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Documents relating to the European Monetary System

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Documents relating to the European Monetary System

Frédéric
BOYER DE LA GIRODAY

Frédéric Boyer de la Giroday was born in September 1918 on the island of Mauritius. He studied economics first in Paris and then at Oxford. In 1949 he entered the International Monetary Fund and left it in 1958 to join the Commission of the European Communities at the time when the Directorate-General for Economic and Financial Affairs was being formed.

The whole of his professional career was from then on spent at the Directorate-General for Economic and Financial Affairs, and was devoted to monetary questions. Having started in 1958 as a principal administrator, he was appointed Director in 1968 and at the time of his departure in 1981 he was head of a Directorate of four divisions dealing with the whole range of monetary and financial questions. In the intervening years, he took an active part in each of the major debates or projects which marked the history of international monetary relations: he participated with people such as Ossola, Mundell, Triffin, etc. in the great debates which marked the reform of the international monetary systems, the creation of the special drawing right, the introduction of the general arrangements to borrow. He made a special contribution, in his role of respected adviser to men directly involved such as Robert Marjolin, Raymond Barre or François-Xavier Ortoli to the Werner Plan, to the creation of the 'snake', to Community loans and to the European Monetary System.

Fascinated by economic history, he was a popular and respected lecturer at the Université Libre de Bruxelles. He was an expert in the literature on international monetary questions, was familiar with the classical authors on the subject, and took an active part in the renewal of ideas and theories, persistent in communicating his taste for research to his colleagues. His personality was strong, his temperament generous and communicative. His strength of character was equalled only by his soundness of judgment.

Shortly before his death, on 29 December 1981 in Arosa, Switzerland, he had been appointed honorary Director-General and Special Adviser to Commission President Thorn. He intended to devote his time to writing on subjects which had always interested him, such as the European capital market, the Eurocurrency system, the Bank for International Settlements, the International Monetary Fund, and the future of international monetary relations.

An earnest and enthusiastic supporter of European monetary integration, he never ceased to demonstrate its advantages. A lucid observer of the difficulties of this undertaking, he never allowed himself to be discouraged by the interruptions, the false starts or the setbacks in the monetary construction of Europe. For him, therefore, who had shared the hopes aroused by the Werner Plan, and the subsequent disappointments, the establishment of the European Monetary System was a matter of great satisfaction.

Foreword

This issue of *'European Economy'* analyses how the EMS has functioned in its first three years and presents a dossier of the studies and discussions which have taken place within the Community on the development of the system. It is built around three topics which are the product of the experience and reflection to date: economic convergence in relation to the system in its existing form (Part One), the development of the system within its present institutional framework (Part Two), and the institutional phase of the system (Part Three). The public is thus given access to hitherto unpublished technical studies and documents.

The three topics are treated in the logical order of the system's development, from the present phase to the final stage. Chronologically, the work on the institutional phase—a task which the European Council explicitly assigned to the Community institutions—preceded the studies which culminated in the proposals for non-institutional development, which were presented in March 1982.

Except for those documents whose status is clearly defined (Commission communication, opinion of the Committees, etc.), the analyses and assessments presented in this issue of *'European Economy'* are those of the departments of the Commission's Directorate-General for Economic and Financial Affairs. They cannot be regarded as positions taken by the Commission. This is particularly true for Part Three, which is a preliminary synthesis of the ideas put forward on the main areas of the institutional phase. The specific proposals have been discussed in detail by the Alternates of the Monetary Committee, but the preliminary synthesis is the fruit of the work of Commission departments. Certain assessments may be modified in the light of changing circumstances and of a more detailed analysis some time in the future.

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The EMS represents the most recent stage in the process, initiated by the Community in the late 1960s, of providing itself with its own monetary identity and organization. The Treaties were devised and signed at a time when the Community countries were integrated into a highly structured monetary system, that of Bretton Woods. The organization provided by this system was a mainstay of the Community's construction and its existence was so taken for granted that it was not even mentioned in the Treaty. However once this support started to weaken, the Community realized that a monetary organization was a necessary complement to a commercial and agricultural organization. With varying success, it launched a series of initiatives to try to make good the deficiency.

The EMS has been the most successful of these initiatives. It has maintained the unity of the Common Market and has made a substantial contribution to closer monetary convergence in a period when economic crisis and commercial strains have reached a degree of gravity unprecedented in the Community's history. It is nevertheless still insufficient; its structures not being strong enough to encompass national economic policies within a common monetary discipline, to free commercial competitiveness from monetary constraints, or to give the Community a role in international monetary relationships commensurate with its industrial and commercial weight.

Aware of these inadequacies, the system's originators from the beginning intended it to be dynamic, destined to evolve and to grow in strength. This dynamism has been one of the strong points of the system's operation in its first three years. It also provided the driving force for the discussions and studies presented here.

The proposals put forward by the Commission in March 1982 mark an—unfinished—step along the road which leads eventually but inevitably towards European monetary inegration.

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This issue is dedicated to the memory of Frédéric BOYER DE LA GIRODAY who, from his very earliest days at the Commission in 1958 until his untimely death in December 1981, placed his great erudition, his profound idealism and his extraordinary capacity for work at the service of the monetary construction of Europe.

The European Monetary System

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Abbreviations and symbols used

Countries

B	Belgium
DK	Denmark
D	Federal Republic of Germany
GR	Greece
F	France
IRL	Ireland
I	Italy
L	Luxembourg
NL	The Netherlands
UK	United Kingdom
EC	Total of the member countries of the European Community
EC 9	Community without Greece
BLEU	Belgo-Luxembourg Economic Union

Currencies

BFR	Belgian franc
DKR	Danish krone
DM	German mark
DR	Greek drachma
FF	French franc
IRL	Irish pound (punt)
LIT	Italian lira
LFR	Luxembourg franc
HFL	Dutch guilder
UKL	Pound sterling
ECU	European currency unit
USD	US dollar
SFR	Swiss franc
SDR	Special drawing right

Other abbreviations, etc.

cif	Carriage, insurance and freight
EAGGF	European Agricultural Guidance and Guarantee Fund
EIB	European Investment Bank
EMCF	European Monetary Cooperation Fund
EMF	European Monetary Fund
EMS	European Monetary System
ESA	European System of Integrated Economic Accounts
Euratom	European Atomic Energy Community
Eurostat	Statistical Office of the European Communities
fob	Free on board (valuation basis for exports or imports of goods)
GDP (GNP)	Gross domestic (national) product
GFCF	Gross fixed capital formation
IMF	International Monetary Fund
LDC	Less-developed country
MTFA	Medium-term financial assistance
OECD	Organization for Economic Cooperation and Development
OPEC	Organization of Petroleum Exporting Countries
SOEC	Statistical Office of the European Communities
STMS	Short-term monetary support
VSTF	Very short-term financing mechanism
( )	Estimate
:	Data not available
s.a.	Seasonally adjusted
,	Decimal point
—	Not applicable

PART ONE

Economic convergence and the European Monetary System

Convergence of economic performance is one of the objectives of the European Monetary System and is at the same time a basic precondition for its successful operation. This dual relationship is clearly brought out in the documents which prepared the way for or set up the system. In particular, the final report [1] on the EMS, presented by the Monetary Committee to the Council and the Commission on 7 November 1978, said that, 'The European Monetary System ought to contribute to reducing divergences in economic performance,' adding immediately afterwards, 'The credibility of the new system depends on progressive convergence of economic performance.' It is this very relationship which is at the heart of the present discussions on the appraisal of the system a little over three years after its inception and the possible ways of developing it further. The complexity of the links between economic convergence and exchange rate stability needs to be examined closely, particularly in the light of past experience, if the objectives and the operations of the EMS in this area are to be viewed in a proper perspective and the progress to be achieved properly measured. It is similarly against this background that the recent realignments between various participating currencies should be assessed.

[1] Annex 1 to the Twentieth report on the activities of the Monetary Committee, OJ C 240, 25.9.1979.

CHAPTER I

The links between economic convergence and exchange rate stability

The very concept of convergence is ambiguous, depending as it does on the economic variables that are taken as objectives and on the rate at which such objectives are to be achieved. In view of the twin concerns jointly underlying the establishment of the EMS, monetary stability and progress towards economic integration, a distinction should be made between on the one hand the immediate need to ensure a convergence of nominal variables—a downward alignment of cost and price trends—and on the other the longer-term pursuit of a convergence of real variables, i.e. alignment upwards of living standards and the quality of life. This distinction, which is convenient for the purposes of analysis, does not, however, obviate the need to take account of the interactions between nominal and real developments in determining the desirable degree of exchange rate stability. Similarly, emphasizing the urgency of the need to combat inflation does not mean that less importance is attached to growth and employment or that the two types of measures should not be pursued jointly.

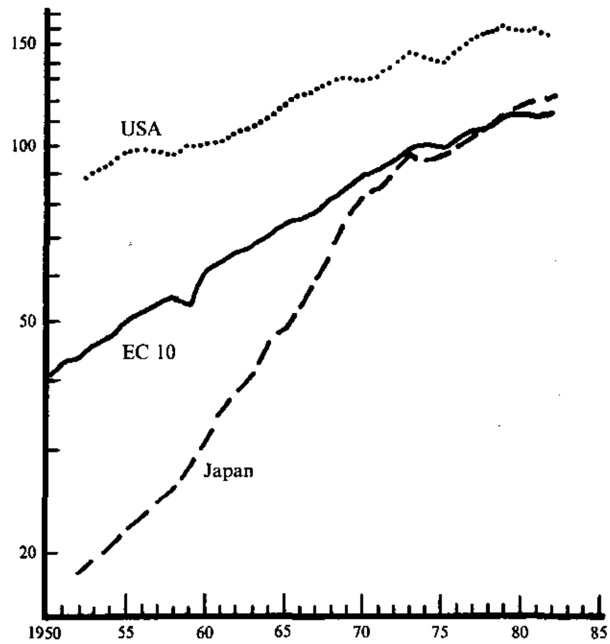
Section 1 — Convergence of living standards: long-term trends

A detailed comparison of the performance of each economy in relation to the other member countries and their main industrialized trading partners is beyond the scope of this study. Such an analysis would require a large number of interdependent factors to be taken into account (endowment in natural resources, demographic trends, technological progress, etc.), and the results might be subject to different interpretations depending on the criteria applied. Table 1 and Graphs 1(a) and 1(b) simply show the development of average living standards during the past few decades, by tracing the relationship between per capita GDP in each country and the Community as a whole. This indicator may be measured, first, in terms of the purchasing power parities established by the Statistical Office of the European Community.[1] Subject to statistical imperfections, per capita GDP is measured here in terms of domestic purchasing power. Alternatively, the indicator may be calculated on the basis of current exchange rates, thus reflecting the external purchasing power of each currency. It will, however, then be affected by movements in real exchange rates which are sometimes excessive relative to the basic economic situation of each country.

[1] Eurostat - National Accounts ESA - Aggregates - 1982.

GRAPH 1 (a): **Per capita GDP at 1975 prices and purchasing power standards**

Index: EC 10 in 1975 = 100



GRAPH 1 (b): **Per capita GDP at current prices and exchange rates**

Index: EC 10 in 1975 = 100

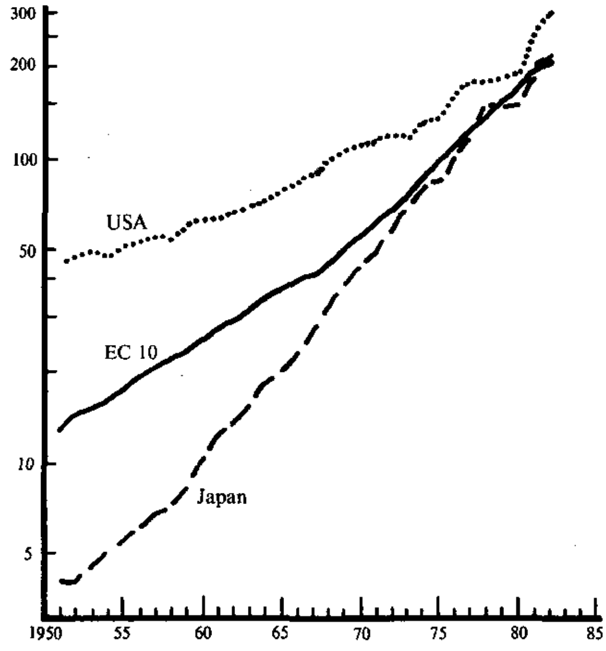


Table 1

Relative changes in per capita GDP

Indices EC 10 = 100

	At current prices and purchasing power standards							At current prices and exchange rates						
	1960	1965	1970	1975	1978	1980	1982 [1]	1960	1965	1970	1975	1978	1980	1982 [1]
B	98,0	100,3	101,7	106,7	105,6	106,2	104,3	107,0	103,0	107,1	120,8	128,0	114,3	98,9
DK	114,8	118,7	117,9	113,6	112,5	110,7	113,1	113,4	124,9	131,2	142,5	146,9	125,3	123,9
D	113,4	113,7	112,6	110,5	112,6	114,8	114,8	113,9	114,9	125,0	130,2	138,6	128,7	121,8
GR	37,3	44,4	50,4	56,2	57,7	57,0	55,5	36,9	41,1	46,3	44,1	44,8	40,6	45,9
F	99,2	102,2	105,1	110,5	110,7	110,1	111,0	115,2	117,8	113,4	123,0	118,2	117,4	118,0
IRL	62,2	61,1	61,7	63,0	63,6	61,7	61,6	54,7	54,8	53,9	49,7	49,7	50,2	58,9
I	78,7	81,3	87,9	85,3	84,2	87,7	88,1	64,8	70,6	76,6	65,9	61,3	66,8	69,7
L	152,6	133,5	137,7	126,5	121,1	119,6	116,3	144,8	124,2	130,3	125,7	130,3	121,6	101,3
NL	104,8	103,1	104,9	104,8	108,2	104,9	104,3	84,0	89,4	99,3	116,1	130,6	114,6	109,0
UK	116,7	109,3	99,9	98,7	96,9	92,9	92,2	119,1	107,3	90,0	79,3	74,8	90,2	97,0
EC 10	100	100	100	100	100	100	100	100	100	100	100	100	100	100
Dispersion EC 10 [2]	22,7	19,4	18,0	16,9	16,8	16,7	16,7	27,3	23,6	24,1	31,9	36,2	27,4	20,4
USA	165,4	160,4	146,4	142,8	146,0	138,4	135,1	244,8	207,8	197,2	137,9	129,2	109,7	145,2
Japan	(53) [3]	68,7	93,1	97,1	99,0	103,1	106,1	(40,1)[3]	53,5	80,5	85,7	111,6	86,1	103,1

[1] Commission extrapolation based on the economic budgets (May 1982).
[2] Average of absolute differences from the mean.
[3] Commission estimate.
Source: Eurostat and Commission departments.

Among the 10 present members of the Community, average living standards measured in terms of purchasing power parities showed significant convergence between 1960 and 1975. After that date, as a result of the divergent economic and monetary policies pursued since 1972-73 and of differing reactions to the economic crisis, this measure of convergence showed only very modest progress. If average living standards are measured in terms of current exchange rates, the slowdown in the convergence process was more marked and began earlier, reflecting from 1970 onwards the weakening in the discipline previously imposed by the Bretton Woods system. The process resumed with the introduction of the EMS. This overall pattern has been accompanied by considerable changes in the relative positions of each country. Germany, the Netherlands and Ireland have, at very different levels, more or less maintained their initial positions, measured in terms of purchasing power parities. Belgium, France and, particularly, Greece improved their positions distinctly at least up to the middle of the 1970s. By contrast, there has been an appreciable deterioration, in relative terms, in average living standards in the United Kingdom and in Luxembourg (where the figure is of limited significance because of the weight of the steel industry in that small economy). Denmark and Italy have seen a slight deterioration in their relative positions as from 1975-78. It is interesting to note, in the case of Italy, that the rise in living standards coincided during the 1960s with a period of sharp inflation and monetary turbulence and did not come to a halt until 1978 with the return to greater monetary discipline.

In relation to the Community's two major industrialized trading partners, the same phenomenon of rapid convergence in living standards can be observed, even more markedly, up to 1970, followed by some subsequent slowdown. In 1960, per capita GDP in the United States, measured in terms of purchasing power parities, was about 65% above the Community average; the difference has narrowed today to only 35%. Japan, whose living standards in 1960 were only half those of the Community, caught up with and overtook the Community in spectacular fashion towards the end of the 1970s.

It would be dangerous to draw hard and fast conclusions from such a brief survey. However, the above facts do justify a number of general observations. In the first place, it was during the 1960s, when the growth of the world economy was sustained and relative exchange rate discipline maintained, that the clearest progress towards convergence was achieved. Secondly, convergence of real variables is a very long-term process which, while benefiting considerably from lasting stability in international monetary relationships, is also dependent on the development strategies pursued by each country. For example, the different growth rates between the various areas may be attributable, among many other factors, to significant long-term differences in investment ratios as between the Community (from 20% to 23%), the *United States (17% to 19%) and Japan (30% to 35%).* The scale of these differences and, above all, their persistence over several decades provides a measure of what convergence implies in terms of allocation of resources, the functional distribution of incomes, and the formation and use of savings.

There are many ways in which the Community as such can contribute to achieving gradual alignment in living standards. One obvious way is in freedom of trade. Another more modest but not insignificant way is in the financial area. As may be seen from Table 2, the Community's financial instruments, in the form of subsidies or loans for structural *purposes, are beginning to become significant at macroeconomic* level. The aid granted amounted in 1981 to 1,1% of GDP in Italy, 1,4% in Greece and 4,7% in Ireland. In Ireland, it represented some 15% of fixed capital formation.

Section 2 — The interactions between real and nominal developments and exchange rate stability

The degree of exchange rate stability depends on the combined effect of the economic performances of the various countries and their relative price trends, with these two factors being able either to offset or to reinforce one another. Clearly, underlying economic trends such as those briefly described above, which are based on differing levels of productivity, the discovery or exhaustion of natural resources and lasting changes in the terms of trade, cannot but be reflected sooner or later in exchange rates. This long-term phenomenon may be illustrated by two significant examples.

The first example is provided by the devaluation of sterling in 1967. As a result in particular of the strict monetary policy pursued, the rise in prices in the United Kingdom had followed a trend that was very close to those of its main partners (see Table 3 and Graph 2). During the 17 years preceding the devaluation, the total cumulative differential in prices was less than 5%. The devaluation was due therefore not so much to a lack of nominal convergence as to real divergences between the United Kingdom economy and those of its trading partners. With its investment ratio being distinctly below those of its partners (17% of GDP between 1958 and 1966 as against 21,5% for the Community as a whole), it was not possible for the modernization and extension of productive capacity to keep pace. Any attempt to reflate the economy came up against the weakness of the productive apparatus and resulted in considerable external deficits (1951, 1955, 1960 and 1964), obliging the authorities to adopt a restrictive stance once again (stop-go policies). It is only recently, with the advent of North Sea oil and the efforts *to achieve structural stabilization of the United Kingdom* economy, that these trends have been reversed.

Table 2

Breakdown of subsidies [1] and loans [2] for structural purposes granted by the Community institutions

Country	As % of GDP			As % of GFCF		
	Subsidies	Loans	Total	Subsidies	Loans	Total
			1981			
B	0,05	0,47	0,52	0,25	2,42	2,67
DK	0,12	0,28	0,40	0,76	1,72	2,48
D	0,04	0,02	0,06	0,17	0,07	0,24
GR	0,90	0,48	1,38	4,42	2,36	6,78
F	0,09	0,09	0,18	0,42	0,44	0,86
IRL	2,32	2,33	4,65	7,58	7,60	15,18
I	0,45	0,60	1,05	2,14	2,82	4,56
L	0,14	0,00	0,14	0,49	0,01	0,50
NL	0,04	0,00	0,04	0,21	0,00	0,21
UK	0,16	0,07	0,23	0,98	0,43	1,41
EC 10	*0,16*	*0,17*	0,33	*0,80*	*0,84*	*1,64*
			1974			
B	0,05	0,06	0,11	0,21	0,26	0,47
DK	0,08	0,07	0,15	0,33	0,30	0,63
D	0,03	0,08	0,10	0,12	0,35	0,47
F	0,05	0,12	0,17	0,19	0,51	0,70
IRL	0,50	0,80	1,30	2,00	3,22	5,22
I	0,10	0,24	0,34	0,43	1,07	1,50
L	0,05	0,02	0,07	0,20	0,08	0,28
NL	0,04	0,06	0,10	0,18	0,26	0,44
UK	0,06	0,13	0,19	0,27	0,65	0,92
EC 9	0,05	0,13	0,18	0,23	0,55	0,78

[1] EAGGF (Guidance Section), Social Fund and, for 1981, Regional Fund and EMS interest rate subsidies.
[2] EIB, ECSC and, for 1981, Euratom and NCI.
Source: Commission departments.

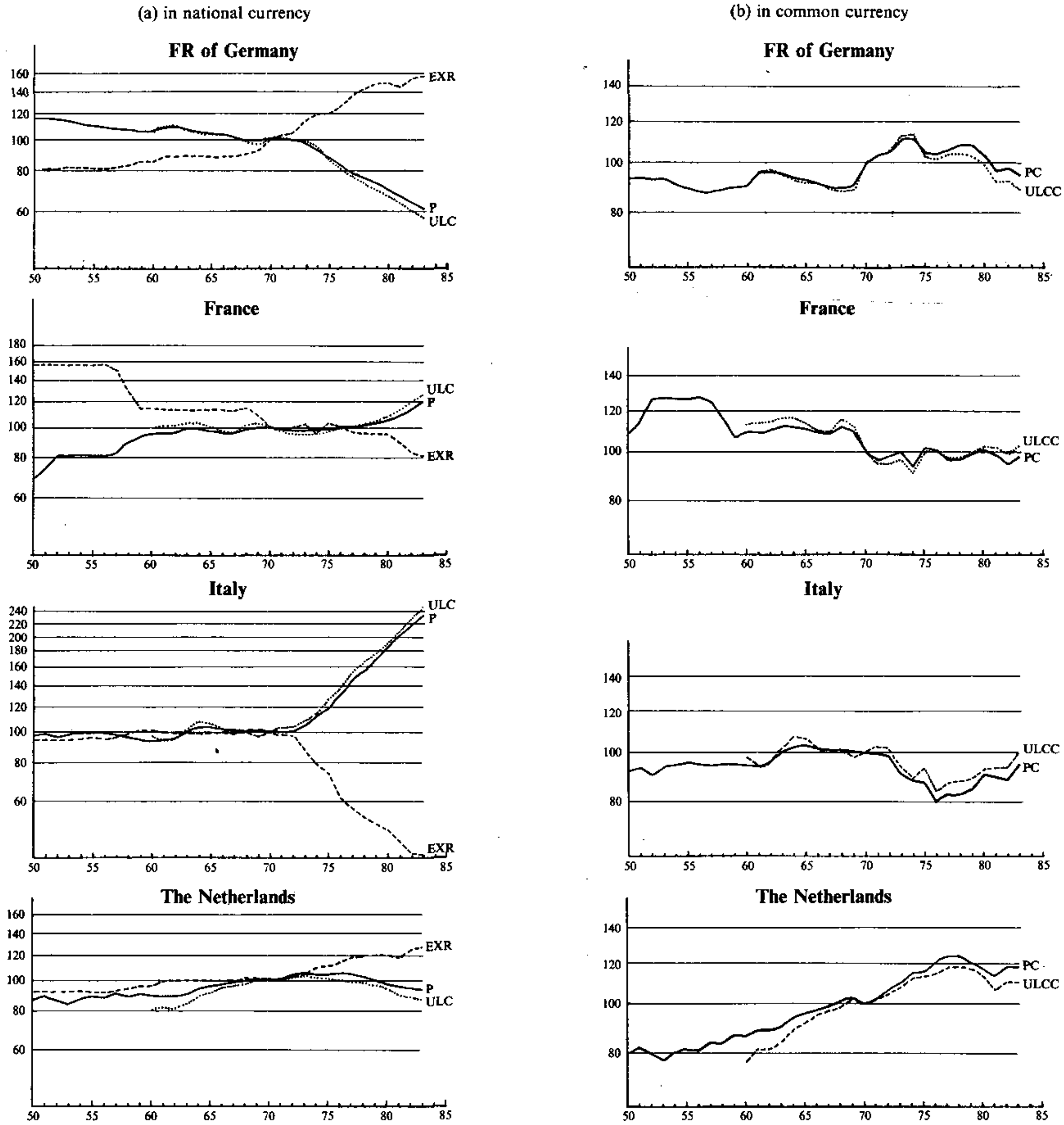
Table 3

GDP price deflators and effective exchange rates from 1950 to 1982, in relation to 17 major partners

Country	Movement of prices (in national currency): in each country (% p.a.)	in partner countries (% p.a.)[1]	Relative prices (Indices)	Effective exchange rate[1] (Indices)	Real exchange rate (Indices)
	1	2	3 = 1 : 2	4	5 = 3 x 4
			(a) 1960 in relation to 1950		
B	1,8	4,0	80,3	106,7	85,7
DK	3,6	4,0	97,0	103,8	100,6
D	3,1	3,9	92,1	106,1	97,6
F	6,6	3,3	137,4	73,3	100,7
IRL	4,6	4,3	102,7	102,0	104,8
I	3,4	3,8	96,2	107,2	103,1
NL	3,7	3,4	103,6	104,4	108,1
UK	4,3	3,8	104,2	102,9	107,2
			(b) 1968 in relation to 1960		
B	3,2	3,9	94,9	99,1	94,0
DK	6,0	3,6	120,1	95,3	114,5
D	3,1	4,0	93,6	105,6	98,9
F	3,9	3,6	102,7	100,1	102,7
IRL[2]	4,7	3,6	106,9	100,4	107,3
I	4,3	3,5	106,7	100,1	106,8
NL	4,9	3,5	111,1	105,8	117,5
UK[2]	3,7	3,6	100,5	99,6	100,0
			(c) 1978 in relation to 1968		
B	7,1	7,8	93,1	115,8	107,9
DK	9,5	8,3	111,8	109,9	122,9
D	5,4	8,3	76,0	159,1	120,9
F	8,5	8,1	103,7	83,4	86,5
IRL[3]	11,2	8,7	131,1	75,7	99,2
I	12,2	7,4	154,8	52,5	81,3
NL	7,9	7,5	103,5	118,0	122,2
UK[3]	10,3	7,2	141,0	54,1	76,4
			(d) 1982 in relation to 1978[4]		
B	5,3	8,2	89,7	87,8	78,7
DK	9,1	9,0	100,3	81,0	81,3
D	4,4	9,0	84,2	107,2	90,3
F	11,6	8,5	111,8	87,1	97,4
IRL	15,9	10,8	119,7	86,9	104,0
I	17,2	7,8	139,8	76,9	107,5
NL	5,3	7,7	91,5	104,2	95,3
UK	13,4	8,6	118,8	116,0	137,8

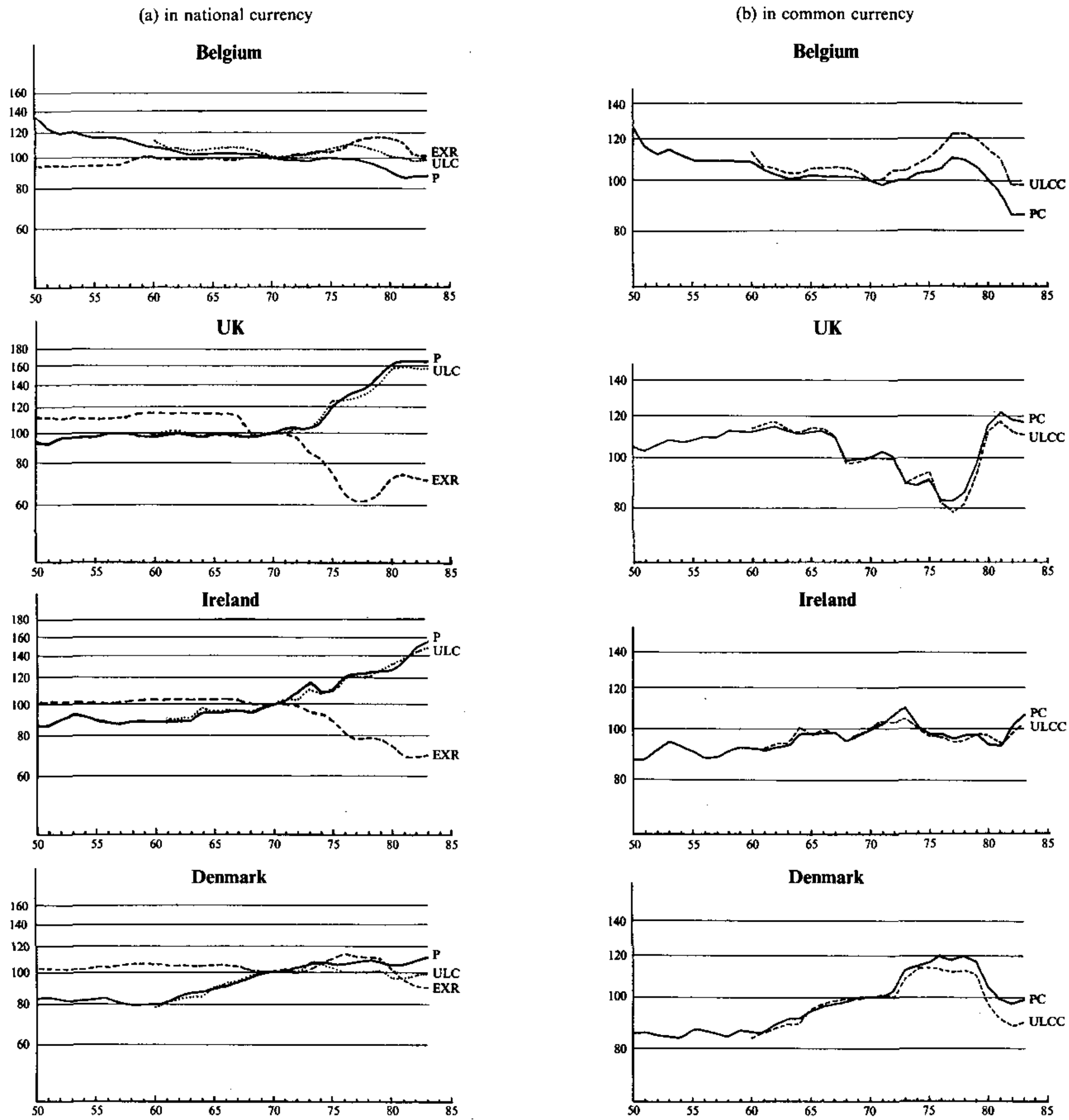
1 Export weighting, variable from year to year until 1977.
2 UK and Ireland: 1966/60.
3 UK and Ireland: 1978/66.
4 1982 effective exchange rate using June 1982 central rates for EMS countries and forecasts for other countries appearing in economic budgets (May 1982).
Source: Eurostat and Commission departments.

GRAPH 2: **Relative price and cost movements in relation to 17 trading partners**
(Indices: 1970 = 100) [1]



P = GDP deflator (total unit costs).
ULC = Unit labour costs for the whole economy (= ratio between wages and salaries per employee and overall productivity per person employed, in indices).
EXR = Effective exchange rate.
PC = GDP deflator, in common currency.
ULCC = Unit labour costs for the whole economy in common currency.
1 : Export weighting, variable from year to year.
1981-82-83: Economic budgets of 8.6.1982.
Exchange rates: from June 1982 onwards, central rates as at 14.6.1982.

GRAPH 2 *(continued)*: **Relative price and cost movements in relation to 17 trading partners**
(Indices: 1970 = 100)[1]



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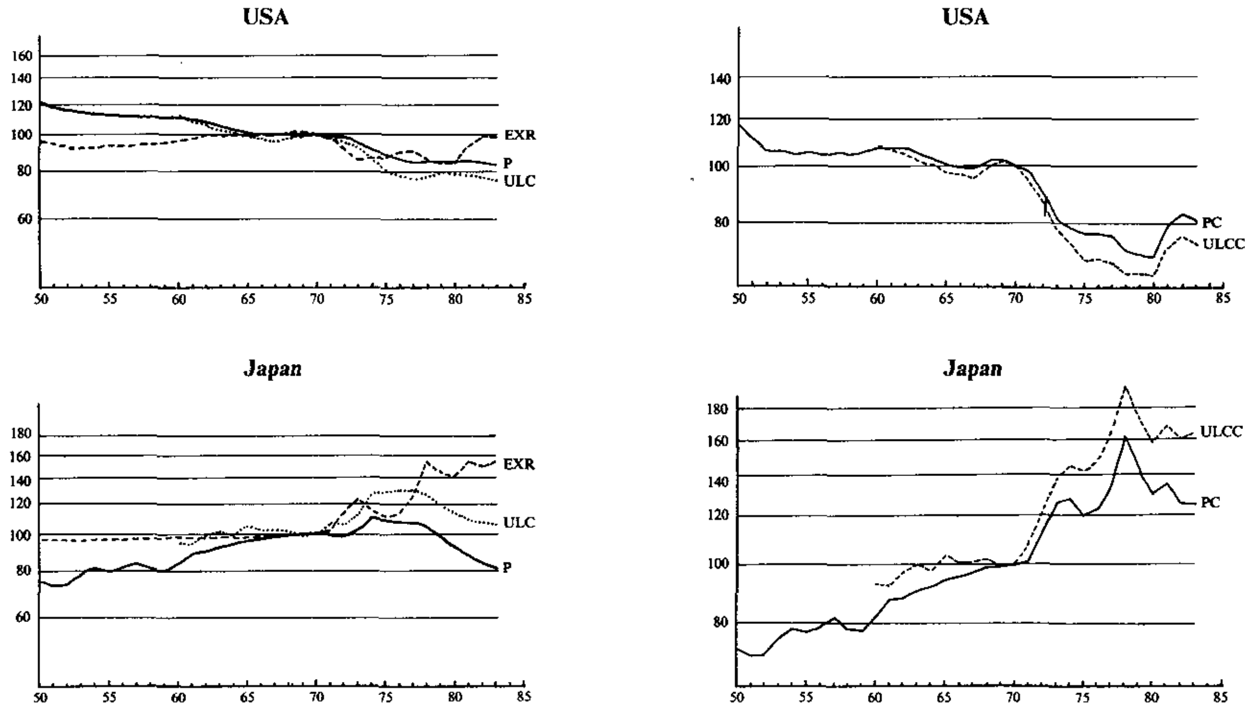
GRAPH 2 *(continued)*: **Relative price and cost movements in relation to 17 trading partners**
(Indices: 1970 = 100) [1]

(a) in national currency

(b) in common currency



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1981-82-83: Economic budgets of 8.6.1982.
Exchange rates: from June 1982 onwards, central rates as at 14.6.1982.

Japan provided a different illustration of the long-term effect of basic economic variables on exchange rates. The rapid establishment of an industry characterized by high productivity and high profitability allowed the Japanese economy, where the growth rate of real GDP rose from the already high level of 7,2% a year in the early 1950s (1952 to 1955) to 12,9% towards the end of the 1960s (1966 to 1969), to cover most of the gap in living standards which separated it from the United States and the Community. Throughout this period, the effective exchange rate of the yen remained remarkably stable (see Graph 2). The high level of growth did not lead to an external deficit: the productivity gains allowed the necessary resources to be made available for the development of exports and prevented a rate of inflation higher than those of its trading partners (a difference of 1,6% a year during the period on average) from harming its competitiveness. A similar, though less dramatic, development occurred in the Netherlands in the process of the country's rapid industrialization and of the exploitation of natural gas and the rise in its price.

Differences in relative economic performance may thus fully justify changes in exchange rates. Deferring them too long results in costly distortions in the allocation of resources. This was no doubt the case in the example of the United Kingdom cited above, where the overvaluation of sterling, in connection with its initial status as a reserve currency under the Bretton Woods system, considerably reduced growth potential. Conversely, such differences in economic performance may allow price divergences to continue without having an impact on current accounts and exchange rates. It should be emphasized, however, that the exchange rate shifts and the inflation differentials implied by the movements in the real economy are by their nature of limited size. As stated previously, the long-term growth path of an economy is determined by long-run policy options and by fundamental factors. Changes in the long-term growth path can only be gradual, barring severe economic or political shocks. Moreover, at least during a transitional period and within certain limits, compensatory capital flows may facilitate the necessary restructuring and reduce pressure on exchange rates (see Chapter 2, Section 4 below). In the search for stable exchange rates, the main effort in the short and the medium term must therefore be concentrated on the convergence of prices; the fact of the matter is that, at present, divergences of costs and prices within the EMS are well in excess of what might be expected from the real phenomena described above.

Section 3 — The need for, and implications of, exchange rate stability

The development of international trade, and in particular of intra-Community trade, has been based to a large extent on exchange rate stability. It is difficult to imagine how frontiers could have been opened up and common policies established at European level if there had not been a substantial degree of certainty about economic variables as important as the relative prices of currencies. This achievement must be safeguarded and reinforced. The adoption of protectionist policies and the fragmentation of capital markets would turn the present stagnation into a deep depression aggravated by an international financial crisis. Growing commercial and financial interdependence is an enormous asset, but it implies responsibilities, which are themselves growing, towards other countries, especially in the area of exchange rates.

The need for stable exchange rates derives not only from the requirements of economic integration. Recent experience shows that attempts to shake off the policy constraints imposed on economic policies by the need to maintain currency parities may rapidly prove fruitless, and indeed harmful. The switch to a system of floating exchange rates gave national authorities greater freedom in the conduct of economic and monetary policy. This room for manoeuvre was used in very different ways by Member States, particularly when they faced major problems of domestic adjustment and of restoring external balances following the first oil price shock. A look at Graph 2 shows the extent of the resultant divergences in terms of relative prices and exchange rates. Some countries, such as Italy and the United Kingdom, thought they could tolerate greater monetary expansion and price increases than their partners, in the hope that they could thus underpin their growth and prevent a fall in employment. In the Federal Republic of Germany and, to a lesser extent, in the other countries making up the 'snake', it was thought preferable to contain monetary expansion and inflationary pressures, in the belief that more moderate price trends provided a better basis for investment, growth and employment. France for its part adopted a middle course. The result of these differing options was that nominal divergences steadily increased and fed on themselves; a cumulative process involving exchange rates, prices and costs became established and contributed nothing to the solution of the underlying problems. At least, the establishment of 'virtuous circles' of revaluation and price stabilization had the advantage of bringing such problems out into the open; conversely, countries that allowed themselves to get caught in a spiral of devaluation and revaluation were in danger of masking the scale and urgency of the adjustments required and of increasing their cost by delaying them. The cost and price divergences resulting from these differing economic and monetary options have proved extremely difficult to reduce, and their effect is still felt today within the EMS.

The fact that such wide divergences have developed since the abandonment of the Bretton Woods exchange rate system and the move to floating exchange rates raises the question as to which system served better to promote the convergence of economic policy, while avoiding excessive rigidity. In examining this question, practical arrangements governing the application of such systems are more important than the principles which led to their introduction. Clearly, exchange rate fluctuations since 1973 have been erratic and on a larger scale than the advocates of floating exchange rates had anticipated. The introduction of that system did not in itself mean the abandonment of the disciplines that were necessary for stability. Experience has shown, however, that people seriously underestimated the danger that certain trends which corrected in many cases a back-log of delayed and necessary adjustment would be magnified.

The exchange rate system established at Bretton Woods was accompanied by fairly remarkable stability and convergence of prices (see Table 2 and Graph 2). Divergences in relative prices between 1950 and 1968 above or below an average Community inflation rate of less than 4% were rarely in excess of an annual rate of 2%, the average divergence being close to 1%. Nevertheless, the accumulation of such small divergences led, because of the relative rigidity of nominal exchange rates, to the undervaluation or overvaluation of currencies over long periods. The persistence of such situations produces disequilibria: the export industries in countries with undervalued currencies develop too fast while countries with overvalued currencies, failing adjustment through a fall in relation to prices, are forced to restrict their growth so as to prevent their external deficits from growing.

The floating of currencies should have allowed gradual correction of such situations. The differing options chosen for economic and monetary policy, though not an inevitable by-product of floating currencies, contributed greatly to the phenomenon of overadjustment. However, the risk of exchange rate instability would have been there even if there had been greater convergence. In the absence of fixed margins of fluctuation, the markets were led to adopt a very short-term view of economic performance and to overreact to the signals given by the direction of economic and monetary policies. Graph 2 show that in many cases, particularly in Germany, Italy and the United Kingdom, exchange rate fluctuation went well beyond the point justified by inflation differentials—great as these were—and by the correction of unsatisfactory initial positions. The disadvantages of excessive exchange rate rigidity were replaced by the undoubtedly graver disadvantages of disorderly movements around highly divergent medium-term trends.

Despite recent experience, and whatever the exchange rate system operated, it is entirely feasible that nominal variables should converge towards greater price stability. The success of a number of countries within and outside the Community in the fight against inflation proves this, as does the satisfactory convergence of prices and costs during the 1950s and 1960s. However, the extent of the difficulties to be overcome must not be underestimated. The nature and scale of the problems to be solved will be examined in greater detail in Chapter II. It is, however, possible at this point to outline in broad terms the measures to be pursued.

The defence of stable exchange rates rests primarily with national monetary policies and their close coordination. To put an extreme case, monetary policy may successfully be used to defend the parity of a currency even where an unfavourable inflation differential has built up *vis-à-vis* trading partners. In such circumstances, the pressures on the exchange rate will require an ever more restrictive stance of monetary policy. Such a tightening is beneficial, and indeed essential, in thwarting inflationary expectations and revealing the need for domestic adjustment. However, just as a relaxation of monetary discipline cannot in itself generate a lasting resumption of growth, so a tightening of monetary policy, unaccompanied by budgetary rigour and moderation in the growth of nominal incomes, will not be sufficient to establish a secure process of disinflation, save through a renewed depression in economic activity. These general considerations explain why the pursuit of convergence is often seen as incompatible with the requirements of growth and employment. In point of fact, it is not so much in the stance to be adopted by policy as in the formation of the mix of the various measures that the risks of incompatibility arise at present.

CHAPTER II

The convergence of economic and monetary policies under the EMS: the progress to be achieved

The setting up of the EMS was a defensive reaction designed to ward off the dangers of disintegration posed in the late 1970s by monetary disorder and growing uncertainty in the international economic environment. It was a positive reaction, since it did not mean a return to isolation, but a difficult effort to establish jointly a zone of stability. It was a realistic reaction, because past experience prompted a certain degree of modesty in its declared ambitions. [1] The first task was to redefine intervention rules and credit mechanisms, adapting them or broadening them as the case might be, so as to achieve greater symmetry between the obligations of the 'strong' currencies and those of the 'weak' currencies. There was above all a need to reaffirm in practice the principle already laid down in the Treaty whereby policies with regard to rates of exchange must be treated as a matter of common concern (Article 107) and to draw from this principle the fullest conclusions for the convergence of economic policies. By rejecting fixed parities and deciding to make changes in central rates a matter of mutual agreement rather than the automatic application of pre-established economic criteria, a pragmatic approach was adopted based on the coordination of national policies and aimed at endowing the system with sufficient flexibility. Such an approach was necessary, because trends as divergent as those which had recently developed could not be changed immediately, while the Bretton Woods system had shown the disadvantages of excessive exchange rate rigidity.

