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THE EUROPEAN MONETARY SYSTEM

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<u>THE EUROPEAN MONETARY SYSTEM</u> (EMS)

<u>First an explanation of the EMS</u>:

The European Monetary System, centred on the European Currency Unit (ECU), is designed as a permanent system aimed at establishing orderly exchange rates which will improve the present situation as regards economic transactions within the territory covered by it, to bring about a coordinated economic policy for all European member countries, and exercize a calming and hence beneficial effect on the international currency market.

The salient features of the EMS are:

1. the introduction of the numeraire;
   (each currency is assigned a central rate expressed in ECU)
2. interventions;
   (these are not triggered automatically, but must be decided upon with the agreement of all participants);
3. the European Monetary Fund
   (yet to be set up).

20% of the currency reserves held by participant countries will be deposited with the Fund. The currency reserves of the European Monetary Fund will total 25,000 m ECU = DM 62,500 million = $33,000 million.

In essence, the EMS will operate as follows:
The currency of each member country will be assigned a central rate expressed in ECU. These rates may move within a 2.25% band (with the exception of Italy). Any deviation will be measured against the rates ruling on the foreign currency exchanges.

Where individual rates fluctuate (bilaterally) by more than 75% of this band, formal consultations will be initiated between the central banks to discuss intervention, and the monetary and lending policies to be pursued.

Debts between the participant countries will be settled through the European Monetary Fund.

As the Fund is relatively large (25,000 million ECU), there is also the possibility of fixing drawing rights at 150% of the funds deposited. The period allowed for using funds for balance of payments stabilization could therefore also be extended to 90 days now after the end of the month (instead of 45 days in the case of the Snake). Short-term aid, previously 2.7 million ECU, will now amount to 10 million ECU (with extensions).

In addition to the funds available for balance of payments purposes, short- and medium-term loans at reduced rates of interest will be available. A margin of 200 million ECU per year over 5 years has been granted for these reduced interest rates. However, these funds will not be handed over automatically; agreement between the central banks is required first. A few words now on relations with the associated countries. These countries, including the United Kingdom, may take part in the European exchange rate system. They would then have the same obligations regarding intervention and would take part in the consultation procedure. They would also have access to finance in the very short term, but not to the short- and long-term loans.

The currencies of the associated members would not be part of the 'basket', that is would have no central rate. Another arrangement would have to be found to fix the rates for these associate countries.

<u>Advantages of the EMS</u>

(a) It is of prime importance for small- and medium-scale industry in countries with export-oriented economies that the risks involved in export transactions are substantially reduced through relatively stable exchange rates. For short- and medium-term export credits the risk is practically reduced to the normal fluctuations between the various currencies. This should therefore make for brisker export business within the area covered by the EMS.

(b) Another point of major importance is the strengthening of confidence in the weaker currencies, which will mean an increased capital inflow into countries such as France or Italy from third countries, as more stable exchange rates can reasonably be expected. This capital inflow will then produce an economic upturn in these countries.

(c) There is much less danger of the West German mark becoming a key currency in place of the US dollar and thus being subjected to intensified speculation. The links with other European currencies will produce a much larger pool of money mass to absorb the effects of such speculation. This will substantially reduce susceptibility to speculative movements and thus help to stabilize the international money markets.

(d) The governments which have joined the European Monetary System will pursue anti-inflationary and stabilizing economic policies, using all the means at their disposal. This in turn should lead to convergence of European economic policies. In the medium term this should have a salutary effect on European industry and probably lead to a further upswing.

(e) With a measure of stabilization of the EEC currency market and of the Community economy, it will be difficult for the relationship with the US dollar to be shaken by pure speculation. The EMS will thus have a damping effect on the American dollar. However, this does not mean that if the dollar is hit by a serious economic recession in the USA this will leave no trace on the European currency market. But as the US Government is currently doing all it can to stabilize the dollar, it can be assumed that in the medium term these two factors - the EMS and the US Government's stabilization policy - will actually stabilize the relationship between the dollar and the European currencies.