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

21st August 1978

(Translation)

Group of Experts under the
chairmanship of M. Heyvaert

No. 39.

EUROPEAN CENTRAL BANK
ARCHIVES

# INTERIM REPORT ON THE EUROPEAN MONETARY SYSTEM

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# INTERIM REPORT ON THE EUROPEAN MONETARY SYSTEM

In pursuance of the mandate given to it by the Committee of Alternates of the Governors of EEC central banks at its meeting on 11th July 1978, the Group of Experts under the chairmanship of M. Heyvaert (see attached list of members) examined the main technical problems arising from the establishment of a European monetary system as described in the Presidency's conclusions and annex on monetary policy that were published at the close of the European Council meeting held on 6th and 7th July 1978 in Bremen.

The Group concentrated on the technical aspects of the whole range of issues raised by the creation of a new European monetary system; however, given the scope and complexity of these issues the experts would like to emphasise at the outset the tentative nature of the present document.

The Group deliberately excluded questions of a political nature from its examination. It also abstained from dealing with the legal questions arising in this context that require solutions both on a Community and, potentially, on a national level.

It may first be recalled that the European Council:

- envisages a "durable and effective scheme", with the European currency unit (ECU) at its centre;
- proposed that the competent Community bodies should elaborate by 31st October 1978 the provisions necessary for the functioning of such a system, "if necessary by amendment" of the broad outlines laid down;
- stipulated that two years at the latest after the entry into operation of the system the existing arrangements and institutions shall be consolidated in a European Monetary Fund.

The Group emphasised that the durability and effectiveness of the system primarily depend not on the adoption of new exchange rate arrangements but on more fundamental measures, an examination of which lies beyond the scope of its mandate.

The report comprises three main sections dealing successively with the numeraire, the intervention system and the European Monetary Fund.

## I. THE NUMERAIRE

The Bremen communiqué indicates that the European currency unit, or ECU, which would be defined in the same terms as the existing European unit of account, will be at the centre of the European monetary system and will be used in particular as a means of settlement among the EEC monetary authorities.

The implications of the choice of this numeraire, in particular as the basis for exchange rate policy, will be examined below with reference to most of the situations in which the participants in a monetary system are likely to be placed in the course of its operation.

The object of this examination is:

- to identify the possibilities or difficulties inherent in using the EUA as currently defined;
- to propose any modifications deemed necessary, as allowed for by the European Council meeting in Bremen, with respect either to the definition of the ECU or to the uses to which it will be put*.

Several formulae for the numeraire are conceivable, differing appreciably in nature, characteristics and implications according to the cases in which they are applied.

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* If a modification of the present structure of the EUA is deemed essential, a problem could arise with regard to the coexistence of the EUA as modified for monetary use and that which would be used in the other sectors of Community activity.

A. The various types of numeraire and their uses

The term "numeraire" in this section is taken to mean the reference basis adopted for obligations assumed under the exchange rate system. Three formulae have been considered:

1. Basket-type numeraire

Under this variant the ECU would be defined as a basket of Community currencies. Within this general category two sub-categories of basket may be distinguished:

- a standard basket (the present EUA) in which the quantity of each component currency is fixed, and in which the weights of the currencies therefore vary in response to exchange rate movements between them;
- an adjustable basket, in which the weights are fixed and the quantities of each currency are adjusted in proportion to exchange rate movements (i.e. increased for depreciating currencies, reduced for appreciating currencies); such adjustments can be confined to cases in which central rates have been altered (or, in the case of floating currencies, when there have been substantial movements).

There is one essential feature which is commmon to both these sub-categories and which distinguishes them from a parity grid system. With the latter system, if one participant currency reaches its upper or lower intervention limit, there will always be at least one other currency at its intervention limit on the opposite side of the band. By contrast, with a basket-type numeraire a currency will normally be alone in reaching its upper or lower intervention limit vis-à-vis the numeraire (in this case the ECU), without there being any other currency at the opposite limit.