Section 1 — Insufficient convergence towards stability

Recent assessments of the operation of the EMS from its introduction on 13 March 1979 up to the end of 1981 [2] highlight the fact that the greater exchange rate stability and improved monetary management attributable to it have not resulted in increased convergence in the area of costs and prices. The available forecasts for 1982 confirm the persistence of a high average inflation rate for the Community and marked divergences between Member States.

Price rises in 1981 and those anticipated for 1982 (see Table 4(a) and (b) indicate only a modest change in the inflation rate for the Community as a whole. In 1982, the Community consumer price deflator will have risen again by 10%, whereas the increase will have slowed down distinctly in the United States (6,4% as against 8,3% the previous year) and will have stayed at a low level in Japan (4,3%). The persistence of these differentials may be expected to affect the competitiveness of European products on export markets and to mean that the European currencies will show a continued tendency to weaken, thus limiting the scope for a fall in interest rates, even if they were to fall in the United States.

This mediocre performance for the Community as a whole is the result of the very uneven performance achieved in this area in the various Member States. Price differentials within the Community are today wider than those recorded on average during the period 1974-78 following the first oil price shock. In 1981, taking only the Member States effectively participating in the EMS exchange rate mechanism, there was a difference of close to 15 percentage points between the most stable country, Germany, and the country in which inflation was highest, Ireland. The inflation rate in France is twice, and in Italy three times, the rate in Germany. The forecasts for 1982 indicate that the Member States with a low level of inflation, such as Germany and the Netherlands, will improve their performances. In the other Member States, progress will be uneven. In Italy and Ireland, though there will be an appreciable improvement, the rise in prices will still be in excess of 15%. In the United Kingdom, the inflation rate will fall below 10%. There will be no major deceleration in France and Denmark, and Belgium will feel the effect of the devaluation of the Belgian franc which occurred early in the year.

Beyond a certain threshold such divergences in inflation rates will inevitably have an impact on the nominal exchange rates of the EMS currencies. During the three and a half years of its operation, the EMS has seen six concerted realignment operations, the main features of which are set out in Table 5(a). Taking the last two realignments (of February and June this year) into account, the variations in effective exchange rates between the participating currencies have been close on average to those which occurred between 1973 and 1979 (see Table 5(b). At first sight, this might prompt doubts as to the capacity of the system to establish greater exchange rate stability. The recent trend towards more frequent and more extensive realignments provided serious cause for concern (see Chapter III below). However, taking the period of operation as a whole, the results achieved may be seen to be positive.

First, there has been a reduction in the very short-term variability of exchange rates between currencies participat-

[1] On the setting up of the EMS, see *European Economy No 3*, July 1979.
[2] See Chapter 5 of the Annual Economic Review 1981-82, *European Economy No 10*, November 1981, and Part Two below entitled 'The development of the EMS in its present institutional framework'.

Table 4

Price changes within the Community: annual rates of change (%)

	1968/1960	1974/1968	1978/1974	1979/1978	1980/1979	1981/1980	1982/1981 [1]
			(a) Consumer prices				
B	3,2	5,9	7,9	3,9	6,5	7,6	10,2
DK	5,3	8,6	9,9	9,6	11,5	10,7	10,1
D	2,9	5,4	4,5	4,0	5,3	5,9	4,7
GR	2,3	8,3	12,6	17,7	23,7	24,4	24,0
F	3,9	7,2	9,8	10,9	13,2	12,5	13,3
IRL	3,8	10,3	15,1	13,4	18,3	20,5	18,5
I	3,8	8,7	16,7	15,0	20,4	19,0	15,0
NL	3,9	7,8	7,4	4,3	6,6	6,7	5,8
UK	3,5	8,7	15,6	14,3	15,5	10,7	9,5
EC: mean [2]	3,5	7,3	10,4	9,7	12,1	11,0	10,0
EC: weighted dispersion [3]	0,4	1,2	4,1	4,3	4,9	3,7	3,6
			(b) GDP deflator				
B	3,2	6,8	7,6	4,3	4,4	5,0	8,2
DK	5,7	9,2	10,2	7,7	8,4	9,6	10,6
D	3,0	6,1	4,3	3,9	4,7	4,3	4,4
GR	3,0	9,0	13,4	18,7	18,4	20,2	23,2
F	4,0	7,2	10,5	10,6	11,5	11,8	12,7
IRL	4,5	10,6	16,2	12,4	14,1	18,1	18,6
I	4,3	9,0	17,1	15,7	20,4	17,6	15,8
NL	(4,9)	7,9	7,9	4,2	5,3	6,0	6,2
UK	3,7	8,7	16,5	15,1	18,9	11,8	8,5
EC: mean [2]	3,8	7,6	10,8	9,9	11,8	10,2	9,6
EC: weighted dispersion [3]	0,5	1,1	4,3	4,5	5,6	4,1	3,9

1 Forecasts: economic budgets, May 1982.
2 Weighted by GDP valued at 1975 purchasing power parities.
3 Weighted averages of absolute differences from the mean (see Note 2).
Source: Eurostat and Commission departments.

ing in the system, including the Italian lira, which enjoys a wider margin of fluctuation about its central rate (see Table 6). By contrast, the exchange rates of the non-participating currencies have remained highly volatile and and this short-term instability has been part of very large long-term fluctuations: since the middle of 1980, the yen has appreciated by some 50% against the ECU, following a similar fall during 1979 and early 1980; in June 1982, 1 ECU was worth less than USD 1 as against USD 1,45 in July 1980, equivalent to a depreciation of the order of 50% in the ECU against the dollar.

Secondly, Table 5(b) shows that the fall in effective exchange rates in countries such as France, Italy and Ireland, which have experienced more rapid inflation than the other countries, has been constrained within narrower limits during the period of operation of the EMS than the previous period. The adjustments in central rates have only partly compensated for the movement in relative costs and prices. This has resulted in a gradual real appreciation of these currencies, particularly the Irish pound (see Table 7). The establishment of the EMS has thus put an end to the phenomena of overadjustment previously observed and has made for a return to more normal conditions and a less tolerant approach to inflation. This same concern to correct initial situations which were not sustainable in the long run justified the downward adjustments in the central rates for the Danish krone and the Belgian franc. On the other hand, the relative positions of Germany and the Netherlands altered little between 1978 and 1982, protecting these countries against imported inflation and preserving a necessary pole of stability within the system as a whole.

Table 5

Changes in exchange rates within the EMS

(a) Realignments in central rates, percentage change against the group of currencies whose bilateral parities were not changed

	Dates of realignments					
	24 September 1979	30 November 1979	22 March 1981	5 October 1981	22 February 1982	14 June 1982
BFR/LFR	—	—	—	—	−8,5	—
DKR	−2,9	−4,8	—	—	−3	—
DM	+2	—	—	+5,5	—	+4,25
FF	—	—	—	−3	—	−5,75
IRL	—	—	—	—	—	—
LIT	—	—	−6	−3	—	−2,75
HFL	—	—	—	+5,5	—	+4,25

(b) Variations in effective exchange rates [1] relative to EMS partners, annual percentages

	1979/1973	1982/1979 [2]	1980/1979	1981/1980	1982/1981 [2]
B	+1,3	−3,1	−0,1	−0,4	−9,1
DK	−1,1	−3,9	−6,8	+0,1	−4,7
D	+4,6	+4,7	+1,2	+3,0	+10,0
F	−3,0	−2,2	+1,0	−1,1	−6,4
IRL	−6,1	+0,2	+0,1	−0,5	+0,9
I	−9,4	−4,8	−3,5	−5,0	−5,9
NL	+1,7	+2,6	+0,7	+0,7	+6,5
UK [3]	−4,9	+6,5	+9,9	+9,9	−0,0

1 Export weighting, variable from year to year until 1977.
2 Forecasts: economic budgets, May 1982. The realignment of central rates on 14 June 1982 is taken into account.
3 In relation to Community countries.
Source: Eurostat and Commission departments.

Table 6

Monthly variability of major currencies against the ECU [1]

	1976	1977	1978	1979	1980	1981
BFR/LFR	38,5	6,2	11,4	8,4	9,0	8,3
DKR	33,8	32,4	7,7	32,7	4,5	8,4
DM	42,7	11,6	11,7	8,6	9,6	19,7
FF	30,1	9,6	18,0	7,4	6,1	13,8
IRL	63,5	11,3	23,8	7,7	9,2	6,3
LIT	55,5	21,1	24,8	9,8	17,9	21,8
HFL	39,0	5,7	11,3	9,0	4,4	21,0
EMS average [2]	43,3	13,9	15,5	11,9	8,7	14,2
UKL	63,2	11,3	23,8	32,2	44,7	40,3
USD	20,1	24,9	49,1	28,1	34,4	62,3
Yen	34,1	39,2	70,8	87,5	82,2	25,9

1 Coefficient of variation (standard deviation of end-of-month rates for each currency in ECU, divided by the annual average of such rates). Results multiplied by 1 000.
2 Unweighted average.
Source: Commission departments.

It may be concluded that despite the instability of the international monetary environment, the disruptions caused by the second oil price shock and persistent divergences in nominal variables, the EMS has succeeded in reestablishing a more orderly structure of exchange rates between participants and in reducing volatility. This achievement, the fruit of an initial phase during which order was restored, will be seriously compromised if greater convergence in economic policies is not established. Greater exchange rate stability requires more moderate and more closely aligned growth of nominal variables, and this achievement cannot without damage be put off any longer. Failing this, the EMS would gradually change in nature to become something similar to a crawling peg system of parities.

The measures to be taken towards this end are in no way inconsistent with the efforts which, irrespective of the EMS, must be made in all the Member States to promote employment and growth. Appropriately applied, they are on the contrary likely to reinforce them.

Table 7

Adjustment of relative changes [1] in costs and prices in relation to EMS partners

Country	(a) Relative change in unit labour costs [2] — whole economy; indices in common currency						(b) Relative change in GDP price: indices in common currency					
	Relative level in 1978 (= available margins relative to different base periods = 100)			Relative level in 1982 [3] (= margins still available relative to different base periods = 100)			Relative level in 1978 (= available margins relative to different base periods = 100)			Relative level in 1982 [3] (= margins still available relative to different base periods = 100)		
	1978/1970	1978/Ø 61-70	1978/Ø 68-72	1982/1970	1982/Ø 61-70	1982/Ø 68-72	1978/1970	1978/Ø 61-70	1978/Ø 68-72	1982/1970	1982/Ø 61-70	1982/Ø 68-72
B	117,8	111,4	115,1	99,0	93,9	96,9	105,6	102,5	105,7	87,8	85,2	87,9
DK	102,7	104,8	102,7	90,3	92,1	90,3	110,2	112,5	110,3	100,7	102,9	100,8
D	99,1	106,4	103,0	94,6	102,0	98,8	104,0	111,2	107,2	101,9	109,0	105,0
F	92,6	81,1	89,3	103,0	90,2	99,3	92,9	83,3	89,9	98,6	88,4	95,4
IRL	77,9	74,8	82,2	103,0	99,0	106,2	82,6	80,1	83,4	110,4	107,0	111,5
I	82,7	81,4	82,7	95,7	94,2	95,8	77,6	76,5	78,0	90,9	89,6	91,4
NL	112,9	121,7	111,5	112,6	121,3	111,2	119,1	123,2	116,3	121,2	125,2	118,3
UK [4]	76,3	69,8	77,7	112,2	102,6	114,2	80,1	73,4	80,6	117,8	107,9	118,5

1 Export weighting, variable from year to year until 1977.
2 Index of compensation of employees per employee divided by the index of productivity per person employed.
3 Forecasts: economic budgets, May 1982. The realignments of 14 June 1982 are taken into account.
4 Change relative to Community countries.
Sources: Eurostat and Commission departments.

Section 2 — Stronger action and a wider range of measures to control inflation

As earlier reviews show, [1] the EMS has provided a major incentive to improved coordination of monetary policies. First, domestic monetary conditions have been adjusted on several occasions, in an orderly and carefully judged way, to enable the margins to be respected. In this day-to-day management, interest rates were often changed to avoid breaches of fluctuation margins or a need for substantial intervention. Moreover, in spite of occasional strains, the extreme volatility of US interest rates has not been reflected in the nominal interest rates for EMS currencies, which have been approximately parallel even though at different levels because of differences in rates of inflation. Secondly, in the longer-term perspective adopted in this study, policies to regulate monetary aggregates have been more closely convergent than in the past.

Between 1979 and 1981, most of the Member States reacted to the inflationary strains resulting from the further rise in the price of oil products by considerably reducing the rate of expansion of the money supply. During those three years, the growth of the broadly-defined money supply (M2-M3) was much slower in most of the Member States than it had been from 1974 to 1978, and about the same as it was in the 1960s (see Table 8). The slowdown was particularly marked in Belgium, Germany and the Netherlands. It was less marked in the other Member States, especially in Ireland and Italy, where the money supply continued to expand by over 15% a year.

In present conditions, monetary policy has very little room for manœuvre. Germany, the Netherlands and the United Kingdom have already taken advantage of the scope for a gradual reduction in interest rates opened up by lower inflation and improved external balance. In the other member countries, however, although the slower rate of monetary expansion was reflected in stable or declining liquidity ratios, the regulation of monetary aggregates has on balance been fairly accommodating towards inflation, to judge by the trend of the money supply per unit of output (see Table 8), which has continued to expand at the same rate as previously or only slightly less. In these countries, any easing of quantitative monetary policy could only lead to further inflationary surges. On the other hand, a marked decline in the rate of monetary growth would lead to a significant decline in the rate of inflation only at the cost of a further, damaging fall in economic activity.

Monetary policy cannot bear the burden of the fight against inflation alone. If the constraints on monetary policy are to be loosened and a fall of interest rates is to get under way, then support must come from other types of action. Convergence must be sought in two other areas of economic policy, where progress has been more modest and results very varied: the control of budget deficits and the moderation of wage costs.

In 1981 and 1982, the general government borrowing requirement for the Community as a whole reached 5% of GDP, a figure previously recorded only in 1975, after the first oil shock. None of the Member States can boast a general government surplus, but the deficits vary from less than 2% of GDP in the United Kingdom to over 14% in Ireland.

These large budget deficits make it much more difficult to control monetary expansion, since rising interest rates or stricter credit controls have adverse effects on private investment expenditure and real growth. The longer these deficits last, the less likely it is that the public will believe that a stabilizing monetary policy will be persisted in. Quite apart from the bad effect of the budget deficit on the current account of the balance of payments, these expectations aggravate the downward pressure on the exchange rate and push interest rates still higher. The increase in the cost of servicing the debt then further swells budgetary expenditure.

Table 9 shows, for the various Member States, the ratio of the absolute value of the general government borrowing requirement to that of the annual change in the money supply. These ratios are not directly comparable from one country to another, since they depend also on the structural liquidity ratio of each economy. However, the changes of the ratio in any given country can serve as an indicator of the restrictiveness of monetary policy in relation to changes in fiscal balance. It is a more significant indicator than a breakdown of the means of financing the budgetary deficit into categories of lenders (banking sector, non-banking sector and external sector); it allows for compensatory movements between the various counterparts of the money supply and the banks' opportunities for developing non-monetary commitments.

From 1979-80, the general government borrowing requirement increased in relation to the extra monetary financing put at the disposal of the economy each year in all the Member States except the United Kingdom. The increase was particularly large in Belgium, where a marked expansion of the public deficit coincided with a substantial slowdown in the rate of increase of monetary financing. The phenomenon was less noticeable in Germany and the Netherlands, where the general government borrowing requirement has remained fairly stable as a percentage of GDP. In Denmark and in Ireland, and to a lesser extent in Italy, the financial pressure resulting from fast-growing or very large budget deficits was partly offset because the rate of monetary expansion slowed down less. In France, the rate of monetary

[1] See note 2 on page 23..

Table 8

Monetary aggregates: annual percentage changes

	1968/1960	1974/1968	1978/1974	1979/1978	1980/1979	1981/1980	1982[2]/1981	1968/1960	1974/1968	1978/1974	1979/1978	1980/1979	1981/1980	1982[2]/1981
	Belgium							Denmark						
1. Money supply [1]	8,3	11,8	12,7	7,9	4,3	5,4	7,4	10,5	9,8	13,6	9,3	8,4	11,8	12,0
2. Liquidity ratio	0,4	−0,6	2,9	1,0	−2,5	1,6	−1,2	−0,5	−2,6	0,8	−1,6	0,2	2,2	−1,6
3. Money supply per unit of output	3,6	6,1	10,7	5,4	1,8	6,6	6,9	5,2	6,3	11,1	6,1	8,6	12,0	8,8
	FR of Germany							France						
1. Money supply [1]	10,3	10,9	9,2	9,6	5,3	6,5	5,6	13,7	14,1	14,9	13,5	11,8	12,6	14,1
2. Liquidity ratio	2,7	0,1	2,2	1,1	−1,4	2,1	0,2	3,8	0,9	1,0	−0,4	−1,0	0,5	−0,8
3. Money supply per unit of output	5,8	6,2	6,7	5,0	3,2	6,5	4,6	7,9	8,1	11,6	10,1	10,4	12,4	11,8
	Ireland							Italy						
1. Money supply [1]	9,2	15,2	17,7	29,2	14,5	21,5	17,5	13,6	16,2	22,4	22,8	19,9	17,9	15,8
2. Liquidity ratio	0,3	−0,4	−3,0	12,2	−1,5	1,1	−3,1	3,0	2,0	2,8	1,2	−4,2	0,5	−1,8
3. Money supply per unit of output	4,8	10,2	12,8	26,1	12,4	19,4	15,0	7,4	11,1	20,4	17,1	15,3	18,1	13,7
	The Netherlands							United Kingdom						
1. Money supply [1]	8,5	13,7	10,6	4,8	8,0	6,6	6,8	5,4	13,7	9,9	12,8	14,9	15,6	12,4
2. Liquidity ratio	−1,4	0,3	0,2	−1,1	2,0	2,0	0,0	−1,4	2,1	−7,3	−3,4	−2,0	4,7	2,3
3. Money supply per unit of output	3,5	8,3	8,1	3,0	7,4	8,1	6,2	2,3	11,0	7,9	11,2	16,5	17,0	11,0

[1] Average money supply.
DK, F, NL: M2
D, I, IRL: M3
B: M2H
UK: UKL M3
[2] Commission staff forecast.
Source: Commission departments.

expansion has followed the changes in the fiscal balance fairly closely, and only at the end of the period did signs of crowding out rrbegin to appear on the capital markets. In the United Kingdom, in contrast to other member countries, the capital market pressure coming from general government has been progressively reduced, without any relaxation of monetary policy, since fiscal deficits are gradually being eliminated. This schematic analysis demonstrates that reducing government deficits, or at least keeping them under control, could make monetary stabilization easier; in the countries where the rate of monetary expansion is sufficiently low and where inflation rates are beginning to decline, such action could restore a margin for real growth; in the other countries, it would make it possible to slow down the rate of monetary expansion without creating intolerably restrictive effects.

The limits encountered in the implementation of stability-oriented monetary policies and the varying degree of success attained are also due to the difficulty of containing nominal increases in income, particularly wages. The simultaneous achievement of lower inflation and rising levels of employment depends in fact on a shift in the functional distribution of incomes which changed markedly in the first half of the 1970s. After increasing rapidly during this period, the real wage gap (the gap between changes in real wages and changes in productivity adjusted for changes in the terms of trade) afterwards narrowed only very slowly in the Community as a whole (see Table 10). This general tendency covers divergent trends in the different Member States. In Belgium, the fairly satisfactory development of prices was not accompanied by an equivalent slowdown in nominal wages. In France, Italy and Ireland, the real wage gapp was wider in 1981 than in

Table 9

Budget deficits and changes in money supply [1]

	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982 [2]
					Belgium					
1. D/ΔM (1 = 2:3)	32,8	31,0	41,2	60,5	81,2	86,7	170,7	515,9	297,8	244,6
2. D/Y (as %)	3,0	2,0	4,3	5,1	5,3	5,7	7,0	9,4	13,1	12,4
3. ΔM/Y (as %)	9,2	6,8	10,6	8,6	6,7	6,8	4,2	1,9	4,5	5,2
					Denmark					
1. D/ΔM (1 = 2:3)	−115,0	−48,8	19,9	16,1	40,3	78,7	77,5	130,4	163,8	171,2
2. D/Y (as %)	−5,9	−1,8	2,0	0,8	1,7	2,2	3,1	5,9	7,2	8,8
3. ΔM/Y (as %)	5,1	3,7	10,0	4,9	4,3	2,9	4,0	4,5	4,4	5,2
					FR of Germany					
1. D/ΔM (1 = 2:3)	−28,5	38,2	154,6	97,6	49,2	54,5	106,8	118,9	189,1	151,1
2. D/Y (as %)	−1,2	1,4	5,8	3,6	2,4	2,8	3,0	3,5	4,5	3,9
3. ΔM/Y (as %)	4,2	3,6	3,7	3,7	5,0	5,1	2,8	2,9	2,4	2,6
					France					
1. D/ΔM (1 = 2:3)	−14,1	−8,8	27,1	8,1	12,4	31,2	12,4	−9,9	36,7	47,9
2. D/Y (as %)	−0,9	−0,6	2,2	0,5	0,8	1,8	0,8	−0,5	−1,9	−2,9
3. ΔM/Y (as %)	6,7	7,1	8,3	6,0	6,5	5,7	6,6	4,5	5,2	6,1
					Ireland					
1. D/ΔM (1 = 2:3)	29,1	59,9	105,6	97,0	79,8	56,2	108,0	124,1	144,9	166,5
2. D/Y (as %)	3,9	7,2	11,3	7,7	7,1	8,6	11,9	12,8	15,1	14,4
3. ΔM/Y (as %)	13,2	12,0	10,7	7,9	9,0	15,2	11,0	10,3	10,4	8,6
					Italy					
1. D/ΔM (1 = 2:3)	37,2	56,1	60,2	48,3	40,4	46,0	46,1	56,3	84,3	84,7
2. D/Y (as %)	7,0	7,0	11,7	9,0	8,0	9,7	9,5	8,4	11,9	11,1
3. ΔM/Y (as %)	18,8	12,5	19,4	18,6	19,7	21,2	20,7	14,9	14,1	13,1
					The Netherlands					
1. D/ΔM (1 = 2:3)	−18,2	1,5	144,5	34,5	116,7	160,1	139,3	248,7	288,0	261,9
2. D/Y (as %)	−1,1	0,1	2,7	2,4	1,4	2,2	3,1	3,4	4,6	4,2
3. ΔM/Y (as %)	6,1	6,0	1,9	6,8	1,2	1,4	2,2	1,4	1,6	1,6
					United Kingdom					
1. D/ΔM (1 = 2:3)	38,0	97,3	223,9	172,9	118,7	103,8	94,1	72,9	62,6	65,8
2. D/Y (as %)	3,5	3,8	4,9	5,0	3,4	4,3	3,3	2,5	2,4	1,9
3. ΔM/Y (as %)	9,2	3,9	2,2	2,9	2,9	4,1	3,4	4,9	3,8	2,9

1 D: General government borrowing requirement (+) or financial surplus (−).
Y: GDP at current prices.
ΔM: Change in money supply during the year (absolute value). The money supply is defined as in Table 8, Note 1.
2 Forecasts by Commission departments (economic budgets for May-June 1982).
Source: Eurostat and Commission departments.

1975, when it was already very wide compared to the average level of the 1960s. The forecasts for 1982, however, indicate an improvement in these countries, especially in Ireland and, thanks to the recovery plan introduced after the realignment of the Belgian franc, in Belgium. In the other Member States, the real wage gap should continue to improve.

There is no alternative but to persevere in the attempt to control wage costs, and to support such restraint by measures to promote saving, if the foundations of a sustainable recovery of investment are to be laid and the rise in unemployment held back.

Table 10

Compensation of employees

	B	DK	D	F	IRL	I	NL	UK	EC
				(a) Per capita compensation [1]: annual change as %					
1960-1968	4,1	5,0	4,7	5,1	4,6	6,6	6,0	2,7	4,5
1968-1974	6,2	3,5	6,3	4,6	5,5	5,7	5,6	3,9	5,3
1974-1978	3,9	0,9	2,7	4,1	4,3	2,9	2,3	0,9	2,5
1979	1,8	−0,4	1,5	2,4	3,9	2,4	1,5	3,0	2,1
1980	1,3	−2,9	1,2	0,9	1,9	1,3	−1,1	4,1	1,4
1981	1,1	−0,7	−0,6	1,3	−1,9	0,7	−2,7	2,7	0,4
1982 [3]	−2,6	1,7	0,0	0,7	−2,1	2,1	−0,1	−0,6	0,1
				(b) Real wage gap [2]: annual average 1961-70 = 100					
1961-1970	100,0	100,0	100,0	100,0	100,0	100,0	100,0	100,0	100,0
1975	116,6	111,1	110,5	107,1	108,2	117,8	115,3	116,4	112,5
1978	119,6	103,0	106,9	108,2	102,9	117,5	114,0	104,8	109,1
1979	120,4	101,8	106,1	107,3	108,4	115,6	116,7	106,5	109,0
1980	121,8	98,7	107,7	108,6	113,4	114,5	116,6	109,3	107,9
1981	124,3	97,6	107,4	110,7	109,7	117,5	113,5	107,4	108,0
1982 [3]	119,3	96,2	104,9	110,2	102,9	118,1	110,0	104,5	106,2

[1] Compensation of employees per employee divided by retail price index.
[2] Compensation of employees per employee divided by retail price index and aggregate productivity (real GDP per person employed) adjusted for changes in the terms of trade.
[3] Forecasts: Economic budgets, May 1982.
Source: Eurostat and Commission departments.

Section 3 — Correcting structural macroeconomic disequilibria

Apart from a brief pause in 1978-79 following a moderate recovery of economic activity, unemployment has been rising steadily in the Community since 1973. As a percentage of the labour force, the average rate of unemployment in 1982 will be twice as high as that observed from 1975 to 1978 (see Table 11). The deterioration of the labour market began earlier and was more gradual in Belgium, France, Italy and Ireland; it began later but was even more brutal in other countries and it now affects all the Member States. Cyclical recovery alone will not reverse so strong and persistent a trend and such a recovery appears uncertain at present in view of the international economic and monetary environment. The restoration of a durable growth vigorous enough to reduce unemployment depends on an internal adjustment which will require great effort. To achieve this aim, all the instruments of economic policy must be deployed to a single end. The specific measures needed in areas as varied as industrial policy, employment and the improvement of financial flows must be part of a general macroeconomic approach designed to correct the growing structural disequilibria which have gradually come to disfigure the European economies.

A comparison of the present breakdown of the uses of GDP with that prevalent from 1968 to 1972, when growth, employment and the current balance of payments position were satisfactory in most of the Member States, shows how

Table 11

Unemployment and growth

	1960-1968	1969-1974	1975-1978	1979	1980	1981	1982 [1]	1968/1960	1974/1968	1978/1974	1979/1978	1980/1979	1981/1980	1982/1981 [1]
	(a) Rate of unemployment as % of labour force [2]							(b) Annual growth rate of real GDP (as %)						
B	2,2	2,7	6,3	8,7	9,4	11,5	13,4	4,5	5,3	1,8	2,3	2,5	−1,1	0,5
DK	1,2	1,3	4,7	5,3	6,2	8,5	8,9	5,0	3,5	2,5	3,0	−0,2	−0,2	2,9
D	0,9	1,1	3,7	3,4	3,4	4,8	6,7	4,2	4,3	2,3	4,3	2,0	0,0	1,0
GR	..	..	..	(2,2)	(2,8)	(3,1)	(3,6)	7,3	6,2	5,5	3,8	1,7	−0,7	0,8
F	0,8	1,6	4,1	6,0	6,4	7,6	8,7	5,4	5,4	2,8	3,0	1,3	0,2	2,2
IRL	4,4	5,4	8,3	7,4	8,3	8,7	10,8	4,2	4,3	4,1	2,4	1,9	1,8	2,2
I	5,6	4,8	5,8	7,5	8,0	8,8	9,6	5,7	4,5	1,6	4,9	4,0	−0,2	1,8
L	0,1	0,0	0,3	0,7	0,7	1,0	1,3	2,7	5,2	−0,2	4,1	0,7	−2,4	0,6
NL	0,8	1,8	3,9	4,1	4,8	7,5	9,9	4,8	5,0	2,3	1,8	0,6	−1,4	0,5
UK	1,8	2,7	4,6	5,3	6,9	10,6	11,7	3,0	2,5	2,0	1,4	−1,4	−1,2	1,3
EC	2,1[3]	2,4[3]	4,6[3]	5,4	6,0	7,9	9,2	4,5	4,2	2,4	3,3	1,4	−0,3	1,5

1 Forecasts by Commission departments: Economic budgets, May 1982.
2 SOEC definition.
3 Excluding Greece.
Source: Eurostat and Commission departments.

the allocation of resources has become distorted (see Table 12).

The figures show that the adjustments made after external shocks were insufficient to keep the current account of the Community as a whole in surplus. The expansion in the volume of exports of goods and services served only partially to offset the deterioration in the terms of trade and the growing debt service payments caused by rising interest rates and the expansion of foreign borrowing.

During this period, the United Kingdom and the Netherlands managed to improve their balance of payments positions on goods and services, by developing their oil and gas and obtaining higher prices for them. In Denmark also the balance on goods and services improved, but this was not reflected in an improved current balance, because of the cost of servicing the external debt. With the exception of these countries and of Germany, where the deficit is shrinking, the balance on goods and services in the Member States was in deficit in 1981. In particular, foreign trade has deteriorated considerably in recent years in Belgium and Ireland. The deficits of these countries reached disproportionate levels in 1981. Belgium is the only Member State where the balance on goods and services, adjusted for changes in the terms of trade, has not improved since 1968-72. In France and Italy, the deterioration of the trade balance may be regarded as acceptable or at least as not yet out of control.

Present forecasts for the current account of the balance of payments in 1982 (see Table 13) indicate that the Community as a whole will achieve a sustainable balance close to zero, if oil prices and the dollar exchange rate remain fairly steady. However, there will still be considerable differences between the Member States. The improvement in the external balance should be maintained in Germany and the Netherlands, but achievements will be more modest in most of the other Member States. In France and Denmark, present current deficits may well increase slightly. A more marked improvement in external positions is essential, to allow for interest payments and the gradual redemption of external debt.

To reinforce the competitiveness of the European economies while at the same time improving the employment situation, not only must internal absorption of resources be reduced, but there must be at the same time a reallocation of resources towards productive uses.

The share of total consumption in Community GDP has increased considerably (almost 5 percentage points of GDP). The relative expansion of consumption expenditure was

Table 12

Changes in the structure of GDP uses and current balance of payments position (as a % of GDP)

(a) Average 1968-72 (b) 1982

		Consumption			Gross capital formation			Balance on goods and services			GDP	Change in balance on goods and services at constant prices
		Private	Public	Total	Fixed capital	Stocks	Total	Exports	Imports	Balance		
B	(a)	61,4	14,1	75,5	21,4	1,3	22,7	42,3	40,6	+1,7	100	
	(b)	64,9	19,6	84,5	19,5	0,3	19,8	64,0	68,4	−4,4	100	
	(b) − (a)	+3,5	+5,5	+9,0	−1,9	−1,0	−2,9	+21,7	+27,8	−6,1	0	0,0
DK	(a)	56,9	20,0	76,9	24,3	0,7	25,0	25,5	27,4	−1,9	100	
	(b)	56,1	28,0	84,1	15,6	−0,3	15,3	36,8	36,3	+0,5	100	
	(b) − (a)	−0,8	+8,0	+7,2	−8,7	−1,0	−9,7	+11,3	+8,9	+2,4	0	+8,3
D	(a)	54,8	16,4	71,2	24,8	1,5	26,3	21,1	18,6	+2,5	100	
	(b)	55,4	21,0	76,4	22,8	−0,1	22,7	29,5	28,7	+0,8	100	
	(b) − (a)	+0,6	+4,6	+5,2	−2,0	−1,6	−3,6	+8,4	+10,1	−1,7	0	+1,6
GR	(a)	70,1	12,6	82,7	24,9	2,5	27,4	8,1	18,2	−10,1	100	
	(b)	70,9	17,2	88,1	20,8	2,8	23,6	14,7	26,4	−11,7	100	
	(b) − (a)	+0,8	+4,6	+5,4	−4,1	+0,3	−3,8	+6,6	+8,2	−1,6	0	+4,1
F	(a)	60,7	13,4	74,1	23,5	2,1	25,6	14,8	14,4	+0,4	100	
	(b)	65,1	15,8	80,9	21,1	−0,1	21,0	22,2	24,0	−1,8	100	
	(b) − (a)	+4,4	+2,4	+6,8	−2,4	−2,2	−4,6	+7,4	+9,6	−2,2	0	+1,5
IRL	(a)	70,7	14,4	85,1	22,9	1,4	24,3	32,1	41,5	−9,4	100	
	(b)	63,4	21,5	84,9	30,1	−0,1	30,0	53,2	68,1	−14,9	100	
	(b) − (a)	−7,3	+7,1	−0,2	+7,2	−1,5	+5,7	+21,1	+26,6	−5,5	0	+4,9
I	(a)	63,4	15,3	78,7	20,6	0,7	21,3	16,0	16,0	0,0	100	
	(b)	64,2	18,1	82,3	20,3	0,9	21,2	24,7	28,2	−3,5	100	
	(b) − (a)	+0,8	+2,8	+3,6	−0,3	+0,2	−0,1	+8,7	+12,2	−3,5	0	+ 2,4
NL	(a)	56,8	16,3	73,1	25,3	1,5	26,8	46,1	46,0	0,1	100	
	(b)	60,5	17,9	78,4	19,0	−1,3	17,7	58,9	54,9	4,0	100	
	(b) − (a)	+3,7	+1,6	+5,3	−6,3	−2,8	−9,1	+12,8	+8,9	+3,9	0	+7,9
UK	(a)	62,5	17,8	80,3	18,5	0,7	19,2	21,7	21,3	+0,4	100	
	(b)	60,3	22,1	82,4	16,2	−1,8	14,4	27,1	23,9	+3,8	100	
	(b) − (a)	−2,2	+4,3	+2,1	−2,3	−2,5	−4,8	+5,4	+2,6	+2,8	0	+2,4
EC	(a)	60,8	14,6	75,4	22,5	1,4	23,9	21,0	20,3	+0,7	100	
	(b)	62,6	17,7	80,3	20,2	−0,3	19,9	29,9	30,1	−0,2	100	
	(b) − (a)	+1,8	+3,1	+4,9	−2,3	−1,7	−4,0	+8,9	+9,8	−0,9	0	+2,8

Source: 1968-72: Eurostat, except B, D, NL: National Accounts.
1981: Economic budgets, Commission departments, May-June 1982. For EC: extrapolation of 1980 data on the basis of rates of growth given in economic budgets.

greatest in Belgium, Denmark and France. The rate of expansion is close to the Community average in Germany, Greece and the Netherlands. The impact of this trend on the external balance was attenuated by a considerable decline in the rate of investment and stockbuilding, particularly in Denmark and the Netherlands, where the decline was so marked as to result in an improvement in the balance on goods and services. The degradation of the pattern of

Table 13

Balance of payments on current account (as % of GDP)

	1959-1963	1964-1968	1969-1973	1974-1978	1979	1980	1981	1982[1]
B	0,0[2]	0,4	2,3	−0,7	−2,9	−5,2	−6,3	−4,8
DK	−1,1	−2,0	−2,2	−3,2	−4,5	−3,4	−3,1	−3,5
D	0,9	0,7	0,8	1,3	−0,6	−1,8	−1,0	0,6
GR	2,2[2]	−3,6	−2,7	−3,0	−2,9	−0,9	−2,2	−2,1
F	1,1	0,0	0,0	−0,8	−0,1	−1,3	−1,5	−1,9
IRL	−2,2	−1,9	−3,6	−3,7	−10,1	−8,4	−12,8	−10,2
I	0,7	2,7	1,1	−0,6	1,6	−2,5	−2,3	−1,6
L	6,1[2]	6,4	13,9	25,2	28,1	22,2	20,3	18,4
NL	2,1	−0,4	1,0	1,6	−1,2	−1,4	2,5	4,4
UK	0,1	−0,6	0,4	−1,6	0,0	1,4	2,9	1,0
EC 10	0,6	0,3	0,5	−0,2	−0,5	−1,3	−0,6	−0,5

1 Forecasts: Economic budgets, May 1982.
2 1960-63.
Sources: 1959 to 1980: Eurostat and OECD national accounts; 1981 and 1982: Economic budgets (May 1982).

domestic uses of GDP was less marked in Italy, where investment declined little in relative terms,[1] and in the United Kingdom, where gross capital formation nevertheless fell further from an initial level which was already rather low. Ireland was an exception among the Member States in that the marked deterioration of its external position was mainly associated with rapidly expanding investment. The share of consumption in GDP has remained stable, although at a higher level than in the Community as a whole, and the substantial increase in public consumption has been entirely offset by the relative decline in private consumption.

In the Community as a whole the decline in the rate of investment as a proportion of GDP is an imperfect indicator of the weakness of capital formation in the Community as a whole. The growth of GDP, the other term in the ratio, has itself declined considerably; and part of the flow of gross investment is destined simply to renew plant and equipment. In fact, at constant prices, net investment (i.e. after deduction of the consumption of fixed capital as estimated in national accounts) has contracted in the Community as a whole by almost 3 % a year on average since 1973. Between 1960 and 1973, it had increased at an annual average rate of 5,6 %.

1 The rate of investment observed in Italy during the reference period 1968-72 was already considerably lower than during the period prior to 1964.

The inadequacy of investment is further aggravated by the fact that some proportion — difficult to quantify — of productive capacity has become obsolete as a result of cost changes and technical development. Since the stock of capital is expanding too slowly in relation to the growth of the labour force, an insufficient number of new jobs has appeared and cyclical unemployment has given way to structural unemployment. By holding back productivity gains, this process reduces the competitiveness of European products both in terms of price and in terms of technological content.

Practically all the Member States face the dual requirement, more pressing in some than in others, of improving the external balance while shifting domestic demand from consumption to investment. At macroeconomic level, such adjustment requires the same type of measure as those which must be undertaken to moderate the trend of costs and prices. Lasting export growth must be based on the control of relative price changes. The reestablishment of surpluses which can be devoted to the internal financing of firms and the reinforcement of profitability, which are essential conditions for a recovery of business investment, requires a gradual adjustment in the functional distribution of incomes. It is moreover unlikely that easier credit would constitute an efficient incentive for this purpose, since the effects of any easing of interest rates that was not based on a parallel decline in inflation rates would probably be rapidly annulled by the reinforcement of inflationary anticipations and a downward pressure on exchange rates. The stabilization of public finance should contribute to slowing down the expansion of public consumption, and, by attenuating pressures on interest rates, help to avoid such crowding out on the capital markets as may result from budget deficits.

Section 4 — A suitable mix between adjustment and external financing

The rate at which the required adjustments can be made will depend mainly on the rate of growth of the European economies, and will vary widely from one Member State to another. In view of the limited availability of official reserves and the economic cost of any brutal adjustment, external borrowing can help as a transitional device temporarily to prevent a serious current payments deficit from leading to a spiral of devaluation and inflation, the undesirable effects of which have already been stressed. Otherwise, there is a risk that protectionist measures aimed directly at reducing the flow of payments abroad will multiply. Apart from the fact that such measures are usually effective only partially and for a short period, they seriously disturb the working of the Community itself. External borrowing does not involve the same risk of market distortion and the accumulation of internal strains, at least in the short term.

The Member States and the Community itself have some room for manoeuvre in their borrowing. Although the surpluses of the oil-producing countries are at present very small, the volume of funds available on the international markets is very large, and investors are more than ever in search of financial assets issued by borrowers with a good credit rating. Finally, in a broader context, adjustment in the industrialized countries must not be so rapid as to transfer current deficits to the developing countries, which have much more limited access to external financing. Nevertheless, as in any borrowing process, prolonged recourse to external financing brings increasing risks and costs, and a gradual loss of independence. Foreign borrowing cannot, therefore, be considered a permanent subsitute for policies aimed at adjustment.

Thus, external financing of a large budget deficit makes it possible in the early stages to reconstitute the external reserves required to support exchange rates and to prevent crowding out on the national financial market.

However, assuming that the proceeds of the borrowings are not sterilized by the central bank, the effects are identical to those of monetary financing of the government deficit. As debt grows, and with it the cost of servicing, lenders will tend to withdraw from the market, or to lend only on stricter conditions. To restore the confidence of the markets, the borrowing country will have to accept a greater increase in interest rates than could be economically justified in relation to the domestic economy, or call on conditional official financing. Basically the need to adjust will merely have been evaded and when it can be avoided no longer the adjustment will be the more severe for having been so long delayed.

If the flow of external financing is mainly channelled into productive uses which fit in with the general adjustment process, it will continually add to the productive capacity which will provide the means of repayment. Even in such cases, the volume of debt and, particularly, its rate of increase cannot exceed certain limits, imposed by the need to service the debt before the investments become fully productive, and, ultimately, to produce a current account surplus with which gradually to reduce the volume of debt.

Recent changes in current deficits and their present size (see Table 13) give, for the various Member States, a summary indication of the external borrowing requirement and the available margins for manoeuvre. Apart from the United Kingdom, the Netherlands and Germany, which have restored a current surplus, the Member States require foreign financing obtained either by encouraging capital to enter the country, or by foreign borrowing in the name of public departments and undertakings. External financing should remain fairly small in France and Italy. In Denmark and Greece, although there has been no marked deterioration in the current payments position over the past few years, repeated deficits have resulted in a level of outstanding debt such as to set a severe limit to the scope for future borrowing. The same is true in Belgium, where current deficits have increased considerably since 1976, leading to a very rapid build-up of foreign debt and eventually to devaluation and the introduction of a recovery programme. In relation to the size of its economy, Ireland is the country with the largest foreign debt in the Community. However, recourse to external financing is closely linked in Ireland with the necessary accumulation of capital. In view of the requirements of economic development, massive redemptions would probably not be in order, and the possibility of supporting the investment effort through a regular flow of external financing should be preserved.

While implementing common policies and ensuring closer coordination of the economic policies of the Member States, the Community can make a specific contribution to determining the right mix of adjustment and financing through its borrowing and lending instruments.

First of all, the Community lending instruments with a structural purpose (European Investment Bank, ECSC, New Community Instrument, Euratom) enable the recipient countries to obtain the necessary supplementary financing for the development of priority sectors and regions on the most advantageous market conditions without directly committing their own credit. This external financing, which is partly subsidized, must be accompanied by an effort to mobilize and channel national savings so that they can gradually take over. The volume of Community loans granted to some countries has, in view of its relative size, reached macroeconomic dimensions (see Table 3). Further substantial development of these operations should perhaps be based on a global adjustment programme which the receipient countries would undertake to implement in addition to the microeconomic criteria specific to each project.

