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

8th September 1987

REPORT BY THE COMMITTEE OF GOVERNORS ON THE STRENGTHENING OF THE EMS

1. In the Communiqué issued on the occasion of the realignment of 12th January 1987 the Ministers of Finance of the EEC countries asked the Committee of Governors and the Monetary Committee to examine measures to strengthen the operating mechanisms of the European Monetary System (EMS). Pursuant to that request, preparatory work for the Committee of Governors was conducted by the Committee's expert groups and the Alternates. Two oral interim reports on this work have been presented by the Chairman of the Committee of Governors to the Council of Ministers of Finance, respectively on 4th April and 15th June 1987. The Governors' final report, which focuses primarily on the matters within their competence, is presented below.

2. The Report is divided into two parts. Part I reviews the experience with the EMS and analyses the major changes in the economic environment that are likely to influence the working of the system. Part II summarises the main conclusions of the analysis and discusses ways and means to strengthen the EMS mechanisms and improve their functioning.

I. THE ECONOMIC ENVIRONMENT AND THE FUNCTIONING OF THE EMS MECHANISMS

A. Changes in the economic environment

3. Over the years, the EMS has performed satisfactorily, despite pronounced instability in the world economy. The Governors are convinced that the system has contributed to the achievement of a considerable degree of exchange rate stability based on greater economic convergence by fostering discipline in monetary and fiscal policies and preventing undue delays in policy adjustments. It is nonetheless their belief that the performance of the EMS benefited from a number of factors and circumstances whose influence on the system may now be changing.

4. Since the inception of the system the EMS countries have given priority to reducing inflation. In many cases exchange rate changes have

not fully accommodated inflation differentials, and higher inflation countries have maintained appropriate interest rate differentials. This has had a stabilising effect on exchange rate expectations and helped to reduce speculation against weak currencies. A remarkable reduction of inflation rates has indeed been achieved, but inflation differentials have not been eliminated and there has been less convergence in budgetary and other policies that have a bearing on exchange rate cohesion. As long as convergence remains incomplete, central rate realignments will continue to be necessary from time to time and there is a danger that interest rate policy will be excessively constrained by external considerations especially if realignment decisions are unduly delayed.

5. The EMS exchange rate arrangement has been affected by the large movements in the dollar exchange rate, both because the Deutsche Mark is a preferred substitute for the US currency in international portfolios and because dollar swings influence the competitiveness of EMS countries differently. Downward pressure on the US currency has generally been associated with upward pressure on the Deutsche Mark within the EMS. As long as large payments imbalances between the major countries persist and the policies being pursued do not appear fully consistent with their correction, the international environment will continue to be a potential source of destabilising pressure within the EMS; this pressure will be reinforced by remaining differences in the performance and policies of the EMS countries.

6. Increasing integration of financial markets, sophistication of market operators and mobility of international capital are likely to accentuate EMS tensions stemming from the internal and external factors indicated above. The Community countries that had maintained capital restrictions have been gradually removing them, in line with the objective of completing the internal market by 1992. In practice, the dismantling of capital controls can have conflicting effects on exchange rate stability. On the one hand, it not only fosters more efficient resource allocation and macro-economic policy convergence but also reinforces external discipline, with a potentially stabilising influence on exchange rate expectations; on the other, it increases the risk of markets amplifying the exchange rate repercussions of external disturbances or perceived policy divergences of a temporary nature.

7. With fixed but adjustable exchange rates and increased capital mobility resulting from progressive integration of financial markets and

the abolition of remaining restrictions, national monetary policies will be exposed to strains so long as individual countries' economic and financial policies and performances leave room for departures from internal and external balance whose effects spill over to other countries. This implies that all partners should pursue in a closely co-ordinated manner policies that foster stability of domestic prices and costs and external balance as a basis for lasting exchange rate stability: in particular, countries should agree that central banks would be committed to giving priority to the objective of price stability in the conduct of monetary policy.

