Committee of Governors
of the Central Banks of the Member States
of the European Economic Community

13th November 1978

Draft

REPORT

OF THE COMMITTEE OF GOVERNORS TO THE COUNCIL ON THE EUROPEAN MONETARY SYSTEM

In pursuance of the mandate given to it by the Council on 24th July 1978, the Committee of Governors hereby submits to the Council the conclusions of its deliberations concerning the new European monetary system which was discussed at the European Council meeting in Bremen on 6th and 7th July 1978.

The Committee of Governors wishes to stress at the outset that, while a durable and effective system is a necessary prerequisite for the establishment of a zone of monetary stability in Europe, no exchange rate arrangement can make a durable contribution to the achievement of greater stability of exchange rate relationships unless it is accompanied by varied but cohesive action to scale down progressively the disparities of economic development in member countries. Thus, while giving priority to the gradual reduction of inflation rates, an effort must be made to identify procedures leading to a balanced distribution, among deficit and surplus countries, of duties and responsibilities as regards both economic growth and balances of payments. The nature of the exchange rate system adopted could play a rôle in this context.

For as long as significant disparities persist, the system must be sufficiently flexible to accommodate imbalances. Steps will have to be taken to permit prompt adjustment of exchange rate relationships in order to avoid their becoming unrealistic, without, however, detracting from the credibility of the exchange rate commitments undertaken, which themselves may have to allow a certain flexibility. Intra-community credit facilities will have to be on a scale which allows economic and monetary policies time to take effect but this will have to be reconciled with the aim of maintaining a satisfactory degree of strictness in order to achieve greater stability.

Finally, the durability of a European zone of stability also depends on close co-ordination of exchange rate policies vis-à-vis the outside world, together, as far as possible, with concertation with the authorities responsible for issuing the major third currencies.

In view of the urgency of these matters, the Committee of Governors concentrated on decisions essential to the smooth functioning of the arrangements due to come into force at the start of the transitional period. It intends to continue its studies on the operation of the future European Monetary Fund.

It is assumed throughout this report that all member countries of the European Community will participate from the outset in the new European monetary system.

The arrangements to be decided upon relate to the choice of numeraire, the exchange rate system, the credit system and the settlement system.

I. THE NUMERAIRE

The decision taken in Bremen to place the ECU at the centre of the system implies that agreement must be reached on the definition of the ECU and on its uses.

1. Definition of the ECU

The ~~Governors~~ consider that the definition of the ECU should correspond to that of the European unit of account (EUA) but should allow for the possibility of revision. Among the various formulae considered for possible modification of the basket, the Governors were more particularly favourable to the idea of the "revisable" basket, the composition of which would be subject to review every five years, or, at the request of any country, if the relative weight of a currency had changed by more than 25 per cent. since the last revision. The object of any change in the composition of the basket would be to restore a distribution of weights consistent with the economic criteria, duly updated, used as a basis for the initial determination of weights. The revision would be effected in such a way as to guarantee continuity of the value of the ECU when the composition of the basket was modified.

Some feel that the composition of the basket should be updated in accordance with the principle suggested above even before the entry into operation of the new European monetary system. Without opposing this possibility, the Governors took note of the reservation expressed in this connection by the representative of the Commission, given the risk of disrupting efforts to harmonise the units of account currently utilised in the Community if the decision to revise the basket remained limited to the European monetary system.

2. Uses of the ECU

The ECU, thus defined, would be used:

- as a common denominator for the expression of central rates;
- as an indicator to detect divergences between Community currencies;
- as a unit in which assets and liabilities held with the EMCF (claims and debts as well as reserve assets) would be denominated;
- as a basis for the settlement of liabilities arising in the context of very short-term financing.

The central rates would be expressed in the form of a fixed, but adjustable, parity between each currency and the ECU, and would be notified to the EMCF. The very nature of the numeraire, comprising a standard basket of Community currencies, implies that any change in the central rate of a currency would require a corresponding adjustment of the central rates of the other currencies, triggering consultations and thus satisfying the requirement of mutual agreement in such circumstances, as outlined by the European Council meeting in Bremen.