This has the advantage, in the view of some experts, of pinpointing the divergent currency. But it complicates the choice of intervention currency or currencies and raises controversial issues regarding application of the rules for the settlement of debts arising out of intervention. These points are dealt with subsequently in Section II, 3 and Section III, D, respectively.

The main features peculiar to the standard basket are as follows:

(a) This variant would assure identity with the EUA, which is tending to be used more widely in the Community. In the opinion of some experts, the ECU would, by its structure, be representative vis-à-vis the rest of the world of the Community currencies as a group. It would have a number of features that would tend to strengthen the solidarity between those currencies and the policies pursued by the member countries (see (b) below). It would thus constitute the embryo of the future European currency.
Other experts point out, however, that a parity grid system might have a greater likelihood of being considered as providing the embryo of a European currency. In its Resolution of 22nd March 1971 the Council of Ministers stipulated that the way to monetary union lay through the reduction, and ultimate elimination, of margins of fluctuation between member currencies, so as to merge them into a single currency. A parity grid system, with progressively narrower margins, lends itself better to such a merging of the nine currencies than a unit of account which would constitute a tenth element.

(b) A parity change in any one participant currency vis-à-vis the ECU numeraire would, as a general rule, oblige other participant currencies also to change their parities vis-à-vis the ECU (see B. 1 below).

(c) Non-participation in the system or opting out would impair the efficient functioning of the numeraire (see B. 2 below).

(d) The system would discriminate in favour of currencies with a heavy weighting in the basket, in that any given movement in their exchange rates vis-à-vis other component currencies would tend to be reflected in a smaller movement vis-à-vis the ECU than would be the case for currencies with a lighter weighting. Moreover, over time weights in the basket change spontaneously, in that appreciating currencies increase their weight while depreciating ones reduce theirs. However, it would be possible to carry out periodic reviews of the weights in the standard basket so as to take account of the development of the underlying economic aggregates.

A numeraire in the form of an adjustable basket would differ from a standard basket in the following ways:

(a) While retaining a stable value vis-à-vis the rest of the world, it would nevertheless be less representative of the group of Community currencies and of developments within the group.

(b) A parity change in one currency vis-à-vis the ECU would not oblige others also to change their ECU parities in the other direction.

(c) The functioning of the numeraire would be less affected by non-participation or opting out.

(d) The problems arising from differences in weights within the basket would be attenuated.

(e) It would not be identical to the EUA.

2. Parity grid

Under such a system the central rates of the ECU in each of the currencies would be used, like the central rates of the EMUA in the present "snake" arrangement, to establish a grid of bilateral parities, to which the margin would be applied in order to determine the bilateral intervention limits. It is consequently impossible for one currency to reach its upper or lower intervention limit without another currency simultaneously reaching its opposite limit. Thus, no problem arises over the choice of intervention currency and there is no doubt or ambiguity concerning the obligations of either debtor or creditor.

The following features distinguish a parity grid system from the standard basket (but not from the adjustable basket):

(a) parity changes in one currency vis-à-vis the numeraire do not require parity changes in any other currencies vis-à-vis the ECU;

(b) non-participation and opting out do not pose technical problems;

(c) there is no problem of different weightings.

3. <u>The ECU as the basis for a parity grid and an indicator of divergence</u>

It is possible to conceive of a compromise between the basket and parity grid variants, whereby the ECU would be used as the basis for a grid of reciprocal central rates, in the same way as the EMUA is at present used in the "snake". Bilateral intervention limits would be derived from these central rates as they are in the "snake". In this way, what some experts see as the principal advantages of the parity grid system (symmetry of intervention obligations, automatic determination of the intervention currency, functional simplicity and efficiency in the event of parity changes, non-participation or opting out) would be preserved.

At the same time, what other experts see as one of the main attractions of an ECU-based system, namely that it pinpoints the divergent currency, could also be preserved, if movement against the ECU were regarded as a kind of "objective indicator" for the purpose of demonstrating whether or not a particular currency was "out of line" with other Community currencies as a whole.