Secondly, the Member States have at their disposal balance of payments support mechanisms either with the other Member States (medium-term financial aid) or with the Community (Community loan mechanism). Because of their purpose, these mechanisms cannot be used directly to cover immediate and specific needs of the domestic economy, such as a budget deficit. It is nevertheless essential to use these mechanisms in good time, in order to ensure that adjustment is gradual, to maintain confidence on the capital markets and thus to prevent a balance of payments crisis which would be costly both for the country concerned and for its trading partners.

CHAPTER III

The realignments of February and June 1982: the system undermined or consolidated?

Since the beginning of the year, the monetary authorities of the member countries have twice realigned parities between the currencies participating in the EMS. These two operations give serious cause for concern, since the frequency and the size of the adjustments threaten a gradual erosion of the system's credibility. The conditions surrounding these realignments—both the decision-taking processes and the economic programmes adopted at national level—make it quite clear, however, that the participating countries wish the EMS to function well and that there is a common commitment to achieve a higher degree of convergence towards stability.

Section 1 — Operations carried out consistently with the logic of the system

The last realignments were separated by an interval of only four months. On 22 February 1982, the central rate of the Belgian and Luxembourg francs was devalued by 8,5% with respect to the other participating currencies, much the largest EMS adjustment up to that time. The Danish krone was readjusted downwards by 3% at the same time. The operation of 14 June resembled that of October of last year, although the widest bilateral change, that between the mark and the French franc, was slightly larger: the mark and the Dutch guilder were revalued by 4,25% in relation to the group of currencies whose bilateral rates remained unchanged, while the French franc was devalued by 5,75% and the Italian lira by 2,75% in relation to the same group of currencies. The four earlier realignments since the EMS was set up in March 1979 were separated by longer intervals—two of them, indeed, by a period of stability of almost 16 months. An examination of Tables 14 and 15 shows how the accumulated change in bilateral central rates resulting from the latest two readjustments compares with changes prior to 1982. In relation to the mark, the currency which has appreciated most within the system since its inception, the largest central rate change (12,2%) was that of the Belgian franc. The French franc depreciated over the same period by approximately the same amount in relation to the mark as it did between March 1979 and the end of 1981, a little under 10%. The other currencies participating in the EMS, particularly the Danish krone and the Italian lira, depreciated much less in relation to the mark as a result of the last two realignments than they had over the preceding two and a half years.

Although changes in central rates have undoubtedly become larger and more frequent, the cohesion of the system and the discipline it requires have been preserved. As before, the two recent realignments were decided by mutual agreement at meetings of the Ministers of Finance and the Governors of the central banks, and the Community nature of these decisions was less than ever a matter of pure form. Indeed, the direction and the size of adjustments were the subject of

Table 14

Appreciation (+) or depreciation (−) of ECU central rates and bilateral central rates from 13 March 1979 to 5 October 1981 [1]

	Bruxelles in BFR/LFR	København in DKR	Frankfurt in DM	Paris in FF	Dublin in IRL	Roma in LIT	Amsterdam in HFL
BFR/LFR	—	+8,1	−7,1	+3,1	—	+9,7	−5,2
DKR	−7,5	—	−14,0	−4,6	−7,5	+1,5	−12,3
DM	+7,6	+16,3	—	+10,9	+7,6	+18,0	+2,0
FF	−3,0	+4,8	−9,9	—	−3,0	+6,4	−8,1
IRL	—	+8,1	−7,1	+3,1	—	+9,7	−5,2
LIT	−8,8	−1,4	−15,3	−6,0	−8,8	—	−13,6
HFL	+5,5	+14,0	−2,0	+8,8	+5,5	+15,7	—
ECU	+3,3	+11,7	−4,0	+6,5	+3,3	+13,3	−2,1

[1] The table is to be read horizontally. For example, the central rate of the Belgian franc appreciated by 8,1% over the reference period against the Danish krone in Copenhagen and depreciated 7,1% in that period against the German mark in Frankfurt.

Table 15

Appreciation (+) or depreciation (−) of ECU central rates and bilateral central rates from 5 October 1981 to 14 June 1982 [1]

	Bruxelles in BFR/LFR	København in DKR	Frankfurt in DM	Paris in FF	Dublin in IRL	Roma in LIT	Amsterdam in HFL
BFR/LFR	—	−5,7	−12,2	−2,9	−8,5	−5,9	−12,2
DKR	+6,0	—	−7,0	+2,9	−3,0	−0,3	−7,0
DM	+13,9	+7,5	—	+10,6	+4,3	+7,2	—
FF	+3,0	−2,8	−9,6	—	−5,7	−3,1	−9,6
IRL	+9,3	+3,1	−4,1	+6,1	—	+2,9	−4,1
LIT	+6,3	+0,3	−6,7	+3,2	−2,8	—	−6,7
HFL	+13,9	+7,5	—	+10,6	+4,3	+7,2	—
ECU	+10,3	+4,1	−3,2	+7,1	+1,0	+3,8	−3,2

[1] See Note [1] to Table 14.

discussions which became intense and at times difficult before unanimous consensus could be reached on a balanced rearrangement of the parity grid. At the same time, as we have already stressed (see Chapter II, Section 1), the adjustments have preserved the stabilizing influence of the EMS, in the sense that the changes in central rates were smaller than the inflation rate differentials which had accumulated between the participating countries.

Section 2 — Confirmation of the importance attached to greater convergence

At each of the last two realignments, the countries most affected agreed to implement accompanying policies which would enhance the beneficial effects and neutralize the perverse effects of the changes in parity. In Belgium, the February devaluation was an integral part of a recovery plan designed to resolve the structural problems in the economy. Apart from a temporary price freeze and specific measures in favour of employment, the measures taken by the Belgian Government were mainly intended to improve profitability in the productive sector by combining the mechanical effects of devaluation with a loosening of wage indexation, while controlling developments in public finance. In this perspective, the devaluation should be seen as an important part of the measures taken and as making them easier to apply. The programme should progressively alleviate external imbalance and the budget deficit, while improving the employment situation.

The June realignment is also indicative of a concern to establish greater convergence. In the countries whose currencies were devalued, stabilization policies are now being applied. The French Government has introduced measures intended rapidly to reduce the rate of inflation, and to encourage the recovery of investment. The measures include a four-month prices and incomes freeze, at the end of which the rate of inflation should have declined considerably, the control of public finances, with a budget deficit kept down to 3% of GDP, and a return to a balanced budget for the social security funds. The countries whose currencies were revalued have recognized that the readjustment could make it easier for them to apply policies which would promote economic recovery. The Commission has for its part actively encouraged the process of convergence. It has not confined itself simply to following through as effectively as possible the coordination procedures for economic policies provided for in Community texts. It has tried to spell out what convergence should mean in practice.

In the middle of 1981, the Commission was led to make its position clear on several occasions and in varying circumstances. On 22 July 1981, the Commission, as authorized by the Council Decision of February 1974 on the attainment of a high degree of convergence of the economic policies of the Member States, took the initiative and addressed a recommendation to the Belgian Government. This recommendation stressed the need to restore external and budgetary equilibrium while pursuing a rigorous monetary policy and holding back the expansion of real incomes. The summary given earlier of the recovery measures taken when the Belgian franc was devalued in February 1982 shows that the Belgian authorities have now stepped up the already substantial efforts devoted to achieving the objectives of this recommendation. On 22 July 1981 the Commission also sent the Council a communication on the principles of indexation in the Community, warning against the risk that general and excessively rigid index-linking of prices and incomes would spread the inflationary process and block necessary adjustments. The earlier decision taken in May 1981 by the Italian authorities to introduce a compulsory deposit for the purchase of foreign currency had led the Commission to examine the economic and financial situation in Italy. On 1 July 1981, it addressed to the Government of Italy a recommendation pursuant to Article 108(1) of the Treaty, in which it expressed its concern about the risk of protectionist chain reactions that could be provoked by such measures (which were in fact gradually relaxed, and finally discontinued in February 1982). The Commission, stressing that measures to hamper trade can only delay the correction of basic factors, also recommended an effort to reduce the government deficit and restrain the growth of nominal incomes, in particular through a less automatic application of the mechanism linking pay to prices.

Finally, at the time when the Council was fixing its annual budget guidelines, the Commission adopted, on 1 July 1982, a communication on budget discipline and economic convergence which sought to bring the Member States into a discussion in depth of the fiscal and budgetary means to be adopted in order to correct developments considered to be extremely disquieting in a number of Member States.

PART TWO

The development of the European Monetary System in its present institutional framework

As a result of circumstances—cyclical and more structural in nature—the EMS could not be definitively consolidated in the two years originally planned, the Commission therefore took the initiative in proposing a non-institutional development of the system, after evaluating the results achieved from 1979 to 1981 (see Chapter IV).

The areas in which progress can be envisaged are set out in Chapter V while Chapter VI presents and comments on the proposed resolution presented to the Council by the Commission on the transition from the system's initial stage to its second phase.

CHAPTER IV

Evaluation of the functioning of the EMS at 31 December 1981

At the start of 1982, Commission departments, at the request of the Council (Economic and Financial Affairs) held on 14 December 1981, prepared an initial evaluation of the functioning of the EMS, the successor to the agreement on the narrowing of margins which was in force from 1972 to 1979 and which is briefly described in Annex A.

The studies in question were chiefly intended to clarify the discussions of the European Council of March 1982, and were made with a view to proposing improvements to the system. [1]

The report which follows, adopted in February 1982 and already communicated to the Monetary Committee and the Committee of Governors by the Commission, [2] examines how the EMS has worked for almost three years, in the light of its objectives and the changes which have taken place in the economic environment since its establishment.

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The objective of the system, clearly defined by the European Council at Bremen, is to devise 'a scheme for the creation of closer monetary cooperation leading to a zone of monetary stability in Europe'. Stability should be interpreted as extending over the whole range of prices, exchange rates, interest rates and other monetary variables. The degree of success should be measured with reference to various criteria, including the previous performance of the EMS economies, the comparative performance of non-participating countries and the amount of economic and monetary cooperation induced by the system.

Part One of this report first examines the main elements for an assessment of the performance of the participating economies. Part Two then goes on to discuss the operation of the system's mechanisms.

Section 1 — Elements for assessment

1. *Central rates*

Since the start of the EMS, the participating currencies have achieved among themselves a greater degree of exchange rate stability than during the previous period. This stability also contrasted with the volatility of non-Community currencies, the dollar and yen, and of the non-participating Community currencies, sterling and the drachma.

Over the period, there have been four changes of central rates, only two of which have involved more than one currency. All have been made by mutual agreement in orderly market conditions, and a common procedure has been developed. Between the start of the system and the October realignment the maximum bilateral change, 18%, has been between the German mark and the lira. The German mark has revalued by nearly as much against the Danish krone, and by between about 7 and 10% against the other currencies apart from the guilder against which it has revalued by only 2%. These amounts are almost exactly half its appreciation against the lira and French franc respectively over the previous three-year period. The changes have in all cases been in the direction suggested by price and cost movements, and no central rate change has subsequently been reversed.

The central rate adjustments have not led to large movements in Community effective exchange rates preserving trade between EMS countries. This stability contrasts with the strongly divergent exchange rate movements recorded within the Community in the period 1973-78, and is an important positive factor for an area in which trade amongst member countries in 1980 amounted to over 50% of their total trade. However, in view of the persistent inflation differentials (see below) between the participants, this development also means that currencies having relatively high inflation have imported stability through the mechanism of direct price interdependence, while countries having less inflation have gained in terms of export potential.

The relative stability within the EMS contrasts strongly with the volatility of sterling, the drachma, the dollar and yen against the participating currencies. The dollar's movements have been dominated by the reversal of the US balance of payments position and by interest rate differentials. The policies of the US administration have not prevented saw-toothed movements of interest rates, nor the resultant short-term capital inflows and outflows. Until mid-1980 the ECU rate of the dollar fluctuated widely around a slight downward trend. There was then a steady rise to a peak in August 1981 about 45% above the level of July 1980. Since then the rate of the dollar declined somewhat, again fluctuating around its trend. Over the whole period these dollar fluctuations have considerably added to the uncertainties for international trade.

[1] See Annex B: Main features of the European Monetary System in its present phase.

[2] The texts already circulated by the Commission are printed in italics.

The two non-participating Community currencies, sterling and the drachma rose by 20% and fell by 18% against the ECU excluding sterling, respectively since March 1979. The depreciation of the drachma in 1979 and 1980 has partially followed the inflation differential. Sterling's evolution has been much more erratic and has reflected interest rate differentials of from 3,5 to 5,5 points against the average for participating currencies in 1979 and 1980; and again in mid-November 1981, when sterling benefited from a favourable differential after the fall in US rates. Added to this was the current account surplus between 1978 and 1981, attributable to North Sea oil and the recession.

2. *Exchange rate management*

Between realignments full use has been made of the limited fluctuation margins. The maximum permissible spread between two currencies has repeatedly been taken up. In 1979, the Belgian franc was at its lower limit against the German mark in late May and early June and then against the Danish krone in October. At the start of 1980, it was again at its lower limit but against the French franc and guilder. The German mark was weak for a large part of 1980, several times falling to its lower limit against the French franc. Their positions were however reversed in early 1981, following interest rate moves by the Bundesbank, implying a total bilateral movement of 4 ½% in a relatively short period.[1] *Such reversibility within the margins weakens the impact of short-term interest rate differentials on capital movements, thus when there are no expectations of central rate changes reducing the need for intervention.*

The divergence indicator has on the whole been a useful additional element to the arrangements. Given the underlying inflationary situation, it is consistent with the aims of the system that it has been systematically activated only by weak currencies although this was probably also influenced by the strength of the dollar. When the threshold has been reached or overstepped, the necessary measures have normally been taken to redress the situation, although there is still some difference of opinion over the interpretation of a 'presumption to act'. The currency most frequently divergent was the Belgian franc: it crossed its divergence threshold from May to July 1979, in February and March 1980, from February to April 1981 and again in December 1981. The Danish krone and French franc have also crossed their thresholds. The most frequent policy reaction has been to raise interest rates. There have, however, been a number of occasions on which bilateral limits have been reached before any currency has crossed its divergence threshold and the movement of sterling and of the lira beyond the 2,25% band has caused some inertia in the movement of the indicator, despite the corrections made.

The amount of intervention necessary to maintain the fluctuation margins has at times been substantial but has not caused problems for monetary targets or depletion of reserves. The currencies supported by interventions were at different times the French and Belgian francs and the Danish krone. Speculative bouts have generally been contained, and in only one case was extensive intervention activity followed by a realignment of central rates.

The basic texts of the EMS specify that 'in principle interventions will be in the currencies of the participating countries'. In practice, however, dollar interventions, which may be addressed either at curbing fluctuations against that currency or be primarily for currency management within the EMS, still predominate. In part, this is because a number of countries prefer to maintain their currency near the centre of the fluctuation band. This has been true particularly for Italy, whose currency has a wider band (6%). For intra-marginal intervention, agreement must be obtained to use another participant's currency, which is not the case for the dollar.

3. *Interest rates and monetary aggregates*

When the markets do not anticipate a change in exchange rates, short-term capital movements are dominated by nominal interest rate differentials, which makes these, together with interventions, an important instrument of currency management. There have been a few examples of policy conflict between domestic and external objectives in the area of interest rates. Shortly after the start of the system both Denmark and Italy had to lower their interest rates, because of capital inflows, when relative domestic conditions would have suggested the contrary.

While in most Community countries there were domestically generated reasons for relatively high interest rates, peaks in US rates may have led, in a number of member countries, to higher interest rates than generally warranted by purely domestic considerations. But as with interventions, it is difficult to distinguish between measures inspired by the system and those in response to changing outside circumstances. There has been a steady rise in interest rates between 1978 and 1981. For domestic reasons, European monetary authorities neither followed the fall of transatlantic rates after March 1980, nor their spectacular rise in the second half of 1980. But the high external deficit and persistent inflation, which was likely to be further aggravated by the strong rise in the US dollar, made further upward movement of interest rates inevitable in 1981 in Europe, despite the low level of activity and high unemployment.

Since 1979, the stance of quantitative monetary policy has become more restrictive in practically all Community

[1] See the calendar of events on page 43 for a graph of maximum spot spreads between currencies participating in the narrow-band system and indicating which currencies crossed their upper or lower divergence threshold for more than five days.

countries. This change has been prompted by the need to combat inflation generally and in particular by the desire to prevent the emergence of secondary inflationary effects following the rise in the price of oil. Conflicts between maintaining central rates and adhering to quantitative monetary objectives have been avoided. Furthermore the very existence of the EMS has provided a strong incentive to improve de facto *coordination of monetary policies.*

4. *Costs and prices*

In 1978, the average of the Community GDP price deflators, which reflect the overall change in domestic costs, had fallen to 8,5%, compared with an average over the previous three years of 11%. The dispersion between Member States had also declined. Following the second oil shock, however, both the average and the dispersion have again increased. In 1979, the Community average was nearly 10% and in 1980 over 11,5%, with a range from 4,3% in Germany to 20,3% in Italy. Exchange rate stability and satisfactory monetary management have not therefore been matched by a greater convergence of costs and prices. When expressed in national currencies, average annual divergences in cost and price trends between EMS partners were, in many cases, quite substantial. Over the period 1979-81, the average annual consumer price inflation rate has been 16,3% in Italy whereas that in Germany has been 5,6%. In contrast the lira/German mark bilateral central rate varied by only 18% over the whole period Furthermore aggregate variations in the relative levels of unit labour costs in national currency have ranged from − 14,5% to + 32,7%. Such a large change in competitive positions in a relatively short period, is the result both of previous movements, in the reverse direction, accumulated mainly through excessive nominal exchange rate movements during the pre-EMS period; and of the policies tailored to maintaining nominal exchange rates. In the future, maintaining exchange rate stability requires decreasing the divergence of cost and price trends.

The shift from a low to a high relative cost and price level in a country with a stable exchange rate should serve to exert pressure to implement appropriate policies to ensure domestic stability. Maintaining exchange rate stability is often the only way in which the real problems of domestic adjustment are forced into the open. These problems would otherwise be obscured by the spiral of devaluation and inflation; with the devaluations doing nothing to resolve the basic problems. This was the experience of the United Kingdom and Italy between 1973 and 1978. It is important that the EMS stabilization mechanism should work fully in those countries where inflation or the level of relative costs is still too high; this not only means that monetary policy must defend the exchange rate but also that domestic adjustment, notably in the areas of incomes and public finances, must be encouraged and speeded up through other appropriate measures. Quite independently from the existence of the EMS, such internal adjustment is necessary in order to increase possibilities of economic growth in conditions of stability and higher employment. The EMS highlights the need for adjustment and provides one of the necessary ingredients to help its realization.

Section 2 — Functioning of the system's mechanisms

In summary, in its first three years of life, the European Monetary System has been remarkably successful in assuring exchange rate stability through a period of great world monetary turbulence. It has provided a monetary environment favourable to the orderly development of intra-Community trade; and has succeeded in avoiding the excessive exchange rigidities that eventually led to the collapse of the Bretton Woods parity system. The system has been managed in a realistic way, avoiding on the one side full or over-accommodation of cost and price trends and on the other stubborn defence of unrealistic exchange rates. Although the situation would have been worse without it, the EMS has however failed to produce the desirable degree of convergence towards price stability. Since 1978 inflation rates have become higher and more divergent because of the second oil shock, the extraordinary appreciation of the dollar, and insufficient domestic discipline in the areas of costs and public finance. The political commitment underlying the EMS, and the mechanisms created by the system itself, have been an essential, albeit insufficient, factor pushing for stability-orientated policies in member countries in which monetary stability was most needed. A stronger impulse in this direction can only come from a strengthened EMS. The critical appraisal of the functioning of the system's mechanisms, which is made in the following paragraphs, can show the appropriate ways to achieve such a strengthening.

1. *ECU creation*

There has been a dramatic increase in the total quantity of ECU created from about 27 000 million, resulting from the initial swap operations at the start of the system, to nearly 50 000 million in April 1981. [1] *This amount subsequently has declined to 42 000 million ECU.*

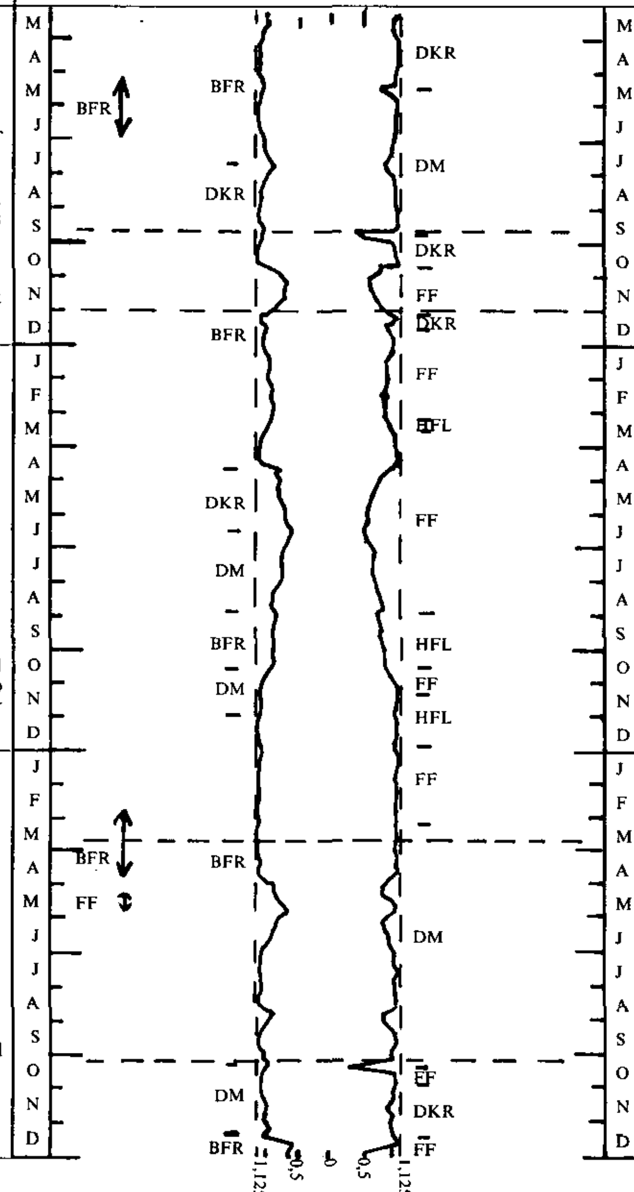
Taking the swap operations of July 1979 and January 1981 as an example, it can be seen that against almost exactly the same amount of gold, 15 800 and 38 300 million ECU were respectively created, because of an increase in the price of gold used in the swap operations of over 140% between the two periods. ECU created against dollars fell only from 11 600 million to 10 900 million because the decline of 6% in the amount of dollars transferred was not entirely offset by the appreciation of the dollar in terms of ECU.

[1] Annex B shows the ECU creation resulting from the swap operations.

Table 16

EMS calendar from 1978 to 1981

	Events concerning the EMS	Operation of the exchange rate mechanism (maximum spot spreads and divergence indicator)	Events concerning relations between the EMS and the dollar	
1978	6-7 July: European Council, Bremen Annex 4-5 December: European Council, Brussels Resolution	Divergence threshold — Bilateral limits — Bilateral limits — Divergence threshold	1 November: the US authorities announce that they will actively intervene on the exchange markets	1978
1979	13 March: the EMS enters into operation 6 July: the Bank of England swaps 20% of its gold and dollar reserves against ECU with the EMCF 17 September: the EMS reviewed after six months: the Council considers that it is operating satisfactorily 24 September: first realignment (DM + 2%; DKR − 3%) 30 November: second realignment (DKR − 4,76%)		Dollar fluctuations around a downward trend: its rate against the ECU rises from 1,35 in March to 1,32 in May, falling again to 1,40 in September and 1,43 in December 6 October: the Federal Reserve Board decides to pursue a strictly quantitative monetary policy and to allow interest rates to fluctuate	1979
1980	1-2 December: The European Council decides to extend the renewable swap mechanism for a further two-year period		Continuing dollar fluctuations in the first half of the year: its rate against the ECU rose from 1,44 in January to 1,35 in April, falling again in July to 1,44; from July onwards, steady rise in the dollar rate, reaching 1,30 against the ECU in December	1980
1981	23 March: third realignment (LIT − 6%) 5 October: fourth realignment (DM and HFL + 5,5%; FF and LIT − 3%)		Further upsurge in the dollar until August (when its rate against the ECU was 1); subsequent fall until November when the rate of the dollar against the ECU was around 1,10 4 May: the US authorities announce that they will no longer intervene on the markets, save in exceptional circumstances.	1981



The key to the growth in ECU has therefore been the rule determining the price of gold used for the swap operations. The automatic link between the price of gold and the quantity of ECU determines, outside the control of the system, the degree to which gold is mobilized. The gold price rule used in the swap arrangements (whichever is lower between the six month average and the latest market price) did moderate the increase in supply of ECU somewhat over the period when gold prices were rising rapidly. The swap price reached a maximum of 447 ECU per ounce whereas the market price went above 670 ECU per ounce.

As the participants transfer gold and dollars in very different proportions the number of ECU that they have each received at successive swap renewals, and hence the distribution of the quantity of ECU between them, has been highly affected by the changes in the prices of these two assets. [1]

In contrast, the use of ECU or the effect on ECU creation of the loss or gain of dollar reserves has had little effect on the distribution of ECU. For example, the amount of ECU received through the swap operations by the Netherlands and Denmark, which have both seen a similar reduction in the amount of dollars that they transfer, has respectively increased by nearly 90% and decreased by 11% between July 1979 and October 1981 because the increase in the price of gold has affected in very different proportions the allocation of ECU to these two countries.

ECU creation is determined by a rule in which the three key variables (the price of gold, the dollar exchange rate and the respective proportions of these two assets) are outside the control of the system. Under these circumstances, the quantity of ECU created cannot be expected necessarily to be consistent with the aims of the system, and hence a wider use of the ECU as a means of settlement and as a reserve asset could not contribute towards achieving greater monetary stability.

2. *The use of ECU*

Participants have a right to use ECU for settlement at the maturity of a very short-term financing operation 'with the proviso that a creditor central bank shall not be obliged to accept settlement by means of ECU of an amount more than 50% of its claim which is being settled'. [2] *With the agreement of the creditor, ECU may however be used for any settlement between participating central banks.*

In practice, ECU use has been limited. Italy, Ireland and the Netherlands have practically never had a net ECU position; and when they have it has been a very low percentage of the ECU that they received through the swap operations. Germany's net position has changed from being positive to negative and then positive again, but at the maximum reached 4% of its ECU holdings. Denmark and Belgium have consistently had substantial net negative positions, and France has had a net positive position. The total of the negative or positive positions has reached 8% of the quantity of ECU created through the swap arrangements (see Table 18, page 46).

Interest on these net ECU positions is calculated as the weighted average of the official discount rates of the currencies of which the ECU is composed. There is therefore no scope for discretionary decisions that would affect the attractiveness of the ECU relative to the dollar. Both its value and its yield are given. Furthermore market interest rates can at times deviate considerably from official discount rates which can result in an even greater variation in its relative attractiveness than in its price relationship vis-à-vis *the dollar.*

Debtors have been reluctant to build up large negative net ECU positions because of the uncertainty over what will happen at the end of the transitional phase, when, unless there is a decision to the contrary, they would be required to clear their ECU positions by acquiring ECU from other participants. Creditors have not encouraged the use of ECU both because the interest rate rules have generally not been favourable to them and because the creation method is unlikely to limit the volume of ECU thereby being an element of restraint on potential debtors.

With the limited use reflecting both inadequate inducements and provisions within the system as well as the reticence of the participants, it would be inadvisable simply to increase the use of the ECU by abolishing the acceptance limit or by enlarging the categories of transactions over which one of the parties had the right to use ECU without amending other parts of the system in such a way as to make the quantity and the yield of the ECU the result of stability-orientated decisions. Only a scarce currency can induce discipline.

Moreover, and for reasons indicated below, it is unlikely that the ECU can become an element inducing stability when its use is in addition to, rather than as an alternative to, other reserve assets and settlement instruments. It is for these reasons that the Commission in its report of 20 March 1980 to the European Council suggested that the possibility of adopting the ECU as an exclusive instrument of settlement between the Community's central banks should be considered.

3. *Credit mechanisms*

Substantial use has been made at times of the very short-term financing. For marginal intervention in Community currencies, the facility is automatically available at the demand of the intervening central bank. With agreement from the creditor, it

[1] See Table 17, page 45

[2] Paragraph 16.1 of the Agreement of 13 March 1979 between the central banks.

Table 17

Distribution of ECU between participants

	Share of total ECU issued		Proportion of ECU received against gold [2]		Change in dollar reserves between initial swap period and October 1981
	Initial [1]	October 1981	Initial [1]	October 1981	
Banque Nationale de Belgique	6,9	8,9	78,3	85,8	+17,8
Danmarks Nationalbank	2,1	1,0	12,1	36,1	−49,8
Deutsche Bundesbank	36,9	32,7	40,8	65,0	−25,7
Banque de France	17,6	21,0	73,3	87,1	−19,7
Central Bank of Ireland	0,7	0,3	9,1	28,6	−53,5
Banca d'Italia	16,3	18,2	64,9	81,7	−18,3
Nederlandsche Bank	9,3	10,7	75,1	91,9	−47,4
Bank of England	10,3	7,1	31,7	59,4	−43,2
	100,0	100,0	—	—	—

[1] The initial positions were established over the period March to April 1979 (July 1979 for the Bank of England).
[2] The proportion of each national central bank's ECU which it receives in return for swapping 20% of its gold varies because of changes in its dollar holdings. Gold holdings have remained virtually unchanged over the period.

may also be used to finance intra-marginal interventions. In both 1979 and 1980, about 2 000 million ECU of financing was obtained by activation of the mechanism. In 1981 use has amounted to about 7 000 million. The overwhelming majority of these operations have been repaid in the creditor's currency, and the balance has resulted in transfers of ECU and other reserves.

Both the short-term and medium-term credit mechanisms were increased substantially at the start of the EMS. The granting of medium-term financial assistance is discretionary: it is subject to a Council decision, which lays down economic policy conditions. In the case of the short-term monetary support, credit can be granted to a central bank automatically on the demand of a debtor up to its limited quota, beyond which it becomes discretionary. Neither of these mechanisms nor the Community loan facility for balance of payments needs has been used since the start of the EMS, but in contrast there has been considerable use of unconditional credit from the international capital markets to finance external imbalances. Following the second oil price shock, the Community as a whole went into substantial deficit, for which financing was necessary while domestic adjustments and an increase in OPEC absorption took place. The deficits have differed considerably between Member States as a percentage of GDP, as have the amount and changes in amount of official external debt.

The imbalances have been financed with little change in overall reserve positions. In 1980, the Community's 31 000 million ECU current account deficit was financed by capital inflows of 28 000 million and a reserve fall of only 3 000 million.

In these circumstances the EMS credit mechanisms cannot on their own contribute towards imposing a tighter monetary discipline in the Community, without general provisions regarding the official recourse to external financing.

4. *Exterior aspects of the system*

The EMS has an important role to play in the existing international monetary relationships. Since the late 1960s and again even more obviously throughout 1981, the dialogue with the American authorities has been hampered by the lack of a strong Community monetary organization comparable to that existing in the areas of trade and agriculture. This dialogue becomes increasingly important both with the development of a multi-currency reserve system and since the US monetary authorities have changed their method of monetary manage-

Table 18

Net use (−) or accrual (+) of ECU as a percentage of ECU received through the swap operations

End of month	Belgium	Denmark	FR of Germany	France	Ireland	Italy	The Netherlands	UK	Total
1979 April	−8,2	+27,4	—	—	—	—	—	—	±0,6
May	−14,7	+33,2	+0,8	+0,2	—	—	—	—	+1,1
June	−15,0	−1,8	+2,8	+0,2	—	—	—	—	+1,2
July	−13,9	−1,9	+2,8	+0,2	—	—	—	—	±1,0
August	—14,0	—1,9	+2,9	+0,2	—	—	—	—	±1,0
September	−14,2	−1,9	+2,9	+0,2	—	—	—	—	±1,0
October	−12,9	−2,3	+2,7	+0,2	—	—	—	—	±1,0
November	−13,5	−26,9	+3,8	+0,2	—	—	—	—	±1,4
December	−25,2	−5,6	+4,2	+2,5	—	—	—	—	±1,9
1980 January	−27,9	−9,8	+2,8	+4,8	—	—	—	—	±2,3
February	−39,7	−21,1	+3,9	+9,6	—	—	+0,8	—	±3,3
March	−54,1	−29,1	+0,8	+15,4	—	+3,5	+6,2	—	±4,5
April	−43,3	−45,7	−1,4	+17,2	—	+2,6	+1,6	—	±4,3
May	−37,6	−46,1	−1,5	+17,4	—	+0,9	—	—	±3,8
June	−31,2	−46,5	−1,5	+15,8	—	—	—	—	±3,8
July	−24,8	−38,8	−1,5	+13,6	—	—	—	—	±3,0
August	−25,0	−39,1	−1,5	+13,7	—	—	—	—	±3,0
September	−24,8	−39,5	−1,5	+13,6	—	—	—	—	±3,0
October	−24,4	−33,6	−3,0	+15,6	—	—	—	—	±3,4
November	−25,7	−33,8	−3,0	+16,0	—	—	+3,0	—	±3,5
December	−30,8	−34,1	−3,1	+17,4	—	—	+1,8	—	±4,0
1981 January	−31,6	−30,1	−3,1	+17,6	—	—	+2,0	—	±4,0
February	−50,0	−30,4	−3,1	+25,0	—	—	+2,2	—	±5,7
March	−69,9	−30,6	+0,6	+27,0	—	—	+3,4	—	±6,4
April	−67,0	−30,6	+1,1	+27,3	—	—	—	—	±6,3
May	−67,2	−30,9	+1,1	+27,5	—	—	—	—	±6,3
June	−68,1	−31,2	+1,1	+27,7	—	—	—	—	±6,4
July	−71,7	−31,5	+1,6	+29,2	—	—	—	—	±6,8
August	−72,3	−31,8	+2,2	+28,6	—	—	—	—	±6,9
September	−72,9	−36,4	+2,3	+28,9	—	—	—	—	±7,0
October	−78,0	−41,7	+3,1	+30,2	—	—	—	—	±7,4
November	−78,7	−42,1	+3,2	+30,5	—	—	—	—	±7,4
December	−79,4	−42,5	+3,2	+30,8	—	—	—	—	±7,5

ment and have concentrated heavily on domestic policy objectives.

A multi-currency reserve system needs more, not less, management than an international monetary system based on only one currency, and as Europe will inevitably, in one form or another, be one of the reserve issuing centres, it should be able to discuss monetary matters productively with the United States.

Over the last 20 years, the relative position of the United States in the world economy has profoundly changed and a tripolar system has emerged. Not only in terms of industry, agriculture and per capita income, but also as a trade partner and as a holder of international reserves, the Community has become one of the three great areas of the industrial world.

An appropriately developed EMS could be a useful way of organizing the European pole of the international monetary system. Through the creation of a common and stable monetary identity for the Community, it would help the orderly evolution of the multi-currency reserve system, both through helping to limit the number of currencies that play a reserve role and through putting greater economic weight and depth of *financial markets behind the ECU. Internally, it would help cohesion within the EMS spreading over several European shoulders the responsibilities of an international currency role that have proved quite heavy even for politically and economically great powers.*

A fundamental part of the exterior aspects of the system is the exchange rate relationships vis-à-vis *third currencies. The internal exchange rate arrangements of the EMS are somewhat facilitated when the dollar is strong relative to the EMS currencies. When the opposite is true, short-term funds tend to flow into the German mark in preference to other Community currencies thereby accentuating any tensions already existing in the system. Just such a movement was the catalyst for the September 1979 realignment.*

In theory, in a system with one dominant currency, the exterior position could be determined as two-step procedure in which the dominant currency manages its exchange rate vis-à-vis *the outside and the others manage theirs against it. In practice, this procedure is not suitable to any of the EMS partners. Nor can the problem be ignored. Even when the US monetary authorities are pursuing a policy of allowing the dollar to find its own level in the exchange markets, that level is a matter about which the Community is neither indifferent nor completely impotent. On the other hand, it is not a question on which any rigid guidelines can be pre-specified. As stipulated in the Bremen Annex and the Brussels Resolution, any actions on the dollar should therefore be subject to a common procedure which would result in some compromise between the different national positions and the aims of the system.*

5. *Wider use of the ECU*

All ECU created by the EMCF, whatever their creation method, have the same characteristics of being 'official' sight liabilities usable only between participants in the system. On the other hand, as the ECU becomes the expression of the Communities' emerging monetary identity, deeper and broader financial markets operating in ECU will develop and a broader category of holders will have access to it. Both these facts pose the problem of a wider use of the ECU.

The basic EMS texts mention that European economies with especially close ties to the Community could participate in the system in some way. Some countries already maintain very close exchange rate links with one of the EMS currencies, but nothing has been done to integrate these relationships within the EMS or to extend the use of the ECU to this wider zone.

The Community has been in deficit to the OPEC countries, who in turn are looking for ways of diversifying their reserves. A move towards allowing them to hold ECU together with invoicing of their exports to Europe in ECU has been advocated by some as beneficial to both sides and could again extend the use of the ECU.

The expression of a monetary identity cannot however be confined to official holders; private use of, and markets for, the ECU will have to develop. The international financial community has started to use ECU for a number of credit operations including opening of deposit accounts, issuing of deposit certificates, granting of loans and issuing bonds. The last of these took off in 1981. There have been six bond issues totalling nearly 250 million ECU, which may be a small figure compared with the total in all denominations over the same period (USD 18 000 million), but it nevertheless amounts to about 5% of the total of public issues in currencies other than the dollar: a remarkable percentage for a start. Three of the issues have been made by Community institutions, two by the EIB and one by Euratom. Other Community institutions use the ECU for accounting purposes and have opened ECU accounts for the relevant transactions with a number of banks.

Today, there are still a number of obstacles, as well as unfamiliarity, to this development of the private use of the ECU. The syndicate leaders of the ECU denominated bonds are banks from those Member States whose authorities have allowed the use of the ECU through giving it the same status as a foreign currency. In other Member States, the ECU is still disadvantaged by its hybrid nature. As seen from any individual country, it is composed partly of national currency and partly of foreign currencies. The national currency part naturally falls under any regulations directed at domestic monetary policy and the foreign currency part is subject to any exchange control type regulations. The result is that the ECU is disadvantaged as compared to either domestic or foreign currency.

CHAPTER V

Analysis of the possible areas in which the EMS can be developed

The evaluation of the way in which the EMS has functioned demonstrates that there are a number of areas in which the system could be improved.

The possible areas for the development proposed by the Commission,[1] which tend to respect the present balance between strictness and solidarity, derive from an analysis of the areas in which progress could be made within the present legal framework, and consequently without recourse to Article 236 of the Treaty of Rome.

The analysis made in Chapter IV has shown that despite the undeniable successes of the EMS, further developments are necessary; and they are likely to become more necessary as the external environment worsens: its achievements have been the result of a combination of favourable external circumstances and its own internal strengths. Similarly its disappointments, in terms of convergence towards stability, stem from hostile external factors and from certain shortcomings in the system itself. Its mechanisms, relying excessively on prespecified rules, have not always worked cohesively towards the underlying objectives, and have not been broad-ranging enough to induce a satisfactory level of price stability.

The aims therefore should be to develop the system: to make the mechanisms more responsive to changes in environment, endow them with a greater disciplinary effect; to encourage public and private economic agents to model their behaviour more closely on necessity of monetary stability; and to organize in a more orderly and effective manner the Community's role in the multiple reserve currency system.

Possible developments, based on technical analysis and on extensive discussions both within the Commission departments and in the competent Committees as well as on the above assessment, are briefly described in the following paragraphs. They can be grouped around four main areas for action:

(i) coherence of the mechanisms;

(ii) opening the system;

(iii) use of the ECU on the markets;

(iv) policy convergence.

[1] Annex C-2 presents a technical study by the Alternates of the Monetary Committee on some of the problems which could be posed by non-institutional development of the EMS.

Section 1 — Assuring greater coherence of the mechanisms

Three years' experience suggests that when the system was designed and put into effect, excessive confidence was placed in the virtues of the automatic mechanisms which did not prove justified. The effect of discipline, inducing rigour and stability, which was expected to be induced by the operation of the mechanisms, has not been sufficiently marked. Adjustments could therefore be made by improving the control over and coherence of the main constituent parts of the system.

1.1. The ECU

The ECU used within the system has two defects: its creation is unmanaged, and it is little used.

Within the swap system, the creation of ECU can only be fully controlled by introducing more discretionary decisions. It is possible to moderate the effects of erratic movements of the price of gold or the dollar exchange rate on the quantity of ECU created,[2] by increasing the duration of each swap or lengthening the reference period over which averages are taken. The consequence of these methods however is that the internal valuation of the assets and the market valuation will diverge, with adverse consequences for the use of the ECU. A more efficient method is to keep the quantity of ECU fixed and make the necessary quarterly adjustments to the amounts of reserve assets transferred according to variation in their ECU price. This has been called the 'closed pool' and would mean determining, (i) the initial pool of ECU, and (ii) the procedure for any subsequent alterations to the pool. It should not be possible for such a decision to be taken except solemnly and at fairly long intervals. One possibility would be for the central banks or the Board of Governors of the EMCF to agree each year on the volume of ECU to be created. Another would to be to set an annual rate of growth for the volume of ECU (linked, for example, to the growth of the Community's external trade or of intra-Community trade), a rule from which the central banks could not depart except by unanimous decision.

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 in the settlement of operations covered by the very short-term financing would enable the debtor to clear his debt in full by surrendering ECU. In return, the creditor would receive a higher remuneration on his net ECU position (the rate of interest could be set each month by the Board of Governors of the EMCF at a level derived from the market level)[3] and could

[2] See Annex C-2: Severing the link between the volume of ECU issued and the price of gold or the exchange rate of the dollar.

[3] E.g. the average of three-month interbank rates on the internal market of various EMS currencies, or the three-month Euro-ECU rate.

be authorized to mobilize his net ECU credit position on the basis of formulae to be agreed.[1]

Adopting all the above provisions would appreciably enhance the ECU's properties, by reaffirming its role both as a settlement instrument and as an instrument based on stability. At the same time the balance of rights and obligations between creditors and debtors would be respected.

1.2. The mechanisms

In the same way as the ECU's properties can be improved and with the same object in view, certain gaps in the existing mechanism could be filled.