The central rates expressed in terms of the ECU would be used to determine the "grid" of reciprocal parities between currencies, and the margins of fluctuation adopted around these parities would make it possible to fix the compulsory intervention rates which would be announced to the market. However, the exchange rate system would differ from that of the "snake" through the addition of an indicator of divergence based on the deviation of the daily value of the ECU expressed in each currency from the central rate. When this deviation exceeded a certain threshold, known as the "divergence threshold" and fixed, for experimental purposes, at 75 per cent. of the maximum theoretical spread for each currency, the monetary authorities of the country in question would be presumed to have to act in such a way as to reduce or eliminate the risk of tension [in accordance with the conditions outlined in the following section and Annex 1]. The divergence threshold would be calculated for each currency in such a way as to eliminate the influence of disparities of weight on the probability of reaching the threshold.

The operations of the EMCF would henceforth be denominated in terms of the ECU instead of the EMUA (European monetary unit of account). This would apply in the first instance to the very short-term financing and claims and debts in respect of short-term monetary support. The developments in the value of the ECU will influence the value of the claims and the liabilities in the EMCF. The assets created as a counterpart to the deposit with the EMCF of gold and dollars would represent reserve assets in ECUs; however, the technique proposed for deposits during the transitional period would mean that the loss or gain attaching to assets transferred in this way to the EMCF would be left with the various central banks.

II. THE EXCHANGE RATE SYSTEM

The stabilisation of exchange rates on which the creation of a zone of stability depends must be based on a durable and effective system. In the Governors' view, this system should incorporate three elements designed to reinforce each other mutually: the fluctuation limits determined by the parity grid and the margins adopted around these parities; the consequences following from the use of the ECU as an indicator of a divergence; the co-ordination of policies vis-à-vis third currencies.

1. The parity grid and the margins

Like the "snake", the exchange rate system would involve compulsory intervention rates fixed on either side of the reciprocal parities. At these rates, the central banks would stand ready to buy and sell on an unlimited scale in their respective markets the currencies reaching the intervention points.

As far as the present member countries of the "snake" are concerned, the maximum spot margins of fluctuation between each pair of their currencies would remain unchanged at 2.25 per cent. /The Governors propose that the option for the other countries of applying wider margins, at least in the initial stage, should be exercised on the understanding that such spot margins may not exceed per cent.[1)] and may not result in the creation of more than two bands of fluctuation in the new European monetary system./

2. The effects of the divergence threshold based on the ECU

The Governors consider it useful to add to the exchange rate system a mechanism for detecting divergences, the first object of which would consist in triggering the action necessary to prevent or check tension or a risk of tension in the Community band or bands. A second object would be to promote the pursuit of policies conducive to greater stability by deficit and surplus countries alike. Some Governors considered that this should be achieved by modifying the settlement rules and credit arrangements relating to the claims and liabilities arising from interventions by countries with strong divergent currencies.

The presumption to act which would be associated with crossing the divergence threshold is /described in Annex 1 for illustrative purposes in terms that are acceptable to most of the Governors./ They all believe that the proposed consultations in the event of a confirmed divergence could make a useful contribution towards the adoption of appropriate measures and the stability of the exchange rate system. It is recognised that such consultations would have to be held at levels of responsibility enabling adequate decisions to be adopted. Some Governors stressed the importance which they attached to the second principle outlined in the previous paragraph as a means of giving real content to these consultations.

While the views of the Governors still differ as regards the emphasis to be laid on interventions as the primary objective of the proposed presumption to act, /the Committee is prepared to recommend, in view of the flexibility of the arrangements envisaged, that the system should be implemented on an experimental basis in accordance with the guidelines set

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1. One delegation has asked for a spot margin of between 6 and 8 per cent.

out in Annex 1, in the traditional spirit of co-operation among central banks]. [the Committee recognised that the hitherto untried nature of the features set out in the Working Document will have largely to depend for their successful operation on an even closer co-operation than usual among the central banks.]