Some experts, however, note the drawback that pinpointing of the divergent currency does not necessarily have any automatic implications either operationally or with respect to adjustment; others point out that this indicator does not in itself suffice for inferences to be drawn from the indicated trend.

B. <u>Implications of the numeraire in the event of changes in central rates and of temporary or lasting non-participation in the system</u>

The satisfactory functioning of the European monetary system presupposes permanent participation by all the EEC currencies on the basis of stable central rates. Provision should nonetheless be made for adjustments in central rates. Moreover, some experts think that the possibility cannot be completely ruled out of certain currencies not joining the exchange rate system at the outset or having to leave it for an indefinite period.

1) <u>Changes in central rates</u>

The annex to the Bremen communiqué specifies that changes in central rates will be subject to mutual consent. The experts wish to stress that the use of a standard basket as the numeraire presupposes not only mutual consent but also acceptance of the principle that the central rates of all the currencies in the system will be changed whenever one country is authorised to adjust the central rate of its currency. A devaluation of a currency in terms of the ECU must be accompanied by an offsetting revaluation of each of the other currencies in the system if the structure of the basket, which is made up of fixed quantities of currencies, is not to be altered or if these currencies are not to be exposed to the risk of being pushed more or less rapidly towards, or even beyond, their intervention limits in terms of the ECU.

In the case of an adjustable basket, a change in the central rate of one currency does not automatically entail changes in the central rates of the other currencies; this is equally true if the numeraire is used as the basis for determining a grid of bilateral parities.

2) Temporary or lasting non-participation

If one or more Community currencies were not to join the system at the outset or were to leave it, their performance would still influence the value of the standard basket and, in the absence of any further provisions, affect the intervention obligations of the other central banks.

The following alternative ways of dealing with "absentee" currencies in the ECU standard basket could be envisaged:

- the "absentee" currency or currencies would be retained in the standard basket on the basis of a fictitious rate; as a result the ECU would no longer be identical with the EUA, and the value of the ECU would no longer reflect the average trend of all the Community currencies;
- the "absentee" currency or currencies would be excluded from the standard basket, which would alter the latter's structure;
- the "absentee" currency or currencies would be retained in the standard basket at their market value; in this case, the other currencies might be brought to their intervention limits vis-à-vis the ECU, obliging the countries concerned to intervene and confronting them with the problem of choosing the intervention medium; use of

the "absentee" currency might conflict with the exchange rate policy and interests of the country of issue, while the use of other Community currencies might be ruled out by their position vis-à-vis the ECU. This would lead to interventions in dollars contrary to the principle set out in the annex to the Bremen communiqué; if such interventions seemed unacceptable, the countries participating in the system would then have to change the central rates for their currencies.

It should be noted that some of the drawbacks outlined above could be alleviated if the numeraire chosen were not the standard basket but an adjustable basket (which would, however, break the link between the ECU and the EUA) and would be eliminated if the parity grid were adopted.

## II. THE INTERVENTION SYSTEM

It may be established from the indications given in the communiqué published in Bremen that the European exchange rate system should:

- comprise all the member countries of the EEC;
- be durable and effective;
- co-exist with the "snake";
- be at least as strict as the "snake";
- be based on interventions undertaken, in principle, in the currencies of the participating countries;
- involve a co-ordinated exchange rate policy vis-à-vis third currencies compatible with international obligations;
- enable countries that are not currently participating in the "snake" to opt for wider margins in the initial stages of operation;
- allow third countries to become associate members;
- have at its centre the European currency unit (the ECU).

As the features of an intervention system based on bilateral limit rates between currencies are familiar (through the "snake"), the considerations that follow are devoted mainly to the implications of a system in which the margins of fluctuation would be defined in terms of the ECU.

1. <u>Width of the margin of fluctuation</u>

The width of the margin of fluctuation will be affected by some of the characteristics required of the system, such as the stability and durability essential to its credibility, co-existence with the "snake" and a degree of stringency at least equivalent to that of the "snake".