8. It is recalled that, as recorded in the conclusions of the Presidency of the European Council in December 1978, the purpose of the EMS is to establish a greater measure of monetary stability in the Community and the EMS should be seen as a fundamental component of a comprehensive strategy aimed at lasting growth with stability, a progressive return to full employment, the harmonisation of living standards and the lessening of regional disparities in the Community. Moreover, the Single European Act specifically aims at reducing such disparities, with a view to strengthening the economic and social cohesion of the Community. In the absence of a strengthening of the economic and social cohesion of the Community, the completion of the internal market and the full liberalisation of capital movements may exacerbate these disparities. Therefore, consistent monetary policies, exchange rate stability and, indeed, overall progress towards monetary and financial integration must not be seen as ends in themselves, but rather as part of a process that, allied to direct Community action, will facilitate the reduction in regional disparities in the Community.

B. The functioning of the EMS mechanisms

Exchange rate management

9. When strains have developed within the system, they have initially been met by intramarginal interventions, sometimes very large, by the central bank whose currency was under downward pressure. Intramarginal interventions have been effective in avoiding destabilising expectations and more generally in providing relief and gaining time to decide on more comprehensive responses when pressures persisted. Experience has nonetheless shown that if a given intramarginal exchange rate is defended for too long and the market becomes aware of the scale of intervention, speculation may be reinforced. Moreover, on occasion market perception of an

inclination by the authorities to rely primarily on interventions may have fuelled speculative pressure.

10. Interest rate policies have also proved helpful in reducing exchange rate tensions when the changes in rates were made quickly and on an appropriate scale. Experience shows that it was the central bank of the weak currency that generally had to raise its interest rates and widen differentials. However, central banks' ability to adjust interest rates to meet incipient market pressures has sometimes been constrained by domestic policy considerations. In certain instances market pressures have been heightened by delays in the implementation of supporting domestic policy measures. Although the initial reaction to strains in the system has normally come from the central bank of the weak currency, when the pressure has proved too strong and the weak currency has been allowed to fall to its lower limit, the strong currency central bank has had to intervene and accept the effect on its money market conditions of the inflow of foreign exchange.

Realignments

11. Realignments have generally been carried out smoothly. In some cases they were nonetheless decided on under heavy pressure after being widely anticipated by the markets; the possibility of deciding upon a new set of central rates has sometimes tended to be linked to member states' domestic political calendars. Moreover, changes in central rates sometimes resulted in significant adjustments in market rates, thereby encouraging the belief that speculative activity prior to a realignment would be profitable.

Interventions

12. Under current EMS rules, interventions at the margins are compulsory, and can be financed without limits by drawing on the very short-term financing facility (VSTF). Intramarginal interventions are basically unregulated except that: (i) those in EMS currencies require prior agreement by the issuing central bank; (ii) those in dollars are to be avoided when bound to accentuate dollar trends or conflict with the aims of simultaneous dollar interventions by other EMS central banks. These rules have been applied flexibly and the concertation procedures have in general made it possible to overcome emerging conflicts.

13. Most of the interventions within the system have been intramarginal, and chiefly in dollars and Deutsche Mark. In some instances, when use of the main currencies appeared inappropriate, resort was made to intervention in the private ECU market.

14. In certain circumstances co-ordinated intramarginal interventions may be effective in forestalling market pressures. However, such interventions can, in some cases, result in an accumulation of EEC currencies in official reserves. Such holdings would need to be fully liquid and usable for intervention in conformity with the existing rules. However, some countries are reluctant to allow the accumulation of their currency as a reserve asset.

Credit mechanisms

15. The Governors agree that the present VSTF arrangements have neither been abused nor caused major difficulties for debtor countries. Nonetheless, the period for repayment under the rules has expired on occasion before capital flows were reversed and debtor positions could be unwound through reflows in the currencies of the creditor countries. Repayment obligations were met in these circumstances by market borrowing, which has so far been easily available. This problem, however, is likely to become more serious as larger capital movements can now be expected. Moreover, since financial market conditions may change, it is important that the financing facilities provide adequate resources for the management of the system in periods of tension.

