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

(Translation)
8th March 1977

REPORT TO THE COUNCIL AND THE COMMISSION ON THE FEASIBILITY OF IMPLEMENTING THE DUTCH PROPOSALS REGARDING TARGET ZONES FOR EXCHANGE RATES WITHIN THE COMMUNITY

In accordance with the mandate issued by the Council of the European Communities (Economical and Financial Affairs) at its meeting on 8th November 1976, the Committee of Governors has studied the Dutch proposals for strengthening economic and financial cohesion within the Community through the introduction of target zones for exchange rates.

A target zone system - which would be expressed in terms of effective exchange rates - could fulfil the following objectives:

- to help achieve more stable relationships within the Community between the "snake" currencies and those floating independently;
- to provide a mechanism that would trigger off Community consultations concerning not only exchange rate policy and related spheres (monetary policy, exchange-market interventions, exchange control, etc.) but also general economic policy.

Several comments were made within the Committee of Governors regarding this system. It was pointed out, in particular, that:

- given the diversity in the structure of individual Community member countries' foreign trade, a mechanism based on effective exchange rates is not by its nature an instrument which would necessarily lead to greater exchange rate stability within the Community;
- from a technical point of view, the setting of a single effective exchange rate for the whole "snake" group would be problematical, while there is a danger that the establishment of individual zones by each of the members of the "snake" could subsequently lead to conflicts between the obligations deriving from the zones and the priority obligations stemming from the "snake" arrangement.

- that, in order to be meaningful, a system of target zones should rest on the assumption that the participating countries will attempt to keep their currencies within the zone set; however, although, according to the Dutch proposals, this would imply no more than consultations and perhaps domestic economic and monetary policy measures, there would nonetheless be a real risk that the markets would assume that there existed intervention obligations and would, on that basis, engage in speculative activities harmful to the currencies in question;
- that the linking of a system of consultation to the overstepping of target zones seems to be restrictive and too automatic; consultations could in fact prove useful and desirable when, for example, important measures were envisaged or taken by a member country or when significant developments or events occurred within or outside the Community.

In the light of these considerations the Governors are unable, at this juncture, to recommend the introduction of a system of target zones for exchange rates within the Community; however, they do feel that the Dutch proposals have the great merit of emphasising two points, namely:

- the need to strengthen the co-ordination of economic and monetary policies, and
- the advisability of taking greater account, in consultations, of the relationship between the development of exchange rates and the development of prices and costs and of domestic economic and monetary policies.

The Governors believe that in regard to these two points some progress could be achieved immediately within the framework of existing bodies and, in view of the particular sphere of responsibility of the central banks, they have concentrated their attention on monetary policy. Moreover, experience in the past few years has shown the importance of the rôle monetary policy can play in respect of exchange rates if it is accompanied by cohesive and appropriate economic and budgetary policies and combined with a flexible intervention policy.

The Committee of Governors has agreed to undertake regular examinations (as a rule three times a year) during which it will in particular study whether liquidity creation through planned budgetary and monetary policies is consistent with requirements in regard to external and domestic monetary stability; it will pay special attention to:

- the development of the public-sector borrowing requirement and methods of covering it, as well as differences in these respects among member countries;
- the impact of such methods and of credit to the domestic economy on the money supply and interest rates;
- the probable effects of the policies pursued on exchange rates and balances of payments.

These examinations, which have been embarked upon recently by the Governors, are similar to those which the Monetary Committee was asked to carry out by the Council on 8th November 1976. The two Committees would thus be working in the same direction; some of their preparatory work could be effected jointly, and could, in particular, include a detailed analysis of the interaction and interrelationship between the development of currencies (both their market rates and their effective exchange rates) and the development of the economic and monetary policies pursued and of the other economic and monetary aggregates.