First, organization of the use of Community currencies in intra-marginal interventions.[2] *At present, a central bank's use of a Community currency for intervention inside the margins is subject to the goodwill of the central bank whose currency is requested. Although interventions of this kind might prevent a currency's movement towards its margin, interventions are instead made in dollars and this often has the effect 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 have been necessary to reverse the trend earlier. Both so as to prevent the latter situation from occurring—in order to economize as much as possible on intervention funds—and to reduce the predominance of dollar interventions, which tends to place that currency at the centre of the system, the use of Community currencies in intra-marginal interventions must be organized by defining guidelines within the spirit and the letter of the system. One possibility would be to authorize the central bank whose currency had crossed the divergence threshold or had gone beyond a given bilateral limit to intervene, at its discretion, in Community currencies.*[3] *These interventions, which could benefit from the very short-term financing facility, would nevertheless be subject to a ceiling.*

Another possibility would be to limit solely the availability of Community currencies for the purpose of intra-marginal intervention, without making provisions as above, for specific cases where they would be allowed. In this case, provision could be made for the central bank, whose currency is used, to have the right to request suspension of interventions in its currency.

Second, relations with the dollar. The organization of intra-marginal intervention in Community currencies will reduce the amount of undesirable dollar interventions, but without eliminating the problem which the dollar represents for the system as a whole. The sharp fluctuations of the dollar exchange rate over the last three years and the large fund movements which they produced, represent so great a threat to the cohesion of the EMS that they call for active efforts for the definition of a common attitude towards the dollar on the part of the EMS currencies. This common attitude would be defined by the central banks at short and regular intervals, as part of an assessment exercise resulting in a quantitative formulation of a 'zone of probability' for the ECU/dollar exchange rate. At a later stage, the same exercise might moreover be contemplated for the ECU/yen exchange rate. Such a zone, which would have to be fairly wide (± 10-15% around an ECU/dollar exchange rate), would serve as a point of reference for the Community central banks, which would be expected to act on their interest rates or to intervene in order to stop the dollar/ECU rate from leaving the zone. The markets could be informed of it in order to benefit from an announcement effect.

The Community monetary authorities represented by the EMCF should also use their influence to persuade the US authorities to reconsider their laissez-aller *exchange rate and interest rate policy: the moves made by the Community would gain in credibility if they were supported by the same methods on the American side. In this connection, the start of talks with the US authorities with a view to replacing the existing network of swaps between certain Community central banks and the Federal Reserve Bank of New York by a single credit line between the latter and the EMCF would provide tangible evidence of the European determination to close ranks* vis-à-vis *the United States.*

Third, a step would be taken towards the consolidation of credit mechanisms—planned for a later stage—if it was decided to make the EMCF responsible for the short-term monetary support mechanism. This would strengthen the EMCF's functions and act as a signal of the determination to organize the existing institutions in function of the needs of the workings of the EMS. No legal difficulty would be involved, since the provision is contained in the Council Regulation of 3 April 1973 establishing the EMCF and was subsequently confirmed by the Bremen and Brussels European Councils.

Section 2 — Opening the system

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.[4] *If the EMS were opened up to the central banks of certain third countries, by authorizing them to acquire and hold ECU, the Community could strengthen the system (by extending its geographical*

[1] See Annex C-3: Mobilization of net ECU creditor positions.
[2] See Annex C-2: Intra-marginal interventions - eligibility for the VSTF facility.
[3] The choice of intervention currencies would then relate to the currencies whose premium or discount over the divergent currency was the greater.

[4] See Annex C-2: The external role of the ECU.

area and increasing the possibilities for mobilizing the ECU), and could protect it from international monetary instability (by channelling at least part of the tendencies of reserve diversification towards the ECU): at the same time it could help with the financing of an overall external payments deficit. Hence the importance of planning and organizing this kind of internationalization of the ECU.

A general principle should govern the opening of the system: third holders should be subject to substantially the same rights and obligations concerning use of and remuneration in ECU as the participants. Extending its role beyond the Community should not destroy the single nature of the ECU. The conditions for acquiring ECU will accordingly have to reflect its precarious existence, so long as the swap system is used for its creation.

2.1. A first possibility would be to extend the ECU's negotiability by permitting designated third holders to acquire existing ECU assets from participating central banks. A third holder arrangement setting out in detail the terms and conditions for acquiring, mobilizing and restituting ECU would be necessary. Participating central banks could thus mobilize their ECU against dollars, offer ECU as a settlement of a debt or satisfy a demand for temporary reserve diversification, without affecting the total volume of ECU in circulation.

2.2. A second possibility would be to permit the EMCF to issue ECU to third countries under the same conditions as those applying to existing participants, i.e. against a swap of reserves. This formula, which would imply the creation of additional ECU, would seem most suitable for those European countries 'with particularly close economic and financial ties with the Community' wishing to be associated in the exchange rate mechanism. The association agreement would have to set out the conditions for acquiring and using ECU on terms analogous to those applied to member central banks.

2.3. In a broader perspective another possibility would be for the EMCF to issue ECU for reserve diversification by non-Community institutions. The purpose of this kind of suggestion is as a contribution to shelter the EMS from strains possible as a result of the trend towards diversification when it is directed overwhelmingly towards one or other Community currency. In view of both the problems which would be posed if the EMCF were to shoulder an exchange risk and of the ECU's characteristics, notably the absence of institutional convertibility, it would seem that the possibilities, in the present state of affairs, are limited. However, certain 'substitution account' formulae might be envisaged, based either on increasing the ECU's negotiability (e.g. by designation formulae), or on the EMS members directly shouldering the exchange risk. This would be the case if the EMCF, having issued ECU against reserve assets, re-lent the latter to those of its members which had an external deficit to finance. Seen from this angle, the Community loans mechanism could thus be handed over to the EMCF.

Since the EMCF has little room for manoeuvre in the field of diversification, the Community would have an interest in promoting the private market of the ECU, thus making available to third country monetary authorities, wishing to diversify their reserves, a wide range of instruments in ECU.

Section 3 — Encouraging the private use of the ECU

Alongside the official ECU circuit and unconnected with it, a genuine 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 can nevertheless not be indifferent to this use of its monetary 'image', and it should not only promote, but also monitor, and even guide this expanding private use of the ECU so as to turn it to the greatest advantage. Whence the importance of proposals designed to supplement the existing provisions and to encourage and control the use of the ECU on the markets.

3.1. It is important to define a sort of ECU 'trademark' so that the term and the instrument 'ECU' is used correctly by the markets. For example, contracts referring to an 'ECU' defined as a closed basket should be avoided because the ECU is by construction open to the currencies of future Community members. The necessary Community legislation should be adopted to ensure that the ECU is not deflected. Thus, for example, prohibiting the insertion of an indexation clause in an ECU contract would ensure that it remains an instrument of stability which is its purpose. The overall purpose would be that the wider private use of the ECU would be solidly based.

3.2. The EIB and the other Community institutions, which use the capital markets for raising funds, should set an example by launching ECU issues and systematically expanding their ECU borrowings. Greater use of the ECU by various Community institutions would strengthen the ECU's role on the markets and at the same time reaffirm its role as the Community monetary identity.

3.3. Other steps should be taken to promote the wider use of the ECU by the financial markets. 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—as it is an infant future common currency. The principle of free movement within the Community of ECU-denominated capital should also be established, and finally the EMCF *should be empowered to monitor ECU operations and issues (calendar, endorsement or joint authorization by the EMCF and the national authorities, etc.).*

The adoption of a regulation containing the above proposals would provide a stable foundation for the expansion of the private use of the ECU, and would make it an instrument capable of developing the Community's ultimate objectives.

Section 4 — Strengthening policy convergence

The development of the EMS will not be a real success without greater convergence of economic and monetary policies. Three years' experience have shown that monetary policies were conducted largely on the basis of the system's requirements, which helped to make it a success, but that price and cost trends continued to diverge. The persistence of these divergences imperils the very nature of the EMS, which is in danger of gradually being transformed into a crawling peg system. Even the measures to strengthen the system discussed above could prove useless or ineffective if not backed by real progress towards convergence. New efforts to improve policy coordination and convergence must therefore be made.

All dimensions of economic policy should be considered, and approached anew from a single view-point, that of their contribution to convergence towards stability. It is clearly a long and difficult exercise. This problem should always be borne in mind when economic policies are formulated. Some concrete decisions should be taken at the Community level and be rapidly implemented, indicating a unerring determination to move towards convergence. These could be:

4.1. phasing-out or modifying restrictions on capital movements at present authorized under safeguard clauses;

4.2. discussion, guided by the operating requirements of the EMS, of the intermediate objectives of national monetary and interest rate policy;

4.3. regular examination of the instruments of national monetary policy and their use, and laying down a list of internal and external monetary policy measures and instruments which are incompatible with participation in the EMS and the customs union;

4.4. establishing a system of mutual information and a monitoring procedure [1] on balances of payments and external indebtedness (with a view to encouraging early recourse to conditional Community financing).

Most of the necessary decisions relate to a more active concertation of monetary policies. It cannot be claimed that by themselves they could remedy the inadequate degree of convergence, but only that they could help to do so: they therefore only represent a number of small steps forward.

Section 5 — Conclusions

The possibilities for developing, strengthening and consolidating the EMS, presented above, form a balanced whole. They maintain the system's existing degree of solidarity and strictness while extending its scope; and, as has been shown in the report of the Alternates of the Monetary Committee of 3 February 1982, putting them into effect would not generally give rise to any insurmountable technical problems. They are addressed primarily at the technical and policy management domains; and are within the limits of the existing institutional framework. They represent a necessary step forward. The analysis of nearly three years of operation has shown that the successes are fragile. The system must be strengthened from within and its ability to resist outside shocks must be increased. In summary the possibilities for development discussed above amount to:

(1) Making the system more coherent:

- *by reinforcing the ECU role as the centre of the system through establishing some degree of control over the process of creating ECU which, together with removing its acceptance limit modifying the interest rate formula and increasing its negotiability, will encourage an increased use within the system;*

- *by removing certain imperfections and filling some gaps in the system mechanisms through:*

  - *organizing the use of Community currencies for intra-marginal interventions and extending the very short-term financing to these interventions;*

  - *coordinating relations* vis-à-vis *the dollar by defining a common attitude, with a quantitatively expressed 'zone of probability', and by cooperating over interest rates;*

  - *taking a step towards consolidating the credit mechanisms by making the EMCF responsible for the short-term monetary support.*

(2) Opening the system towards the outside by permitting third country monetary authorities to hold and use the ECU.

(3) Encouraging the use of the ECU on the financial markets by protecting its image of stability, by increasing the ECU borrowing and lending activity of Community institutions, by minimizing restrictions on the use of the ECU by

[1] As agreed by the Monetary Committee in its October 1980 report on recycling (§ 3.4).

progressively liberalizing the movement of ECU denominated capital.

(4) Reinforcing policy convergence by fully utilizing the existing framework and by improving the follow-up to measures taken.

As well as these technical improvements, there are others, with more political content. These are, in particular, the full participation of sterling and the lira, and the issue of an ECU coin which would circulate freely throughout the Community.

The European Monetary System will not assume its full significance and will not achieve its full potential until it organizes, on an equal footing, the exchange rate relationships of all the Community currencies: sterling's, and later the drachma's, participation in the exchange rate mechanism (and the narrowing to 2,25% of the Italian lira's present margins) would bring the system to full fruition and would act as a signal to the markets and to public opinion of the determination to pursue in common the attempt—accepted and recognized by all—to establish a zone of monetary stability in Europe.

From another point of view, the issue of an ECU coin [1] would strike public opinion just as hard, though in a different way: by bringing the ECU out of the specialists' circle (central banks, exchange dealers, capital market operators) to which it is now confined, and putting it in the pocket of the man in the street, the ECU's destiny as the monetary symbol of the Community would be fully affirmed.

[1] See Annex C-2: Minting an ECU coin.

CHAPTER VI

Commission proposals for a non-institutional development of the EMS

In the spring of 1982, as a result of the postponement of the institutional phase and the Council's manifest intention nevertheless to develop the EMS to some extent, the Commission presented the Council (Economic and Financial Affairs) of 15 March 1982 with proposals for action that could be implemented without it being necessary to amend the Treaties.

Section I below reproduces the text of the Draft Resolution submitted to the Council [1] by the Commission, while Section II reviews the principal arguments put forward when the text was examined by the Community bodies concerned.

It will be remembered that the Council, meeting in informal session on 15 May 1982, was unable to agree on the draft, but that it instructed the Monetary Committee and the Committee of Governors to keep these questions under review.

Section 1 — Draft Resolution on the 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 on 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.

[1] The draft was preceded by a communication to the Council (see Annex D).

2. The ECU

2.1.1. At the next quarterly swap, the base volume of ECU will be set at 40 000 million [2]. 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 adjustments 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.

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*

[2] 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).

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;*

- *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.

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 of 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 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 (EEC) No 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 2.1.1., 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.

Section 2 — Discussion of some of the proposals

The Commission's suggestions formally presented in the above draft Resolution were discussed in detail, first by the specialist committees (the Monetary Committee and the Committee of Governors: see Annex E and Annex F), and then by the Council (Economic and Financial Affairs) meeting in February and April 1982.

This section summarizes the discussions and deals with the main objections to the Commission's proposals.

1. **Must greater convergence precede any development of the system?**

Some governments believe that the lack of convergence between the Community economies poses the main threat to the EMS. The most pressing requirement is therefore for policies that will increase convergence rather than for technical improvements that would—however desirable in themselves—distract attention from the real problem.

The Commission, too, thinks that the achievement of a satisfactory degree of convergence is essential to prevent an undesirable change in the character of the EMS. Indeed, its proposals are largely concerned with this matter. But the Commission feels that convergence and the development of the system must be pursued simultaneously because each reinforces the other. The EMS has undeniably helped to stabilize exchange rates and has supported the anti-inflationary policies implemented in several countries. There is little doubt that, without the EMS, divergence would have been even greater. Consequently, it is desirable to strengthen all aspects of the EMS; this would provide the markets with tangible proof of the monetary authorities' commitment to the system, and by this very fact would exert a stabilizing influence.

2. **Link between the acceptability and convertibility of the ECU**

Some Member States link unlimited acceptability with institutional convertibility of the ECU. Their main argument is that the ECU is only a regional instrument of settlement, while the international role of certain Community currencies means that the authorities issuing these currencies need to have a stock of reserve assets that will be accepted by all countries. If acceptability is increased, there is a greater risk that quantities of ECU will be accumulated. These Member States do not therefore think that any increase in acceptability can be considered unless the ECU is fully convertible into other assets.

This argument calls for two remarks:

First, the requirement for a convertible ECU cannot be taken into consideration in the present transitional stage, where ECU are created precariously through a system of swaps under which the EMCF does not have unrestricted freedom to use the reserves against which the ECU are created. In these circumstances, it is both legally and technically impossible for the EMCF to guarantee the convertibility of the ECU.

Secondly, there is little evidence from past experience to support the fear of an excessive accumulation of ECU. Such accumulation could only derive from settlement operations in ECU at the settlement date for drawings on the very short-term financing facility, as this is the only instance in which central banks are entitled to use ECU (up to a limit of 50%) to discharge their debt. All other transfers of ECU must be made by mutual agreement. In the three years of existence of the EMS, total repayments of very short-term financing amounted to the equivalent of 7 300 million ECU, only 9% of which (660 million ECU) was actually settled in ECU. This was because debtors preferred, and still prefer, to discharge as much as possible of their debt by purchasing the creditor's currency (80 % in this instance) on the market, rather than to lose reserves, whether ECU or dollars.

Nevertheless, the Commission is aware that future developments are not necessarily a continuation of past experience, and it has attached several other suggestions to its proposal that the ECU be made fully acceptable: control of ECU creation so as to reduce the risk of an inflationary expansion of the volume; increase in the remuneration on the ECU in order to enhance its attractiveness to creditors; and the right to mobilize ECU when the outstanding amount of ECU held by a participant exceeds a certain ceiling (exercise of this right being perhaps subject to some monitoring of the need for convertible reserves).

All in all, the proposed system seems all the more balanced since in the present system the 50% acceptance limit applies to each claim and not to the total amount of ECU held by each participant. Assuming that, in order to defend their currencies, several Community countries became debtors of the same Community central bank under the very short-term financing facility, that bank would, according to present rules, have to accept settlement in ECU for 50% of each of its claims. Contrary to what one might think, the acceptance limit therefore offers no real guarantee against the accumulation by a central bank of a relatively large amount of ECU relative to the initial stock of ECU acquired against the transfer of reserves.

The Commission's proposal would change the present situation by offering potential creditor countries an assurance that the net ECU credit positions which they might build up could be mobilized beyond a certain threshold; at present, the system's creditors can trade in their ECU for other exchange assets only through mutually agreed transactions.

In the debate, some countries moreover considered the amendment proposed by the Commission too favourable to the system's potential creditors.

3. Reservations about extending the private use of the ECU

In principle, the Member States are in favour of extending the private use of the ECU, but not all are prepared to follow the Commission's proposals: these aim at promoting and giving a framework to such use by the means of a single basic text giving an official basis to the private use and prescribing methods of use.

The basic text would stipulate, among other things, that the ECU should have the status of a foreign currency. This status is in fact already largely granted to it by the monetary authorities in most of the Member States which, *de jure* or *de facto*, treat transactions in ECU as foreign currency transactions for the purposes of their exchange regulations. These regulations authorize resident banks to use ECU for a wide range of transactions, comparable with those usually carried out in foreign currency.

The absence of a genuine European capital market (one of the objectives of economic and monetary union), has been partly compensated by the development of the Euromarket. However, this is not enough. So, in order to facilitate the emergence of a European capital market, the Commission has proposed establishing the principle of the free movement, within the Community, of ECU-denominated capital.

The Member States with exchange controls find it difficult to accept this principle, which could breach their systems of protection; for it would be easy to get round the rules forbidding certain exports of capital by denominating transactions in ECU. However, it seems that agreement might be possible on progressive liberalization, starting with the financial operations of the Community institutions, which are already exempt from exchange controls in most of the Member States. It would also be conceivable to free ECU issues for Community residents within an annual ceiling that could be raised periodically.

The Commission's proposals on developing the use of the ECU for the Community institutions' borrowing and lending activities have been well received. However, its suggestions for the ECU to be used, first for keeping the Commission's accounts with the financial institutions of the Member States and second for denominating the rights and obligations which the Commission contracts met with some misgiving.

Modelling itself on the rules in force in some countries (e.g. Germany) for claims and prices expressed in national currencies, the Commission has proposed that claims, values and prices expressed in ECU may not, except by way of derogation, carry indexation clauses; it feels that such clauses could damage the good reputation of the ECU, which is intended to be an instrument of stability and should therefore be based on solid foundations. Discussion has shown that formulation of such a principle applying specifically to the ECU did not seem essential to a number of Member States which felt that the treatment of the ECU in this respect should conform to the general rules applicable in those countries.

4. Objections to the organization of intra-marginal interventions

In the present system, intra-marginal interventions in an EMS currency, like the acquisition of an EMS currency through the very short-term financing facility, requires the prior agreement of the issuing bank. For some of the central banks, the Commission's proposals for improving the organization of these transactions are unacceptable, as they could interfere with national autonomy as regards monetary policy. The strong-currency countries, i.e. those likely to be supplying the intervention currencies, point out that the use of the VSTF facility for intra-marginal interventions would be inflationary in that it would increase the volume of money supply during the facility's period of activation.

The same central banks also feel it undesirable to embark on the *de facto* reduction of the 2,25% fluctuation margins since this would mean a systemization of procedures relating to intra-marginal interventions.

The Commission supports its position by pointing to two facts. First, since the EMS was introduced central banks have intervened within margins, mainly in order to keep the overall cost of intervention down; second, the present prior agreement procedure has frequently turned out in practice to be too lengthy in view of the requirements of rapidly changing markets, so that monetary authorities have tended to save time by intervening in dollars rather than in the Community currencies.

Consequently, the Commission thinks the intervention procedure should be improved by giving the central banks a limited power of initiative, while ensuring that there is no adverse effect on the conduct of internal monetary policy in the country whose currency is used. The implementation of the Commission's proposals could lead to better balance between interventions in Community currencies and interventions in dollars, allowing the choice to depend on the respective movements of the currencies in question. This would prevent dollar interventions being used to maintain the cohesion of the EMS, when such intervention would move the dollar in an undesired direction. Conversely, the dollar, and not Community currencies, would be used when use of the dollar would help both the cohesion of the EMS and the stabilization of its exchange rate. In concrete terms, this would mean that weakening Community currencies would be supported by the sale of other Community currencies rather than dollars when it was obvious that the exchange rate of the dollar ought not to fall further.

However, if the dollar exchange rate was too high, weak Community currencies would have to be supported, primarily by sales of dollars. This improvement in the coordination of interventions as a whole would not interfere with the requirements of national monetary policies since the *amounts of national currency automatically available would* be small, and since the central banks involved would be able to suspend recourse to their currencies.

5. **External aspects: acquisition of ECU by third countries**

Most of the Community countries think that, in the non-institutional stage, the use of the ECU can be extended *beyond the Community frontiers only with great caution. It* would be advisable, in particular, to authorize only the transfer to third countries of pre-existing ECU by the Community central banks. For so long as the system for creating the ECU makes it a precarious asset which cannot be converted through the EMCF, any creation of new ECU for non-Community countries is out of the question.

Although its own proposal goes further, the Commission is prepared to accept this argument, which would enable the area of use of the ECU to be extended and would therefore constitute some progress.

6. **Legal problems raised by the non-institutional development of the EMS**

The Commission considers that the changes to the present system could be made on the basis of Article 235 of the Treaty of Rome, [1] and by amending the Agreement of 13 March 1979 between the central banks: numerous Council statements have clearly established that the development of the EMS is necessary to achieve the Community's objectives of promoting continuous and balanced expansion, an increase in stability and closer relations between the Member States (see Article 2 of the EEC Treaty). Furthermore the substance of the Commission proposals is in keeping with the logic of the Resolutions of the Bremen and Brussels European Councils which are themselves the basis of the present system.

Although most of the Community Member States take the same view as the Commission, there is not unanimity.

The need to resort to Article 236 [2] (i.e. to amend the Treaty) is upheld by the countries in which domestic monetary order is based on the Constitution and the central bank's independence from government. In these circumstances, and given the effects of the Commission's proposals on the domestic monetary policies in Member States, they feel that *successive changes to the EMS based on Article 235 would* gradually undermine the sovereignty Member States have over monetary matters without there having been a debate beforehand in national parliaments. Such a debate—and with it recourse to Article 236—is thought to be essential, as is detailed consideration of the development of the EMS by the legislative authorities would provide the system with a clear legal basis and place it firmly on democratic foundations.

Although aware of the validity of the arguments put forward by the supporters of recourse to Article 236, the Commission feels that a revision of the Treaty would not be essential for the development of the EMS in the way in which it proposes. Recourse to Article 235, can, at this stage of the discussion, provide an adequate legal basis for making technical improvements to a system itself based on that Article.

Conclusion

After a series of discussions during the first four months of 1982, the Monetary Committee, which concentrated initially on the system's mechanisms, tried to devise a compromise which might be based on the following points:

(i) raising the acceptance limit of the ECU from 50% to 60% or 70% (instead of 100%, as suggested by the Commission);

(ii) allowing the VSTF facility to be used to finance intra-marginal interventions, while maintaining, under certain conditions, the right of veto of the creditor central bank; (the Commission had proposed automatic access to the VSTF facility for intra-marginal intervention, unless the central banks issuing the intervention currencies proved that the use of their currencies impeded the conduct of domestic monetary policy);

[1] Article 235 of the Treaty of Rome:
'If action by the Community should prove necessary to attain, in the course of the operation of the common market, one of the objectives of the Community and this Treaty has not provided the necessary powers, the Council shall, acting unanimously on a proposal from the Commission and after consulting the Assembly, take the appropriate measures.'

[2] Article 236 of the Treaty of Rome:
'The government of any Member State or the Commission may submit to the Council proposals for the amendment of this Treaty.
If the Council, after consulting the Assembly and, where appropriate, the Commission, delivers an opinion in favour of calling a conference of representatives of the governments of the Member States, the conference shall be convened by the President of the Council for the purpose of determining by common accord the amendments to be made to this Treaty.
The amendments shall enter into force after being ratified by all the Member States in accordance with their respective constitutional requirements.'

(iii) lengthening the reference period to be used for the valuation of gold from six months to one year; (the Commission had proposed an extension to two years);

(iv) opening up the System to the outside world by authorizing the central banks of European countries having particularly close links with the Community to acquire ECU from EEC issuing institutions; (the Commission had proposed that third countries would also be able to acquire ECU against transfers of reserves in the form of swaps with the EMCF).

However, a consensus could not be reached on these proposals, chiefly because it was impossible to overcome the objections to the proposals concerning the acceptability of the ECU and intra-marginal interventions.

The difficulties in reaching a technical consensus were compounded by the prevailing feeling, expressed in the oral statements of the Chairmen of the Monetary Committee and of the Committee of Governors on 17 May 1982 (see Annexes E and F), that given the economic and monetary situation in the Community, absolute priority should be given to improving the convergence of economic policies.

PART THREE

Preliminary synthesis of ideas on the institutional stage of the European Monetary System

Transition to the final stage of the EMS, which will be a decisive step in the progress towards economic and monetary union in the Community, will be achieved only if sustained efforts are made to promote economic convergence (cf. Part One) and if a genuine political resolve is forthcoming. By definition, final consolidation of the EMS means that Member States must relinquish at least some of their national policy-making powers and that there must be *an active search for common solutions to the main problems with which the Community is* generally confronted.

Consequently, this European construction would have to have a tangible effect at the day-to-day operational level, and have to make its impact felt as a means of creating at the Community level broader and more effective potential for action than in each individual Member State. The interdependence of Member States, which is already a fact of life, should be positively exploited as a source of strength and so as to enable the Community to become a pole of monetary attraction in its own right in international relations.

If there were a real desire to make headway, the legal problems would not be an insurmountable obstacle, and a start could be made in the process of monetary integration involving the transfer to the Community of prerogatives hitherto exercised by each individual country's monetary authorities.

In March 1980 the Commission sent to the European Council a report concerning the European Monetary Fund. [1] All the subsequent work up until now has been inspired by the ideas in that document. During 1980 and 1981, the Commission prepared for the Monetary Committee a number of working papers which examined direct transition from the initial stage to the institutional stage of the EMS, and did not envisage any intermediate stage for developing the system (cf. Part Two). Although these papers no longer necessarily reflect, in all their points, the arguments that could currently be developed, nevertheless, it was felt useful to attach them as an annex.

The crucial feature of the institutional phase is the establishment of a decision-making body, the European Monetary Fund, which is entrusted and empowered to pursue the objective of creating a stable European monetary standard. As the way in which this objective is achieved will depend upon the Fund's decisions in response to prevailing conditions, it is neither necessary nor possible to lay down in detail a specification for the institutional phase of the EMS. It is, however, necessary and possible to specify a number of preconditions and likely features. This is done below through some brief considerations on:

(i) the ECU;

(ii) the Fund;

(iii) the exterior aspects of the EMS;

(iv) institutional questions.

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[1] See Annex H.

Section 1 — The ECU

The ECU will be the sight liability of the Fund and as such will be used by the participating central banks. It will also be used progressively by the private sector to denominate the whole range of financial transactions. The conditions surrounding the use of the Fund's sight liability within the system is a matter between the participants; they may have conventions, rules and *ad hoc* agreements as discussed below. The use of the ECU to denominate private financial transactions cannot be forced upon parties to contracts but it can be permitted and encouraged by legislation and more importantly by ensuring that the ECU is attractive. For both the official and the private roles, it is essential that the ECU's fundamental characteristics allow the Fund to develop it in such a way that it is associated with stability.

The present definition of the ECU as a basket ties it to the national currencies. It can be neither more nor less stable than the best or worst of them. This is a prudent formula and gives support to the ECU in its formative stage. It uses the joint identity of the component currencies while it is acquiring its own. The purpose of the EMS is to ensure that the component currencies are stable; and as it succeeds, the ECU, defined in terms of them, will also become more stable. It might also however be desirable at some stage that it is more stable than their average, in which case the existing basket definition would have to be modified. Eventually when a single stable monetary standard is achieved the definition becomes irrelevant as there will then be no fundamental difference between the national currencies or between them and the ECU.

Within the system the supply and demand conditions for the ECU should be developed in such a way as to be conducive to stability. The method chosen for ECU creation must reflect the fact that any money can only exert a disciplinary effect through scarcity. The present method of ECU creation against a swap of gold and dollars suffers from the overriding disadvantage that the decision on the quantity of ECU in the system has been abandoned to a formula based on the market price of two assets which are not in the control of the participants. In the institutional phase, the Fund should have the power to control the quantity of ECU and should do so in the interests of the aims of the system. This has clear implications for the way in which gold and dollars are transferred to the system as will be discussed below. The transfers must allow the creation of a permanent ECU and full control over the quantity.

All settlements between participating central banks would normally be made fully and exclusively in ECU. Changes in the amount of other reserve assets held by the participants and the Fund would occur only in relation to exterior imbalances which will be discussed below. Moving to this position of ECU use will only gradually be achieved, but an obvious first step is the removal of the 50% acceptance limit. The purpose is to ensure that there is a demand for the asset which is under the control of the system and which can therefore exert a disciplinary effect. The more it is used, the more other instruments are effectively demonetized within the system. At present the relatively easy availability of settlement instruments, especially the dollar, through the international markets allow countries to delay necessary adjustments to external imbalances. In the institutional phase of the EMS, the ECU will play an important role in ensuring that timely adjustments are made. For cases where additional financing is needed the credit mechanisms will be consolidated in the Fund. Decisions on credit will therefore be made as a complement to the decisions on ECU creation and in the light of its use by the participants.

As well as being the system's settlement instrument, the ECU's qualities as a reserve asset must be ensured. It must be as attractive as other assets held as reserves, i.e. as dollars, gold, SDR etc. Given the very different qualities of each of these, the implications for the ECU are not immediately clear, but it is true that special measures for the ECU may be necessary because its use is confined to a regional block. The participants will continue to need and hold other reserve assets and it is important to consider how one asset can be transformed into another, and especially how dollars may be acquired with ECU. Two complementary procedures are necessary. The ECU should be both negotiable and convertible.

Negotiability is the regulated possibility to exchange ECU for dollars with other participants of the system. The possibility already exists in the present phase of the EMS and has been used to a limited extent. Although the transactions may be recorded by the Fund they essentially involve a voluntary agreement of two central banks. There is now a provision that such transactions shall not be done for the sole purpose of reserve diversification. Potential net ECU accumulators may fear that even if this provision was removed their access to dollars would be too limited given the small number of ECU holders. It would be possible to supplement the voluntary negotiability with a designation scheme. This would involve some participants being designated to supply dollars to another participant in given circumstances determined by the Fund. They would then have to supply dollars either according to a pre-arranged key or according to their ability as judged by the Fund. Such a scheme has great similarities with the short-term monetary support and is a form of credit arrangement.

Convertibility is also necessary. *Institutional convertibility* means that under certain circumstances the Fund would be obliged to provide dollars to members in return for ECU which should thus be destroyed. The main questions posed by convertibility are associated with the circumstances in which, and the price at which these operations would be done and the possible effect on the Fund's liquidity. The degree to which institutional convertibility is necessary depends upon the size of the potential imbalances within the system and the resultant net ECU positions as well as on the extent to which participants need other reserve assets. The Fund must be given powers to influence these factors as well as being in a position to use the dollars that have been transferred, or other assets, to acquire dollars, to the extent necessary to ensure the required degree of institutional convertibility.

The major difference between convertibility and negotiability is that the former involves the destruction of ECU whereas the latter only involves a redistribution between participants. It is therefore natural that whereas the Fund must be directly involved in convertibility it need not necessarily be involved in negotiability, although there would be cases in which it was desirable that it should be because the distribution of ECU could be an important element in overall control.

When reserve assets are being held in considerable amounts and for long periods of time, a supplementary factor to their characteristics as a store of value is any *income* that can be earned. The growth of dollar holdings during the Bretton Woods System was certainly associated with the fact that it was better than gold in that it could be converted into gold and held in a form which carried an interest payment. Given the very different proportions in which its central banks hold gold and dollars it is clear either that they do not decide reserve composition using portfolio optimizing techniques or that they have very different views about the future. Considering this and the fact that interest payments have often been swamped by capital movements, the importance of interest-type payments on ECU should not be exaggerated. A return is available on dollars because central banks hold their dollars in the form of bonds and obligations mainly of the US Government. The same procedure is not available for official ECU as long as no official authority issues ECU-denominated securities, but the Fund will have some income from its assets which could be used to remunerate ECU. The remuneration per ECU will depend upon the quantity of ECU created on the income available to the Fund. This latter is based on the actual income on dollars, any income available on gold, and any income from credit.

Section 2 — The Fund

To ensure the development of a common and stable monetary standard for the Community, the Fund will eventually have to make decisions over the whole range of monetary policy dimensions: exchange rates, external financing, domestic monetary developments. The instruments which it can use will depend upon its power to influence the monetary policy in Member States. Initially, the Fund will concentrate on the exchange rate and financing dimensions of monetary policy while the adjustment dimensions will remain primarily the responsibility of national authorities.

Exchange rates

The exchange rate mechanism includes both day-to-day interventions and changes in central rates. The exterior aspects of the system are examined below and so here only interventions in Community currencies are considered. Without large quantities of national currencies the Fund could not itself undertake interventions. Member central banks have both the market size and the skills to be the active operators in this area for their own currencies. There is no need to change this situation in the institutional phase.

The very short-term financing facility has proved a useful addition to the intervention mechanisms, and the Fund would continue to play its accounting role for these operations. However, the mechanisms would also be made less rigid by making: (i) the financing period variable below a maximum rather than fixed; (ii) the interest rate set discretionally, and (iii) credit available also for intra-marginal interventions under circumstances and conditions to be determined. The Fund would have to make decisions on these questions in the light of the prevailing circumstances.

Parity changes are already decided by mutual agreement through a common procedure. In the institutional phase, it would be natural to incorporate realignments into the Fund's decision-making structure. No rules about the appropriate size or time of parity changes can be prespecified, but guidelines may help both technical judgment and policy decisions. In this sense, the divergence indicator can continue to be used as a method of monitoring developments on the exchange markets, but other monetary markets should also be followed, as well as the underlying economic developments. The Fund will have to develop extensive technical capacities in these fields so that it can provide a major input into the overall decision-making process.

Although they are the necessary final point of a process of monetary integration, irreversibly fixed parities should not be rigidly planned in advance. As long as central rates are the result of a common decision through the Fund they could continue to be adjustable after the establishment of the institutional phase without undermining the objective of stability.

The Fund's balance sheet

The Fund's decisions will be reflected in its balance sheet, and to a considerable extent its powers are determined by its asset transformation ability within the balance sheet. The liability side of the ECU was discussed above; it is now necessary to consider the asset side.

(a) *Initial transfer*

The present swap system has various defects: the number of ECU created is mechanically determined by the transfer; this number is unstable, depending upon the price of gold and the dollar exchange rate; and it is unrelated to the needs of either the system as a whole or of individual participants. Furthermore, as the participants have the right to the return of exactly the gold and dollars which they transfer, the ECU created are nothing more than a transient denomination of the particular gold and dollars transferred by each individual participant. The transfer of assets in the institutional phase should avoid these problems.

Along with delicate political questions, the definitive transfer of reserves poses economic problems because gold and dollars have very different characteristics and a highly volatile price relationship, which makes the decision on the initial price or valuation method difficult. It would be wise to separate the problem of transfer of assets as much as possible from that of the initial volume of ECU and its distribution between participants. Through their transfer of gold and dollars, the members of the system would participate in the Fund. As a separate action the Fund would then issue an initial quantity of ECU without specifying an ECU price for the two assets. The total amount of gold and dollars transferred would then take into account the need for the Fund to be a credible financial institution and its potential operational role inside and outside the system. The gold proportion of this total amount would depend upon the extent to which it is thought desirable to mobilize gold.

(b) *Subsequent operations*

Once the Fund is established with an initial quantity of assets and a set of decision-making procedures, its main task, apart from exchange rate policy, will be to control the total quantity of ECU consistently with its policy objectives. It will do so by exchanging assets against ECU, such assets being 'external' (gold and dollars) or 'internal' ones (credit).

ECU creation (or destruction) against other reserve assets will occur through the obligation of participants to hold in ECU not less than a given percentage of their reserves and/or through conversion permitted under certain circumstances. For the latter case possibilities will depend not only on the extent of institutional convertibility as discussed above but also on dispositions enabling members to obtain ECU against dollars.

As to credit, the present mechanisms have been largely taken over from pre-EMS arrangements and do not necessarily give rise to ECU creation or assets in ECU except in the case of the very short-term financing facility. Instead, ECU (created from gold or dollars) are partly used for reimbursement. At present, although the short-term mechanism is meant to be a mechanism of 'first resort' it has hardly been used, simply because access to international capital markets has been so free. In the next stage, private access would remain unchanged but official access would be less as ECU rather than dollars would be needed for Community settlements. Credit could then become a significant policy instrument in the hands of the Fund.

The establishment of the institutional stage would undoubtedly imply consolidation within the EMS of the existing Community credit mechanisms: the very short-term financing, the short-term monetary support and the medium-term financial mechanism.

Consolidation of the VSTF facility raises two issues: provision of the currency requested and the settlement and financing procedures. As for the first point, there is room for improvement on two fronts: intra-marginal interventions could, if not already eligible, qualify for the VSTF facility, and the foreign exchange needed for intervention purposes could be supplied by the European Monetary Fund and not, as at present, on a bilateral basis by the banks participating in the exchange-rate mechanism. An innovation could also be introduced in the settlement procedures under the VSTF facility whereby the creditor central bank could have its debts settled immediately in ECU created by the Fund. In return, the latter would acquire a claim, also in ECU, on the debtor bank. As concerns the consolidation of the STMS and MTFA it would have to be accompanied by a revision of the amount of credit available and of the conditionality both in the light of the Fund's responsibilities in the adjustment process.

The credit instruments available in the Fund would probably not be the same as those now in existence which are largely automatic and which are separated by duration. It is necessary to consider credit generally from a functional point of view and ask what overall limitations on amount and duration are necessary. Within any such limits, the Fund should make discretionary decisions about whether credit should be granted in a particular instance or not, and if so on what conditions as to duration, interest rate, etc. A decision to grant credit would thus be parallel to one on exchange rates. It would be natural in both cases that general policies of the member countries are reviewed and recommendations made.

Situations may arise when there are too many ECU, with the result that credit becomes an irrelevant policy instrument. In these circumstances, the Fund would be incapable of pursuing its objectives if it could not take measures to decrease the amount of liquid ECU. This could be done by a ratio type method which would require members (a member) under certain circumstances to hold a given percentage of its total ECU in a term deposit rather than as sight ECU. Alternatively the Fund could vary the attractiveness of term deposits relative to sight ECU through the interest rate. Normally only a low interest rate at most would be payable on sight ECU and participants could be encouraged to hold less sight ECU and more term deposits through an increase in the interest rate on the latter.

Section 3 — Exterior aspects of the EMS

In its institutional stage, the EMS will have to develop in a way consistent with the main features of the post-Bretton Woods era. International monetary relationships are no longer organized by one dominant currency. Various new reserve centres have emerged. Managed floating has become the prevailing exchange rate regime. Private financial institutions have largely outgrown official ones in the role of creating international liquidity and of intermediating between surplus and deficit countries. Domestic monetary targets have to a large extent replaced gold as the anchor of the money creation process.

The institutional phase must satisfy three requirements. First, it must help the effective conduct of external monetary policy by the Community. Second, it must promote cooperation with outside monetary authorities. Third, it must contribute to the evolution towards a new world monetary order.

Regardless of the attitude of the American authorities *vis-à-vis* their exchange rates and intervention, member countries of the Community have since 1971 always individually followed a policy of managed floating *vis-à-vis* the dollar but have never accepted common management. This is inefficient because it allows internal policy differences to be concealed; it lets the dollar/German mark relationship magnify the EMS/dollar relationship, with the result of sometimes reducing and sometimes amplifying the intra-EMS tensions generated by internal factors; and it may lead to contradictory actions on the exchanges such as simultaneous buying and selling of dollars by different participants. For the institutional phase, a truly 'common dollar policy' should consist in handling dollar interventions by common decision through the Fund. Collective decisions on the necessary amount of intervention would, like individual decisions taken today, be based on a judgment about the desirable combination of exchange rate and reserve objectives. There is no technical difficulty in stating such objectives in terms of an ECU/dollar exchange rate and of the desirable change of dollar reserves for the system as a whole.

The difficulty is much more the political one of defining an appropriate decision-making procedure and a key for the repartition of the change in reserves among the member central banks. From an operational point of view there would be no need for the Fund itself to undertake the task of intervening on the exchange markets. This could continue to be done by member central banks, once they act in execution of a commonly defined policy line. Such a common dollar policy would be consistent with the idea outlined above that settlements within the system would be made exclusively in ECU, and hence that dollars would have a purely external role.

In contrast to intervention policy, monetary cooperation with other authorities outside the EMS requires agreement and participation by other parties. Such parties are not only the US authorities, but also the authorities of other important monetary centres, such as Japan and the oil-producing countries. Monetary cooperation may take several forms in the areas of exchange rate management and of financing payments imbalances. The common definition of some kind of exchange rate target among key world currencies seems unlikely today, but could be considered again in the future. Actions are possible in the field of financing, such as activation of swap lines between monetary authorities or official borrowing or lending like the 'Carter Bonds' as in 1978. A well developed EMS could have considered an equivalent action in 1981, when exchange rates clearly moved out of line but when market pressures were too strong for interventions alone to be effective. Similarly, the Community could finance protracted oil deficits with its own liability, thus also meeting the desire of OPEC countries to hold non-dollar denominated assets. A full development of both common intervention policy and of a common policy of financing payments imbalances by the EMS would require that ECU-denominated assets of different maturities be issued to non-members of the system.

Finally, the European Monetary System will have a role in promoting the evolution of the international monetary system. If the ECU and the EMS were fully developed, the natural consequence would be for them to replace the existing currencies and their authorities in international monetary relationships. The ECU would have a larger role to play than the sum of national currencies would have in its absence. The ECU would thus be one of the few currencies of which the multi-reserve currency system was composed. Such a system would be simpler and less difficult to manage than one in which the European pole had failed to give itself the necessary organization.

Section 4 — Institutional questions

The problem of the institutional phase has three facets: the functional, the institutional, and the legal. The functional facet, to which most of the above has been devoted, is the basis for identifying institutional and legal arrangements. *The institutional aspect essentially consists of defining the* appropriate charter of the Fund. The legal aspect is the problem of approving the charter by a satisfactory procedure. These three facets are different but related, and the system will be able to achieve its objectives only if efficient and mutually consistent solutions are found for all of them.

The heart of the institutional problem is giving the Fund the instrument and organization that are necessary to assure that it not only can but also that it is obliged to pursue the necessary policies to reach the objective of 'creating a zone of monetary stability in Europe' in the sense of both prices and exchange rates. In a world in which floating is managed and conditions are continuously and unpredictably changing, this requires the possibility to take decisions that are both discretionary and rapid. In the monetary field there can be no 'stopping the clock' or 'delaying the campaign year'.