3. Co-ordination of policies vis-à-vis third currencies

While closely linked with whatever action is recommended in regard to the indicator of divergence, the co-ordination of exchange rate policies vis-à-vis third currencies remains a highly desirable objective even in the absence of tensions or divergences in the Community band. Moreover the Governors note that in the existing Community exchange rate mechanism it is frequently the case that strains in the system appear or are intensified when the exchange rates for major third currencies are unstable.

The Governors consider that in this field close concertation among them and, if necessary, with the issuing authorities of the third currencies concerned would make it possible to co-ordinate the action taken. While there can be no question of pursuing a common policy with a view to stabilising the rates of a third currency, it is nonetheless desirable to avoid applying incohesive national policies in respect of interventions in third currencies.

III. THE CREDIT SYSTEM

The Governors have sought the most appropriate ways and means of implementing the desire expressed at the meeting of the European Council in Bremen to increase the potential for intra-Community credit in connection with the exchange rate system and, in particular, to provide substantial short-term credit facilities.

In this regard the Governors have considered the possibility of modifying the structure of short-term monetary support in such a way that credit would be provided not through central-bank financing but by creating assets in ECUs against the deposit of national currencies.

The flexibility of such a mechanism and the fact that it accords with the Bremen guidelines - in particular with regard to the issue of ECUs against national currencies - aroused considerable interest among the Governors, some seeing in it a forerunner of the procedures that will possibly be employed by the future European Fund. In particular the abolition of creditor quotas that such a system would entail was viewed by them favourably. On the other hand, a number of the Governors expressed concern regarding the volume of assets in ECUs that a single central bank might have to accumulate in the absence of any acceptance limit. /The Governors therefore, and because of legal and technical difficulties, agreed to propose for the immediate future that the support mechanisms be expanded in their present form pending solution of the problems to which implementation of a revamped system would give rise./

1. The volume of credit

An increase in the volume of credit facilities raises the problem of allocation between medium-term financial assistance, which is not the direct responsibility of the central banks, and short-term monetary support (it being agreed that very short-term financing should remain unlimited in amount). The relationship between the two mechanisms is further complicated by the length of time that, in all probability, would be required to implement any increase in medium-term financial assistance.

Assuming that the overall amount of credit facilities should be about ECU 25 billion, which is generally accepted as the intention of the European Council in Bremen, the Governors have examined various ways of dividing the total between the short and medium-term support mechanisms, several different approaches based either on the volume of financing commitments or on that of the credit effectively available, and a variety of combinations of relative increases in the quotas and rallonges under the short-term monetary support arrangements.

Further consideration is necessary before the Governors can draw any final conclusions from this examination. /However, it did appear that, provided medium-term financial assistance were suitably increased within a sufficiently short space of time, a compromise between the ideas expressed might lie in maintaining the existing relationship between quotas and rallonges within the short-term monetary support mechanism but increasing the amount credit effectively available under this arrangement from ECU 5.8 billion to around ECU 15 billion. The quotas and rallonges would accordingly be multiplied by approximately 2.6/7 (see Annex 2).

2. The duration of credit

The Governors are in agreement in proposing that the maximum combined duration of automatic very short-term financing and short-term monetary support should be extended from 10-11 months to 14-15 months.

As long as the present structure of short-term monetary support remains unchanged, this total duration would be divided as follows: the initial maturity of unlimited financing would be extended by one month, thus increasing its duration to 60 days from the end of the month. The facility providing for the automatic three-month renewal of this financing for an amount not exceeding the debtor quota under the short-term monetary support arrangement would remain unchanged. The maximum duration of short-term monetary support would be increased to three periods of three months.