The first of these requirements may be met fairly easily by stipulating, in broad terms, that the band of fluctuation should be sufficiently wide to be respected without unduly frequent recourse to intervention or adjustment of central rates and sufficiently narrow to impose some measure of discipline and make the system effective.

It will prove more difficult, however, to meet the other two requirements. By definition, under a system in which margins of fluctuation are fixed in relation to the ECU, there is no way of accurately determining the levels that bilateral nominal rates might reach. The only figure that may be calculated with certainty is the "maximum" spread between nominal rates, which, in percentage terms, will amount to double the margin ruling in respect of fluctuations vis-à-vis the ECU, if that margin is uniform.

Hence, an ECU margin half as wide as the "snake" margin would result in extreme limits for nominal rates comparable to those existing within the "snake", although in practice the latter would scarcely ever be attained; an ECU margin more than half as wide as the "snake" margin would thus be necessary to exclude the possibility of the "snake" limits never again being reached, and of that system consequently ceasing to be operational, although it is not possible to determine precisely the level at which the two systems would impose the same degree of constraint.

The nominal exchange rate limits, corresponding to twice the ECU margin, could be disclosed to the market, as the central bamks would undertake to ensure that they were observed on their own markets; some experts have doubts, however, about the wisdom of such a disclosure, which would to a large extent have only theoretical significance.

A number of considerations tend to support the adoption of different ECU margins for the various currencies:

- the annex to the Bremen communiqué indicates that provision could be made for the countries outside the "snake" to apply wider margins, at least during the transitional phase, in order to facilitate their participation in the new European exchange rate system; the consequences of such a provision would have to be examined separately at a later date;
- the setting of ECU margins in inverse proportion to the weight of each currency in the basket would be one way of counteracting the asymmetry of a basket with different weightings; some experts consider that such a system of graduated margins would constitute the best way of restoring the symmetry of nominal exchange rate fluctuations and consequently of the intervention burden, without departing from an ECU corresponding to the EUA or raising difficulties in its use.

  However, most of the experts are in favour of selecting a uniform margin in relation to the ECU, even if it has to be somewhat wider, at least in the initial stages.

2. <u>The degree of automaticity and compulsion of the intervention obligation</u>

Whereas in the "snake" interventions at the limits of the margin automatically and compulsorily involve two central banks, the obligation to intervene in a system based on the ECU would in most cases be unilateral, thus raising the question of the choice of European intervention currency or currencies (see 3 below). It is in fact unlikely that the currencies of two central banks would reach their intervention points vis-à-vis the ECU simultaneously - one its lower limit and the other its upper limit. This situation creates the possibility of involuntary "debtors" or "creditors" by giving rise to intramarginal intervention obligations for the other currencies (see Section III, 3, D, below).

Moreover, the point at which intervention became compulsory could not be determined from the development of nominal exchange rates but would depend on the value of the ECU, itself determined by a combination of nominal rates.

Recognition of this point would therefore require permanent monitoring, especially at times of tension, of the results of complicated calculations which could only be effected in real time (without a time-lag) by means of technological equipment and which would have to be effected for each participating currency. The publication of official exchange rates on certain markets augments the need for such monitoring when these rates are quoted.

The method of calculation would have to be uniform.

The feeding of data into the calculating equipment would have to be sufficiently frequent.

The triggering of interventions by the attainment of maximum margins vis-à-vis the ECU rather than by the attainment of nominal exchange rate limits familiar to the market might be a source of market uncertainty; some experts feel that this could create a climate of instability and speculation, whereas others believe it might encourage prudence. Moreover, it seems likely that more frequent interventions would be necessary under a system based on the ECU, at least as far as currencies with a light weighting are concerned, than under a system of nominal exchange rate limits.

On the other hand, the initiative for intervention would pass to the central banks, particularly with regard to the choice of intervention currency; while this would give the central banks greater flexibility, it would also require them to guard against being overtaken by events. A further element of flexibility could be introduced by giving a central bank the right, subject to prior concertation, to intervene in the market when its currency approached its limit in relation to the ECU.