An important question is the interdependence between the Fund and other national and Community institutions. It is generally agreed that a money-creating institution must benefit from a certain degree of independence if it is to be able to resist pressures for excessive liquidity creation that would inevitably lead to inflation. Independence has its basis not only on legal provisions, but also on prestige and tradition. In member countries institutional arrangements vary widely from great to very limited independence of the central bank, although in no country is independence pushed to the point of permitting the central bank to overtly oppose the general policy orientation of the elected government. At the Community level it is of the greatest importance to properly formulate the terms of the problem.

Independence means that the power to create money should be sufficiently separated from the power to spend so as to ensure that decisions satisfy the general objective of monetary stability rather than the particular needs of individual spenders. In today's national contexts, this essentially means the autonomy of the central bank from the budgetary authority, which is at the same time the largest spender and the interpreter of popular will. In a Community context, the budgetary authority (the Commission, the Council and the European Parliament) is unlikely to be the major source of inflationary pressures, as the budget is small and balanced by law.

The 'money spenders' are not only the budgetary authority but also, and perhaps more, deficit countries. Seen in this light, the issue of independence is not so much one of determining which authorities will sit in the organs of the Fund, as one of defining the decision-making rules, such as majority rules, within such organs. In an institution like the EMF, which will have to take decisions, and often to take them very quickly, it is hard to imagine anything different from majority decisions which are in fact the rule in all multilateral monetary and financial institutions, whether at *world or at Community level. In designing the details of* voting procedures careful consideration should be given to possible formulae such as: the number of board members determined by the importance of the country; voting powers proportional to the capital-quota position; voting powers dependent to some extent on credit positions. Some of these formulae are used in existing institutions e.g. EIB and IMF.

A further category of problems concerns the structure of the Fund. Different types of institutions have been outlined in the studies discussed by the Alternates of the Monetary Committee: an accounting type, a central bank type, a regional IMF type and a *sui generis* institution. This typology *results from different hypotheses about the attribution to the* Fund of functions that in the present arrangements belong alternatively to central banks, ministers, etc. This distinction is useful but it should not be carried too far. It is clear from the discussion of the functional aspects that the Fund would be incapable of pursuing its objectives if its responsibilities did not envelop the three dimensions of monetary policy: exchange rates, financing and adjustment. These three dimensions are part of a whole and yet, in the existing national arrangements, they are split between different authorities (central banks, treasury, other organs and agencies) and split in a way that differs from country to country.

A last aspect of the institutional problem is related to the evolutionary character of the institutional phase. Although the full potential of the EMS will be realized in a gradual way, the fundamental characteristics of the final form of the system should be defined from the outset. In other words, the direction of the movement should be stated without ambiguity from the beginning, but the movement would then be gradual. If this is so, provisions will be needed to assure that the dynamic process will actually occur. The Community knows this kind of problem being itself a dynamic institutional system. Indeed it has always needed 'a motor', although through the years this function has been successively performed in very different ways.

To sum up, an appropriate institutional setting will have to satisfy different requirements: the need for discretionary and rapid decisions; autonomy from actual and potential money-spenders; competence over the full range of dimensions of monetary policy; clearly defined position in the constellation of national and Community institutions; provisions to assure the evolution of the system. In practice, if the political will develops for a transition to the institutional phase, all these problems may prove less difficult to solve than might at first sight appear. Existing Community and non-Community institutions offer a wealth of suggestions to the ingenuity of legislators.

Annexes

The system narrowing the margins of fluctuation between the currencies of the European Economic Community from April 1971 to March 1979

The system for narrowing the fluctuation margins between the currencies of the European Economic Community from April 1972 to March 1979 (the 'snake') was the precursor to the European Monetary System, which retains some of its features.

The history of the snake can be split into two periods: April 1972 to February 1973 and March 1973 to March 1979.

I. April 1972 to February 1973: the narrowing of margins between the European currencies in a system of fixed parities (the snake in the tunnel)

1. *Origin: the Basle Agreement*

The main achievement of the Community's first ten years was the establishment of a customs union; at the start of its second decade the Werner Plan was the first step in an attempt to achieve economic and monetary union by stages. In compliance with this plan, the Council, on 22 March 1971, invited the central banks of the Member States 'from the beginning of the first stage, and on an experimental basis, to hold exchange rate fluctuations between the currencies of Member States within margins narrower than those resulting from the application of the margins in force for the US dollar, by means of concerted action with respect to that currency'.

Nevertheless, speculation against the US dollar in May 1971 and the deepening crisis culminating in the suspension of the dollar's convertibility into gold on 15 August 1971 [1] meant that the European monetary authorities were unable to implement these provisions.

After the Washington Agreement of 18 December 1971,[2] the maximum spot spread of the EEC currencies around their parities, expressed in dollars, were in fact widened to ±2,25% (as against ±0,75% previously). Over time, the maximum fluctuation margins of these currencies were thus increased to 4,50% *vis-à-vis* the dollar and to 9% *vis-à-vis* any other currency.

Such possible variations (9%) between the Community currencies were incompatible with the Werner Plan objectives. So, after a Council resolution of 21 March 1972, the Community central banks agreed, in the Basle Agreement signed on 10 April 1972 which entered into force on 24 April 1972, to reduce the margins of fluctuation of Community currencies around their reciprocal parities to +2,25%, i.e. to the same level as the margins applicable to the US dollar.[3]

So that these new margins could be respected (they denoted—and still do—the points for interventions in Community currencies), the Community's issuing institutions agreed (the agreement is still in force) to grant each other an unlimited amount of very short-term financing facilities (VSTF) in their currencies; these facilities are administered by the European Monetary Cooperation Fund (EMCF).

2. *Participating countries and functioning of the snake in the tunnel*

At the end of May 1972, ten countries implemented the Agreement to reduce margins: the six founder members of the EEC (Belgium, the Federal Republic of Germany, France, Italy, Luxembourg and The Netherlands), the three countries which were to accede on 1 January 1973 (Denmark, Ireland and the United Kingdom) and Norway (see below: Chronology of the 'snake').

The Basle Agreement, as it functioned from April 1972 to February 1973, is generally known from the way it looks on a graph, as the 'snake in the tunnel' (see Graph 1).

The axis of the tunnel was represented by the parity of the Community currencies against the US dollar and its two outer extremes were formed by the fluctuation limits (i.e. a ceiling of +2,25% and a floor of −2,25%) against the dollar parity.

Within the tunnel—which therefore had a diameter of 4,50%—the European currencies participating in the Basle Agreement moved within a Community band—usually called the 'Community snake'—which was necessarily narrower than the tunnel since the maximum spread of rates which two European currencies could show in relation to their reciprocal parity was limited to 2,25%.

Up to the start of 1973, the 'snake in the tunnel' worked relatively well apart from three exceptions. Three Community currencies had to withdraw from the snake and allow their exchange rates to float: the pound sterling and the Irish pound, on 23 June 1972, and the Italian lira at the beginning of 1973.

1 The suspension of the dollar's convertibility into gold transformed the international monetary system from an exchange rate system pegged to gold (nevertheless a somewhat hybrid system since only the dollar was convertible into gold) into an exchange rate system pegged to the US dollar.

2 The main points of the Agreement were:
(i) a general realignment of parities and notably a 7,89% devaluation of the US dollar against gold, the official gold price rising from USD 35 to USD 38 per ounce;
(ii) a widening of the fluctuation margins from 1% (0,75% for the EEC currencies) to 2,25%.

3 The 1972 Basle Agreement remained in force until the implementation of the European Monetary System on 13 March 1979.

II. March 1973 to March 1979: the joint floating of the European currencies (the 'snake outside the tunnel')

1. *The abolition of the tunnel and the start of joint floating of the European currencies*

At the beginning of 1973, developments on the foreign exchange market showed that the general parity realignment decided in December 1971 had not ushered in a new period of stability for the international monetary system.

In fact, February 1973 saw an increase in speculation against the US dollar to the benefit of the German mark and the yen. On 12 February 1973 the dollar was devalued for the second time (10% against the official price of gold which rose from USD 38 to USD 42,22 per ounce). But despite the dollar's devaluation, the foreign exchange markets remained unsettled and had to be closed at the beginning of March 1973.

In this crisis situation, the Community Finance Ministers met in Brussels on 11 and 12 March 1973 and decided among other things to keep the maximum spread between six Community currencies at 2,25% (see below) and to cease their systematic intervention at the maximum fluctuation margins of the United States dollar.

For the European currencies these arrangements marked the end of the system of fixed parities and the birth of the system of the joint float, which has been in existence ever since (though in a modified form since the establishment of the European Monetary System on 13 March 1979).

To use a metaphor, it can be said that the decision of 12 March did away with the 'tunnel'—since the maximum margins of fluctuation against the dollar were no longer defended—but retained the snake since the maximum spread between Community currencies remained fixed at 2,25%.

* * *

2. *The functioning of the joint float*

Eight currencies were originally involved in the joint float: six EEC currencies (the Danish krone, the Dutch guilder, the French franc, the Belgian and Luxembourg francs, and the German mark) and two other currencies (the Norwegian krone which had been associated since 23 May 1972 and the Swedish krona which had entered the joint float on 19 March 1973).

The six years from March 1973 to March 1979 saw a fall in the number of currencies participating in the joint float mainly because of tensions due to the oil price shocks, the variety of responses to the energy crisis and the lack of success of Community policies to reduce economic and monetary divergences.

Apart from numerous adjustments of central rates (see chronology), the following were the main events:

(i) the French franc, which had withdrawn from the snake on 19 January 1974, re-entered the joint float system on 10 July 1975 only to leave it again on 15 March 1976;

(ii) the Swedish krona ceased to be associated with the snake on 28 August 1977;

(iii) shortly after the conclusion of negotiations on the European Monetary System which provided for the implementation of a new exchange rate mechanism, Norway, on 12 December 1978, announced its withdrawal from the snake.

Thus by the beginning of 1979, only a mini-snake was left, containing five Community currencies: the Danish krone, which had maintained its participation in the joint float at the cost of several devaluations, and four 'stronger' currencies (the Dutch guilder, the Belgian and Luxembourg francs and the German mark).

The other European currencies (French franc, Italian lira, pound sterling and Irish pound) practised a 'dirty' float.

* * *

The European Councils in 1978 (Copenhagen on 7 and 8 April, Bremen on 6 and 7 July and Brussels on 4 and 5 December) were to reintroduce into the EEC a unified joint float system *vis-à-vis* other countries, grouping together eight of the EEC countries within the framework of the European Monetary System (see Annex B).

The effective implementation of the EMS, on 13 March 1979, was accompanied by the abrogation of the Basle Agreement signed in 1972 and by the implementation of new provisions.[1]

[1] Basle Agreement of 13 March 1979 between the central banks of the Member States of the EEC laying down the operating procedures for the European Monetary System.

Chronology of the 'snake'

(April 1972 to March 1979)

1972

24 April Entry into force of the Basle Agreement of 10 April 1972 establishing a fluctuation system limited to 2,25% between Community currencies (the snake in the tunnel). The countries taking part were Belgium, France, the Federal Republic of Germany, Italy, Luxembourg and The Netherlands

1 May The pound sterling, the Irish pound and the Danish krone join the snake

23 May The Norwegian krone is associated with the snake

23 June The pound sterling and the Irish pound leave the snake

27 June The Danish krone leaves the snake

10 October The Danish krone rejoins the snake

1973

13 February The Italian lira leaves the snake

12 March 3% revaluation of the German mark against the EMUA[1] and announcement by the Council of a joint float of EEC currencies within margins of fluctuation of 2,25% against one another, with the exception of the pound sterling, the Irish pound and the Italian lira, which continue to float independently

14 March The Swedish krona is associated with the snake

29 June 5,5% revaluation of the German mark against the EMUA

17 September 5% revaluation of the Dutch guilder against the EMUA

16 November 5% revaluation of the Norwegian krone against the EMUA

1974

19 January The French franc leaves the snake

1975

10 July The French franc rejoins the snake

1976

15 March The French franc again leaves the snake

17 October 'Frankfurt realignment' of exchange rates against the EMUA, with the German mark being revalued by 2%, the Danish krone being devalued by 4% and the Norwegian krone and Swedish krona being devalued by 1%

1977

1 April 6% devaluation of the Swedish krona and 3% devaluation of both the Danish and the Norwegian kroner against the EMUA

28 August The Swedish krona leaves the snake, 5% devaluation of both the Danish and the Norwegian kroner against the EMUA

1978

13 February 8% devaluation of the Norwegian krone against the EMUA

17 October 4% revaluation of the German mark and 2% revaluation of both the Dutch guilder and the Belgian franc against the EMUA

4-5 December European Council in Brussels: adoption of a resolution on the establishment of the European Monetary System

12 December The Norwegian krone leaves the snake

1979

13 March Signing by the Governors of the central banks and by the members of the Board of Governors of the EMCF of instruments relating to the implementation of the EMS

[1] EMUA: European monetary unit of account created on 3 April 1973 and defined by a weight of fine gold (1 EMUA = 0,88867088 grams of fine gold, i.e. the gold parity of the dollar from 1934 to 1971). The EMUA was the European Monetary Cooperation Fund's unit of account from 3 April 1973 (the date on which this body was established) to 31 December 1978.

ANNEX B

Main features of the European Monetary System in its present phase

The European Monetary System (EMS) was established by the Resolution of the Brussels European Council of 5 December 1978 and implemented on 13 March 1979 after the conclusion of an arrangement on the progressive reduction of the monetary compensatory amounts.

The Brussels Resolution provided for an initial phase, which originally was to have lasted two years, but which was prolonged. In due course, on transition to the definitive phase, all the elements of the system will be consolidated, and the European Monetary Fund (EMF) will be set up.

All the EEC countries, at the different levels of responsibility concerned, are signatories of the instruments constituting the EMS. However, the United Kingdom and Greece do not participate in the system's exchange rate mechanism and Italy's currency benefits from special arrangements which will be described below.

Since its creation, numerous commentaries have been devoted to the EMS, including one in particular in *European Economy*. [1] The system will therefore not be described again here; instead a simple reminder of its main features at the present time is given below in two sections — one relating to the ECU and the other to the exchange rate and credit mechanisms.

I. The ECU

The ECU is at the centre of the EMS.

Its definition, the way in which it is issued and its use are described below.

A. *Definition*

The ECU is defined as a 'currency basket' type of *numéraire*. A procedure exists for periodically re-examining its composition and for revising the latter, if necessary.

1. *Present situation*

The composition of the ECU and the way in which its value is determined are identical to those of the European unit of account (EUA) created in March 1975.

The ECU is therefore equal to the sum of fixed amounts of nine Community currencies (see Table 1). The tenth EEC currency — the Greek drachma — is, according to the Greek Treaty of Accession, due to be introduced into the ECU by 31 December 1985 at the latest.

[1] See *European Economy*, No 3, July 1979.

Table 1

Composition of the ECU

The ECU is at present equal to the sum of the following amounts of the currencies of the EEC Member States (except Greece):	
0,828	German mark
0,0885	pound sterling
1,15	French francs
109	Italian lire
0,286	Dutch guilder
3,66	Belgian francs
0,14	Luxembourg franc
0,217	Danish krone
0,00759	Irish pound

Because each currency accounts for a fixed amount in the composition of the ECU, the relationship between these amounts and the value of the ECU or, in other words, the respective weight of each of the currencies in the ECU, varies in line with exchange rate movements between the Community currencies. These weights have changed appreciably since 1975 (see Table 2).

2. *Revision of the ECU's composition*

The Brussels Resolution laid down that the weights of the currencies in the ECU would be re-examined and if necessary revised 'every five years or, on request, if the weight of any currency has changed by 25%'.

'Revisions have to be mutually accepted; they will, by themselves, not modify the external value of the ECU. They will be made in line with underlying economic criteria.'

The circumstances in which the ECU's composition can be altered must be laid down by the Council, acting unanimously on a proposal from the Commission and after an opinion from the Monetary Committee and the EMCF's Board of Governors.

B. *Issue of ECU reserves*

ECU reserves are created by the EMCF for the EEC central banks against the transfer, by these banks, in the form of three-month revolving swaps, of 20% of their gold assets and 20% of their dollar reserves; under the present provisions, the swaps are to be unwound in March 1983, save in the event of a unanimous decision to the contrary by the Governors of the central banks.

Table 2

Weighting of the various currencies in the ECU

	Reminder of the initial weightings of the currencies in the EUA (March 1975)	Weightings on the basis of the ECU central rates in force on						
		13 March 1979	24 September 1979	30 November 1979	23 March 1981	5 October 1981	22 February 1982	14 June 1982
		1	2	3	4	5	6	7
Belgian and Luxembourg francs	8,2	9,63	9,54	9,55	9,31	9,32	8,50	8,45
Danish krone	3,–	3,06	2,95	2,81	2,74	2,74	2,65	2,63
German mark	27,3	32,98	33,31	33,36	32,54	34,36	34,24	35,48
French franc	19,5	19,83	19,64	19,67	19,18	18,63	18,56	17,39
Irish pound	1,5	1,15	1,13	1,14	1,11	1,11	1,11	1,10
Italian lira	14,–	9,50	9,40	9,41	8,63	8,38	8,35	8,07
Dutch guilder	9,–	10,51	10,41	10,42	10,17	10,74	10,70	11,09
Pound sterling	17,5	13,34	13,62	13,64	16,32	14,72	15,89	15,79
Total	100,–	100,—	100,—	100,—	100,—	100,—	100,—	100,—

1 Entry into force of the EMS on 13 March 1979.
2 On 24 September 1979, the German mark was revalued by 5% against the Danish krone and by 2% against the other EEC currencies participating in the EMS exchange rate mechanism.
3 On 30 November 1979, the Danish krone was devalued by 5% against the other EEC currencies participating in the EMS exchange rate mechanism.
4 On 22 March 1981 (with effect from 23 March), the Italian lira was devalued by 6% against the other EEC currencies participating in the EMS exchange rate mechanism.
5 On 4 October 1981 (with effect from 5 October), the German mark and the Dutch guilder were revalued by 5,5% against the Danish krone, the Belgian franc, the Luxembourg franc and the Irish pound; the French franc and the Italian lira were devalued by 3% against these same currencies.
6 On 21 February 1982 (with effect from 22 February), the Belgian franc and the Luxembourg franc were each devalued by 8,5% and the Danish krone by 3% against the other currencies participating in the EMS exchange rate mechanism.
7 On 12 June 1982 (with effect from 14 June), the German mark and the Dutch guilder were revalued by 4,25% against the Belgian franc, the Luxembourg franc, the Danish krone and the Irish pound; the French franc and the Italian lira were devalued by 5,75% and 2,75% respectively against the same currencies.

Table 3

The creation of ECU by swap operations

Swap operations starting in	Gold transfers (million ounces)	US dollar transfers ('000 million)	Gold price (ECU per ounce)	USD 1 = ... ECU	Counterpart in ECU ('000 million) Gold	US dollars	Total
April 1979	80,7	13,4	165	0,75	13,3	10,0	23,3
July 1979[1]	85,3	15,9	185	0,73	15,8	11,6	27,4
October 1979	85,3	16,0	211	0,70	18,0	11,3	29,3
January 1980	85,5	15,5	259	0,69	22,2	10,7	32,9
April 1980	85,6	14,4	370	0,77	31,7	11,1	42,8
July 1980	85,6	13,7	419	0,70	35,9	9,6	45,5
October 1980	85,6	13,9	425	0,71	36,4	9,9	46,3
January 1981	85,6	14,5	447	0,75	38,3	10,9	49,2
April 1981	85,7	14,2	440	0,84	37,7	12,0	49,7
July 1981	85,7	12,7	406	0,97	34,8	12,3	47,1
October 1981	85,7	11,5	402	0,91	34,5	10,5	45,0
January 1982	85,7	11,7	368	0,92	31,6	10,7	42,3
April 1982	85,7	10,5	327	1,—	28,1	10,5	38,6

1 The Bank of England transferred 20% of its gold and dollar reserves from July 1979. The Bank of Greece has made no transfer.
Source: Monthly reports of the agent of the EMCF.

As a result, at present, the creation of ECUs is not definitive.

Furthermore, the amount of ECUs issued — at present 38 600 million (see Table 3) — varies every three months for two reasons:

(i) first, the swap system itself means that the volume of gold and dollar transfers made by the issuing institutions fluctuates in line with the volume of official gold and dollar reserves held by these institutions;

(ii) second, the rates at which the transfers are valued are themselves fluctuating. The conversion rate for gold is equal to the average of the prices recorded daily at the two London fixings during the previous six calendar months but not exceeding the average price of the two fixings on the penultimate working day of the period; the rate used for the dollar is the market rate two working days prior to the value date of the swap operation.

C. *Use of the ECU*

The use of the ECU by the official authorities—national or Community—and by the private sector, is now examined.

1. *The 'official' use of the ECU*

(a) The use of ECU reserves is specified in one case only: a debtor is entitled to use the ECU in order to repay at the settlement date a debt under the very short-term financing arrangement. However, the creditor central bank is not obliged to accept settlement by means of ECUs of an amount more than 50% of its claim. In other cases, the use of the ECU between central banks takes place by mutual agreement.

(b) Apart from its role as a reserve asset, the ECU is also used as a *numéraire* for the exchange rate mechanism, as the basis for establishing the divergence indicator, and as the denominator for operations in both the intervention and the credit mechanisms.

(c) Lastly, as a unit of account, the ECU has been progressively introduced into all the Community's areas of activity.

From 1975 to 1978, it was used first of all — in the initial EUA form — by various institutions (the EIB since 18 March 1975; the EDF — under the Lomé Convention — since 21 April 1975; the ECSC since 24 April 1975) and for a variety of purposes (the general budget since 21 April 1978; in customs matters since 23 November 1978). With effect from April 1979, the ECU was introduced into the common agricultural policy, but with specific conversion rates ('green rates'). Lastly, since January 1981, the ECU has replaced the EUA in all the sectors in which the latter had been used and has thus become the sole unit of account used by the Community authorities.

As a general rule, two principles, whose degree of application depends on the sectors concerned, govern the use of the ECU for the administrative needs of the Community: the first concerns the recording in ECU of operations in national currencies; the second aims at the denomination, wherever possible, of claims and debts of the Community authorities in ECUs.

2. *The private use of the ECU*

Before examining the expansion in the use of the ECU by the private sector, it must be pointed out that there is no connection (except for the ECU's definition and the use of identical exchange rates — the latter being determined by the foreign exchange market) between the use of the ECU within the official framework of the EMS and its use by the private sector; in the former case, we are referring to an agreement between the authorities of the Member States and to Community decisions; in the latter, each operation gives rise to a contract under private law.

This said, the use of the ECU by the private sector, after getting off to a fairly slow start, is now expanding.

(a) The first operations in EUA, the initial form of the Community's currency unit, were chiefly concerned with the keeping of current accounts opened mainly on behalf of the Community authorities. However, the ECU really started to be introduced into private contracts as a monetary instrument only from 1979 onwards, when it became a currency of settlement for operations within the EMS, and operations did not really start until April 1981 with the launching of the first public ECU issue. Since then several issues have followed and, at the end of June 1982, they totalled some 1 000 million ECU.

(b) At present, the private use of the ECU is expanding significantly for two main reasons. First, the majority of the Community's issuing institutions now grant the ECU, *de facto* or *de jure*, the status of a currency, and second, since the start of their ECU operations, the banks themselves have used the ECU not only as a simple unit of account, the use of which would have required a currency of settlement, but also as an instrument of settlement, at least between final operators. This approach has led the banks to extend all the services normally available on convertible currencies to the ECU.

At present, the ECU is thus dealt-in in on-the-spot and forward foreign markets (up to one year); it can also be kept in an interest-earning current account or be placed on a time deposit. There are also short-term overdrafts and syndicated bank loans for up to seven years.

In future, the establishment of a clearing house should facilitate operations for small and medium-sized banks which will thus operate directly on an ECU market without any longer having to break down their operations into the different component currencies.

II. The exchange rate and credit mechanisms

A. *The exchange rate mechanism*

The EMS exchange rate mechanism organizes exchange rate relationships between the Community currencies according to a system of stable, but adjustable when necessary, parities.

1. *The stability of exchange rates*

With the exception of the United Kingdom and Greece, the other EEC countries have joined or rejoined a system of stable parities, consisting of limited margins of fluctuation based on a common *numéraire* — the ECU — and on intervention rules.

All the currencies participating in the EMS have an ECU-related central rate. The central rates as a whole serve to determine the grid of bilateral central rates (see Table 4). Fluctuation margins of ±2,25% are established around the bilateral central rates, except for the Italian lira which temporarily observes ±6% margins.

Once a currency reaches its lower or upper bilateral intervention point *vis-à-vis* another currency, the central banks of the countries concerned are required to intervene. Interventions at the margins must be made in the currency at the opposite bilateral limit.

These intervention rules, which are similar to those used in the snake, have been supplemented in the EMS by an original mechanism: the 'divergence indicator'. As its name indicates, the divergence indicator, which is based on the ECU, identifies the currencies whose exchange rate performance diverges from the 'Community average'. A 'threshold of divergence' is fixed at 75% of the maximum spread of divergence for each currency and when a currency crosses the threshold, this results in a presumption that the country concerned will act.

The indicator in fact works as an early warning system and is designed to encourage the monetary authorities to take adequate measures even before the compulsory intervention points are reached. These measures may be diversified intervention, measures of economic or monetary policy, or changes in central rates.

2. *The adjustments*

The inadequacy of economic policy convergence means that adjustments of central rates are inevitable with varying frequency. Adjustments were made even under the Bretton Woods system which is sometimes called — not quite accurately — a system of fixed parities.

The originality of the EMS is that it organizes the adjustments to take place in the best possible conditions.

Thus the Brussels Resolution states: 'Adjustments of central rates will be subject to mutual agreement by a common procedure which will comprise all countries participating in the exchange rate mechanism and the Commission. There will be reciprocal consultation in the Community framework about important decisions concerning exchange rate policy between countries participating and any country not participating in the system.'

Since the entry into force of the EMS, six adjustments of central rates have taken place (see Table 2, notes 2 to 7); the changes in bilateral central rates, resulting from these realignments, are indicated in Table 5.

B. *The credit mechanisms*

The existing credit mechanisms — which are to be consolidated into a single fund, in the final phase of the EMS — have been reinforced and supplemented by measures to assist the less prosperous countries of the Community.

1. *The reinforcement of the credit mechanisms*

We shall consider in turn very short-term financing, short-term monetary support and medium-term financial assistance.

(a) Very short-term financing (VSTF) is designed to facilitate respect of the maximum margins of fluctuation. All the central banks of the countries belonging to the EMS exchange rate mechanism are eligible for it.

Under the VSTF arrangement, the participating central banks open for each other unlimited credit facilities through the EMCF in their respective currencies for a very short period.

With the establishment of the EMS, the VSTF arrangement was changed in two important respects: the initial credit period was extended from 30 to 45 days from the end of the month in which the debt was incurred, and the debtor central bank was enabled to make settlement by transferring ECUs, with the proviso that the creditor central bank is not obliged to accept a settlement by means of ECUs of an amount more than 50% of its claim. The balance of the debt is settled by the transfer of other reserve components.

(b) Like the VSTF, the short-term monetary support system (STMS) is an agreement between central banks. Unlike the VSTF, reserved solely for participants in the exchange rate mechanism of the EMS, all EEC countries may request short-term monetary support.

The granting of short-term monetary support is linked to the need for short-term financing caused by a temporary balance-of-payments deficit.

Table 4

Bilateral central rates and intervention margins for currencies participating in the EMS exchange rate mechanism

(rates in force as from 14 June 1982)

		Amsterdam in HFL	Brussels in BFR/LFR	Frankfurt in DM	Copenhagen in DKR	London in UKL	Dublin in IRL	Paris in FF	Rome in LIT
	+ 2,25 %		1 782,85	92,525	326,45		27,3975	262,21	55 577,0
HFL 100	central rate	100	1 743,23	90,4673	319,183	[1]	26,7864	256,380	52 341,9
	− 2,25 %		1 704,45	88,455	312,08		26,1915	250,67	42 296,0
	+ 2,25 %	5,8670		5,308	18,726		1,57155	15,042	3 188,0
BFR/LFR 100	central rate	5,73646	100	5,18961	18,3098	[1]	1,53659	14,7072	3 002,58
	− 2,25 %	5,6090		5,074	17,903		1,50241	14,380	2 828,0
	+ 2,25 %	113,05	1 970,85		360,83		30,2845	289,85	61 433,0
DM 100	central rate	110,537	1 926,93	100	352,817	[1]	29,6090	283,396	57 857,4
	− 2,25 %	108,0775	1 884,00		344,97		28,9520	277,09	54 490,0
	+ 2,25 %	32,0425	558,60	28,990			8,58300	82,150	17 412,0
DKR 100	central rate	31,33	546,154	28,3433	100	[1]	8,39216	80,3239	16 398,7
	− 2,25 %	30,6325	534,00	27,715			8,20550	78,535	15 444,0
UKL 1	central rate	[1]	[1]	[1]	[1]	[1]	[1]	[1]	[1]
	+ 2,25 %	3,8180	66,56	3,454	12,187			9,7890	2 074,80
IRL 1	central rate	3,73324	65,0792	3,37736	11,9159	[1]	1	9,57129	1 954,05
	− 2,25 %	3,6500	63,6315	3,302	11,6509			9,3585	1 840,32
	+ 2,25 %	39,8925	695,40	36,090	127,33		10,6855		21 677,0
FF 100	central rate	39,0045	679,941	35,2863	124,496	[1]	10,4479	100	20 415,7
	− 2,25 %	38,1375	664,80	34,500	121,73		10,2155		19 227,0
	+ 6 %	2,02850	35,360	1,835	6,475		0,54338	5,2010	
LIT 1 000	central rate	1,91051	33,3047	1,72839	6,09804	[1]	0,511758	4,89818	1 000
	− 6 %	1,79925	31,365	1,628	5,743		0,48197	4,6130	
1 ECU	central rate	2,57971	44,9704	2,33379	8,234	(0,560453)	0,691011	6,61387	1 350,27

[1] Does not participate in the exchange mechanism.

Table 5

Appreciation or depreciation of the bilateral central rates of EMS participant currencies from 13 March 1979 to 14 June 1982[1]

	Belgian and Luxembourg franc	Danish krone	German mark	French franc	Irish pound	Italian lira	Dutch guilder
Belgian and Luxembourg francs	—	+2,–	−18,4	+0,1	−8,5	+3,2	−16,8
Danish krone	−1,9	—	−20,–	−1,8	−10,3	+1,2	−18,4
German mark	+22,6	+25,–1	—	+22,7	+12,2	+26,5	+2,–
French franc	−0,1	+1,9	−18,5	—	−8,6	+3,1	−16,9
Irish pound	+9,3	+11,4	−10,9	+9,4	—	+12,8	−9,1
Italian lira	−3,1	−1,2	−21,–	−3,–	−11,3	—	−19,4
Dutch guilder	+20,2	+22,6	−2,–	+20,3	+10,–	+24,–	—

[1] The table reads horizontally (for example, the Belgian franc has appreciated 2 % against the Danish krone and the Danish krone has depreciated 1,9% against the Belgian franc).

The amount actually available for short-term monetary support has been more than doubled and increased to 14 000 million ECU. In addition, the duration of the facility, previously fixed at six months (three months, renewable once) was extended to nine months (three months, renewable twice).

(c) Medium-term financial assistance (MTFA) is granted by the Member States of the EEC, for a period of between two and five years, where a Member State is in serious balance-of-payments difficulties.

The credit amount actually available was more than doubled at the start of the EMS and at present stands at 11 000 million ECU.

2. *Transfers of resources to less prosperous countries*

The less prosperous countries of the Community which do in fact participate in the exchange rate and intervention mechanism — at present, Italy and Ireland — are eligible for loans on special terms.

The Community institutions and the European Investment Bank are empowered to make available to them, for a period of five years with effect from the establishment of the EMS, loans of up to 1 000 million ECU per year; these loans are eligible for an interest rate subsidy of 3%, limited to an annual cost of 200 million ECU.

ANNEX C

Examination by the Monetary Committee of some aspects of the non-institutional development of the European Monetary System

At the end of 1981, it was clear that the introduction of the institutional phase would take some time, and a relatively long time at that.

The Monetary Committee therefore felt it useful to pin-point the areas in which progress could be made in the less distant future.

In this connection, the Chairman of the Monetary Committee, at the Council (Economic and Financial Affairs) held on 14 December 1981, suggested a number of points for consideration (see Annex C-1).

In addition, the Alternates of the Monetary Committee — on a mandate from the Committee and in the reports which follow — studied some of the problems posed by the non-institutional development of the EMS.

The first report (Annex C-2) examines four questions:

(i) how to break the link between the volume of ECUs issued and the price of gold and the exchange rate for the dollar;

(ii) the eligibility of intra-marginal interventions for the very short-term financing facility;

(iii) the external role of the ECU;

(iv) the minting of an ECU coin.

The supplementary report (Annex C-3) examines the problem of the mobilization of net ECU credit positions.

ANNEX C-1

Statement by Mr Jean-Yves Haberer, Chairman of the Monetary Committee, to the Economic and Financial Affairs Council of 14 December 1981, on the European Monetary System

I. Progress report on the work assigned to the experts

On 13 March 1982 the European Monetary System will celebrate three years of official existence.

The Monetary Committee has complied with the wish expressed on several occasions by the European Council and the Council of Ministers for Economic and Financial Affairs, and in 1980 and 1981 devoted numerous studies to the reinforcement of the EMS until its transition, at the appropriate time, to the institutional phase. With the invaluable assistance of its alternates, a report was produced containing six documents prepared by Commission departments and revised after discussions with the experts of the Monetary Committee. The report was submitted to the Monetary Committee which took it into consideration in presenting the broad options which I am about to mention.

In accordance with the guidelines laid down by the Luxembourg European Council of 2 December 1980, the technical work centred on the gradual development of the use of the ECU, the renewal and reinforcement of the credit arrangements, and the coordination of monetary policies and exchange rate policies pursued in relation to third countries. In the course of their work on these subjects, the experts, in the six documents I have mentioned, brought out the importance of the problems and options connected with:

(i) the status of the ECU and its acceptability as a means of settlement;

(ii) the liquidity of the central monetary institution;

(iii) the arrangements for transferring reserves to the European Monetary Fund;

(iv) the consolidation of Community credits in the EMF;

(v) the external role of the ECU;

(vi) and lastly, the institutional aspects of the EMF.

It is certainly true that, when the time comes, certain points will have to be examined in even greater detail. These include, for example, the questions of the return paid on the ECU and the legal status which the period of transition to the institutional phase of the EMS will have by reference to the Treaty of Rome and the member countries' constitutional rules. Nevertheless, it seems to me that the detailed and comprehensive technical studies already made provide, as from now, a sufficient basis for exploring the directions in which the EMS can go forward, and in particular for responding to the call of the recent London European Council. I therefore have the honour of asking the Council to recognize that we have acquitted ourselves of the preliminary work carried out at its request.

II. The successes of the EMS

As the European Council has several times noted, the EMS has worked remarkably successfully for three years.

1. First, it has provided a satisfactory response to the central problem of a common market, i.e. of a zone the purpose of which is to promote the interdependence of its economies by trade, the movement of capital and individuals, and free competition; this problem is the stabilization of exchange rates without which it becomes far too hazardous to calculate profitability and to devise marketing strategies.

Despite the existence of a wide fluctuation margin and the four — albeit moderate — realignments which have taken place within the EMS, trade between the countries participating in the exchange rate and intervention mechanism has benefited greatly from the security of transactions created by the foreseeable nature of exchange rates. By reducing the uncertainties involved in intra-Community trading operations, the EMS has thus made it possible to cut their cost and speed their development.

2. This success has been confirmed despite the turmoil in the international environment: the three years of the European Monetary System's existence have seen a very serious oil price shock succeeded by a monetary shock which was no less disruptive because of the sudden and erratic variations in the dollar interest rate and exchange rate. During this period, the interest rate on the major international currency doubled and its exchange rate appreciated by over 40% against the major European currencies, but without any lasting effect on the internal cohesiveness of the EMS.

3. The four currency realignments which occurred during the period, among which the only real general realignment was that of October 1981, were carried out calmly and remained within reasonable limits. They showed the ability of the countries participating in the EMS to anticipate market movements and to regulate them without allowing undue disruption of the foreign exchange markets to develop. In this respect, interventions were clearly consistent with their natural purpose since they were for the most part reversible. Net transfers of reserves between participants remained limited.

4. Contrary to the fears expressed by some at the moment of the establishment of the system, the mechanisms providing for a very large amount of credit (a total of 25 000 million ECU for medium-term financial assistance and short-term monetary support) did not have to be activated. The corrective measures which were needed were taken early enough for any momentary divergences on the foreign exchange markets to be amply covered by very short-term financing between central banks. But the credibility of the EMS was greatly enhanced by the existence of a generously endowed credit system.

5. Even if the economic policies of the Member States are often very diverse, the constraint of having to respect the central rates established within the EMS has been important and has favoured the convergence of monetary policies, and through them, of economic policies: the general rejection of a permissive interpretation of the European monetary rules has been an active element in bringing economic policies closer together, and a number of Member States are a well-known demonstration of this development.

6. The success of the EMS has been assisted by the prospects it offers for Europe's progress towards genuine economic and monetary union, and by the technical and political rendez-vous which it has set itself from the outset. The existence of the European Economic Community's monetary ambition has, in its way, been crucial for the credibility of the EMS and has aroused manifest interest from the banks and the international markets.

III. Scope for a non-institutional development of the EMS

In line with the conclusions of the recent European Council in London, I believe it is essential to mark the third anniversary of the EMS by real and meaningful progress. In this area, as in any other, but perhaps even more so in view of the momentum created and the expectations inherent in the system, we cannot afford to stand still, for fear of losing what we have already achieved. Nevertheless, we must not be unrealistic. My colleagues and I myself feel that it would be inappropriate, in the present circumstances, to embark on the final phase, which, because of its scale, would require ratification by the national parliaments in long and complex procedures. It therefore seems that at this stage we must set on one side the question of the institutional framework of the EMS, together with other fundamental questions which also involve parliamentary procedures, e.g. the definitive transfer of foreign exchange reserves to a European Monetary Fund.

That said, I have made use of the opportunities for personal diplomacy enjoyed by the Chairman of the Monetary Committee to form a personal opinion, which reflects many others, on the points which could permit, with a satisfactory degree of coherence, a non-institutional development of the EMS, if this were to find favour with the political authorities of the Community. These points are the following, in increasing order of importance:

1. A signal to public opinion: each of the member countries, following its customary national procedure, should mint an ECU-denominated metal coin of standard design, which would circulate freely in the Community.

2. Improved technical cooperation between the central banks participating in the exchange rate and intervention mechanism. Thus, very short-term financing could be activated not only for obligatory interventions at the bilateral limits, but also for preventive intra-marginal interventions designed to promote the stability of the system; the divergence indicator mechanism could be improved; and acceptance of the ECU as a means of settlement between the participating central banks could be increased from 50% to 100%.

3. Greater credibility for the ECU. The ECU's success must first be ensured in the Community itself; the Community institutions should set an example by using it for their accounts and for their market borrowings. The central banks of the European countries with an exchange rate policy linked to the EMS could be authorized to hold ECUs obtained either by deposits of reserves with the EMCF or by settlements with EMS central banks. The central banks of oil exporting countries which had agreed to financial cooperation with the borrowing Community institutions could also be allowed to hold ECUs on the same terms.

4. The regrouping of the credit mechanisms. The present short or medium-term mechanisms would be incorporated into the EMCF itself where they would become credit lines, and this would confirm the Community's ultimate intention of setting up a genuine European Monetary Fund.

5. Stabilization of the volume of ECUs issued. A re-examination might concentrate on the relationship between the volume of ECUs, which deserves to be under control, and the gold and dollar prices, which have the disadvantage of continually fluctuating.

6. Closer convergence of monetary policies. Interest rate policies in particular could be concerted more frequently.

7. The determination of a 'zone of probability' for the dollar. There is a clear need for a common approach to third currencies and to the dollar in particular. An attempt should be made to determine a zone of probability for European exchange rates vis-à-vis *the dollar, in consultation with the US authorities.*

I have ventured on a list which is in no way restrictive: in taking advantage of the opportunity provided by my presentation to the Council of the Monetary Committee's work on the EMS, my purpose is none other than to express the feeling that progress is possible in certain areas which are consistent with each other, and hence necessarily interconnected.

The Council of Ministers may call on the Monetary Committee at any time to translate the guidelines of the London European Council into concrete proposals.

ANNEX C-2

Report on some aspects of the non-institutional development of the European Monetary System presented on 3 February 1982 by the Alternates of the Monetary Committee

At its meeting of 13 January 1982, the Monetary Committee discussed various proposals for the non-institutional development of the European Monetary System (EMS) and requested the Alternates to examine and report on the following questions:

(i) How can the volume of ECUs issued be divorced from the two widely fluctuating variables, the market price of gold and the exchange rate for the US dollar?

(ii) How is the extension of the very-short term facility to the financing of intra-marginal interventions to be circumscribed (either by attaching conditions, imposing a ceiling, or limiting its duration)?

(iii) How can the option open to non-Community institutions to hold ECUs be organized?

(iv) How would the problems of legal tender arise in relation to the free circulation of an ECU coin minted according to national procedures?

The Alternates accordingly met on 25-26 January and on 3 February 1982 and herewith submit their report to the Committee. In conformity with the mandate received, the Alternates confined their examination to the feasibility, technical implementation and implications of the four courses of action mentioned above, without taking a position on their overall merits or otherwise; nor did they examine the links with other proposals affecting related aspects of the system (e.g. ECU acceptability, remuneration, etc.). Finally, their examination remained within the confines of a non-institutional development of the EMS, although views as to the precise limits of such a development differed.

I. How can the volume of ECUs issued be divorced from the two widely fluctuating variables, the market price of gold and the exchange rate for the dollar?

1. Since the inception of the EMS, the rules governing ECU creation against swaps of gold and dollars have led to marked fluctuations in the total volume of ECUs issued. The amount rose from an initial 27 000 million ECU in July 1979 [1] *to a peak of almost 50 000 million ECU in April 1981, with a subsequent fall to 42 000 million ECU at present. The key to these developments lies almost exclusively in changes in the price of gold. The volume of ECUs created against gold transfers rose from 16 000 million ECU at the start of the system to 32 000 million ECU at present (i.e. from 58% to 75% of total ECU creation). The amount of ECUs issued against the transfer of dollars has, on the contrary, remained generally stable, ranging between 10 000 and 12 000 million ECU since the start of the system, because of volume declines which almost totally offset the rise caused by the dollar's appreciation.*

2. Before examining automatic formulae acting either on the valuation rules or on the volume of reserves transferred, the Alternates considered an alternative approach: endowing the Board of Governors of the EMCF with some discretionary powers over the adjustments to be made on the occasion of the swap renewals. These powers could be limited to the possibility of overriding the agreed rule under well-defined circumstances and on specific items (e.g. valuation rules, which already in 1979 were left to an agreement between central banks). Such a step could be justified by the consideration that, in the existing system, there is an over-reliance on automatisms, which always risk producing unforeseen results, and an insufficient scope for stability-oriented discretionary decisions. Under these circumstances, the growth in ECU volume and its distribution between participants cannot be expected to always reflect the overall objectives of the system. Such a step is, however, generally seen as moving into institutional ground; one should furthermore not underestimate the contribution that automatic and clear rules have made to the overall credibility of the system, avoiding potentially difficult discussions at periodic intervals.