16. The VSTF was conceived at a time when most interventions were expected to be at the margins. Since then, intramarginal interventions have become standard practice and now far exceed compulsory interventions. Some Governors therefore consider that the fact that recourse to the VSTF for intramarginal interventions is dependent on the consent of the two central banks involved may have deprived the system of a powerful deterrent against speculative attacks. Indeed the few instances of use of the VSTF for such interventions occurred only in 1979. Easier access to VSTF for intramarginal intervention would also represent an encouragement for countries not participating in the exchange rate mechanism to join it. Other Governors, by contrast, consider that speculation could actually be encouraged by a perception that the system's financing constraints had been eased. It was pointed out moreover that the central banks with stronger currencies liberally and flexibly accepted the use of their currencies for

intervention in the past. These central banks might have reason to reconsider their attitude if the financing of intramarginal interventions were to compromise the stance of their monetary policy.

17. Short-term monetary support has not been used since 1974. This has not been due to shortcomings in the mechanism, but rather to the reluctance of EEC countries to finance balance-of-payments disequilibria with official credit when market financing was easily available. Moreover, when recourse to official credit mechanisms was made, countries showed a preference for medium-term instruments, such as the Community loan mechanism, in view of the nature of balance-of-payments imbalances and the time needed to correct them.

The role of the ECU

18. On the whole little use has been made of official ECUs in settlements and no large net ECU positions have built up since debtor countries have tended to repurchase their ECUs promptly. This tendency has undoubtedly been strengthened by the switch from official discount rates to market rates for the remuneration of ECU positions. The usability of the official ECU has been improved by the mobilisation mechanism introduced in July 1985. This allows central banks to obtain dollars or Community currencies against ECUs, for a limited time, subject only to the requirement of a need for intervention currencies.

19. The development of the private ECU market has been followed closely by the Committee of Governors on the basis of periodic reviews by their experts. The Governors welcome the fact that with the recent abolition of specific restrictions on the use of the private ECU in Germany and Spain the ECU is now essentially on the same footing as any other foreign currency in all EEC countries. The remaining restrictions on use of the ECU are side effects of the foreign exchange controls still in force in some countries.

Non- or incomplete participation in the exchange rate mechanism

20. The EMS was intended to encompass all the EEC countries; at present only eight of them participate in the exchange rate mechanism. In general, non-participation has not caused major difficulties, though the movements of sterling have from time to time put pressure on the Irish pound, owing to Ireland's close trade links with the United Kingdom.

However the inclusion of the pound sterling and the Greek drachma in the ECU basket means that changes in their exchange rates affect the market value and yield of the ECU. Such changes, and movements of the lira outside the narrow band of the exchange rate mechanism, can to an extent distort the divergence indicator and alter the value of claims and liabilities in the VSTF; they can also affect the private ECU market. The basic problem with non-participation, however, is that it casts doubt on the future of European monetary integration.

21. Italy's retention of wider fluctuation margins has not caused significant problems for other EMS countries or for the system as a whole, in part because less than full use has been made of its broader band, which has served principally to provide operational flexibility and to avoid large changes in market rates on the occasion of realignments. However the reduction in inflation differentials has weakened the reasons for maintaining wider margins, but it is understood that Italy is giving priority to the dismantling of its long-standing foreign exchange controls.

22. For many years, the BLEU has maintained a two-tier exchange market as a way to stabilise official exchange rates for commercial transactions while achieving and maintaining full freedom for capital transactions. This arrangement has allowed the authorities to avoid the introduction of restrictions at times of crisis. Moreover, the spread between the rates in the two markets has generally been less than 1 per cent. Nevertheless, the participation of the BLEU in a fully derestricted Community-wide capital market would logically entail the adoption of a unified exchange rate system.

II. POLICIES TO STRENGTHEN THE EMS

Main conclusions of the analysis

23. Persistence of international payments disequilibria coupled with the remaining disparities in economic fundamentals and increased capital mobility between EMS countries could result in destabilising capital flows. In such circumstances it would prove more difficult to preserve exchange rate stability within the EMS, especially if monetary policies are not adapted more promptly and co-ordinated more closely when temporary pressures develop in foreign exchange markets. Some member countries with highly open economies fear the adverse impact on economic growth of raising

domestic interest rates to stem capital outflows. Conversely, the countries that have defeated inflation and whose currencies are tending to appreciate fear lest the huge capital inflows that could occur in periods of tension should cause them to lose control of their monetary aggregates. There is, therefore, the risk that temporary pressures will lead to realignments that economic fundamentals do not justify and that would otherwise have been avoidable. This would impair the credibility of the EMS and compromise its positive role in promoting the downward convergence of inflation rates.