A large number of experts fear, in more general terms, that the disadvantages of imprecision and uncertainty inherent in an intervention system based on the ECU would outweigh its advantages in terms of flexibility.

## 3. The choice of intervention currencies

In the "snake" system the intervention currency is indicated automatically by the nominal rate reaching its intervention limit.

However, an ECU system would raise the general question of the choice of intervention currency or currencies, and of its implications for the foreign exchange reserves and the monetary policy of the central bank whose currency is chosen.

When intervention is necessary under a system known to the market, central-bank action must not be delayed nor be entirely dependent on concertation. Any difficulties over the choice of currency could therefore lead to the use of dollars in preference to partners' currencies, which would be contrary to the annex to the Bremen communiqué. In these circumstances it is important to establish a number of rules which would guide the intervening central bank in its choice.

In establishing these rules, account should be taken of considerations such as:

- the position and trend of the other currencies in relation to the central rate in ECUs;
- the size of the market in the intervention currency;
- the differing impact of the currency used for these interventions, depending on its weight in the basket;
- if a "snake" currency is involved, its position within that system.

It may be noted in this connection that if a country whose currency has a heavy weight in the ECU were to intervene in a currency with a light weight because that currency was furthest from the central rate on the opposite side, its interventions could modify the rate of its currency vis-à-vis the ECU only marginally, whereas the rate of the light-weight currency would be altered more appreciably and its value in terms of the ECU could rapidly approach the central rate.

In such a case, the intervening country might have to use the currencies that successively became furthest from its own. If this procedure seemed too complicated or inadequate, it could be agreed that only heavy-weight currencies on the opposite side of the central rate should be used. Finally, interventions in dollars could be authorised where interventions in European currencies proved inadequate or inappropriate.

4. Coexistence with the "snake"

The question of the coexistence of the monetary system based on the ECU and the "snake" is linked principally with that of the numeraire, the width of the margin of fluctuation vis-à-vis the ECU and the scope and effectiveness of a co-ordinated policy vis-à-vis the dollar (see 7 below).

As was mentioned in the section on the numeraire, if the ECU, like the EMUA in the present "snake", were to be used only to determine bilateral nominal intervention rates, coexistence would raise no problems even if the EEC countries had different margins depending on whether or not they belonged to the "snake". The narrower margin applied in the past by the Benelux countries within the "snake" is a concrete example of such coexistence.

Assuming that the margin of fluctuation would be applied directly to the numeraire, coexistence of the two monetary systems (the "snake" and the ECU) would depend on the width of the margin. It has already been noted in Section II.1 that if the margin vis-à-vis the ECU is more than half as wide as that under the "snake", there will be no incompatibility in this respect between the two systems, and the "snake" will thus remain operational.

Coexistence will normally lead to a certain alternation in the occurrence of obligations under the two systems.

The extreme cases of a central bank having to intervene simultaneously in conflicting directions, by making purchases under the rules of the EMS and effecting sales within the framework of the "snake" and vice versa, could only arise if the margin adopted vis-à-vis the ECU considerably exceeded that used for the "snake".

Coexistence also raises the problem of the unit to be used for booking and settling the balances that result from interventions effected under the two systems. The experts feel it is advisable to book the liabilities and claims resulting from interventions under both systems in the same instrument as will be created against initial deposits of gold and dollars, i.e the ECU. Settlements would thereby be facilitated.

5. Simplification of the rules for the new intervention system

The utilisation of a basket-type unit to fix the fluctuation limits for each currency participating in the EMS would give rise to various problems which have been described in earlier sections.