3. The Alternates examined the possibility of reducing the volatility of ECU creation by acting through the valuation rules. Central banks would still swap 20% of their gold and dollar reserves, but the valuation method would be changed and/or, in the same line of thinking, the duration of each swap would be extended. In this respect, the Alternates agreed that any solution which would lead to disregarding the market price of the reserve assets for any extended period of time would be undesirable. Renewing swaps at unchanged prices would mean that over time the value of the ECU issued could diverge markedly from the current value of the underlying assets, with the ECU assets thus becoming much more (or less) valuable than their backing, which could in either case adversely affect the use of the ECU. It could furthermore give the impression of an attempt to peg the price for gold, in contrast to commitments under the IMF Articles of Agreement.

On the above grounds, the Alternates would tend to reject proposals aimed at stabilizing ECU creation through a 'freeze' on the gold and dollar price for future swap renewals.

3.1. The Alternates did, however, consider three possibilities for moderating the effects of erratic price movements:

[1] July 1979 is taken as the point of departure for comparisons as it is the date at which the United Kingdom joined other members in transferring 20% of its gold and US dollar holdings to the EMCF.

(i) a lengthening of the duration of the swaps from the present 3 months to say 6 or 12 months. This would reduce the frequency of the adjustments and therefore somewhat dampen the short-term volatility in ECU creation, but would not avoid large movements when the adjustments eventually took place, and would also encounter legal difficulties in certain member countries;

(ii) a lengthening of the reference period for the valuation of gold, with the existing caveat of using whichever is lower between the average price and the latest market price. This would of course moderate the growth of ECUs in a period of rapid gold price increases, albeit to a limited extent (see attached graph); the effect could be more significant only if the reference period were much longer than 12 months;

(iii) an alternative proposal is to value gold conservatively by comparison with present market rates, for example by applying a discount of 10 or 20% in the current price. This would have a once-and-for-all effect in reducing the volume of ECUs created, but would not eliminate subsequent volatility, unless the discount varied proportionately to price movements.

3.2. The above methods are not mutually exclusive and could perhaps be combined. In all cases, to the extent to which they succeed in dampening the effects of unstable market variables on ECU supply, they necessarily lead to a divergence between the internal and the market's valuation of the underlying reserve assets. These methods would thus all require a compromise between the objective of moderating the volatility in ECU creation and the principle, stated in point 3 above, that any prolonged or marked departure from market rates should be avoided.

4. The Alternates finally examined various 'closed pool' systems for controlling the volume of ECUs issued. In such systems the quantity of ECUs would in principle be fixed and the volume of reserves transferred by each participant at a swap renewal would be adjusted in accordance with the price evolution of the assets. The percentage of reserves transferred would accordingly change at each swap, i.e. the 20% rule would no longer be applicable.

4.1. The first issue arising in this context relates to the decision-making process for fixing the initial volume of ECUs to be created and for subsequent periodic reviews (annual or biennial). The Alternates did not discuss this point as it falls beyond their mandate.

4.2. The second point relates to the technical functioning of a 'closed pool' mechanism. Various possibilities were considered:

(i) a 'uniform shares' rule: central banks would transfer gold and dollars according to a uniform proportion, say 20% of their holdings of each asset. At subsequent swap renewals, the adjustments to take account of price changes (while maintaining constant the total volume of ECUs created) would be made in such a way as to ensure that each central bank continued to transfer an equal proportion of its holdings of the two reserve assets, e.g. 18% of each if the price of the reserve assets had risen or 22% of each if it had fallen. The current proportion under this system (if ECU creation had been kept at its original level) would be 12% of central banks' gold holdings and 12% of their dollar reserves, instead of the initial 20% (see Table 1). This system would, however, have the drawback of making the amount of dollar transfers vary also in relation to the gold price;

(ii) an alternative system would be one where gold transfers would vary inversely to movements in the gold price and dollar transfers inversely to movements in the dollar exchange rate. This system could work as follows: to establish the initial quantity of ECUs, a given proportion of gold and dollars would be transferred. At subsequent swap renewals, gold or dollars would be returned to or required from each participant in proportion to price rises or falls of these assets in terms of the ECU. With this system, the total amount of ECUs created remains constant, as does the share of this total allocated to each participant, whereas under the present arrangements these factors vary in relation both to market prices and to volume changes. The system would in fact function as though a constant ECU allocation had been made to each participant until a new decision was taken. Its operation could possibly have adverse effects on liquidity for dollar holders. Had such a system been applied during the period since July 1979, the subsequent price movements in gold and dollars would have resulted in sizeable reductions in the share of gold deposited and increases, for most members, in the share of dollars deposited (as a proportion of their holdings of these assets — see Table 2);

(iii) given that the main cause of the fluctuations in ECU creation has been changes in the price of gold, another possibility would be to maintain the 20% rule for dollar transfers but to adjust the volume of gold transfers inversely to movements in the price of gold and in the ECU creation against dollars, so as to keep the total volume of ECU supply constant (see Table 3). This would, however, mean that the two assets were treated very differently in the process of ECU creation;

(iv) the two latter systems could be modified to take account also of volume changes in participants' reserves, with a country which had used some of its dollar reserves decreasing proportionately the dollars transferred.

Table 1

Share of assets transferred to the EMCF in % of gold and dollar holdings under a 'uniform shares' rule

	III-1979			II-1980			I-1981			I-1982		
	Gold	Dollars	Total	Gold	Dollars	Total	Gold	Dollars	Total	Gold	Dollars	Total
Belgium	20	20	20	12,8	12,8	12,8	11,1	11,1	11,1	12,9	12,9	12,9
Denmark												
FR of Germany												
France												
Ireland												
Italy												
The Netherlands												
United Kingdom	20	20	20	12,8	12,8	12,8	11,1	11,1	11,1	12,9	12,9	12,9
Amount of ECUs created												
(thousand millions)	27,3			27,3			27,3			27,3		
against gold	15,8			20,3			21,3			20,4		
against dollars	11,6			7,1			6,1			6,9		
Conversion rates												
ECU/ounce of gold	185,064			370,546			446,958			368,025		
USD/ECU	1,37653			1,29517			1,33166			1,08806		

Table 2

Share of assets transferred to the EMCF in % of gold and dollar holdings under the 'rule of proportionate volume adjustments for gold and dollars'

	III-1979			II-1980			I-1981			I-1982		
	Gold	Dollars	Total	Gold	Dollars	Total	Gold	Dollars	Total	Gold	Dollars	Total
Belgium	20	20	20	10,0	28,1	11,4	8,3	15,3	9,1	10,0	12,5	10,4
Denmark				9,7	54,2	32,8	8,1	26,6	20,0	9,8	29,8	23,0
FR of Germany				10,0	19,7	13,6	8,3	21,5	12,4	10,0	20,5	13,8
France				10,0	18,2	11,3	8,3	16,8	9,5	10,0	20,2	11,5
Ireland				10,6	19,7	17,7	8,8	12,5	11,8	10,6	15,5	14,6
Italy				10,0	23,7	12,7	8,3	26,9	11,2	10,0	22,6	12,7
The Netherlands				10,0	22,4	11,3	8,3	21,3	9,5	10,0	21,1	11,3
United Kingdom	20	20	20	9,8	19,2	14,7	8,1	21,2	14,0	9,7	29,0	17,7
Amount of ECUs created												
(thousand millions)	27,3			27,3			27,3			27,3		
against gold	15,8			15,8			15,8			15,8		
against dollars	11,6			11,6			11,6			11,6		
Conversion rates												
ECU/ounce of gold	185,064			370,546			446,958			368,025		
USD/ECU	1,37653			1,29517			1,33166			1,08806		

Unlike the adjustments made in relation to price changes, these adjustments would change the total quantity of ECUs created (except in the unlikely case of precisely offsetting volume movements in the participants' reserves). The system would thus reduce volatility in ECU creation but would not operate as a pure 'closed pool'.

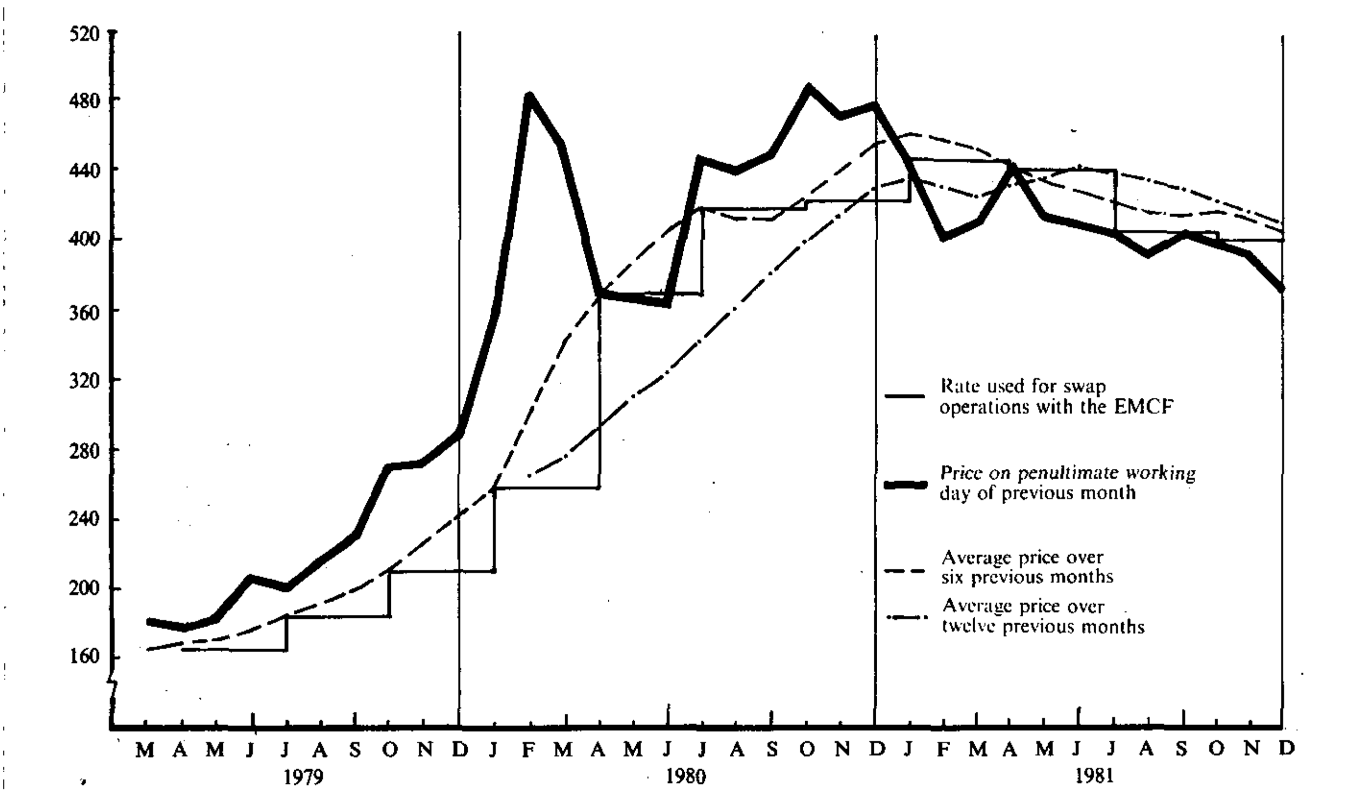
4.3. A third issue is whether in all the above systems there should be a fixed rule regarding the proportion of reserves to be swapped or whether, given that each country may differ in its appreciation of what constitutes the most appropriately balanced portfolio of gold and dollar reserves, countries could be given some latitude (e.g. ±5%) in the distribution as

Table 3

Share of assets transferred to the EMCF in % of gold and dollar holdings under the 'rule of volume adjustments of gold only'

	III-1979			II-1980			I-1981			I-1982		
	Gold	Dollars	Total	Gold	Dollars	Total	Gold	Dollars	Total	Gold	Dollars	Total
Belgium	20	20	20	10,2	20	11,0	8,6	20	9,9	10,5	20	12,0
Denmark						15,3			15,9			16,8
FR of Germany						13,9			12,1			14,0
France						11,8			10,2			11,9
Ireland						17,9			18,0			18,3
Italy						12,2			10,4			12,5
The Netherlands						11,3			9,6			11,6
United Kingdom	20	20	20	10,2	20	15,3	8,6	20	13,7	10,5	20	14,5
Amount of ECUs created (thousand millions)	27,3			27,3			27,3			27,3		
against gold	15,8			16,2			16,4			16,6		
against dollars	11,6			11,1			10,9			10,7		
Conversion rates												
ECU/ounce of gold	185,064			370,546			446,958			368,025		
USD/ECU	1,37653			1,29517			1,33166			1,08806		

ECU/GOLD RATES (ECU per fine ounce)



between gold and dollars, which would help to overcome some technical difficulties for the monetary authorities. This would introduce an element of flexibility, but also of arbitrariness, in the system.

4.4. In conclusion, a 'closed pool' system would allow ECU creation to be controlled and divorced from market variables. It would, however, mean departing from the 20% rule set out in the European Council Resolution of 5 December 1978, and though market variables would no longer influence the volume of ECUs created, they would affect the volume of reserves transferred. In some cases, the different treatment of gold and dollar assets would be accentuated.

II. How is the extension of the very short-term facility to the financing of intra-marginal interventions to be circumscribed (either by attaching conditions, imposing a ceiling, or limiting its duration)?

5. The Brussels Resolution states that in principle interventions in the EMS will be made in participating currencies and provides for diversified interventions when a currency crosses its divergence threshold. The Agreement of 13 March 1979 between the central banks, however, makes no specific arrangements for intra-marginal interventions or their financing; such interventions are carried out on an ad hoc *basis within the framework of concertation among EEC central banks. Currency availability then depends on bilateral agreements on either credit lines or using working balances (limited in principle by Article 15 of the central banks' Agreement). Intra-marginal interventions in Community currencies have nevertheless been considerable, amounting to over 20 000 million dollars or some 55% of total interventions in Community currencies since the inception of the system.* [1] *No intra-marginal intervention sales in EMS currencies were covered by very short-term financing through the EMCF.*

The Alternates have confined their examination to the general orientations which might govern the possible extension of the VSTF to intra-marginal interventions; it would be the task of central bank experts to eventually define the technical details of its implementation.

6. It is the general view that, if access to the VSTF for intra-marginal interventions were to be made automatic or semi-automatic as discussed below, such access could be made subject to a trigger related to the situation on the exchange markets (a présomption de déclenchement*). Without fixing rigid rules, there should be a presumption that the financing of intra-marginal interventions through the VSTF would be justified, for example, when a given bilateral spread (say 2%) is reached or when the divergence threshold is crossed.*

7. The Alternates felt that the extension of very short-term financing to intra-marginal interventions should in any event, if they were to be automatic, be circumscribed by imposing a ceiling for each participating currency. It would be necessary to fix rules determining the amount of this ceiling (e.g. related to quotas in the short-term monetary support mechanism), on how it would apply to debtor and creditor central banks, on how a ceiling would be reopened, etc. Within such a ceiling, cover of intra-marginal interventions by means of the VSTF could be either completely automatic or semi-automatic, in the sense that the central bank issuing the currency of intervention could object only in the case of special and concrete circumstances (such as conditions on the exchange markets or on domestic monetary markets) which it would be required to illustrate to the other authorities in the framework of concertation or in the appropriate Community bodies. The making available of amounts in excess of the ceiling to finance intra-marginal intervention would continue to be a matter for concertation between central banks on an ad hoc *basis.*

8. Apart from fixing a ceiling, one could envisage altering the other elements of the VSTF (duration, interest rate, means of settlement, etc.) when extending the facility to intra-marginal interventions. This would, however, be tantamount to creating a new facility and could not be described as an 'extension' of the existing VSTF.

9. In this context the question arises whether the conditions under which intra-marginal interventions can take place should be altered. The Alternates agree that it is of fundamental importance for the proper functioning of the exchange rate mechanism that intra-marginal interventions should continue to be the subject of close concertation among central banks. This being said, it has been suggested that central banks should be given more leeway in their on-the-spot decisions for interventions in participating currencies, by making available a limited amount of individual Community currencies for intra-marginal interventions. This amount could be used automatically, in case of emergencies, on the intervening central bank's own initiative and on the understanding that the issuing central bank and the other central banks should be informed without delay. This proposal relates to the availability of currencies for interventions and does not touch upon the question of financing.

10. Some Alternates consider that if automatic facilities for limited amounts were accepted, the central bank whose currency was being used might be expected to discourage intra-marginal interventions beyond those limits; thus the present flexibility would be reduced rather than increased. These Alternates are furthermore of the opinion that the use of the

[1] The significance of this figure should, however, be qualified: it includes repurchases of the currency previously sold as well as the sale of proceeds of official borrowing.

VSTF for intra-marginal interventions is justifiable only if there is a sufficient probability that these interventions will reduce the total of interventions otherwise needed. Thus, the presumption should not relate to a currency becoming divergent but rather to the causes of the imbalance and the measures being taken to remedy it.

In the view of the other Alternates however, the application of such principles would not represent a significant departure from present practices.

III. How can the option open to non-Community institutions to hold ECUs be organized?

11. The Alternates examined the above question in relation to the external use of ECUs issued by the EMCF, i.e. not in relation to ECU-denominated paper which might be issued by other Community entities or by private financial institutions. The possible interest of third parties in holding ECUs has also not been examined.

12. A general principle governing the external role of the ECU should be that third holders of ECUs should be subject to substantially the same rights and obligations concerning the ECU (use, remuneration, etc.) as those of participant central banks: the single nature of the ECU should not be compromised in extending its role beyond the Community. The conditions for acquiring ECUs will accordingly also have to reflect the ECU's present precarious existence.

13. A first possibility would be to permit designated third holders to freely acquire existing ECU assets from EMS members.[1] *For example, a member central bank could swap ECUs for dollars with a third country central bank in order to mobilize its ECU holdings. This swap could not be allowed to overlap the underlying swap of the member central bank with the EMCF. Such transactions would not imply an increase in the total volume of ECUs in circulation; there would merely be a transfer, in the EMCF's books, of ECUs held by members to official third holders. Such a transfer could also take the form of a sale rather than a swap, provided a prior 'third holder arrangement' had been concluded between the EMCF and the third party concerned, setting out in detail the terms and conditions for acquiring, mobilizing and restituting ECU assets. The third holder would in particular be required to surrender its ECU assets, if necessary, to allow EEC members to settle their obligations at the swap renewals and in the event of a definitive unwinding of the swap mechanisms.*

14. A second possibility would be for the EMCF to issue ECUs to third countries against the contribution of reserve assets, as it does with member central banks. The present legal texts empower the EMCF to issue ECUs against the transfer of reserves by the monetary authorities of the Member States alone. To authorize it to issue newly-created ECUs against the contribution of reserve assets by non-Community institutions would therefore require a modification of the relevant Regulation (EEC No 3181/78). Unlike the first case, new ECUs would be created by this operation and third countries would furthermore be given the possibility of mobilizing part of their gold holdings through the Fund, thereby increasing mobilizable international liquidity.

This formula would seem particularly, if not exclusively, suitable for those European countries with particularly close economic and financial ties with the Community wishing to be associated to the EMS exchange rate and intervention mechanism. The association agreement would have to set out the conditions for acquiring and using ECUs on terms analogous to those applied to member central banks. It is doubtful that such an extension of the ECU would appeal to third countries unless the ECU were established as a full means of settlement within the system.

15. In a broader perspective, an external role for the ECU could be envisaged as a reflection of a demand for reserve diversification by non-Community institutions. A possibility of this kind is examined in more detail in the note by the Commission departments on the external role of the ECU,[2] *already discussed in depth by the Alternates. In the majority view of the Alternates, such a development would presuppose* inter alia, *that the ECU were already a fully-fledged means of settlement and reserve asset for EMS participants, that it had a less precarious existence than that deriving from the present revolving swap mechanisms, and that the EMCF were transformed into an institution able to support an exchange rate risk and to offer real possibilities of substitution. The contrary view is that one could envisage a 'substitution account' without institutional convertibility: its attractiveness would obviously be reduced, but the conversion of ECUs into third currencies could be ensured at a market rate, in the framework of a negotiability formula between member central banks and third holders. There is therefore scope for a non-institutional development in this regard and, according to this view, the matter deserves to be studied further.*

[1] Allowing third parties to acquire ECUs in this way would entail a modification of the composition of their reserves as well as of those of the member central banks concerned. This would run counter to the limitation of Article 18(4) of the 13 March 1979 Agreement which rules out operations having the sole purpose of altering the composition of a central bank's reserves. The question of lifting this limitation for third holders or of abolishing it altogether would need to be further examined.

[2] See Annex I-5: Preparatory studies on the European Monetary Fund — External role of the ECU.

IV. How would the problems of legal tender arise in relation to the free circulation of an ECU coin minted according to national procedures?

16. The Alternates examined this question in full awareness of the limits of their competence as regards the legal implications of such a step and the more technical aspects of the mint. These aspects, whose importance and potential difficulties should not be underestimated, would have to be studied by the competent experts at the appropriate time.

17. From a legal point of view, it appears that adaptation of national legislation concerning the minting and circulation of coins will be required in most or all countries, whether the ECU coin is granted full legal tender (i.e. compulsory acceptability by all economic agents within a certain amount, as with national coins) or whether it enjoys voluntary acceptability between agents. The question of the issuing authorities' commitment to repurchase the coins at a given rate would arise in both cases.

18. As to the amount of the issue, the Alternates suggested that a global ceiling should be fixed for the Community as a whole, with quotas per member country based on some appropriate key (weight in the ECU, quota in the STMS, etc.). If the amount were a modest proportion of total coin circulation, it would be of negligible size vis-à-vis *the Community money supply and as such would not raise significant problems with respect to the likelihood of additional intra-Community capital flows.*

19. Doubts were raised as to whether the coin would effectively remain in circulation, given also past experience with certain national coinages issued in small amounts. Doubts were also expressed as to whether the coin would be used in transactions. The rules governing its conversion rate into national currencies would be an important element in determining its effective circulation. A first possibility would be for the ECU coin's value to be set at the level of the participating currencies' central rates, rounded off to an appropriate figure. This would confer a certain stability to its value between two realignments, but would raise a number of difficulties: the central rate rule could not be applied for conversion into pounds sterling or into Greek drachmas, nor into Belgian francs, given the existence of a dual exchange market; it would introduce a distinction between the ECU coin converted at the central rate and ECU-denominated deposits to which market rates are applied; it would create arbitrage possibilities, in so far as national currencies could be exchanged at their central rates through the ECU coin. It should be noted, however, that the practical significance of these difficulties would be limited by the small denomination of the coin (which should be of 1 ECU) and the modest amount of the issue in relation to total coin circulation. A second possibility would be for the ECU coin to be exchanged at market rates, though this would raise practical difficulties in transactions given the fluctuations in daily rates.

ANNEX C-3

Supplementary report on some aspects of the non-institutional development of the European Monetary System presented on 26 February 1982 by the Alternates of the Monetary Committee

At the Monetary Committee meeting of 11 February 1982, the Alternates were invited to examine the following question:

'In the context of the abolition of the ECU's acceptance limit, what technical arrangements could ensure that holders of ECU net credit positions could mobilize such positions against other assets?'

The Alternates met on 23 February 1982 and herewith submit their report to the Committee. As in their previous report, the Alternates refrained from discussing the desirability of amending the existing provisions of the system and confined their examination to technical aspects in the context of a non-institutional development of the EMS.

The first section of this report recalls the existing provisions for mobilizing ECUs and their limitations. The second and third sections discuss possible new schemes for ensuring such mobilization. The last section offers some concluding comments regarding, inter alia, *the difference between such schemes and full institutional convertibility.*[1]

I. Preliminary remarks

1. According to the existing provisions of the Agreement of 13 March 1979, a central bank may acquire dollars against ECUs either from the EMCF, by unwinding a swap transaction, or from another central bank. In the first case, mobilization can in practice only be used in the case af a fall in dollar reserves; it does not apply to the mobilization of ECU net credit positions. In the second case, the transaction is subject to mutual agreement. In both cases, mobilization is at present restricted by Article 18(4)of the Agreement stating that the operations referred to above 'shall not be carried out for the sole purpose of altering the composition of a central bank's reserves'.

2. Although mobilization could conceivably be allowed more freely by removing this provision, it would not ensure that holders of ECU net credit positions could at any time mobilize such positions. Therefore, two types of schemes are examined below, which could be devised to offer this possibility, subject to amendments in the present arrangements.

Under both schemes, the right to mobilize an ECU net credit position might either be unconditional, or be subject to some requirement of need, or be restricted to net credit positions exceeding a specified threshold. Any limitation on ECU mobilization would lessen liquidity problems for the system but would on the other hand restrict the degree of effective convertibility of net credit positions.

[1] The convertibility issue was discussed by the Alternates in the context of the institutional phase of the system when assisting the Commission in its studies for the European Monetary Fund (see Annex I-5).

II. Mobilization through the EMCF

3. The technical considerations concerning a scheme by which ECU mobilization is assured by the EMCF are mainly circumscribed by the swap system through which reserve assets are transferred.

4. ECUs are created against both gold and dollars but mobilization would presumably only be against dollars. Depending therefore on the stringency of the conditions under which mobilization is possible and/or on the possible ability of the Fund to acquire currencies from outside the system, there could be a liquidity problem if large net credit positions arose and the central banks concerned sought to mobilize them, especially as the majority of ECUs are created against gold.

5. The swap method of transfer limits the way in which dollars can be made available through the EMCF and mobilization could only be accomplished through a swap in the other direction between the Fund and the central bank concerned, thereby temporarily destroying ECUs. Such a swap would initially have to match the duration of the swap in force and would from then on be open for renewal on a quarterly basis under the same conditions as the original mobilization.

6. The EMCF under existing arrangements returns the management of transferred assets to the participating central banks. These dollars are invested in various maturities according to the central bank's preferences, and the remuneration is retained by them. It would therefore be necessary to specify criteria under which the dollar assets to be used for mobilization would be selected, and provide compensation for the loss of remuneration, including the possible costs of unwinding investments before maturity. These costs would have to be charged to the central bank mobilizing ECUs.

III. Mobilization with the other participants in the system

7. This scheme provides for mobilization with the other participants according to a designation plan. It would allow the ECU to be mobilized not only into dollars but also into SDRs. Mobilization in Community currencies could also be envisaged but this possibility should be assessed in the context of enhancing the scope for intra-marginal intervention or for reimbursement before maturity of ECU debts in the VSTF.

8. The scheme raises the following issues:

(a) criteria for the designation of the potential ECU recipients. Possible criteria are the following:

(i) the balance of payments and the foreign reserves situation;

(ii) the composition of reserves;

(iii) the credit or debit position in ECUs in the VSTF;

(iv) some quota system such as that in the STMS;

(b) the mobilization technique: the actual mobilization could either take the form of a swap transaction or of a straight transfer;

(c) constraints on the operation of the scheme: a major constraint would arise when all or most participants were simultaneously in a deficit position with the rest of the world. A possible solution to this problem might be found by the EMCF borrowing currencies outside the Community under conditions consistent with its present status, e.g. borrowing with the BIS.

9. It was observed that, given its basic regional character, this scheme differs from the SDR designation system: first of all the present method of ECU creation implies that the ECU system is not a zero-sum mechanism, as is the SDR scheme. Moreover, the EMCF—unlike the IMF with the SDRs—cannot become a holder of net creditor positions in ECUs.

10. The view was expressed that, irrespective of the maintenance or abolition of the 50% rule, a designation scheme would imply another acceptance limit beyond which a central bank would not be obliged to accumulate ECUs by virtue of designation.

IV. Concluding remarks

11. The Alternates examined the extent to which the above formulae differ from a technical point of view from full institutional convertibility for net ECU credit positions. In the first place, unless there were recourse to assets from outside the system, the potential of mobilization would be limited, according to the formulae, either by the size of the Fund's dollar holdings or by the volume of assets which could be activated under a designation scheme. Secondly, the formula of mobilization with the EMCF would satisfy short-term liquidity needs, but would still leave the central bank with a net forward ECU position. Thirdly, mobilization with other participants through a designation scheme would, if done by transfer, have the same immediate result for the mobilizing central bank as institutional convertibility. However, the central bank concerned might at a later stage find itself subject to obligations under the designation scheme. Furthermore, given the limited number of participants, the operation of such a scheme could be constrained if all members were in balance-of-payments deficit. For designated central banks with ECU net debtor positions it would be tantamount to a reconstitution obligation.

12. In conclusion, none of the above formulae would seem to pose insurmountable technical difficulties. They are, from this point of view, feasible. They would, however, require rather elaborate rules and procedures, which could give the impression that there is some unwillingness to keep or acquire ECUs and might do a disservice to a system which should remain largely based on mutual cooperation and flexibility. Against this, the schemes described could go some way to increase possibilities for central banks accumulating large ECU net creditor positions to mobilize these positions.

Commission communication to the Economic and Financial Affairs Council of 15 March 1982 on the development of the European Monetary System

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.

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 operation have 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 price 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, since monetary stability, more certain prospects and increased employment are closely linked. The proposals respect the existing institutional framework and form a balanced whole, both from the viewpoint 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 committees, 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 ECUs and the organization of arrangements for mobilizing it.

The creation of ECUs against transfers of reserves has in fact been disorderly and potentially inflationary: as a result of the quarterly swaps, the 27 000 million ECU created in March 1979 became almost 50 000 million in April 1981; the figure has now fallen to 42 000 million. Although these variations are primarily linked to the variations in the price of gold, the volume of ECUs 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. The Commission proposes that ECU creation should be brought under control 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 outstanding amount of ECUs issued.

Another less satisfactory possibility would be to dampen the effects of erratic gold price movements on the quantity of ECUs by lengthening 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 used 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 ECUs. In return, the creditor should receive a higher remuneration on his net ECU position (the rate of interest would 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 define 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. Further, they should set an example by developing the use of the ECU in their borrowing and lending operations to the full extent compatible with the ECU's proper establishment on the financial markets. Greater use of the ECU by issues which each represent another facet of the Community's institutional edifice 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). In the Community countries the ECU should be given the status of a foreign currency and even 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.

All dimensions of economic policy should be reconsidered from the viewpoint 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 be taken at Community level and be implemented rapidly. The main objective would 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 effectiveness of the monitoring of Member States' economic policies. Their results and methods will be assessed by reference to a set of comparative indicators and to objectives laid down by common agreement. Once they started to diverge significantly, the Commission would have to 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 US 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 at the request of one of the parties 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.

(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 the 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.

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 ECUs would extend the system's zone of stability and increase the possibilities for using and mobilizing ECUs.

Central banks of countries which seek to have special economic and financial ties with the European Communities should be authorized to acquire existing ECUs freely from the participating central banks, and the EMCF should be empowered to create ECUs 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 ECUs.

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 1978 the Council decisions or guidelines could be the subject of a resolution. A draft resolution based on the suggestions of this communication is attached. [1]

[1] The draft resolution can be found in Chapter VI.

ANNEX E

Statement by the Chairman of the Monetary Committee on the non-institutional development of the EMS to the Council (Economic and Financial Affairs) of 15 March 1972

Following the request of the Council of 15 February 1982, the Monetary Committee continued its work on the non-institutional development of the European Monetary System. Its work centred on the four areas indicated by the Council, i.e. the mechanisms of the system, the private use of the ECU, the strengthening of convergence and the system's external relations.

The Committee concentrated in the first instance on the technical aspects of the system, in the expectation that if agreement could be reached on these, agreement might well be attainable on the other points also. It therefore attempted to assemble the elements of a package on the technical aspects to see whether these could command general acceptance. The proposals discussed in detail in the Committee were as follows:

(i) *raising the acceptance limit to a figure between 60 and 70% and improving ECU remuneration by relating it to market interest rates for future debtor positions;*

(ii) *supplementing the current possibilities for intra-marginal interventions in Community currencies by means of a presumption that such interventions would be generally justified, and access to the very short-term facility possible, when a given bilateral spread were reached or when the divergence threshold were crossed, while maintaining—under certain conditions—a right of veto for the creditor central bank;*

(iii) *lengthening the reference period for gold valuation from the present six months to one year, in order to dampen the effects of an unstable gold price on ECU supply. Changes in the gold price have been the main cause of the marked growth and fluctuations in ECU volume;*

(iv) *giving the system an external dimension by allowing central banks of European countries with particularly close economic and financial ties with the European Community to obtain ECUs by acquiring them from participant central banks.*

It was recognized that any set of proposals would have to strike a balance between the interests of potential creditor and debtor countries in the system. However, no general agreement proved possible on this group of proposals as a result of the Committee's discussion.

Moving to another area indicated by the Council, that of the private use of the ECU, the Committee agreed that an exemplary use of the ECU in the borrowing and lending activities of the Community institutions should continue and be expanded as far as market conditions permit. ECU-denominated issues by Community institutions should consequently be exempt from exchange controls where these exist. The Committee also supported the general direction of the other proposals regarding the private use of the ECU, but noted that these are largely a matter for the private sector itself and that the ECU has already come to be used substantially in the private sector without the need for official intervention. The Committee has furthermore not examined the technical and legal questions which might arise from the implementation of the various proposals on the private use of the ECU.

As regards the strengthening of convergence, I already stressed at the last Council meeting the top priority which the Committee considers should be given to achieving progress in this area, both in terms of economic policies and performances and of rectifying existing imbalances between member countries. The Committee therefore welcomes the Commission's intention to make full use of the existing consultation and recommendation procedures. Although the Committee has not addressed itself in full on the subject of convergence since the Council's last meeting, it has placed the issue at the centre of its work programme. It has agreed, for example, to regularly prepare and update a dossier on the 'fundamentals' of our economies, which would allow a better appraisal of the conduct of economic policies and performances and also be useful for realignment discussions. I already stressed the importance of a greater freedom of capital movements in my statement to the last Council meeting: in this regard the Committee will explore the scope for action, keeping in mind the interrelation between the advancement of convergence and the liberalization of capital movements.

As regards the final chapter indicated by the Council, that of the system's external relations, I have already mentioned one technical aspect, i.e. that of allowing central banks of certain European countries to acquire ECUs from participants. On the more general point of the system's relations with the dollar and other major currencies, the Committee—while acknowledging that our own policies have an important part to play in these relations—considers that it is also necessary to convince the US authorities to pursue policies which take full account of the importance of the US economy and of the dollar at world level. The Monetary Committee has on several occasions formulated a Community position on these issues and keeps the matter under constant review. During its meeting of 5 March, for example, members agreed to pass on to their national authorities a note by the Commission departments, prepared in response to a ministerial request, on the international implications of US fiscal and monetary policies.

ANNEX F — Statement and letter from the Committee of Governors on the future of the EMS

ANNEX F-1

Oral statement from the Committee of Governors of the central banks of the Member States of the European Economic Community to the Council (Economic and Financial Affairs) of 15 March 1982 on the future of the EMS

1. Following the meeting on 15 February 1982 of the Council of the European Communities (Economic and Financial Affairs) the Committee of Governors has continued its studies on the future development of the EMS and has examined in particular the four areas which have been enumerated in the conclusions of that Council session, i.e.

(i) the mechanisms of the system,

(ii) opening the system to the outside world,

(iii) private use of the ECU,

(iv) strengthening convergence.

The Committee of Governors wishes to reiterate that the system so far has worked well; it must nevertheless be recognized that this was partly due to the realistic central rates selected at the start of the system and to the weakness of the German mark over prolonged periods. More generally, the good functioning owed much to the high degree of cooperation between central banks in managing the system. The lack of convergence of economic policies and of fundamental economic variables in participating countries means, however, that, at present, conditions are not appropriate for major institutional changes in the EMS.

2. Accordingly, the strengthening of convergence is a prerequisite for any significant future development of the EMS. Such strengthening of convergence should apply to all economic policy areas (in particular budgetary policy) and be achieved by implementing coordinated domestic and Community policies designed to rectify existing imbalances within and between EEC countries. The ultimate success of these policies will, however, depend more on the determination of national authorities to ensure the attainment of economic objectives than on consultation procedure.

The EMS itself can assist this process because, notably, the exchange rate constraints which it imposes have doubtless influenced participant countries' monetary and other policies in the direction of greater discipline. But that is not enough. If divergences in other areas are building up, then monetary policies in individual countries ultimately cannot withstand the pressure. Nor can exchange rate realignments be counted upon to relieve the strains: if they are too frequent or too large they detract from the system's credibility and risk further accentuating diverging developments.

In these circumstances, technical improvements to particular elements of the system cannot be regarded as a viable alternative to closer convergence of economic policies. Progress in this area is of crucial importance for the continued existence of the EMS.

Concerning monetary policies, the Committee of Governors will continue to monitor developments in the Member States of the EEC, as well as their compatibility with one another and with the objectives of achieving greater domestic and external stability. To this end, the Committee of Governors evaluates regularly the adaptations that may be required to foster the cohesion of monetary and exchange rate developments within the Community. In particular, the Governors are analysing the recent growth in borrowing abroad by EEC members and its implications for the pursuit of monetary policy.

3. The Governors have carefully examined a number of possible adaptations to the mechanisms of the EMS, which fall within their sphere of competence. These adjustments relate to: (i) intervention and financing within the system, and (ii) creation and acceptability of ECUs.

The Governors, however, did not reach a consensus on the introduction of amendments to existing arrangements and agreements at the present time. They wish to point out that their in-depth review of the operation of the EMS in its first three years has led to the conclusion that the system is functioning satisfactorily from a technical point of view.

The Committee of Governors will continue to monitor closely the performance of the EMS and stand ready to introduce those adaptations to its mechanisms that might become appropriate as circumstances develop.

4. With regard to the relations of the EMS with the outside world, the Committee of Governors focused its attention on the desirability of obtaining a higher degree of exchange rate stability, in particular between the EMS and the US dollar. However, this cannot be achieved merely through exchange market intervention. Rather, the solution of present problems requires increased coordination of economic policies within the Community and also between EEC countries and the United States of America. It should be recalled in this respect that EEC central banks already have adequate opportunity for constant communication with their American colleagues both through the concertation procedure and through their monthly meetings.

The extension of the use of ECUs issued by the EMCF outside the circle of EMS member central banks is difficult to envisage, given the precarious nature of the ECU and the fact that its convertibility into third currencies has not been defined. This does not exclude the possibility of central banks of 'European countries with particularly close economic and financial ties with the European Communities' obtaining ECUs by acquiring them from an EMS central bank. The legal implications of this change, however, would have to be examined.

5. EEC central banks do not have objections to the development of the use of ECUs in private markets, and, indeed, progress in this field is taking place in several countries. Care must, however, be taken to prevent developments which would interfere with the proper conduct of domestic monetary policies.

The Governors specifically wish to draw attention to the following issues:

(i) There is a danger that, if Community institutions were forced to borrow in ECUs beyond the possibilities offered by the developing ECU market, these institutions might suffer a financial burden.

(ii) Although there would be advantages in exempting ECU-denominated loans from restrictions on capital movements, this step would create segmentation within the national capital market as long as these restrictions persisted; efforts must therefore be made to facilitate the issue of ECU loans through a progressive removal of capital controls.

(iii) By permitting the opening of ECU-denominated bank accounts by residents there is the danger of circumventing exchange control measures where they are still in force. Difficulties for monetary control would also arise.

The nature of these problems and their implications for legal and structural conditions in individual EEC countries, in the Governors' view, mean that appropriate measures fall to be taken by individual countries.

ANNEX F-2

Letter of 29 April 1982 from the Chairman of the Committee of Governors of the central banks of the Member States of the European Economic Community to the President of the Council of the European Communities

Dear Mr President,

I refer to my letter of 30 March in which I confirmed that, in response to the Economic and Financial Affairs Council's request, the Committee of EEC Governors would undertake discussions in April about the European Monetary System.

At its meeting of 20 April 1982 the Committee of Governors re-examined the question, with particular regard to the four areas specified in the conclusions to the February 1982 meeting of the Economic and Financial Affairs Council. During their discussion, the Governors confirmed the position taken in the attached note verbale [1] *that I presented to the Economic and Financial Affairs Council in March 1982. Furthermore, developments, and in particular the tensions, of the past weeks only underline further the need to give priority to strengthening the convergence of national economic policies and to coordinating these policies with Community policies. Indeed, action to improve convergence appears necessary to preserve the very viability of the European Monetary System.*

Yours sincerely.

[1] See Annex F-1.

Oral statement of the Chairman of the Monetary Committee on the development of the EMS to the informal meeting of Economic and Finance Ministers on 17 May 1982

1. On 21 April and 5 May 1982, pursuant to the Council's request, the Monetary Committee again examined the Commission's proposal for a draft Council resolution on the development of the European Monetary System. [1]

2. With regard to the propositions covering the technical aspects of the system (i.e. ECU creation, acceptance and remuneration, intra-marginal interventions and the external role of the ECU), the Committee continues to find that no general agreement proves possible at present, either on the proposals as they stand in the draft resolution or on an alternative group of proposals as set out, for example, in my previous statement to the Council of 15 March 1982. You will recall that the Committee had attempted to assemble the elements of a package on the technical aspects of the system to see whether these could command general acceptance, in the expectation that if agreement could be reached on these, agreement might well be attainable on the other points of the draft resolution as well. That had not been the case at the time, and today I cannot but confirm that outcome. The Committee felt that under these circumstances a continuation of the discussion would not alter the situation.

3. As to the other group of proposals, covering the private use of the ECU, the measures to enhance convergence, and the external aspects of the system, the Committee's Alternates have examined their technical implications and, although they found that technical problems persist in some cases, the Committee's view is that the general direction of several of the proposals should be supported and encouraged. The Committee expressed, for example, its support for the promotion of the private use of the ECU. This is an area where developments are largely spontaneous and can proceed at a pace of their own: thus, for example, the ECU is already treated as a foreign currency in the majority of Member States. The Committee also agreed that the use of the ECU for the borrowing and lending activities of the Community institutions should be expanded as far as market conditions permit. As regards external relations, the Committee has often contributed to a common Community position, for example in the field of exchange rate and interest rate developments, where it insists on the need to persevere in our efforts to persuade the US authorities to pursue policies which take full account of their responsibilities to the world economy.