24. The Governors agree that the risk of exchange rate stability being adversely affected by increased mobility of capital and the elimination of exchange controls should be avoided. To this end the anti-inflationary stance of economic policies and the present flexibility of the system should be preserved. Moreover, to help achieve these goals, they consider that various policy steps are in order. Some of these steps require action by national governments, while the central banks are competent to act on others related more specifically to the management and operating mechanisms of the EMS.

A. Issues requiring action by national governments

25. The stability of the EMS and the possibility of further progress in the construction of an integrated monetary area in Europe depend primarily on the convergence of economic fundamentals. Indeed, since monetary policy on its own cannot ensure the convergence required to achieve stable exchange rates, the full support of fiscal and other policies is required. Further convergence would help to stabilise exchange markets and strengthen private operators' perception that exchange rates will remain stable.

26. It is also desirable for all the EEC countries to accept the discipline of the exchange rate mechanism on an equal footing (see paragraphs 20-22). The Governors stress that progress towards this objective should be made sooner rather than later, as an important step towards full monetary integration in Europe.

27. Realignment policy can also enhance EMS stability by minimising the potential gains from position-taking in expectation of a realignment. In the first place, markets should be led not to expect large exchange rate movements in the wake of a realignment. Secondly, any impression that the authorities are prepared to yield to market pressures through realignments should be avoided. Accordingly, realignments should be infrequent and changes in central rates should be kept small so as, whenever possible, to

avoid changes in market rates. This implies, however, that further progress should be made in the convergence of economic fundamentals. There is also a need to make realignments less predictable, notably by early recognition of fundamental disequilibria and, when these develop, by a prompt decision to realign before the markets see this as inevitable. Finally, everything possible should be done to dispel the impression that realignments are somehow linked to domestic political events.

B. Action by Central Banks

The role of monetary policies

28. In a medium-term perspective, monetary policies should be geared to narrowing the remaining inflation differentials and making national inflation rates converge on price stability. In the short run, this approach should continue to be implemented in a flexible way. Departures from the desired path of monetary growth should, however, be temporary so as not to allow serious or extended divergence from a policy course that is consistent with domestic price stability and convergence; otherwise, expectations would be generated in the market that the emergence of fundamental causes of tensions will be tolerated. Accordingly, short-term policy adjustments should be made in full consideration of the causes of exchange market strains and the final objectives of price stability and convergence within the system.

29. Increased financial innovation and liberalisation of capital movements in those countries which have not already taken this action will not only have implications for interest and exchange rate policies, but also for monetary policy instruments and intermediate targets. The foreseeable increase in residents' holdings of foreign liquid assets will make it more difficult to analyse monetary and credit aggregates. The scope for circumventing controls will be greatly increased, thereby strengthening the case for the use of indirect monetary tools based on interest rates. The abolition of exchange restrictions will improve the allocation of resources and reduce the cost of financial intermediation, but careful consideration must also be given to the differences in the supervisory, regulatory and fiscal arrangements governing financial markets with a view to eliminating distortions that might have a bearing on financial stability.

Exchange rate management - a strengthened monitoring procedure

30. The Governors agree that in the new environment there is scope for a more active and flexible use of all the instruments available to central banks for meeting short-term exchange rate pressures and for better co-ordination of such action among the central banks participating in the EMS. Full and concerted use of all the instruments for defending EMS stability will be all the more necessary to cope with any financial shocks that originate outside the system and affect the participating currencies differently. While recognising that intramarginal interventions will continue to play an important role, the Governors are considering allowing fuller use of the exchange rate fluctuation band with the aim of enhancing the perception of exchange risk among market participants. They also believe that interest rates should be adjusted more promptly when incipient pressures arise, thereby helping to check speculation by raising the cost of open foreign exchange positions. Moreover the Governors intend to seek ways of strengthening central bank co-operation on interventions and related policies, regarding not only EMS currencies but, when appropriate, third currencies and ECUs.

