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THE EMS TEN YEARS ON

Communication from the Commission to the Council

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EXPLANATORY MEMORANDUM

The Communication is intended to provide the opportunity for an exchange of views in the Council on current EMS issues on the occasion of its tenth anniversary.

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1. Introduction

The European Monetary System (EMS) started functioning ten years ago on 13 March 1979. It was set up following the Resolution of the European Council on the establishment of the EMS and related matters of 5 December in Brussels and implemented by an agreement between the central banks of the Community. The EMS has become the cornerstone upon which European monetary co-operation is built. It has been successful in promoting lower inflation and more stable exchange rates, thereby fostering healthy economic growth, which is an essential base for the Community's strategy to complete the large internal market by 1992.

The ecu is intimately linked to the EMS. In the ecu's ten years of existence, its private use in financial markets has grown fast and, with its increased use in European international commercial transactions, it is now maturing into a currency.

2. Three phases of the EMS

The EMS is not a rigid system. It has evolved over the last ten years in the face of changing circumstances, both within and outside the Community. Its rules have been adapted and its procedures have been implemented flexibly. The credibility of the EMS is based on an underlying policy consensus. This too has developed over the years, strengthening the system and helping it to function more smoothly. It is possible to distinguish three main phases during the system's ten years of existence.

- 1979-1983.

During its early years, the EMS functioned against a difficult background within the Community. Economic divergences were substantial: policy stances were still at variance; inflation was high and differences between EMS countries large; current account performances were varied; budget deficits were frequently sizeable and sometimes partially financed by monetary means. Externally, the dollar was strengthening.

After the experience of the 1970s, a learning process on the part of EMS participants was necessary. Realignments were frequent at the beginning, but gradually their aim moved from that of accommodating inflation differentials towards reducing inflation. This meant that realignments came more and more to be accompanied by domestic adjustment measures. In contrast to the 1970s, economic divergences were becoming increasingly matters for domestic policy adjustment.

During this period also, the financial use of the ecu by the private sector was beginning to expand rapidly. Its property as a ready-made vehicle for currency diversification gave both investors and borrowers perceived advantages in using the ecu. An active interbank market for ecu credits and deposits was growing. However the ecu was still not treated as foreign currency in all Member States.

- 1984-1987.

By now the EMS policy consensus, which recognizes no trade-off between inflation and growth, was being translated gradually into more convergent economic performances within the Community. Inflation was being steadily brought down with the help of falling commodity prices. Differentials in cost and price inflation narrowed considerably. The process of liberalising capital movements had restarted and was making significant progress. However, the international monetary background was very turbulent. The dollar first rose, then fell sharply from its February 1985 peak. Financial innovation and globalization was continuing apace, adding to the dangers from speculative capital movements. In spite of the disorderly external environment, only two general EMS realignments took place, one in April 1986 and another in January 1987, each involving smaller changes than its predecessor.

During 1985, a first set of changes to the EMS rules was agreed. It was designed to allow the role of the official ecu to grow by improving its usability through a mobilization mechanism. Although the changes were modest, they marked the willingness of EMS participants to improve its mechanisms and procedures. By the end of the period, agreement was emerging to end all restrictions on capital movements, in a majority of Member States before 1992, but not at the expense of EMS stability. This factor and the January 1987 realignment, caused by tensions exacerbated by external factors, gave the impetus towards a second, more substantial package to strengthen the EMS.

The so-called "Basle/Nyborg" agreement of September 1987 provided for a more balanced implementation of the exchange rate commitment, while leaving the fundamental rules

and objectives of the system unaltered. Measures were adopted to promote further the co-ordination of policies through indicator-based surveillance. The EMS intervention and credit mechanisms were refined to take account of the different scale of capital movements, the increased use of intramarginal interventions and of the restraint shown by Member States in the use of credit facilities. A monitoring process was agreed to encourage the combined use of concerted interest rate changes, interventions and movements within the fluctuation band in managing the system.