/Two central banks, however, maintained their reservations about extending the duration of the initial very short-term financing to 60 days from the end of the month./

3. Special arrangements linked to the ECU as indicator of divergence

Some Governors considered that for the reasons explained in the section on the exchange rate system, special rules should apply to the settlement rules and credit arrangements arising from interventions in which the currency of one of the interveners was divergent but not the other, whether the interventions took place at the bilateral margins or intra-marginally. They therefore proposed that in cases where the divergent currency was that of a creditor, there should be automatic provision for rolling over the very short-term financing until such time as it was agreed in joint consultations that the normal settlement rules should apply or until the creditors' position had reversed itself thus enabling his claims to be liquidated by purchases of his own currency to reinforce this mechanism. Interest normally payable on such very short-term financing would be reduced if the amount of the financing grew beyond a certain point which could be related to the quotas in the short-term credit arrangements.

4. Other provisions

The short-term and very short-term credit facilities would remain unchanged in all other respects. The interest rate for very short-term financing and for short-term monetary support would continue to be set by the Governors who will take into account the fact that claims and liabilities are now denominated in ECUs.

IV. THE SETTLEMENT SYSTEM

From the beginning of the transitional period the settlement system should be based on the use of assets in ECUs created as a counterpart to the deposits of gold and dollars to be made to the EMCF.

The Governors have considered in broad terms the method of creating ECU assets, their potential uses and their principal properties. They will only be able to further their consideration of these points once the fundamental characteristics of the European monetary system are clarified.

1. The creation of ECU assets

During the transitional period functional simplicity should be a major consideration in the formulation of solutions to the problems raised by the creation of assets in ECUs against reserve contributions.

With this aspect in mind, it is proposed that initial contributions should be confined to assets in gold and dollars, as indicated in the guidelines laid down by the European Council in Bremen. Each central bank would contribute to the EMCF an amount of gold equal to 20 per cent. of the weight of its gold holdings, together with either 20 per cent. of its gross dollar assets or in dollars, as some would prefer, 20 per cent. of the dollar equivalent of all its non-gold, non-EEC currencies gross reserves (see Annex 3).

Each central bank would be credited with the ECU equivalent of its contributions. The conversion rate in the case of the dollar would be the market rate; in the case of gold, the Governors consider that the conversion rate should be close to and derived from market prices, on a basis agreed by the Governors.

The Governors feel that for the transitional period the creation of ECU assets against gold and dollar contributions should take the form of three-month swaps renewable indefinitely. The risks attaching to the contributions, whose composition would vary widely, would thus continue to be borne by the individual central banks. At a later date, when procedures are being worked out for the European Monetary Fund, consideration might be given to the definitive transfer of reserve assets to the Fund and a consequent Community-wide pooling of risks.

/The initial creation of ECUs would be followed at set intervals by adjustments to maintain the initial relationship between the overall volume of ECU assets and the volume of other reserve assets. Procedures for these adjustments, which should constitute a simple means of responding to the desire expressed in Bremen that ECU assets should move in line with reserve changes resulting from purchases and sales of dollars, will have to be worked out but must be compatible with the rôle of ECU assets in intra-Community settlements./

2. The use of assets in ECUs

If they are to rank with other categories of reserve instruments, assets in ECUs will have to be endowed with comparable properties, notably as far as usability is concerned.

The main function of ECU assets will be in the settlement of liabilities arising in the context of very short-term financing.

Specific provision should be envisaged to make it possible to use ECU assets to buy convertible currencies, in particular dollars, in case of need. Mobilisation for this purpose could take the form of dollar swaps with the EMCF itself or voluntary transfers between central banks.

3. Properties of ECU assets

The Governors are, for the time being, of the opinion that all ECU-denominated assets or claims held by a central bank either as a result of very short-term financing or in the form of claims under short-term monetary support or reserves corresponding to deposits of gold and dollars should be treated uniformly from the point of view of remuneration.

This would be possible if two complementary provisions were implemented: the first would be to charge the central banks a custody fee in respect of their gold contributions so as to give the EMCF a return on the gold comparable with that on investment of the dollar contributions. The second would be to pay interest on the ECUs on the basis of the average return obtained by the EMCF on its dollar investments, the gold contributions and its ECU-denominated claims.