31. To promote more effective use of the instruments available for maintaining exchange rate cohesion within the EMS, the Governors have agreed to strengthen, within the Committee of Governors, the procedure for joint monitoring of economic developments and policies with the aim of arriving at common assessments of prevailing circumstances and appropriate policy responses. This new procedure will build on existing arrangements for mutual exchange of information and monitoring, but it will entail two significant innovations. First, to ensure that potential strains are identified as early as possible, monitoring will focus more specifically and systematically on simultaneous consideration of intervention, exchange rate, and interest rate policies. Secondly, the Governors will use the findings of the monitoring exercise to discuss appropriate policy responses, including the use of interventions and their co-ordination.

EMS mechanisms

32. The Governors emphasise that it is essential to avoid any easing of discipline or change in the balance between adjustment and financing of balance-of-payments disequilibria. In the light of their operational experience with the EMS mechanisms and the changes in the environment, the

Governors have agreed that a number of modifications would be useful and desirable.

(a) Very short-term financing

33. The duration of such financing (which is unlimited in amount) will be extended by one month, taking the maximum duration from two and a half to three and a half months. Initial financing operations will still be automatically renewable for three months at the request of the debtor country, but the ceiling on automatic renewal, at present equivalent to the country's debtor quota in the short-term monetary support mechanism, will be raised to 200 per cent. of this quota.

34. The Governors have agreed that automatic VSTF financing of intramarginal interventions should not be introduced. They point out that such financing of intramarginal interventions through the EMCF is already possible if the central banks directly involved concur. They accept a presumption that intramarginal intervention agreed to by the central bank issuing the intervention currency will qualify for financing via the EMCF on the following conditions:

- the cumulative amount of such financing does not exceed the double of the debtor quota of the debtor central bank in the short-term monetary support mechanism;
- the debtor central bank is also prepared to use its existing holdings of the currency to be sold for intervention in amounts to be agreed;
- repayments shall be made in accordance with the rules specified in Article 16.1 of the EMS Agreement. The creditor central bank reserves the right to request payment in its own currency if this appears necessary in the light of its own monetary conditions, taking into account the reserve position of the debtor central bank.

35. Larger cross-holdings of EMS currencies in participating central banks' reserves can be expected to develop as a natural consequence of increased integration and monetary convergence in the EMS. Although substantial accumulations of assets in EMS currencies do not appear desirable, holdings of larger working balances in these currencies, subject to prior agreement by the issuing central banks, could in certain circumstances help to improve the working of the system. The Governors believe that current

arrangements in this regard do not constitute an obstacle to such enhanced holdings of partners' currencies.

(b) Short-term monetary support

36. The Governors consider that the short-term monetary support mechanism does not need to be modified.

(c) Matters relating to the ECU

37. On the basis of the positive experience with official ECU mechanisms, the Governors have agreed to accept settlement in ECUs of outstanding claims in the VSTF in excess of their central bank's obligation and up to 100 per cent. as long as this does not result in an unbalanced composition of reserves and no excessive debtor and credit positions in ECUs emerge since these would in time endanger the ECU's credibility. After two years of experience, the formal rules relating to the official ECU will be subject to review.

38. As regards the further development of the ECU, the Governors reaffirm their belief that the private ECU market should continue to develop in response to market forces. The Governors welcome the lifting of restrictions on the use of the private ECU in Germany and Spain and are confident that the remaining restrictions on the use of the private ECU will be removed as part of the liberalisation of capital movements under way in the Community.

39. The Governors have examined other ways to broaden the usability of the ECU. In particular, they have considered various proposals to introduce a link between the private and official ECU circuits. They have reached the conclusion that these proposals would be feasible and that they would neither raise major technical or legal problems nor have major monetary or exchange rate implications under present circumstances. Although their practical consequences in the short term would appear to be limited, their implementation would nonetheless raise issues relating to the long-term evolution of the ECU and the involvement of the monetary authorities in the functioning of the private ECU market, issues which the Committee of Governors will keep under review.