4. There was general agreement within the Committee that the top priority area for our future efforts must be the strengthening of convergence, both in terms of economic policies and performances and of reducing existing imbalances between member countries. It is clear that the system's prospects hinge crucially on our ability to make progress in this area, and that there is thus a parallelism between an improvement in convergence and the system's development. The EMS has in fact already become an increasingly important part of our economic policy framework. In its three years of existence, the coordination and consultation process at Community level has been intensified; at national level, the system has promoted the adoption of stability-oriented policies in a number of member countries, and notably in those where they were most needed. But disappointing results in the fundamental areas of domestic cost and price trends and of public finances, underlying the recent tensions within the system, indicate the urgent need for a renewed and incisive effort. It is along this road, in the daily implementation of our economic policies and in our capacity to direct them towards stability, that the system can continue to give its support and must progress further. Such progress is not a question of new procedures, but of resolute and forceful cooperation at all levels, and especially in the bodies where views may be exchanged most frankly and confidentially. It is the firm intention of members to actively use the forum provided by the Monetary Committee to this end, and to keep matters having a bearing on convergence at the centre of our work programme.

5. In conclusion, therefore, although the proposals contained in the draft resolution do not appear to be acceptable in their totality at the present stage, notably for the absence of agreement on a technical package which is at the same time significant and balanced, there are possibilities and scope for pragmatic progress on a number of issues, and most notably that of convergence. It is my intention that the Monetary Committee play its full part in contributing to such progress.

[1] See Chapter VI.

Report from the Commission (of 20 March 1980) to the European Council on the European Monetary Fund [1].

I. At the Dublin meeting on 29 and 30 November 1979, the European Council invited the Commission to submit, for the meeting in March 1980, a report setting out the progress made in studying the establishment of the European Monetary Fund and pointing out any difficulties.

The studies on the European Monetary Fund were started by the Commission as early as May 1979. Since then, the Monetary Committee and the Committee of Governors have looked into this question, and their respective chairmen have reported to the Council on the progress of work. This work has not yet been completed; rather than producing specific guidelines, it has so far made it possible to identify problems and possible choices between solutions. However, as can be seen from the analysis below, the preliminary technical work has shown that, if it is to make a real extra contribution, the transition to the institutional stage of the European Monetary System can be carried out only if certain basic questions have been resolved which have not yet been fully clarified.

II. Current work is based on three main elements:

A. The first is the desire expressed by the European Council in Bremen and Brussels, to transform the European Monetary System into a 'durable scheme' guaranteeing the creation of a zone of monetary stability in Europe. For the purpose of attaining this objective, the European Council defined the operating rules of the system in the first stage and indicated certain characteristics of the 'final stage'.

B. The second is the lessons to be learnt from the first year of operation of the European Monetary System and from monetary and exchange-rate developments in the Community since 13 March 1979.

The assessment of the operation of the European Monetary System in its first year is largely positive. The procedures for consultation between the authorities of the Member States in the various Community bodies have been improved. Despite sharp economic and monetary disturbances which entailed interest rate increases ranging from 3 to 5 points according to the country, the group of participating currencies maintained a greater degree of cohesion than that recorded since 1972. Two adjustments of central rates in September and November 1979 were carried out in good time and fairly smoothly. Lastly, the monetary compensatory amounts were reduced appreciably, reflecting progress towards the objective of uniform prices on the European agricultural market.

In stressing the positive factors, the Commission is expressing its conviction that it would have been much more difficult to achieve these results if there had been no European Monetary System. However, between the end of 1978 and the end of 1979, the average rate of inflation in the Community rose from 6,9% to 9,0%, and the spread between the lowest and the highest rate of inflation in the Member States widened from 10 to 17 points. Although progress has thus been made towards exchange-rate stability, the same has not been the case in the field of prices. Consequently, the European Monetary System must be consolidated and strengthened so as to make its own active contribution to better economic equilibrium in Europe. Economic policies for their part will have to be brought to converge more closely to ensure the stability of the monetary system.

C. The third element is the developments in the international economic, financial and monetary situation. In 1978, the serious disruption of exchange rates, payments balances, prices and financial markets caused by the 1971-74 monetary and energy crises, seemed to be about to ease. Today, the threat of renewed disequilibria in international payments relations is growing.

The future development of the European Monetary System must therefore be such as to contribute actively to the overall stability of the international financial and monetary system and to meet the Community's general interests in the trade and financial fields—both its own interests and those of the countries with which it has particularly close relations.

III. The Commission and the committees concerned have primarily concentrated on the role of the ECU and on the organization of the credit mechanisms in the European Monetary Fund. They have examined the institutional aspects, which will be largely governed by the solutions adopted to the questions of substance discussed above.

1. The credit mechanisms

Two features of the credits granted under present agreements should be noted: to a large extent they are bilateral credits, the accounting procedures for which are handled by a Community body, the EMCF; and since the body which issued the ECUs—the EMCF—is only an accounting intermediary in the credit operations, these do not give rise to the direct creation of ECUs.

Two problems have been studied in particular: first, the consolidation of existing credits (short-term and medium-term) and of very short-term credit facilities. It became clear that, whatever solution is adopted, this is not a fundamental problem in the transition to the institutional stage of the European Monetary Fund.

Second, the EMF's ability to create ECUs against credits, which is a crucial issue. This ability raises the problem of the limits and conditions under which these ECUs could be created

[1] Previously published in *European Economy* Number 7, November 1980: Chapter 6 of the Annual Economic Review 1980-81.

or the credits could be granted, and therefore that of the means which would be available to the European Monetary Fund to impose tighter monetary discipline in the Community. The solutions to this problem will depend to a large extent on the role of the ECU in the institutional stage of the European Monetary System.

2. The ECU

(a) *In the present system, the ECU serves as the* numéraire *for the exchange-rate mechanism, as the basis for the divergence indicator, as the denominator for intervention operations and as a means of settlement between the Community's monetary authorities.*

However, the ECU lacks the principal features of a currency: it is not an instrument of payment; there can be no autonomous creation of ECUs through the credit operations; and though it appears in the central bank's balance-sheets, this does not mean that it is a genuine reserve instrument, since it is merely the expression in the accounts of the assets (dollars and gold) against which it has been issued and whose movements it reflects automatically.

(b) *The decisions taken at Bremen and Brussels, certain fundamental considerations and recent monetary trends together mean that the development of the ECU will be the locomotive for transition to the institutional stage of the European Monetary System: it is by expanding the role of the ECU that the Community will be able to organize internally the coordinated action necessary to achieve a greater degree of monetary stability and establish its monetary identity at international level.*

(c) *The full and complete use of the ECU as a means of payment and the regulation of the creation of ECUs to serve the objective of monetary stability raise the question whether, to what extent and under what conditions the future Monetary Fund could possess an independent power of money creation.*

If it were given such power, the future European Monetary Fund could create ECUs in two ways: against a contribution of reserves (as is done under the present agreements), or through credit operations; these two methods could even be combined.

The full use of the ECU as a means of payment or reserve instrument within the Community would require that several conditions be met:

(i) *certain legislative measures would have to be taken to abolish the limits to the acceptability of ECUs to the central banks, to provide that a certain percentage of reserves must be held in the form of ECUs, and possibly to impose the exclusive use of the ECU as an instrument of settlement between the Community's central banks;*

(ii) *if the limits to the acceptability of the ECU were abolished, the ECUs inherent characteristics (convertibility and yield) would have to be strengthened to make it as attractive as the other possible reserve instruments;*

(d) *Apart from the role to be performed by the ECU in the areas described above, a second major decision of principle will have to be taken; this concerns the wider use of the ECU outside the system of Community central banks, both on the private financial markets and by the authorities of non-Community countries, so as to ensure the full negotiability of the ECU and to enhance its status as a reserve asset. In this context, the question arises as to whether the strengthening of the role of the ECU might allow it to play a part in recycling the surpluses of the oil-producing countries.*

IV. Once the European Monetary System enters into its institutional stage, consistency between domestic monetary policies, credit mechanisms and exchange-rate agreements will have to be ensured within a single system of procedures, so as to provide a full and proper basis for the smooth operation of the system and the achievement of monetary stability.

This raises the questions firstly, of the institutional powers with which the Fund will be endowed in order to administer the system itself and, secondly, of the back-up measures which will have to be taken so as to ensure the smooth working of the system, including measures such as the coordination of exchange-rate policies vis-à-vis *non-Community currencies and the achievement of a sufficient degree of convergence in the economic and monetary policies pursued in the Member States.*

Examination of the institutional aspects has already begun. It has started from the principle that a Fund endowed with increased powers should be integrated into the institutional system of the Community and of the existing international monetary organizations on the basis of clear precise legal arrangements. Fuller examination of the institutional aspects must necessarily be carried out in parallel with the basic questions raised above; it is on the solutions arrived at with regard to these basic questions that the powers of the European Monetary Fund and the nature of the bodies running it will to a large extent depend. It will at all events be necessary to work out a balanced system of tasks, responsibilities and safeguards for the European Monetary Fund; this is essential to the exercise of any function of a monetary nature. A balanced system of this kind is, moreover, to be found in all the Member States, though the features of each system differ in accordance with national legal and institutional circumstances.

Some of the functions or tasks allotted to the European Monetary Fund once it is established will probably have to be taken up only gradually depending on how the relevant political authorities assess the way in which the situation is developing and on whether they find the mechanisms suitable.

In conclusion, the Commission proposes that the European Council request the relevant Community bodies to pursue their work along the lines set out in this report. The Commission is ready to provide the European Council with further information on the progress achieved and difficulties encountered in setting up the European Monetary Fund proposed in the texts that were released after the meetings of the European Council in July and December 1978.

ANNEX I

Preparatory studies on the European Monetary Fund

Notes prepared by Commission departments in 1980 and 1981

The papers in this annex were drafted in execution of the mandate given by the Monetary Committee on 26 February 1980 on the study of different aspects of the transition to the institutional phase of the European Monetary System. Though they have been discussed in depth by the Alternates, they remain technical notes of the Commission departments. In accordance with the Committee's request, each topic is treated in a separate paper which develops the different options which may be envisaged.

The subjects studied are the following:

(1) acceptability and convertibility/negotiability of the ECU;

(2) the liquidity of the Fund;

(3) arrangements for transferring reserves to the EMF;

(4) consolidation of Community credits in the European Monetary Fund;

(5) external role of the ECU;

(6) the EMF—institutional aspects.

ANNEX I-1

Preparatory studies on the European Monetary Fund — Acceptability and convertibility/negotiability of the ECU

Contents

I. Introduction

1. *Nature of the paper*

The purpose of this paper is to raise some questions for discussion of the development of the ECU towards its full utilization as a reserve asset and settlement instrument as outlined in the Resolution of the European Council of 5 December 1978. The approach adopted is to consider in a first section some particular characteristics of existing currencies, reserve assets and settlement instruments and to consider whether implications can be drawn for the development of the ECU. The characteristics examined are acceptability, exclusivity, convertibility and negotiability, chosen mainly because it is thought that there are limitations on the ECU in these areas in the existing phase of the EMS. These will be examined in the second section of the paper. The third section will examine possible developments for the next stage and the final section attempts to identify possible links between the choices to be made and the role of the Fund.

The findings of this paper should be regarded as tentative both because the characteristics examined are not exhaustive and also because existing currencies and reserve assets can only shed some light on what qualities should be given to the ECU, which will necessarily be a new and to some extent different type of instrument, issued by an institution, the EMF, whose role and characteristics remain to be agreed upon.

2. *Definitions*

Within a currency area transactions are normally denominated and settled in the national currency, which has the qualities of both acceptability and exclusivity. In general, the national currency is the only instrument recognized by the law; a creditor must accept it in discharge of a debt. Although two parties could in principle agree on something else, there are in many countries restrictions on residents acquiring or holding other currencies. These concepts cannot be directly applied to the ECU, but it is convenient in what follows to call the degree to which creditors are obliged to accept ECUs in settlement, the degree of acceptability; and to employ the word exclusive when a debtor must use ECUs in settlement.

Between currency areas there is a limited number of settlement instruments that are normally used. For any transaction the denomination and the means of payment are generally part of the contract, and important elements in the choice are the convertibility or negotiability of the instrument. As the meaning of the term convertibility has changed along with developments over time in the international monetary system, some definitions are necessary. Until August 1971, the US dollar, the major reserve currency, was said to be convertible because it could be officially converted through its issuing authority into gold at a known and fixed price. Although neither the dollar nor the European currencies now possess this quality,[1] *they are still said to be convertible because, for eligible transactions with other currency areas, domestic nationals may sell their own currency to purchase the necessary foreign currency on an organized market but not necessarily at a fixed price, and foreign nationals with balances in that currency may sell these balances on the same market. As these are market rather than official transactions, the currencies could be said to be negotiable rather than convertible. The ECU will not necessarily develop into either an instrument exactly like the dollar was nor with all the characteristics of existing currencies. In transposing these concepts to the ECU in what follows the word convertibility will be reserved for transactions through the Fund: and the word negotiability for transactions in ECUs between participants.*

[1] The EMS to some extent restores the previous situation for transactions between the participating currencies for which price fluctuations are limited to a narrow band.

II. The present situation

1. *Acceptability/exclusivity*

In the present transitional phase, as well as being used by agreement between participants, the use of the ECU as a denominator for claims and liabilities and its use as a settlement and reserve instrument is prescribed in specific instances. Each central bank must transfer at least 20% of its gold and dollar holdings to the Fund. Against these transfers it receives ECUs which can be used as follows. When an intervention is made at the margin, the debtor may choose whether or not to activate the very short-time financing (VSTF). If he chooses to do so, the debt is denominated in ECUs but settlement may be made at any time before the financing operation falls due in the currency of the creditor. If there is no advance repayment the creditor is not obliged to accept settlement by means of ECUs of an amount more than 50% of the claim. In cases where the financing mechanism is not activated, the transaction is not denominated in ECUs but the two banks can agree that all or some part of the settlement should be made in ECUs. When intra-marginal intervention takes place, the debtor has no right to the VSTF, but it may be granted with the agreement of the creditor in which case the above settlement rules would again apply. These types of transactions give rise to net ECU positions, the interest on which is fully settled in ECUs. The settlement arrangements using ECUs do not therefore involve absolute exclusivity since the provisions are without prejudice to other mutually agreed forms of settlement; and as indicated above acceptability is limited to 50% of a claim at the end of the financing period of the VSTF.

2. *Convertibility or negotiability*

The present arrangements for the transitional period exclude the possibility of ECU convertibility by the Fund into other reserve assets, except to the extent that swaps may be unwound. The initial allocation of ECU is made against three-month swaps of gold and reserves. This system, together with the arrangement that the management of the assets is entrusted to the contributing central banks, does not allow the Fund any discretionary powers or control over the reserve assets. Moreover, since participants may reobtain their assets by unwinding the swaps at two working days' notice, it is impossible for the Fund to convert any net ECU position by spot buying and selling operations.

Subject to the restriction that the transactions should not be made solely with a purpose of altering the composition of reserves, the ECU is however negotiable between central banks. This implies that when two central banks agree, ECUs can be used in spot transactions to acquire other reserve assets or Community currencies, and that these currencies and assets can be used to acquire ECUs.

III. The institutional stage of the EMS

1. *Acceptability/exclusivity*

The ECU would be given the characteristics of acceptability and exclusivity if debts and claims between the central banks had to be denominated and settled in ECUs. Denomination and settlement are closely linked. Normally a transaction will be settled in the instrument in which it is denominated, although this is not always true and is not true in the existing arrangements for the VSTF. These arrangements were, however, substantially taken over from the previous system in which it was not possible for settlement to be made in EMUAs in which the debts were denominated. In the EMS however, the ECU is to be fully used as a settlement instrument which can be taken to imply that more transactions should be denominated and settled in ECUs. It is not foreseen at this stage that the ECU itself will be used for interventions but it would still be possible for these transactions in national currencies to be denominated in ECU, as they would be if they were to pass through the Fund.

For acceptability, it is necessary to specify not only the type of obligation requiring settlement but also the extent to which a participating bank is obliged to accept ECU. In the present system, as seen above, there is a 50% lower acceptance limit on each settlement. Consideration could also be given to other percentages or the abandoning of all limits as well as to different types of limits. An example of the latter is full acceptance until a central bank holds more than a given percentage of its reserves in ECUs.

It is evident that a monetary instrument cannot usefully be given the qualities of exclusivity and acceptability if its supply is not regulated. The monopoly power of central banks is closely connected with their responsibilities for their currency. The implication for the ECU is that questions of exclusivity and acceptability cannot be determined without reference to the way in which it is created, its supply regulated and the facilities by which participants may obtain more either through credit from the Fund or through transactions with other participants. Important elements in these topics are the convertibility/negotiability of the ECU to which this note now turns.

2. *Convertibility or negotiability*

There are two basic approaches to the questions of how participants can acquire more ECUs when needed or exchange ECUs for other reserve assets when they consider that they hold too many ECUs. One is that these transactions should be made mainly through the Fund by emphasizing the convertibility of the ECU through its issuing authority. The other is that the transactions should be made mainly with other *participants, i.e. by putting the emphasison negotiability. The two approaches are, however, not mutually exclusive. The following considerations should be taken into account in considering the correct balance between the approaches.*

The negotiability approach would imply that participants would rely predominantly on each other rather than on the Fund for acquiring more ECU or for disposing of ECU in case it was thought that net balances in either direction were too large. With this approach considerations of what assets can be acquired against a positive position or used to replenish stocks of ECU and the rules and conditions under which it can be done are relatively unimportant beyond the parties concerned when transactions are voluntary. If there are two central banks willing to make the transaction there would seem to be no purpose in restricting them. The principal question to be asked about the approach is whether the 'market', which at this stage is composed only of the participating central banks, is large enough relative to the supply of ECUs to ensure that the ECU is sufficiently negotiable to be a fully usable asset. It is also worth noting that with this approach the yield characteristics of the ECU become very important because, with its value being fixed by a formula, changing its attractiveness depends upon varying the yield. It will not be used in a negotiability approach if it is either too attractive or not attractive enough as it will not be possible to find two willing sides to a transaction.

In the case that it was thought that the 'market' composed only of the participants was too restricted it would be possible to supplement negotiability with a designation scheme. In this case, when a participant required dollars, it could call on the Fund to raise them from the other members. This could be done through a designation plan. Once a key had been agreed upon, participants would be required to supply dollars. The key could either be prespecified or determined on an ad hoc *basis according to circumstances. For the former, experience with the IMF would suggest that the procedure risks being rather rigid; whereas for the latter, the Fund would have to have powers to impose its decisions on participants. This type of scheme would be available in cases where a participant could show that it had a need for dollars. In a regional scheme, it is possible that the provision of dollars under a designation plan could pose difficulties for the participants at a time when the Fund's holdings of dollars had not been tapped. In such cases, it would then be possible for the Fund to use its own resources to supply dollars on a temporary basis. In a later stage, if the international role of the ECU is developed, this possibility could be extended through operations in which non-EEC monetary authorities acquired ECUs against their own currencies or other reserve assets.*

ECU convertibility through the Fund raises two important issues: (i) into what should the ECU be convertible and with what ECUs can be acquired, and (ii) according to what rules and conditions?

(i) In the existing system each participant acquires an initial allocation of ECUs against gold and dollars through the swap operations. For the next phase it will be necessary to consider arrangements for issues against these and other reserve assets and also perhaps for allocations against national currency. The way in which any subsequent ECUs can be acquired through the Fund will be influenced by these arrangements. For example, if the original arrangements involve all banks transferring a similar proportion of their contributions in gold, so that exchange risks are equalized, any subsequent acquisitions of ECUs would require a transfer of the same proportion of gold if the exchange risk position was not to be changed. The degree to which excess balances of ECUs can be converted into reserve assets could also be influenced by the way in which the initial allocation of ECUs was created. Furthermore, convertibility into gold would be likely to raise many problems such as those regarding any conditions based on need (see below). Convertibility into dollars raises the questions of whether the Fund has enough in a sufficiently liquid form, and if not, how it can use, either through selling or by borrowing against, any other of its assets (especially gold) to supplement its dollar holdings. This is of course linked with the question of the way in which assets are transferred to the Fund.

(ii) Two types of conditions can be considered, quantitative or qualitative. With quantitative type conditions, participants would have the right to convert other reserves into ECUs when their ECU holdings fell below a certain percentage, and to convert ECUs into other reserves when their ECU holdings rose above a certain percentage. The two percentages should neither be the same nor be permanently fixed. With qualitative type conditions, participants would have the right to convert ECUs into reserve assets or vice versa when they could show that the transaction was justified by need, defined in some way. Whether the conditions are qualitative or quantitative the role of the Fund remains to be determined. For quantitative conditions if the percentages are fixed, and for qualitative conditions if the criteria are prespecified, the Fund's role is limited to that of managing its assets to ensure a satisfactory rate of return and sufficient liquidity. At the other extreme the Fund could have extensive powers over varying the percentages or over specifying conditions depending upon circumstances.

IV. Implications for the Fund

The characteristics of the ECU cannot be determined in isolation from the role that the Fund is expected to play and the whole monetary environment developed by the system. Some implications for the ECU can be drawn from the charac-

teristics of acceptability, exclusivity, convertibility and negotiability present in national currencies but these must be regarded as tentative because the ECU may at least for the foreseeable future be different in some very important ways from national currencies: it has a limited number of users who are all official authorities, as a basket of currencies its value is not directly determined by supply and demand, it is not used for interventions, etc.

Acceptability and exclusivity are complementary characteristics related to the use of a currency within its own domain. The more the ECU possesses these qualities the more it will be equivalent to a national currency, and to the extent that the Fund is endowed with discretionary powers over ECU supply, the greater will be the potential of this institution to act in a way similar to that of a national central bank. The important issue is the domain of the ECU, i.e. the range of transactions over which the ECU will be used and within this the degree of prescriptive use. This question cannot be settled without taking into consideration other important characteristics of the ECU like its valuation and yield as well as its convertibility or negotiability.

Convertibility and negotiability are to some extent alternatives and so a choice has to be made over the degree of emphasis to be given to one or the other. This choice has important implications both for the Fund and for the ECU. With a convertibility-type approach the question has to be settled as to whether the Fund has the power to set and vary the (quantitative or qualitative) rules or whether these are prespecified and fixed. In the case that they are fixed the Fund's powers are limited to surveillance and to managing its assets. The Fund's degree of control over the quantity and use of the ECU is also influenced by the extent to which participants have the right to convert ECUs. With the convertibility approach therefore any possible powers conferred to the Fund over the control of ECU supply would be limited by prefixing rules for automatic convertibility. A negotiability approach could be compatible with a swap system if the Fund could mobilize the reserves by some designation plan. To the extent that ECUs cannot be exchanged for reserve assets not restricted to regional use, it would, however, increase the importance of any powers that the Fund has to determine the quantity of ECUs in circulation.

ANNEX I-2

Preparatory studies on the European Monetary Fund — The liquidity of the Fund

Contents

Introduction

Generally speaking, a financial institution's liquidity relates to its ability to meet its liabilities on demand or at an agreed date; it is therefore dependent both on the quality of its assets and the maturity profile of its assets and liabilities alike.

In the context of the EMF, the concept of liquidity should be assessed in the light of the system's special characteristics. When used as an instrument of settlement between participants in the EMS, the ECU does not pose any direct liquidity problem for the Fund, since an ECU settlement is simply an accounting exercise, namely transfer by the Fund, in its books, of ECU liabilities vis-à-vis *one central bank to another. The operation does not in itself involve a call on the Fund's assets. However, as well as being a regional settlement instrument, the ECU is a reserve asset, and reserves are normally held as a cushion against any payment imbalances, not merely those arising out of intra-Community operations. Since the ECU is acceptable in the settlement of debt only within the EMS, any solution adopted with a view to acquiring other, more widely used assets against ECUs could confront the Fund with a liquidity problem since, in certain circumstances, it would be obliged to repurchase its liabilities against its assets. The extent of this obligation will depend largely on the choice made in the matter of the convertibility and negotiability of the ECU.*

If the ECU were convertible, and if the Fund were obliged to exchange it for other assets, a liquidity problem could arise.

If the ECU were negotiable, there could be no demand on the Fund's assets from holders of its liability and hence, strictly speaking, no liquidity problem. In this case, the question would then be whether the 'market' formed by the participating central banks (and, possibly, by associated central banks) was wide and flexible enough to ensure that the ECU was sufficiently negotiable to be a fully utilizable asset.[1] *The ECU's negotiability could be supplemented by a designation formula and by temporary mobilization with the Fund. Here too, if the Fund were obliged to lend some of its assets to members who wished to mobilize their ECU assets temporarily, a liquidity problem might arise, even though it would be temporary and less acute.*

Below we examine these two cases in turn, although obviously the convertible ECU is dealt with in more detail.

I. Liquidity and convertibility

In the case of a convertible ECU, the Fund's liquidity requirement would be determined, first, by the demand for converting ECUs into reserve assets and, second, by the Fund's ability to supply the assets required.

A. Conversion demand

The demand for conversion would depend on the following factors:

1. *Total volume of ECUs outstanding*

Since all ECUs, whether issued against reserves or against credit operations, will have the same characteristics, the maximum potential conversion demand will be well below the total volume of ECUs outstanding. It will partly depend on the distribution of surpluses and deficits within the EMS, and also on the balance of payments of the Community as a whole with the rest of the world. Potential conversion demand will therefore vary over a period with circumstances, but the Fund will naturally have to conduct its affairs in such a way as to be able easily to satisfy all potential demand.

2. *Degree of convertibility of the ECU*

The second factor affecting the Fund's liquidity is the degree of convertibility of the ECU.[2]

There are two possible alternatives:

(i) convertibility on demand or convertibility in case of need: the right to convert ECUs may be unconditional or

[1] As discussed in the paper 'Acceptability and convertibility/negotiability of the ECU' (Annex I-1).

[2] This document discusses only the convertibility of the ECU within the Community; the problems arising in connection with ECU holdings built up by other holders are dealt with in Annex I-5 on the external role of the ECU.

subject either to the existence of need arising from balance-of-payments difficulties, or to other rules to be agreed. Existence of such a need could be recognized with full benefit of the doubt being given or could be challenged. The right to convertibility might also be made dependent on whether or not ECU assets exceeded a predetermined threshold defined either as a proportion of the initial allocation or as a percentage of total reserves;

(ii) convertibility subject to predetermined rules or insistence on the general principle of Fund responsibility: under the first solution, the emphasis is on the right of conversion for holders of ECUs or on the limits to these rights; the second solution places emphasis on the responsibility of the Fund for the smooth working of the system, including the quality of the ECU as a duly mobilizable reserve instrument.

3. *Attractiveness of the ECU*

A convertible ECU would entitle, but not oblige, a holder of this instrument to obtain other reserve assets. Whether or not this right is actually exercised will depend mainly on the attractiveness of the ECU, which itself is dependent on a variety of factors, such as its acceptability, its movement against the dollar, its remuneration and the fact that the ECU is the monetary expression of a region in the process of integration.

B. **The Fund's ability to satisfy the demand for assets**

First, it is important to determine the assets into which the ECU could be converted. Liquidity is not the same as solvency, and the Fund might possess assets which do not correspond to its members' needs. Thus, if ECU convertibility were to be used to satisfy the need to finance an external deficit, the participant in question would want to convert his ECUs into dollars and not into gold. Then again, even if ECU convertibility were introduced in order to prevent an excessive accumulation of ECUs, this formula would also have to take account of the needs flowing from any external imbalances.

In the light of the above considerations, a convertible ECU would impose on the Fund the burden of providing primarily dollars. The Fund's ability to satisfy any demand for dollars would depend mainly on:

(a) the size of the Fund's dollar holdings.

Under the present arrangements for transferring reserves to it, the Fund holds close on 80% of its assets in gold and only 20% in dollars;

(b) the Fund's ability to dispose of its assets.

A convertible ECU is feasible only if reserves are transferred to the Fund in such a way that the Fund enjoys full control over all or some of its assets, including the right of sale;

(c) the possibilities of acquiring new dollar assets.

In theory, these would include:

(i) the sale of gold against dollars.
This possibility will depend on the formula adopted for the transfer of gold in the Fund. However, even if the Fund enjoyed full control over its gold assets, it would probably be as reluctant as its members to sell them;

(ii) mobilization of its assets.
The Fund could conclude swap agreements with the Federal Reserve, and by activating them, temporarily mobilize its assets;

(iii) borrowing directly from countries in surplus and borrowing on the Eurodollar market.
The source, the form and the maturity of such borrowing would have to be consistent with the prospects for reconstituting the Fund's stock of dollars;

(iv) new transfers of reserves to the Fund.
Such new transfers could take place under rules requiring the maintenance of a minimum percentage of reserves with the Fund, as is the case at present, under an obligation to reconstitute ECU assets or under a designation formula allowing the Fund to purchase dollars from its members against ECUs. This would not always be possible, however, particularly if the Fund's liquidity problems arose from excessive creation of ECUs.

II. Liquidity and negotiability

In the case of a negotiable ECU, the conversion of ECUs into dollars would not, in theory, be the responsibility of the Fund but would essentially be a matter for the participants in the EMS. The Fund could, however, contribute to the proper functioning of this system by placing at its members' disposal the dollars they required. These dollars could be supplied by other participants through the Fund according to a designation formula or by the Fund directly if members were allowed to mobilize their ECUs through its offices. This would be tantamount to the Fund lending its dollars temporarily according to a formula to be determined (e.g. dollar-ECU swaps).

Use of this mobilization facility could present the Fund with a liquidity problem, depending on the extent of its mobilization obligation. As distinct from the problem of liquidity that arises with a convertible ECU, this problem would be temporary since the Fund would merely be engaging in a lending operation; moreover, it would be less serious and less likely to arise.

In this context, since priority ought to be given to the smooth working of the EMS, the Fund would, in the management of its assets, have to take account not only of the yield on its portfolio but also of the need to maintain a certain margin of liquidity in the interests of its members.

III. Conclusions

The matter of liquidity cannot be considered independently of the choices to be made as regards convertibility or negotiability of the ECU. It would also be closely linked to the arrangements for transferring reserves to the Fund and to regulation of the issue and circulation of ECUs.

If the ECU were to be negotiable rather than convertible, the liquidity problem would be replaced by a management problem.

In the case of a convertible ECU, the Fund's liquidity would depend on its ability to satisfy the demand for conversion of its liability, the ECU, into more commonly used international reserve assets. The main factors affecting the Fund's liquidity would be:

(i) the attractiveness of the ECU in relation to other assets;

(ii) the quantity of ECUs created;

(iii) the terms on which conversion took place;

(iv) the types of asset into which conversion would be guaranteed;

(v) the ability of the Fund to acquire further amounts of these assets.

It should also be noted that, as the ECU becomes established as a means of settlement and international reserve asset, the potential demand for assets other than the ECU—mainly dollars—will tend to fall relative to the Fund's total balance sheet, thereby reducing the threats to the Fund's liquidity.

Preparatory studies on the European Monetary Fund — Arrangements for transferring reserves to the EMF

Contents

Introduction

(a) Transfer of reserves under the existing system

Under the existing system, the central banks transfer to the EMCF 20% of their gold assets and 20% of their dollar assets in the form of three-month swaps against ECUs. It has been agreed that these swaps will be renewed until 13 March 1983 unless transition to the institutional phase before that date leads to the adoption of another transfer formula. Any volume or price adjustments needed are made at each quarterly renewal. On 13 March 1983, if no unanimous decision to the contrary has been taken, the swaps will be unwound.

This system is marred by serious limitations, notably the following:

(i) the fact that the system reverts to its starting point at the end of the transitional period tends to make the existence of the ECU precarious;

(ii) the quarterly value adjustments, and in particular those carried out for ECUs created against gold swaps, have produced substantial automatic variations in ECU liquidity;

(iii) the transfer of reserves is not definitive;

(iv) the EMCF plays a passive role and has no discretionary power either over the amount of ECUs created or over the use of reserves deposited with it.

These limitations are not compatible with the full utilization of the ECU as a reserve asset and a means of settlement as had been laid down by the European Council of 5 December 1978 for the institutional phase of the EMS.

(b) Transfer of reserves in the institutional phase

It must first be stressed that the different formulae for transferring reserves to the EMF cannot be looked at in abstracto; *the basis must be the solutions envisaged for a whole range of more general problems relating more particularly to the functions of the Fund and to the characteristics of the ECU.* [1]

However, the different assumptions possible in this connection have one feature in common: they all lead to the idea of 'permanence' for the transfers of reserves to the Fund. The following considerations are behind this conclusion, those of:

(i) etting up a permanent ECU system with no automatic and parallel increase in liquidity;

(ii) enabling the Fund to help finance and adjust the disequilibria which exist between the Community and the rest of the world;

[1] See 'The EMF: institutional aspects' - Annex I-6, 'Acceptability and convertibility/negotiability of the ECU' - Annex I-1.

(iii) *providing the Fund with a guarantee* vis-à-vis *third parties; this would be necessary should the Fund be authorized to contract loans on the international capital market and if ECU holdings were built up by other official holders.*

Below, we deal first with the various formulae for initial transfer; we then discuss the problems connected with the periodic adjustment in the volume of these transfers, and end by considering the questions raised by the return on the ECU.

I. Formulae for initial transfer

A. Retention of the swap system in a modified form

The first question to ask is the following: could the swap system as it operates at the moment be modified sufficiently to remedy its deficiencies? The idea has been mooted in this context that the swaps be accompanied by a renewal obligation, until an agreement has been reached on a definitive formula for transferring reserves. The precarious nature of the ECU could be reduced without, however, implying a definitive surrender of reserves.

Consideration might also be given to either a 'freeze' on the gold and dollar price for the duration of the system, while retaining the volume adjustment, or non-automatic discretionary adjustments to either the volume alone or to volume and prices. A midway solution might be to reduce the frequency of the price adjustment.

In a 'closed pool' context, the reverse procedure might also be contemplated: price adjustments would no longer be reflected in the amount of ECUs outstanding but in the volume of reserves swapped. This method would have the effect of imposing a tight ceiling on the overall amount of ECUs outstanding.

Even so, introduction of a modified swap arrangement would not resolve the problem of the permanent nature of the ECU. This is because the swaps would have to be unwound at the time of the changeover to a definitive system. The prospect of the Fund reverting to its starting point would not completely eliminate the precarious nature of the ECU and the Fund would have control over its assets only to the extent of holding them itself in the form of swaps. The situation would, in principle, be different if it were agreed at the outset to consolidate the ECU positions when the changeover to a definitive arrangement took place. A commitment of this kind would, however, be difficult to reconcile with the actual concept of a 'swap'.

B. Definitive surrender of reserves transferred to the Fund

The gold and dollar reserves would be definitively surrendered to the Fund, which would have full control over them. [1] *This could take place by sale/purchase, although other legal formulae are also possible.*

(a) *Transformation of present swaps into the sale of reserves to the Fund*

The purchase of reserves against ECUs by the Fund is an operation similar to that carried out by a central bank when it issues its currency by, for example, purchasing foreign currencies on the exchange markets. Both operations are definitive and irreversible. The bank becomes the owner of the assets purchased and, unless the operation in question resulted from an intervention at the bilateral limits in accordance with the EMS exchange rate mechanism, it is not required to buy back its currency. Likewise, the Fund, after selling ECUs against reserves, would become the owner of these reserves in exchange for ECUs definitively acquired by their purchasers; this arrangement would result in the setting-up of a permanent ECU system.

This formula calls for the following comments:

(i) *By the sale, the central banks would definitively surrender a fraction of their reserves to the Fund. For some of them this solution would have the disadvantage of severing, too sharply, all links with the gold which had been surrendered. In any event, they would all have to be sure of acquiring in return for the definitive transfer of assets, an asset with similar characteristics, including the one of being itself fully and easily usable and exchangeable against other assets. The sale would give the EMF full control over its assets, so that the Fund would be able — but not obliged — to confer a measure of convertibility on the ECU.*

(ii) *By the sale, transferors of gold and dollars would be passing over to the Fund the risk of losses or gains resulting from variations in the price of the surrendered assets. Then again, if the arrangements laid down in 1978 at Bremen were to be adopted for reserve transfers to the Fund, the central banks would be contributing in differing proportions, to the constitution of the Fund's gold and dollar assets, and consequently, they would also be contributing in differing proportions to the Fund's income and to the return on the ECU to the extent that the Fund distributed its income between all the ECUs.*

1 The transfer of other reserve assets (SDRs) is not discussed, but this is a problem on which a decision would have to be taken.

(b) Transfer of gold and dollars in standard proportions

It is conceivable that, while the 20% figure would be retained for calculating transfers, this figure would no longer apply to gold and dollars separately but to the whole of the reserves (gold and dollars) of each participant, expressed in ECU. With each participant's overall contribution having thus been determined, a standard percentage would be fixed indicating the share of the transfer to be made in gold. With this transfer technique, some countries would have to add to their gold transfer and reduce their dollar transfer, while other countries would be in the reverse situation. The result would be changes in the composition of national reserves; the scale of the changes would depend on the key used.

The advantage of this formula over the one discussed above is that it would establish for each participant equality between his share in the constitution of the Fund's assets and his share in the Fund's income. But this advantage would be temporary, in that the application of this solution, in the event of subsequent transfers of reserves, would pose considerable problems.

C. *Ad hoc* formulae based on the specific character of gold assets

Given the specific problems linked to the transfer of gold, it seemed useful to examine the alternative options for transferring gold to the Fund[1] *which leave the transferor of gold with rights over his transfer. In each of these cases, dollar transfers would take the form of a surrender pure and simple.*

(a) Transfer of gold as capital

Under this formula, gold transfers made by the central banks would represent participation in the Fund's capital. The transferor of gold would receive a title of ownership, not transferable, expressed in gold weight, and not a means of settlement. The Fund would also allocate simultaneously to the participating central banks an amount of money in ECUs proportionate to their capital participation; these ECUs would be permanent in character. In order to maintain the accounting equilibrium of the EMF's balance sheet, the latter operation, which would increase the Fund's liabilities, would require the entry of an equivalent amount on the assets side.

This formula thus consists of two separate, albeit coordinated operations: a transfer of reserves as capital and the creation ex nihilo *of a quantity of ECUs which might be equal to, or different from, the countervalue of the reserves transferred.*

[1] The retention of swaps for gold transfers alone could also be regarded as an *ad hoc* formula, but this would not really eliminate the precarious nature of the ECU.

At first sight, the advantage of this formula would be that each participant would retain a right of recovery over the assets transferred to the Fund, and that the profits from any revaluation would be reserved for that participant.

On closer examination, however, the situation is not so clear-cut.

(i) The holder of a title representing a participation in capital can, in theory, exercise his right only if the organization is wound up. In the event of the Fund being wound up, the claim would be exercised over the net assets of the Fund; there would therefore be no guarantee that the initial deposit of gold would be recovered.

(ii) The guarantee of recovery also depends on the extent of the Fund's control over the assets received as capital. This is a grey area. According to the reasoning behind the 'capital' formula, the Fund could lend its assets, i.e. contribute to mobilization of the ECU, but would not be able to ensure its convertibility since the latter operation could be interpreted as an indirect recovery by the participants of their capital contribution. It could here be argued that this would not be the case, however, where a participant wished to convert ECUs accumulated over and above his initial allocation. Because of the difficulties of interpretation raised by the question of the extent of the Fund's control over its assets, there would seem to be a need for the 'capital' formula, in any event, to be supplemented by precise statutory clauses.

(iii) The link between participation in the capital and the creation of money in ECUs should be clarified. More than one hypothesis is possible:

- *ECU issue equal to the entire capital; money creation would occur to the extent that the capital was not fully paid up;*
- *ECU issue independent of the amount of capital; the Fund would have the right to decide, depending on circumstances, on the amount of ECU to be created.*

(b) Gold transfer against issues of mobilizable certificates of deposit

The gold transfer would give rise to the issue of a non-interest-bearing certificate of deposit, expressed in gold weight; the risks on gold would continue to be borne by the depositing central bank.

For the certificate of deposit to be converted into an instrument of settlement — the ECU — it would have to be mobilized; at the holder's request, the Fund would 'rediscount' the gold certificate. This mobilization, which could be automatic and *for an indeterminate period, would entail the payment of interest. Being a liquid instrument, the gold certificate would be recorded as a reserve asset in central bank balance sheets while the gold deposited would be shown among the Fund's assets.*

This option, while ensuring that the gold was mobilized, would reserve for the transferor of gold the profits from any revaluation.

However, since it would only be the holder of the gold, the Fund could not release it: this could have implications for the Fund's liquidity assuming that it had to ensure a fairly high degree of ECU convertibility.

This solution would also mean that the creation of ECUs against gold would keep pace with the mobilization of these certificates. As a result, the volume of ECUs created at the start of the final phase would be smaller than the amount in circulation at the end of the transitional period, unless there is a substantial (and perhaps temporary) increase in the proportion of dollar transfers. Although this formula achieves a relatively satisfactory solution with regard to the return, it does not lead to a genuine transfer of reserves. For this reason, it might be agreed that the participants would have the right to convert gold certificates into a definitive surrender. Such an operation would have to be done collectively at an agreed time, if it is considered necessary to avoid any problems that might arise from the coexistence of several formulae for the transfer of gold.

(c) Transfer of gold with preservation of rights over revaluation profits

Under this option, the transfer of gold against ECUs would be accompanied by the preservation of a right to the profit from any revaluation of the gold. Since the Fund would pay interest on all ECUs held by the participants, and since gold does not produce interest, each member country would have to pay back compensatory interest on its share of ECUs received against gold.

Like the previous formula, this form of transfer would not amount to a definitive transfer; it would pose scarcely any accounting problems. Nor would it show up a reduction in the amount of ECUs outstanding at the time of transition to the institutional phase.

II. Links to be established between the volume of reserves transferred to the Fund and the stock of ECUs outstanding

Under the present system, participants are required to keep at least 20% of the volume of their gold and dollar reserves permanently with the EMCF. This means that, when the participants record an increase in their reserves after the initial deposit, there is an obligation for them to make further transfers; in the opposite case, they would receive a refund. The adjustment in the volume of the reserves deposited and, consequently, the stock of ECUs outstanding takes place when the swaps are renewed each quarter.

In the institutional phase, several formulae can be considered for new transfers and the final choice will be influenced by the method of transfer used initially and by the option chosen as regards the control of ECU creation. The possible formulae are based on the following principles:

A. Retention of volume adjustment

The retention of the existing formula for adjusting the volume of reserves transferred would continue to link the stock of ECUs outstanding to changes in the participants' gold assets and to their exchange rate policy vis-à-vis *third currencies; it would involve agreement on the price at which the new transfers were made. Consequently, the rate of ECU creation, as well as the rate of new transfers of reserves, would continue to be highly automatic in character. Assuming a convertible ECU, this formula would be something of a brake on the conversion of ECUs on the sole gounds of reserve diversification.*

B. Imposition of a ratio for ECU holdings

Instead of the requirement to keep a minimum percentage of reserves (gold and dollars) with the Fund, participants would be required to hold a certain percentage of their reserves in the form of ECUs. Such a rule would establish a degree of parallelism between the use of the ECU and the use of national reserves. From this point of view, it would moderate the possible convertibility of the ECU as, when a participant's ECU holdings fell to the level determined by the ratio, any conversions of ECUs would have to be accompanied by a proportional reduction in the reserves held on own account by the participant in question. However, this rule would inhibit the use of the ECU for Community settlements since it would require the user to reconstitute them. Although the period for reconstitution could, by agreement, vary in length, the effect of such a rule would be to make the ECU more like a credit instrument than an instrument of settlement.