The first revision of the ecu basket took place in September 1984 without disturbance to the private ecu markets. The rapid development of the private use of the ecu by the financial sector continued during 1984 and 1985, though its growth tailed-off somewhat during 1986 and early 1987. By the summer of 1987 the ecu was treated throughout the Community as foreign currency.

- 1987 onwards.

The "Basle/Nyborg" agreement marked the beginning of a new phase for the EMS. Although the experience acquired in managing the system since September 1987 has been short, it has been relatively varied concerning external factors, such as the dollar, the yen and the G7 accord. It is therefore possible to draw preliminary conclusions which suggest that the "Basle/Nyborg" agreement has proved extremely beneficial to the functioning of the system. Interest rate differentials have become the main weapon to combat tensions in the parity grid. The appropriate width of these differentials has been reached at times by way of changes in the levels of interest rates in both strong and weak currency countries without endangering anti-inflation strategies. This more balanced and more efficient management of the system, has increased confidence in the stability of the parity grid. Also, the understandings to keep realignments small, should they occur, as well as to allow currencies to fluctuate within the exchange rate band, have discouraged speculative capital movements. As a result, with the good, but by no means perfect convergence of economic performances being maintained, there has been no EMS realignment since January 1987.

By the end of 1987 all twelve Member States were participating in the system of swaps used to create official ecus, as well as taking part in the surveillance and monitoring procedures. The Bank for International Settlements and the Swiss National Bank have been accorded the status of Other Holder of official ecus. In contrast, only eight countries participate in the exchange rate mechanism (ERM) of the EMS, as at the outset ten years ago.

Activity in the ecu markets has expanded fairly rapidly again, especially during the last eighteen months, helped by the stability of the EMS and perhaps boosted by the 1992 process. The UK started in October 1988 a programme to issue ecu Treasury Bills which has considerably improved the liquidity of short-term ecu markets. The Italian government's ecu-linked borrowings have also been expanded. In addition to this more intensive financial use of the ecu, there are also signs that the ecu is beginning to be increasingly used as a currency for international commercial transactions.

3. Lessons and Challenges

Looking back over the last ten years, the EMS has undoubtedly proved a great success, even if some of the far-reaching intentions have not been fulfilled. It has exceeded the expectations of many. But the Community is changing fast and presenting new challenges to which the EMS will have to react. Most importantly, the 1992 process is now irreversible and the full liberalisation of capital movements will come into effect in July 1990 for most member countries. The EMS will have to meet new challenges as the large internal market develops.

- The EMS as a factor of stability

The EMS has succeeded in achieving its primary goal of creating a zone of internal and external monetary stability, based around the exchange rate mechanism (ERM). The first decade of the EMS has led to a reduction in the variability of nominal and real exchange rates among ERM currencies, to lower levels of inflation and to smaller interest rate differentials. The misalignments that have so characterized the international monetary system during the 1980s have been avoided in the EMS. Thus, most important from the point of view of the business sector, exchange rates have become more predictable in ERM countries.

After having been regarded to a certain extent as an anomaly in the international monetary system, it is now gratifying to note that the IMI has carefully examined the System on a number of occasions. The question is now raised as to the concrete implications the successful operation of the EMS has for the design of the international monetary system.

Capital markets are becoming increasingly interdependent. The full liberalization of capital movements, which is due to take place by 1 July 1990 for most ERM members, and the development of a common financial area in the Community may pose new problems for the maintenance of monetary stability. Therefore, ever closer monetary co-operation

in the framework of the EMS will be required if tensions are to be avoided and properly managed, since it is evident that renewed flexibility of exchange rates will endanger the functioning of the internal market. At the same time, the growing interdependence of economies in the run-up to 1992 will show up all the more the paradox and the inconveniences of the non-participation in the ERM of those currencies in a position to do so.

