dollar in relation to the EMS can be acted upon.

4.5. The central banks of countries which seek to have special economic and financial ties with the European Communities will be able to obtain ECU, either by acquiring them from the participating central banks, or against transfers of reserves, in the form of swaps, from the EMCF.

5. Further procedure

5.1. So as to implement the provisions of point 2.2. above, the Council notes the Commission's intention to submit, to the extent this is necessary, the appropriate modifications to regulation (CEE) n° 3180/78.

5.2. The Council invites the Central Banks to modify their agreement of 13 March 1979 laying down the operating procedures for the European Monetary System to take account of points 2.1, 4.4 and 4.5 above.

5.3. The Council invites the Commission, in close cooperation with the Monetary Committee and the Committee of Governors, to report in time for its July meeting on the implementation of the measures and procedures set out in paragraphs 3 and 4 above.