C. Non-automatic subsequent transfers

In this case, there would be no subsequent automatic transfers. They would either be decided collectively by the Fund authorities or made, with the agreement of the Fund, on the initiative of the participants who wished to reconstitute or to increase their ECU assets. This practice would be the one most compatible with an effective control of ECU liquidity.

III. The return payable on the ECU and the various formulae for transferring reserves

A close link exists between the problem of the return payable and the problem of transferring reserves. The return on the ECU is in essence a distribution of the Fund's income; the level of this income, as well as the amount of ECU liabilities on which a return had to be paid, depends on which of the various transfer formulae is chosen.

The return payable on the Fund's ECU liabilities is one of the factors which will determine the attractiveness of this instrument as a reserve asset. The return would be paid in ECUs.

Without embarking on inflationary ECU creation, the return payable on the Fund's ECU liabilities as a whole can in no way be greater than the income obtained by the Fund on its own assets, i.e. the reserve assets transferred by the participants and the credits granted by the Fund. In other words, with regard to yield, the ECU cannot be better than the assets backing it.

Within the limits of its own income, the Fund will be able to modify the return on the ECU. However, its power to influence its income is more restricted: it is non-existent as regards revaluation gains and very limited for dollar income, but the interest rates for the credits granted (Community credits, mobilization of gold certificates) are fixed discretionally by the Fund.

The main questions raised by the distribution of the Fund's income, and consequently the return payable on the ECU, are the following:

(i) What income will the Fund possess and what will be the amount of liabilities on which a return has to be paid?

(ii) Given the heterogeneous nature of the assets transferred to the Fund against ECUs, how could the income arising from these different kinds of assets be fairly redistributed by the Fund in the form of a return which ought to be identical for all ECUs?

The answers provided by the different transfer formulae are briefly reviewed below.

1. *Sale of gold and dollars against ECUs*

Under this formula, the Fund would possess the following types of resources:

(i) current income: interest received on dollar investments and on credits granted to members;

(ii) potential gains (or losses): gold or dollar revaluation profits.

The return paid on the ECU would be relatively low if it were to be based on the Fund's current income alone (interest received on its dollar investments and on its loans). This return might, however, be considered satisfactory if it were borne in mind that the ECU enabled a relatively illiquid, non-interest-bearing asset, i.e. gold, to be mobilized.

A higher return could be paid if not only current income but also the revaluation profits on the Fund's gold and dollar assets were taken into account.

If the return were topped up in this way, this would presuppose (a) that there were capital gains on the assets transferred (which will depend on the transfer prices of the gold and dollars and on subsequent changes in them) and (b) that agreement has been reached on the arrangements for realizing and distributing these capital gains. If the Fund were to effect payment of the return in ECUs, the problem arises, in connection with the equilibrium of its balance sheet, of the contra-entry on the assets side for some portion of the interest paid. Several solutions can be envisaged:

(i) the Fund would make these interest payments by imputing purely accounting gains. Such a formula, which would not involve realizing such gains, could in particular be adopted in the event of an official price for gold being reintroduced, or of the central banks regularizing rates; in this system, the payment of a return in ECUs would result in the Fund's liabilities being inflated against assets which were unchanged in volume but revalued in value;

(ii) the Fund would realize its capital gains by the sale of gold and dollars to the participants. It would acquire the ECUs needed to pay the return; the effect of this formula would be to reduce the volume of the Fund's assets, while leaving the stock of ECU outstanding unchanged;

(iii) the Fund would realize its capital gains by the sale of gold and dollars on the market. In this case, the Fund would acquire Community or third currencies against which ECUs would be created when the return was paid.

Whatever the formula adopted for this payment, the continuity of a high remuneration on the ECU cannot be assured in all circumstances and the Fund's solvency would require the participants to guarantee the Fund against a turn-round in the situation, i.e. against capital losses. It therefore follows that a distribution of interest payments to the Member States is liable to involve them in incurring expenditure at a later stage.

2. *Transfer of gold as capital*

Should the Fund create ECU ex nihilo, *in parallel with transfers of gold as capital, the return payable on these ECUs would have to be the same as that payable on ECU created in other ways. As in the case of the formula discussed above,* *distribution of the Fund's current income alone would provide a low return on the ECUs. If, moreover, any exchange-rate profits on the gold capital were reserved for the shareholders alone, their distribution would not represent a topping up of the return on the ECUs. Large transferors of gold would receive a return on the ECUs created* ex nihilo, *while retaining a right to the revaluation profit on their gold transfer. For their part, participants who had made a greater transfer of dollars — an asset whose income and exchange rate gains would be spread over all the ECU — would be at a disadvantage.*

3. *Transfer of gold against issues of mobilizable certificates of deposit*

The gold certificates would not constitute ECUs; consequently, no return would be paid on them. As a result, the Fund's obligation to pay a return would be limited, at the outset, to the ECUs it had created against the acquisition of assets generating current income (dollars and Community loans). Since interest would have to be paid on the creation of additional ECUs by the mobilization of gold certificates, the Fund's income would be sufficient, in any event, for it to pay a relatively high return on the ECUs.

4. *Transfer of gold with preservation of rights over revaluation profits*

The transfer of gold would give rise to the immediate creation of ECUs on which the Fund would be required to pay the same return as on ECUs created in other ways. However, gold transferors would have to pay the Fund interest in order to reserve any revaluation profits for themselves alone. This would give the Fund substantial current income. The accounting implications of this formula are comparable to those of solution 3 above since all the gold certificates would have been permanently mobilized.

ANNEX I-4

Preparatory studies on the European Monetary Fund — Consolidation of Community credits in the European Monetary Fund

Contents

Introduction

This note analyses the consolidation of the credit mechanisms in the Fund. It does not prejudge the range of mechanisms to be included in such consolidation, either from the start of the institutional phase or at a later stage depending on the way in which the EMS develops.

The note begins by recalling the main characteristics of the mechanisms in force and the EMCF's role in these mechanisms. It then goes on to analyse the possible role of the Fund in the consolidation of these mechanisms; lastly, it comments on some of the major problems which such consolidation would raise.

I. Role of the EMCF in the mechanisms in force

Under the present credit system, the EMCF's role varies according to the type of credit, but, in any event, its role is a minor one.

1. Very short-term financing

This is not strictly speaking a credit at all, but a reciprocal cash facility between central banks in the context of interventions in Community currencies. This type of financing is automatic and unlimited when it relates to interventions made at the fluctuation margins, such interventions themselves being obligatory and unlimited in nature. However, interventions within the margins are subject to agreement by the bank issuing the currency sold; the agreement on making the currency available also relates to other arrangements: immediate settlement or recourse to very short-term financing.

Although the system is a strictly bilateral one (central bank making the currencies lent directly available to central bank, agreement between the parties concerned as regards intra-marginal interventions), the EMCF fits into it as a mandatory but purely formal intermediary, being both creditor and debtor for identical amounts. It also keeps the accounts for these operations.

2. Short-term monetary support

This is a reciprocal credit system between the EEC central banks under which each of the members is assigned a creditor quota determining the proportion of support which it undertakes to finance and a debtor quota determining the amount of support which it may receive on application. This quota system is supplemented by non-individualized creditor and debtor rallonges *which enable the volume of such support to be increased. Support, which is for a period of three months (renewable twice), can be obtained almost automatically and is unconditional within the limits of the debtor quota, but subject to the discretion of the Committee of Governors when the amount requested necessitates recourse to a* rallonge. *The creditor central banks exercise a certain power of assessment as to their individual ability (balance of payments and reserves situation) to participate in a credit operation. The support is denominated in the currency actually supplied; it is denominated in ECUs in the case of an operation which replaces a very short-term financing arrangement.*

In raising the amount of short-term monetary support to 14 000 million ECU, the Brussels Resolution introduced the new concept, accepted by the central banks, of the maximum amount of effectively available credit: the quotas and rallonges *were adapted accordingly.*

The role of the EMCF is limited to keeping the accounts of this mechanism.

3. **Medium-term financial assistance**

The Brussels Resolution set at 11 000 million ECU the maximum amount of effectively available credit under this form of assistance: it is granted by Council decision and carries economic policy conditions laid down by the Council. The credit, which is normally granted in successive tranches, is denominated in ECUs and paid up in a national currency. This is a reciprocal credit system, but the credit is granted by the Member States instead of the central banks.

The EMCF has no role in operating this mechanism.

4. **Community loans for balance-of-payments support**

This mechanism, established by specific Council decisions in 1975, has just been modified and renewed. Its purpose is to raise capital, either directly from third countries and financial institutions, or on the capital markets, with the aim of relending the funds raised to Member States, in order to help them overcome balance-of-payments difficulties directly or indirectly related to an increase in prices of petroleum products. The funds lent carry economic conditions fixed by the Council. The outstanding amount of borrowings authorized has been set at 6 000 million ECU in principal.

The funds are borrowed by the Commission on behalf of the EEC after authorization by the Council. The financial operations pass through the accounts of the EMCF, which is responsible for managing the borrowings. However, the operations are self-balancing: the borrowing and lending operations are carried out on the same terms and with the same value dates, with the result that the EMCF is never required to manage cash funds.

II. Consolidation of the credit mechanisms and role of the Fund

The above exposition shows that the EMCF has no significant role in the Community credit mechanisms: even though it is a necessary intermediary for very short-term financing, this is a legal device of no real consequence; in fact its role is confined to tasks of managing the accounts, and these are, moreover, carried out by the agent on the Fund's behalf.

The principle of these mechanisms, or at least some of them, being taken over by a Community body has been laid down by the following instruments:

(i) as regards the EMCF: Article 3 of the Council Regulation of 3 April 1973 establishing the EMCF made the Fund responsible for the administration of very short-term financing and of short-term monetary support and for the regrouping of these mechanisms in a renewed mechanism; [1]

(ii) as regards the EMF: the Annex to the Conclusions of the Presidency of the Bremen European Council provides for the creation of ECUs for credit purposes against the contribution of national currencies and for the existing arrangements and institutions to be consolidated in a European Monetary Fund. The Brussels European Council confirmed these conclusions, giving particular emphasis to short and medium-term credit.

The term consolidation is interpreted, in this note, as the regrouping of disparate mechanisms, introduced at different times by different authorities, into a single and definitive structure. The advantages to be gained from consolidation would be that a more effective mechanism better suited to requirements would be established, the status of the ECU would be enhanced and the economic convergence of Member States would be furthered.

(i) The transition to a system in which the Fund had a central role would be equivalent to effectively putting Community credits on a multilateral basis. It would necessarily mean a revision of at least some of the rules governing the present mechanisms and would result in an important change in the nature of the system of Community credits: the mechanisms in force — which are, in fact, a network of bilateral relationships — would be replaced by a Community institution granting a range of credits in its own name: the comprehensiveness of the range would depend on the option chosen. This would allow the duration and amount of credit as well as its terms to be adapted to the specific requirements of each Member State.

(ii) The fact that the Fund granted credits in ECUs would enhance the role of the ECU as a means of settlement between participants in the EMS; consequently, the Community could gradually switch to using its reserve assets other than ECUs solely for external settlements.

(iii) Through its role both on exchange markets and in defining the conditions attached to the credits it grants, the Fund could increasingly help to foster economic convergence between the Member States.

[1] This task has not been carried out.

A. Powers of the different types of Fund as regards credit

Consolidation of the credit mechanisms within the EMF would constitute only one of the functions attributed to this new institution. It is consequently clear that the decision to choose one or other of the credit options will flow from the fundamental choice which will be made between the different options concerning the nature and purpose of the Fund.

Other notes addressed to the Monetary Committee have distinguished four possible types for the European Monetary Fund:

(i) an 'accounting' type Fund similar to the present EMCF;

(ii) a 'central bank' type Fund, which would be assigned monetary powers;

(iii) a 'regional IMF' type Fund, which would be essentially an economically-oriented institution;

(iv) a 'sui generis' *Fund: whereas in the two preceding options, either the monetary function or the economic function predominates, a* 'sui generis' *Fund would be endowed with both monetary and economic powers.*

The choice between the different types of Fund would govern the nature and extent of this body's power as regards credit.

(i) The sole task of an EMCF-type Fund would be to administer all the mechanisms; its powers would vary according to the interpretation given to this administrative function which, moreover, had already been laid down in Article 3 of the Council Regulation of 3 April 1973 establishing the EMCF. The powers of the EMF would enable it as a minimum to administer the accounts of all credit mechanisms, from very short-term financing to Community loans.

(ii) A central bank type Fund would in its own name take over responsibility for the credits of a monetary nature which the central banks grant each other in the event of difficulties considered to be temporary: cash credit for very short-term financing, credit lasting some months for short-term monetary support. It could also be responsible for administering the accounts of the other credits.

(iii) Under a regional IMF type Fund, very short-term financing would remain the responsibility of the central banks,[1] *and short and medium-term credit would be consolidated in a single mechanism ranging from three months to five years. However, if it were felt important to retain the principles at present governing these two credit mechanisms, the Fund would grant short-term monetary support to the central banks, as under the present rules; medium-term credit (over one year) would be granted to Treasuries and would carry economic and monetary policy conditions.*

(iv) A 'sui generis' *Fund with both economic and monetary powers could unify, in a homogeneous structure, all credits, ranging from the very short-term financing to medium-term financial assistance and, possibly, Community loans. These credits are complementary in purpose but up to now they have been separated and are the responsibility of different authorities; if they were consolidated, credit could, without any break in continuity, be tailored to the specific needs of each participant, both in terms of duration and amount and in terms of conditions.*

Instead of taking each of these different types of Fund in turn, and studying their powers as regards credit — which would be repetitious — we propose, in the paragraphs which follow, to discuss the consolidation of very short-term financing separately from the consolidation of the other credits. The problems raised by very short-term financing are different from the problems concerning the consolidation of the other credits which, whatever the option contemplated, are similar and can therefore be examined together.

B. Very short-term financing

There are two aspects to very short-term financing: the first is the provision of the currency requested, and the second the possible financing operation involved; the currency provided can either be settled on the spot, or be the subject of a financing operation. It is important to distinguish between these two aspects in analysing consolidation.

1. *Provision of the currency*

Two solutions are possible as regards consolidation.

1.1. In line with current practice, the bank issuing the currency requested would supply it directly and compulsorily to the intervening bank when interventions at the margin were involved. It might be possible to envisage extending the obligation to supply national currency (up to a certain amount) to intramarginal interventions justified in particular by a currency crossing the divergence threshold; at the request of the intervening central bank, these interventions would be the subject of a financing operation.

[1] Except for the renewing of such financing which would be regarded as forming part of short-term monetary support.

1.2. Alternatively, in order to establish a genuinely multilateralized mechanism, the intervening central bank ought to be able to obtain directly from the EMF the foreign exchange required for interventions, whether these were interventions at the margins or interventions made after the divergence threshold had been crossed.

One way by which the EMF could obtain this foreign exchange could be through swap facilities, automatic and unlimited in amount, at least for interventions at the margins, between the Fund and each of the Community central banks, whereas the present arrangements operate bilaterally between all the central banks concerned.

2. *Financing procedures*

A choice is also possible between two financing procedures depending on whether or not the Fund creates ECUs for financing interventions.

2.1. In the first case, the central bank supplying the currency would immediately be settled in ECUs by the Fund, [1] *on the debtor's behalf, unless the parties had agreed otherwise. The Fund would create the ECUs delivered to the creditor against a claim in ECUs on the debtor central bank.*

The proposed system would not affect the present practice whereby the debtor repurchases the currency sold and refunds it to the issuer as an advance repayment. The interest of the debtor would, as previously, continue to lie in limiting, as far as possible, the definitive loss of reserves. Only the procedure would be different: the debtor, having repurchased the currency previously sold, would exchange it against ECUs with the issuer; with the ECUs obtained in this way, he would clear his debt with the Fund. So as to reinforce the present practice of repurchase, it could also conceivably be extended, under the auspices of the Fund, to all the partners wishing, in connection with the ECU's negotiability, to obtain this reserve asset against remittance of the currency which the issuer wanted to see mopped up from the market. Thus, the procedure in force under the present bilateral arrangements could be extended to all the participants in the system.

2.2. If it were thought that ECU creation for very short-term financing would not offer any real advantages over the present situation and would even be a source of difficulties for controlling the amount of the overall issue of ECU, one could fall back on a solution whereby the creditor acquired a claim in ECU on the Fund, with the debtor settling the EMF at the settlement date, either by remitting the currency previously surrendered (and possibly repurchased in the meantime), or by remitting ECUs. In so far as the issuer, and not the Fund, supplied the currency requested, and in so far as this operation gave rise to a claim in ECUs instead of a settlement, a system would still exist under which the Fund fulfilled only a formal role, with the very short-term financing mechanism then remaining the responsibility of the central banks alone.

2.3. Each of the two financing procedures outlined above is compatible with one or other of the two methods of providing currency, i.e. directly by the central bank (point 1.1. above) or indirectly through the Fund (point 1.2. above).

C. **Other financing operations**

The mechanisms involved are the following: short-term monetary support, medium-term financial assistance and possibly Community loans raised for the purpose of giving balance-of-payments support.

Examination of the consolidation of these mechanisms cannot be confined to the questions flowing from their simple juxtaposition within the Fund, but extends to certain connected questions — in particular, the amounts, cost and duration of the credit. This approach must not be considered as going outside the problem of credit consolidation; on the contrary, it is justified by the concern to merge mechanisms which up to now have not really been linked.

1. *Financing procedures*

While starting from the principle that credits are denominated in ECUs, the financing procedure differs depending on whether the liquidity is created through the issue of ECUs or through the lending of existing assets: the adoption of one or other of these options will flow from the choice made between the different types of Fund.

1.1. Financing by ECU creation

In so far as the Fund has a role to play in the financing of credits, it is logical for it to finance them by means of ECUs it creates itself.

[1] In the proposed system, the central bank issuing the currency sold, instead of holding a very short-term claim in ECUs on the Fund, would immediately be settled by a transfer of ECUs which would be recorded as an increase in the heading 'ECU'. The outstanding amount of this heading could then decrease rapidly to the extent that the central bank concerned re-entered into possession of the national currency previously issued. Some central banks already group ECUs held as reserves or as claims in respect of very short-term financing together in their balance sheets under a single heading 'ECU' or 'claims on the EMCF'. For these banks, immediate settlement in ECUs would involve no change in the way in which their balance sheets were presented. But those central banks which now divide these operations into two separate headings in their present balance sheets, would have to merge them into a single heading, 'ECU'.

1.2. Financing by the redistribution of existing assets

There are several possibilities here:

(i) redistribution of the Fund's assets.

Under the operation, the Fund would temporarily make its assets available to participants; such financing would be carried out by putting back into circulation assets held as a result of the transfer of reserves;

(ii) redistribution of central bank assets.

This procedure would make no change to the present situation with regard to the financing of the various credit mechanisms, and the Fund would create no liquidity of its own: the credits, although denominated in ECUs, would be paid in monetary instruments which already exist (dollars, ECUs or SDRs) and which would be drawn from the reserves of the participating central banks.

However, it should be noted that such redistribution would itself generate new liquidity, unless the creditor renounced the liquidity of his claim. This method of financing would mean that the concept of creditor quotas would have to be retained;

(iii) redistribution of international assets.

The Fund could make available to its members assets which it had itself borrowed, either under swap agreements or on the international markets.

2. *Principles for determining the credit amounts*

The principles governing the determination of the overall or individual credit amount do not depend on the option chosen, but the solutions envisaged would differ according to whether or not the credit were financed by ECU creation.

2.1. Overall credit amount

If the Fund were to take over financing by means of ECU creation, this would lead to the ending of creditor quotas: since they determine individual contributions, they would become pointless. It would then be possible to fix a maximum amount for the volume of credit and medium-term financial assistance. Another approach might conceivably be to determine no ceiling in advance for the volume of credit, which would be incorporated into a general ceiling set for the issue of ECUs whether they were created against the transfer of reserves or credit. This is because the danger that monetary discipline in the system might be weakened lies not so much in an excess of credit as in an excessive creation of ECUs, whatever the source. In that case, however, assuming that very short-term financing gave rise to immediate settlement with the creditor in ECUs, the ceiling should not include the volume of ECUs corresponding to the outstanding amount of very short-term financing, which should remain unlimited. If financing were carried out through the redistribution of the central banks' assets on the basis of creditor quotas, the overall amount of available credit would vary with the circumstances (particular difficulties of potential lenders) and the borrower, while not excluding providing some of the credit through a rallonge *as in the current arrangements.*

2.2. Individual credit amount

Several formulae are possible, but whether or not the individual credit amount is determined, the potential beneficiary would in all cases have to be guaranteed being able, as under the present system, to count on a virtually automatic minimum credit amount. Perhaps the total individual amount might not be determined, for example if an amount were set for the overall volume of credit which could be granted by the EMF. The absence of a ceiling set in advance would in no way mean that a beneficiary could run up unlimited debt, but on the contrary would give the Fund discretionary power over the conditions and procedures for granting the credit.

If, however, the creditor quota solution were adopted, one might consider whether it would not be necessary, in return, to assign to each Member State an overall debtor quota which determined the maximum ceiling on the credit which that State could receive. If a system of rallonges *were retained, this would introduce an element of flexibility.*

3. *Automatic nature of the credit and discretionary power of the Fund*

The system at present in force for short-term monetary support comprises an automatic part, the quotas, and a discretionary part, the rallonges. *It is proposed that, under the consolidated system, each participant be guaranteed the availability of a credit that would be virtually automatic, though limited in amount and duration.*

According to the circumstances, this virtually automatic credit would either be a part of its debtor quota, under the new system, or the guaranteed part of an indeterminate credit potential left to the Fund's discretion. The discretionary power of the Fund would be exercised from the outset if the amount which could be granted automatically was exceeded, and on renewal of a credit granted automatically.

The sum of these individual amounts which could be obtained automatically within the overall credit — fixed in advance or not — would determine a credit amount: the Fund would, whatever the circumstances, have to be sure of having the necessary resources available to finance this credit amount.

4. *Conditionality and cost of the credit*

Beyond narrow limits of amount and duration, within which a credit could be obtained automatically, the granting of assistance would justify an examination of the monetary situation similar to that currently made for the granting of short-term monetary support. For longer periods and greater amounts, should consolidation extend to medium-term credits, whether or not they are part of debtor quotas, economic policy conditions would be imposed as is now the case for medium-term financing assistance and Community loans.

For very short-term financing, the present rules impose an interest rate based on the average of national discount rates, weighted in accordance with the weight of each currency in the ECU. By contrast, interest rates on short and medium-term credit are left to the discretion of the authorities granting the credit. If the Fund were given discretionary power, it would be logical for it also to be able to set the rates at which it lends.

III. Problems raised by the consolidation of credits

The consolidation of credits raises the following three problems:

1. **Choice of the credits to be consolidated**

The answer to this problem will depend on the choice made in institutional terms between the different types of Fund. This question was examined in Chapter II.A.

2. **Method of financing consolidated credits**

Two types of solution may be applied to this problem, depending on whether or not financing is carried out through the issue of ECUs created for this purpose.

The problem differs according to the type of Fund:

An accounting type Fund could finance a credit only by redistribution of existing assets.

A central bank type Fund should logically finance the credits it grants in its own monetary instrument, the ECU.

The issue of ECU for short-term financing — which theoretically can be unlimited — is liable to be permanent if the debtor, when the credit matures, repays the Fund in reserve assets other than ECUs. However, it must be stated that this would not increase the overall volume of credit but would add to the balance sheet of the Fund, since the counterpart of these permanently created ECUs would not then be the credits granted, but an additional deposit of reserves.

Although a regional IMF type Fund is more an economic than a monetary institution, it would, however, be conceivable for such a Fund to assume certain monetary functions such as the issue of liquidity in ECUs or the administration of reserves and for it thus to be able to finance the credits it grants by creating ECUs.

However, problems could be created by such an institution creating ECUs to finance medium-term financial assistance: the duration of medium-term assistance exceeds that generally accepted for monetary financing and as a rule needs to be financed by redistribution of pre-existing assets.

The sui generis *Fund would be structured so as to possess monetary powers, like the 'central bank' Fund, and economic powers, like the 'regional IMF' Fund. These closely associated powers by definition ought to open the way to the financing in ECU of these credits as a consolidated whole.*

It should be recalled that if a credit were financed by ECU creation, there would be no difference between the ECUs created against the transfer of reserves and those created through a credit operation. In both cases, they would be 'money' ECUs. For transactions between partners, the origin of these ECUs would not be known and they would all enjoy the same characteristics of acceptability, convertibility/negotiability and remuneration.

Because it would be impossible to identify the origin of such an ECU, a central bank could not avoid accumulating them by seeking to limit its contribution to the financing of the credit in the form of a creditor quota. A country accumulating too many ECUs for its liking would find itself in a surplus payment situation and its monetary authorities could not settle this problem by limiting their contribution to a credit which would now be granted by the Fund; they would have to find other solutions so as not to have to bear the burden of financing deficit partners: opportunities for converting the ECU and, in the last resort, exchange rate adjustments.

3. **'Checks and balances'**

For credit to cease to be granted on the basis of individual contributions and to be granted by a central institution with the power of money creation would be a major change, which would pose the problem of checks and balances, i.e. of the demarcation and interaction of the competent authorities' respective powers as regards money creation. These questions are part of the larger group of institutional problems posed by the establishment of the Fund. Consequently, we confine ourselves below to studying the problems posed for institutional equilibrium by the disappearance of the link existing in the present system between creditor quotas and liquidity creation.

In this connection, it is felt by some that the existence of creditor quotas is an adequate answer to the problem of checks and balances. Changes in these quotas, made in response to a request by the political authorities, require the individual assent of each participating central bank. It is these quotas as a whole which determine the potential scale of liquidity which can be activated by the system. [1] *Fears have been expressed that this balance may be disturbed in the context of a Fund which as regards the financing of the credit did not confine itself to redistributing the liquidity available within the quotas agreed by the central banks, but which itself granted these credits by means of ECUs created for the purpose.*

It can, however, be argued that an institutional balance similar to the one which exists at present could be introduced into such a system. The practicalities of creating this balance would clearly vary according to the type of Fund chosen. Thus, for example, in a central bank type Fund, it is conceivable that any raising of the credit ceiling requested by the political authorities could not take place until it was agreed by the body managing the Fund, i.e. all the central banks. However, the decision to raise the ceiling would be a collective one taken within the Fund and no longer the adding together of individual decisions. Consequently, the decision-making procedure within the Fund (unanimity or majority) would determine the degree of influence which each central bank, taken separately, would continue to exercise in this area.

1 However, when such activation takes place, the central banks record, in their balance sheets, the corresponding claims as the maintenance of their available reserves.

ANNEX I-5

Preparatory studies on the European Monetary Fund — External role of the ECU

Contents

Introduction

1. This note is a preliminary attempt to present and analyse the objectives and the technical implications of conferring an external role on the ECU issued by the Fund.

The ECU will have an external role as a reserve asset and means of settlement when it will be used by the monetary authorities of countries outside the Community, and when, in order to do so, they will hold ECU in an account with the Fund. Whether these ECUs are drawn from the ECU reserves of Community central banks, or whether they are issued directly by the EMF to third countries, they would in essence be reserve asset-ECUs.

This extension of the ECU's role presupposes that it would already have become a fully-fledged reserve asset and means of settlement for EMS participants, i.e. the extension of the external role of the ECU is dependent on the strengthening of its internal role: consequently, extension belongs to the institutional phase of the system. Having said that, certain forms of use of the ECU can be envisaged in a nearer future, in the Fund's relations with third country central banks, e.g. the use of the ECU as a simple unit of account.

2. The external use of the ECU will in the first instance result from a decision by the Fund, but in the end, it will depend on how the instrument will be received by third countries. The task of the Community authorities, if they were to decide to give the ECU an external role, would be that of creating favourable conditions for enlarging the circle of official ECU holders.

3. There already is, moreover, a certain use of ECU denomination by the private sector; the development is spontaneous, and independent of the ECUs issued by the EMCF. It consists particularly in ECU bank deposits, certificates and issues. The possible holding of such assets by monetary authorities cannot, however, be assimilated to reserve asset-ECUs proper.

4. The first part of the note examines the interest which the Community and third countries might have in extending the role of the ECU and the areas of application which can be envisaged. Next, it deals with the techniques by which third countries would acquire and use ECU claims on the Fund and the implications of such techniques for the characteristics of the ECU and the functioning of the EMF.

I. Interests of those involved and areas of application

5. The question of the external role of the ECU must first be considered from the viewpoint of the interest which the Community might have in such a development, while also taking into account the possible effects on the functioning of the international monetary system. The internationalization of the ECU must also be placed in the context of an international monetary system evolving towards a multipolar system.

The Community

6. The possibilities of mobilizing the ECU would be increased by extending its zone of transferability. If the EMF were to empower authorities other than the Community central banks to acquire and hold ECU, the question of the convertibility/negotiability of the ECU held by the Community central banks might no longer arise in the same terms: the Community central banks would be able to obtain dollars against ECU from sources other than the Fund or EMS participating banks. With the development of the ECU's external role, the demand to convert or mobilize the ECU with the Fund would tend to decrease, since the main reason for such operations—the regional nature of the ECU's acceptability—would tend to disappear. The Fund would, however, have to continue to guarantee, in the last resort, the convertibility or possibility of mobilizing the ECU.

7. The Community might have an interest in an extension of the zone of exchange rate stability, in accordance with the Brussels Resolution of 5 December 1978, to 'European countries with particularly close economic and financial ties with the European Communities'. Furthermore, to the extent that the Community might wish to favour a moderation in the fluctuations of major third currencies, it could accept certain forms of association with other central banks, authorizing them to intervene in Community currencies. The techniques of association would be varied, ranging from the accounting centralization by the EMF and the use of Community currencies to avoid accentuating the undesired fluctuations in third currencies' exchange rates, to participation in the exchange rate and intervention mechanism on an equal footing with Community central banks. The ECU's role would differ according to which formula was proposed: a unit of account if the agreement was for operations in Community currencies to be centralized and recorded in ECUs with the EMF; a reserve asset and means of settlement if these operations were to be settled in ECUs and if, for this purpose, the EMF were to empower third country central banks to acquire and hold ECUs.

8. The tendencies toward reserve diversification, which have been evident for some years, add to the instability of international monetary relations. The Community would therefore have an interest, in order to preserve the cohesiveness of the EMS, to give third countries which were holders of large reserves and wanted to diversify into Community currencies the possibility of acquiring and holding ECUs. Such a possibility would in fact help to avoid the destabilizing effects on the exchange markets provoked by massive purchases and sales of certain Community currencies and the unsettling consequences of such transactions on the domestic monetary policy of the countries issuing the currencies concerned. The ECU can, however, fulfil this role only if it is competitive in comparison to the national currencies one would wish to substitute it to.

The third country acquisition and holding of ECUs would also make it possible to finance a current account deficit, if one existed, of the Community as an entity, by the EMF becoming indebted in ECU. The ECU would thus gradually become an official reserve instrument, and the Community — the EMF — would administer this instrument, and become a reserve centre. An internationalization of the ECU in this way is not without its dangers, both for the autonomy of the Community's monetary policy and for the control of international liquidity. However, with its progressive emergence as the monetary symbol of a vast economic area in the process of integration, the ECU will, like all major currencies, spontaneously begin to play an international role.

Third countries

9. Outside the Community, certain third countries may have the same interest in reducing the effects of the exchange rate fluctuations of major third currencies. Certain European countries with very close economic and financial ties with the Community might wish to participate de jure *in the EMS exchange rate and intervention mechanism, in order to form part of the zone of exchange rate stability which it defines. Yet other countries might wish to have access to the ECU — and to extend its zone of transferability — and to have ECU accounts with the EMF in order to use them as a reserve instrument, or even as a means of settlement with member and associated countries.*

10. Third countries holding large reserves might also be interested in the ECU as a diversification medium. In particular, the surplus OPEC countries, whose reserves are mainly in dollars, might wish to match the composition of their reserves more closely to the structure of their imports, of which Community products represent a large share. Their decision to hold ECU reserves will, however, be influenced by the yield and exchange risk of the ECU.

Coincidence of interests

11. The areas in which the external role of the ECU applies will be defined by the conjunction of the Community's interests with those of third countries. A preliminary examination suggests that these interests coincide where the extension of the ECU's zone of transferability or the zone of stability of EMS exchange rates are concerned; and, although different, they seem to meet in seeing the ECU as an answer to the wish for diversification. For the Community, the decision to promote the external role of the ECU would not be taken until a more thorough analysis had been made of its advantages and costs: for the extension of the role of the ECU might involve changing its characteristics to make them more attractive.

II. Techniques by which third countries could acquire and use ECU claims on the Fund

12. Giving authority to third countries to acquire and use ECUs means, in effect, giving the Fund the right to open ECU accounts for these countries.

13. In the present situation, the EMCF is not empowered to issue ECUs, as a means of settlement, except to and for the use of Member State central banks alone. [1] *However, not all claims on the Fund are by nature ECU reserve assets. Thus, interventions in Community currencies can give rise to ECU claims to be settled at least partially in other reserve assets than the ECU. In this case, the ECU is used as an instrument of*

[1] Council Regulation (EEC) No 3181/78 of 18 December 1978 relating to the European Monetary System.

denomination only and not as a means of settlement. Such third country use of the ECU would pose legal and technical problems less complex than the ones raised by the holding of reserve ECUs.

14. The third country acquisition and use of ECUs which would be a means of settlement raises a number of questions concerning the criteria to be used to define the external role of the ECU, the origin of the ECU acquired by third countries, the techniques for acquiring them and the implications for the ECU's characteristics and the functioning of the Fund. These questions are briefly examined below.

A. **Criteria for enlarging the 'ECU zone'**

15. Any enlargement of the 'ECU zone' for official holders requires, at the very least, the Fund's assent, for not only is the Fund the sole authority entitled to create ECUs but, since there is no market in ECUs, the transfer of ECUs between participants must be carried out by debit or credit entries in the Fund's books. Consequently, the Fund is in a monopoly position which enables it to lay down the criteria which the extension of the ECU's role should satisfy. These criteria might cover:

(i) the demarcation of the geographical area: the Fund could, for example, limit the circulation of the ECU to the countries associated with the exchange rate mechanism;

(ii) the laying-down of general terms on which third country official authorities or international monetary organizations could acquire, hold and use ECUs.

In the absence of general criteria, the Fund could authorize, on an ad hoc *basis, a third country to acquire ECUs.*

B. **Origin of the ECU**

16. One possibility would be to permit third countries to acquire ECUs from EMS members. In this case, the stock of ECUs would remain unchanged since no new ECUs would be issued; there would merely be a transfer, in the Fund's books, of ECUs held by members to official third holders. For example, a central bank could 'swap' ECUs for dollars with a third country central bank; this would improve the possibilities of mobilizing the ECU. Or a member country whose currency is used by third official holders as a reserve currency could buy it back outside the market in exchange for ECUs which would help to regulate the diversification of reserves. Or again, an EMS member could surrender ECUs to associated countries in settlement for their interventions to support its currency.

17. A second, wider-ranging alternative, would be for the Fund to issue ECUs to third countries. Unlike the first solution, new ECUs would be created by a direct operation between the Fund and third countries. This would be the case if, for example, the present swap network between EC central banks and the FED were replaced by a single dollar/ECU swap between the FED and the Fund; or if the Fund contributed directly to the diversification process by buying dollars against ECU, or contributed to recycling for the purposes of balance-of-payments financing, by issuing ECU-denominated securities against, for example, dollars for on-lending to Member States. The significance of these operations would differ since, for some of them, ECU creation would be only temporary (swaps), while for others (diversification), it could be more lasting.

C. **Techniques for the acquisition of the ECU by third countries**

18. In exchange for 'what' will the official third country holder be able to acquire the ECU? The answer is obvious for ECUs surrendered by another participant in the context of the wider negotiability of the ECU: the counterpart would be the one agreed between the parties.

19. For ECUs issued to third countries by the Fund, the counterpart could vary according to the circumstances surrounding such an operation. Thus, the issue of ECUs to third countries or the offer of ECU-denominated investment instruments is conceivable:

(i) against surrender of reserve assets;

(ii) against surrender of Community currencies; [1]

(iii) in the form of credits.

D. **Implications for the characteristics of the ECU**

20. Conferring an external role on the ECU means that the ECU, as it exists within the EMS, will be made available to official third holders. This should not, in theory, have much influence on the unity of the ECU. A monetary instrument does not change its nature just because it changes hands.

21. Nevertheless, the extension of the ECU's role beyond the Community, or the mere prospect of it being so extended, should perhaps be taken into consideration from the start of transition to the institutional phase. The areas likely to be affected are the following:

[1] The possibility of a third country acquiring ECUs against the surrender of Community currencies should not be dismissed out of hand if only in order to avoid the case of a third country which held Community currencies exchanging them for dollars on the foreign exchange market, since this would have the effect of upsetting exchange rates. In this case, steps would, however, have to be taken to prevent the financing of a Member State's external deficit by its own currency: the central bank issuing the currency in question could be required to buy back against ECUs the amounts of its currency acquired by the Fund.

Documents relating to the European Monetary System

4. Tasks in the field of exchange rate policy:

(i) coordination of intra-marginal and third-currency interventions;
(ii) coordination and multilateralization of relations with non-member countries:
(iii) Fund intervention on the foreign exchange market, where appropriate against ECUs, which would presuppose the existence of an ECU market.

5. Granting on own account and financing of the credits available under the system.

6. Definition of (i) monetary or (ii) economic conditions that may be attached to Fund credits, and monitoring of compliance.

7. Implementation of enabling clauses; in other words, action to ensure that the Fund's development is endogenous.

Functions	Type of Fund:			
	EMCF accounting agent	central bank	regional IMF	*sui generis*
(1) Accounting and executive functions:	×	×	×	×
(i) recording debts and claims arising from interventions in EEC currencies and from activating the STMS mechanism				
(ii) creating ECUs against the temporary deposit of reserves (present swap system)				
(iii) managing the MTFA mechanism and Community loan operations to support Member States' balances of payments				
(2) Management of reserves held on own account:				
(i) in the case of reversible transfers (amended swap system)	×	×	×	×
(ii) in the case of definitive transfers to the Fund		×	×	×
(3) Regulation of the issue and circulation of ECUs:				
(i) among EMS members		×	×	×
(ii) in relations with official other holders		×	×	×
(iii) for use by the private sector		×		×
(4) Tasks in the field of exchange rate policy:				
(i) coordination of intra-marginal and third-currency interventions		×		×
(ii) coordination and multilateralization of relations with third countries		×		×
(iii) Fund intervention on the foreign exchange market		×		×
(5) Granting and financing of credits available under the consolidated system:				
(i) very short-term and short-term		×		×
(ii) short-term and medium-term			×	×
(iii) all three types of credit				×
(6) Definition and administration of loan conditionality:				
(i) monetary conditionality		×		×
(ii) monetary and economic conditionality			×	×
(7) Implementation of enabling clauses		×	×	×
(8) Issuing of Community loans to give Member States balance-of-payments support			×	×

8. Issuing of Community loans to give Member States balance-of-payments support.

9. Decision-making centre for adjustments of central rates and amendments to the definition of the ECU.

10. Tasks in the monetary policy field:

(i) coordination of domestic monetary policies;

(ii) formulation of a Community monetary policy;

(iii) Fund intervention on national money markets.

B. **Respective functions of the different types of Fund**

The Committee earlier distinguished four broad types of Fund. This is necessarily a rough but none the less useful classification in that it provides a reference framework for the Committee's future work. The four types of Fund were as follows:

(i) an 'accounting agent' Fund along the lines of the present EMCF. Since such a Fund would perform merely an accounting function, it would not require any new institutional structure;

(ii) a 'central bank' type Fund. Such a Fund would be assigned monetary powers and its governing bodies would basically be modelled on those of central banks. However, since participation by the political authorities in the exercise of monetary powers differs from one country to another, it would be necessary to determine what place and what role these authorities would have in such a Fund.

A variant of this would be an institution which, while providing support for the general course of Community economic policy, would be completely independent of the political authorities, at least as regards the means used to achieve its statutory objectives;

(iii) a 'regional IMF' type Fund. The functions assigned to such a Fund would be those currently carried out by government authorities (exchange rate regime and balance-of-payments financing normally with conditions attached), the implication being that it would be largely governed by those same authorities. Since a Fund of this type could also assume certain monetary functions (liquidity creation in ECUs, reserve management), the central banks would have to be represented on its governing bodies;

(iv) a sui generis *Fund. Whereas monetary or economic functions would be predominant in the two preceding types of Fund, a* sui generis *Fund would have both monetary and economic functions. The problem would then be to create an appropriate institutional set-up, say a multi-tier structure, within which all the participants, i.e. central banks and national Treasuries, would be able to play their respective roles.*

The table on the preceding page relates the four types of Fund to the different spheres of activity listed above, making it possible to identify the powers that could be exercised by each type of Fund.

III. General observations on institutional matters

In view of the evolving nature of the European Monetary Fund, the functions listed above could be assigned to it only gradually.

Leaving aside the 'accounting agent' Fund, the institutional structures of all the other types of Fund would have to reflect the division of powers and responsibilities that exists at the national level between central banks and governments. Since powers and responsibilities are allocated quite differently from one country to another, a compromise will have to be found when this new body is set up. The problems of 'checks and balances' that are encountered in relations between the different decision-making centres both at national and at Community level can be resolved only on the basis of appropriate national and Community legislation.

The EMF would be the common decision-making body, and its actions could not but reflect the joint resolve of the EMS participants. Two points should be emphasized here: first, the Fund would operate within a framework in which the general policy choices remained the responsibility of the government authorities; second, as regards the exercise by the Fund of its own powers, one needs to stress the importance of its internal decision-making process. Questions that may arise in this respect concern the following points in particular:

(i) the balance to be struck between prescribed rules and discretionary powers. When conferring powers on the Fund, the national authorities could also spell out how these powers should be exercised. If, as a result, it did not possess any powers of appraisal, the Fund would have no competence of its own; its role would be restricted to that of a managing body;

(ii) general direction of the Fund's activities. The Fund will have to assist in framing and in giving expression to a Community policy in the monetary and economic field. Whatever type of Fund is chosen, its activities will have to further the objectives set at Community level;

(iii) unanimity or majority. Although unanimity may be required for the most important decisions, it ought not to be the rule. In view of the need to strike a balance between the collective interest and the individual interest, decisions could be taken, depending on their purpose, either unanimously, by a qualified majority or by a simple majority; furthermore, the nature of this distinction could itself evolve: as time went by and the Fund developed, a decision for which unanimity had been required at the beginning could subsequently be taken by a majority.

If a decision-making procedure were adopted for the Fund that, at least in certain matters, did not require unanimity, it would have to be accepted that action by the Fund would not always meet with the approval of all its members. A unanimity requirement would downgrade the Fund's functions to those of a managing body or would make it impossible in practice for the Fund to take any decisions.