Some experts therefore considered the possibility of using the ECU formula as the basis for a parity grid and divergence indicator (see Section I. A. 3). They feel that this procedure - which would combine some of the characteristics of the ECU system and those of the "snake" - would be far simpler, while at the same time making it possible, by observing the development of the value of the ECU in each of the participating currencies, to pinpoint the currency which was diverging most from the central rate and, consequently, the country which would, as a rule, have to bear the burden of the adjustment process. In the view of these experts, such a formula would avoid:

- the technical problems that would arise from having to maintain the rate for the currency of each central bank within upper and lower limits vis-à-vis the ECU;
- market uncertainty concerning central banks' actions.

It would, moreover, facilitate the coexistence of the ECU and "snake" systems.

Other experts consider, however, that a formula of this type would be not a simplification but rather a disguised modification of the system described in the Bremen communiqué, and would constitute the effective maintenance of the present system. Linkage to the ECU would be only a fiction: the ECU, far from being at the centre of the new exchange rate system, would be dislodged from it and, as a result, most of the elements of flexibility inherent in the use of the ECU as the numeraire would disappear.

The simplified formula set out above could, in the view of many experts, prove useful for a transitional period, particularly if the indications supplied by the "ECU barometer" were to result in the effective implementation of the necessary corrective measures.

Some experts are, however, doubtful as to how reliable an "ECU barometer" would be in identifying the divergent currency, given the structure of the ECU and the effect of the weightings of its component currencies: the indicator provided by the development of the rate for the ECU in a given currency would need corroboration from other sources.

6. Book-keeping and financing arrangements in respect of interventions in currencies participating in the system

In the same way as under the present "snake" system, the balances arising from interventions in the context of the EMS would have to be converted into ECUs and entered in the books of the European Monetary Fund (during the transitional period, the EMCF)*.

The question of the rates to be applied in converting into ECUs the currencies used for interventions (daily rates or central rates in terms of the currency of the creditor or that of the debtor) will have to be examined in due course.

Under the new system, just as in the "snake", provision would have to be made for an unlimited amount of initial very short-term financing for the balances resulting from interventions, even if the creation of assets in ECUs against deposits of official reserves were to allow immediate settlement up to the amount of such assets by their simple transfer in the books of the Fund.

The questions concerning the duration of very short-term financing, interest payments and settlement procedures in respect of the balances resulting from very short-term financing operations will be considered in Section III.

7. Co-ordination of exchange rate policies vis-à-vis third currencies

The annex to the Bremen communiqué stipulates that the countries participating in the system shall co-ordinate their exchange rate policies vis-à-vis third currencies and to this end shall intensify consultations in the appropriate bodies and between the central banks participating in the system.

As numeraire of the new system, the ECU contains no intrinsic element that would be likely to contribute automatically to the conduct of a common policy vis-à-vis the dollar since, unlike the SDR for instance, the basket would consist solely of Community currencies.

* This proposal implies an amendment of the regulations governing the EMCF, in particular Article 5 of the Statutes which lays down that the Fund's operations in the currencies of the member states shall be expressed in EMUAs.

On the other hand, the adoption of a common numeraire would hardly permit widely diverging developments in relation to the dollar. The operation of the new system would, moreover, probably have fewer repercussions on the performance of the dollar inasmuch as the facilities for intervening in Community currencies would be systematically afforded to all members of the Community instead of being limited to the "snake" countries as at present.

The co-ordination of exchange rate policies vis-à-vis the dollar can neither rest solely on regular or ad hoc consultations nor be governed by unduly detailed or stringent regulations, since these would be unacceptable to some members or inapplicable in practice. Between these two extremes, only a few alternatives can be envisaged. These would, in particular, have to provide:

- that the utilisation of the dollar instead of or in addition to the currencies in the system would be strictly limited to instances warranted by the respective positions of the currencies concerned in relation to their central rates against the ECU and the recent margins recorded by each of them in relation to the dollar,
- an overwhelming presumption in favour of interventions in dollars by countries whose currencies are within the margin, as long as such interventions do not, on the one hand, tend to take the currency in question further away from its central rate and, on the other, reinforce any spontaneous tendency in the dollar (i.e. do not involve sales of dollars when the dollar is noticeably weak on most EEC markets, or purchases of dollars when the dollar is noticeably strong).