- The EMS as a factor for convergence

The EMS has played a vital role in bringing monetary policies and performances closer together. Since the EMS is first and foremost a monetary system, it is not surprising that its success is concentrated in the area of monetary convergence. On the policy side this is reflected in the similarity of monetary targets and spread of market-based methods of monetary control. The convergence of inflation rates at low levels shows how monetary performances have also come together. However, if differences in other economic variables such as growth, current accounts and budget balances are too great, monetary stability will be endangered. The EMS is therefore becoming more and more the focus for general economic policy co-ordination. One example of this evolution is the indicator-based surveillance process agreed as part of the "Basle/Nyborg" package. Here the exchange rate constraint of the EMS is used as the key element in an emerging procedure designed to show up potential incompatibilities or divergences in economic policies using a set of indicators ranging from growth to current account balances, and from budget positions to inflation rates, both in a short-term and in a medium-term framework.

Budget policies are perhaps the area in which the greatest policy divergences remain in EMS countries. The financing of budget deficits, however, appears to have been undertaken much less by monetary means in recent years, a development in which the EMS constraint has no doubt played a key role. Also the pressure for the budget policies of EMS members to converge has increased substantially, as recognition has grown that the large differences persisting pose a threat to the stability of the EMS parity grid.

Current account imbalances too remain very different between EMS countries. The use of nominal exchange rate stability within the EMS as a constraint may have contributed somewhat in certain cases to the relative payments imbalances that have appeared. But the source of these imbalances is basically structural in nature and correction will require action on that side. As long as offsetting capital flows continue to take place smoothly, the EMS should be able to cope with these persisting imbalances.

The success of the large internal market, to be completed by 1992, requires closer economic and monetary co-operation, for which there is plenty of scope for improvement. The national economies of the Community countries will become integrated to a significantly greater degree. Any inconsistencies in policies will therefore cause all the more disturbance to economic activity. The EMS is already at the centre of the Community's convergence efforts. As recognized explicitly in the Single European Act, experience with the EMS should be used in reflections on the further development of the Community. A strengthened EMS itself will undoubtedly have an important role to play in the actions concerning economic convergence that we shall find necessary for the smooth functioning of the large internal market.

As long as the present progress on convergence is kept up, it is natural that it should be reflected in the way in which the EMS functions. Gradually, as more and more countries approach the inflation rate of the best performer, the procedures by which the system promotes and manages convergence will need to become more balanced. On the one hand this may appear to complicate matters both within the EMS and with third countries, but, on the other hand, the EMS will be more solid as a result, given the increased commitment that will be behind it. This can only be an advantage for efforts to create a zone of monetary stability in Europe. It will also add to the force of Europe's voice on the world monetary scene.

- The ecu

The ecu has progressed enormously over the last ten years. It has become a major international financial instrument, overtaking most of its component currencies in its international financial use, though it now only occupies sixth place in the euromarkets. The ecu's role in international commercial transactions is only just beginning. If it is to play the useful role of increasing transparency in the large internal market of 1992, various impediments to the ecu's development should be dismantled and its commercial use encouraged. The ecu should remain a constant reminder to policy-makers of Europe's potential monetary identity.

The rapid development of the private ecu contrasts with the lack of progress of the official ecu towards the role of a true reserve asset. Indeed it is the private ecu which at present better fulfils that role. The reasons for the official ecu's slow progress are manifold, rooted in the delicate balance between the availability of credit facilities and the pressure for internal adjustment in the EMS. The official ecu creation mechanism encourages it to be treated as additional liquidity, potentially affecting all component currencies, backed by gold and dollar reserves. The temporary nature of the official ecu and its treatment

more as a credit facility than as a reserve asset are factors holding back its development. Until these drawbacks are rectified, which would add to the financial fabric of the EMS, the official ecu will not be much more than an accounting unit.

4. Conclusion

The success of the EMS over its ten years of existence should not be allowed to lead to complacency. The world is changing, developments are moving particularly fast in the Community itself. The evolutionary character and the adaptability of the EMS, which have been essential to its success, must continue. The challenges facing the Community require more efficient and more intense monetary co-operation. The EMS is the core of efforts in this field. The experience gained with the EMS and the ecu should be used in order to make the large internal market function more efficiently and increase the welfare of the citizens of the Community.