Furthermore, the effective application of the rules embodied in the arrangement of 12th March 1975 and those contained in the report of the Committee of Governors to the Council of 9th December 1975, rules which have not been revoked and which retain their merit, would, in particular, preclude simultaneous interventions in opposite directions, and so meet the wishes of the European Council.

## 8. Association of third currencies

The Bremen communiqué states that "non-member countries with particularly strong economic and financial ties with the Community may become associate members of the system".

The actual association of third countries would naturally have to be the subject of discussions and negotiations between the candidate countries and the Community in due course. The experts have therefore confined themselves at this stage to sketching the broad outlines of association as it can be envisaged on the basis of the characteristics of the system.

A distinction has to be drawn between actual participation in and association with the ECU system.

In effect, three possible cases are conceivable:

- a third country would actually become a member of the EEC: it would have to choose whether to participate in the "snake" or only in the system based on the ECU;
- a country that is not a member of the EEC would remain in the "snake" (the case of Norway), join or rejoin it (which could be the case of Sweden), and opt whether or not to become an associate member of the system based on the ECU;
- a third country would only become an associate member of the system based on the ECU.

Assuming that the ECU, whether it is a standard basket corresponding to the current EUA or an adjustable basket, would constitute the numeraire of the system, association would mean that a third country would agree to declare a central rate in relation to the ECU and to maintain its currency within limits expressed in relation to that central rate. Although there is no question of the currency of an associated country being included in the composition of the basket comprising the ECU, the value of the ECU can be calculated at any time in the currency in question provided it is quoted on the foreign exchange market.

The associated countries would have to subscribe to the same intervention obligations and to benefit from the same very short-term financing facilities as the EEC countries. On the other hand, the settlement of balances when such financing matured would be effected by means of traditional reserve assets. On the technical side there would be no objection - and it would, in fact, be simpler - if the financing of intervention operations involving associated countries were entered in the books of the Fund (EMCF at first, and afterwards the European Monetary Fund) in ECUs. This would, in particular, provide a clearer overall picture. The Group has not, however, examined the problems of a legal or political nature that could arise in defining the relationships between the associated countries and the Fund (or the EMCF) with regard to intervention operations, book-keeping procedures and settlement.

It should be noted that as far as Norway's current association with the "snake" is concerned, no change would be necessary.

Finally, the central banks of the associated countries would have to be connected to the existing telephone concertation network.

## III. THE EUROPEAN MONETARY FUND

### 1. The Bremen guidelines

The establishment of an initial fund of ECUs forms an integral part of the European monetary system that is to lead to a zone of monetary stability.

The fund is to be set up through the deposit of gold and dollars amounting to, say, 20 per cent. of the reserves held by member central banks and a contribution in national currencies of the same order of magnitude.

As a counterpart to the assets that it receives, the fund will issue ECUs to be held exclusively by the central banks. The use of the ECUs created against deposits of national currencies is to be subject to certain restrictions, bearing in mind the need for substantial short-term credits (up to one year).

The initial deposit of reserve instruments is to be supplemented by further deposits in the fund of a portion (say, 20 per cent.) of any growth in reserves due to purchases of dollars; sales of dollars will result in a corresponding withdrawal from the assets of the fund.

Two years at the latest after the entry into operation of the system, the existing arrangements and institutions are to be consolidated in a European Monetary Fund.

2. Rôle and general concept of the EMF

Analysing, on the basis of the Bremen communiqué, the operations which it is proposed to entrust to the Fund, the latter's functions or objectives may be defined as follows:

- to demonstrate that the new European monetary system is a step towards European monetary union;
- to establish the ECU as the mainstay of the European monetary system and provide for the creation of ECUs;
- to facilitate intra-Community financing and settlements;
- to encourage to some extent the application of a common policy vis-à-vis the dollar and to contribute to the financing of surpluses and deficits hitherto settled in dollars;
- to enhance the credibility of a new exchange rate system by creating a fund of ECUs and managing the financial assistance designed to meet the needs of the participating countries;
- to consolidate existing arrangements and institutions;
- to mobilise a portion of the central banks' gold reserves.

However, the number and nature of the functions entrusted to the Fund will depend on the powers that its members are willing to vest in it. In this regard two extreme concepts of the Fund are conceivable.

Under the first concept, the Fund would remain essentially an accounting entity, despite the centralisation in it of a portion of the reserves of its member countries and of the financing mechanisms existing in the Community. Such a Fund:

- would not in any way alter the rights, obligations and risks deriving from the possession of foreign exchange reserves and existing credit facilities;
- would have no power to act in its own right or to co-ordinate the policies of its member countries.

Under the second, more ambitious concept, the Fund would be an administrative entity invested with some powers of action. Such a Fund:

- would possess assets of its own and would manage them on the basis of a pooling of risks at Community level;

- could participate, if necessary, in the costs arising from intervention policies;
- would itself lay down guidelines for the use by central banks of the various facilities that it offered;
- finally, could constitute the normal forum for concertation among member countries.

Some of the experts consider that the second concept of the Fund goes well beyond the intentions expressed in the annex to the Bremen communiqué.

The establishment of operating procedures - which will be discussed below - will depend, at least in part, on the general concept that is adopted. This choice will be influenced by political considerations which are beyond the competence of the present Group. However, the Group has also noted the existence of legal problems, particularly in connection with the transfer to a Fund of rights of ownership of national reserves and the nature of the resources to be created in ECUs. Leaving aside the political aspects, it seems unlikely that these problems can be resolved before the beginning of 1979. It therefore appears more realistic to concentrate initially on the possibility of expanding the rôle not only of the EMCF in its present form but also of the Agent of the EMCF.

3. Operating procedures of the Fund*

A. Depositing of reserve assets against ECUs

(a) Reserve components to be transferred

The Bremen communiqué envisages the depositing of gold and dollars only. The drawback of such an arrangement is that the assets of the Fund would not reflect the composition of the reserves of the Community. However, reserve positions with the IMF cannot be transferred as such to the Fund and the depositing of SDRs depends on the Fund being granted "other holder"

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* In order to take account of the special position of Luxembourg, where overall responsibility for monetary affairs is not centralised in a central bank and where some powers have been delegated to the National Bank of Belgium under a monetary association agreement between the two countries, a formula for participation in the new institutions should be adopted that would give Luxembourg a special place, as in the case of other Community or international financial institutions such as the EIB and the IMF.

status. The possibility of making contributions in SDRs at a later stage should, however, be left open so as not to compromise the general stance adopted by the Community in favour of promoting the SDR as a reserve instrument in the international monetary system. The depositing of assets in currencies other than the dollar would not seem to be advisable, since such assets consist largely of EEC currencies, which do not constitute reserves from the point of view of the Community as a whole.

The depositing of gold with the Fund should not normally raise serious difficulties; it would probably not be effected by the physical movement of gold but by means of earmarked deposits in the name of the Fund - or the agent of the Fund - at each member central bank.

If problems were encountered, however, in depositing gold with the Fund or in its treatment, contributions could, at least initially, be made in one reserve component only, namely dollars. Moreover, if this arrangement were opted for, it would simplify the problems relating to the distribution of risks and the yield on assets in ECUs.

Nevertheless, in the remainder of this section it has been assumed that the contributions will consist of both gold and dollars.

(b) <u>Fixing the assessment basis and the distribution key</u>

In order best to reflect the volume of the Community countries' reserves, it would be desirable to adopt <u>as broad a concept as possible</u> in defining the basis of assessment, rather than one limited to holdings of reserve components eligible for contribution to the Fund. The Bremen communiqué indicates as the basis of assessment "the stock currently held by member central banks", but it does not specify whether the concept adopted should be that of gross reserves or net reserves. In the latter case, what types of external liabilities (those of the monetary authorities, the whole public sector, the banking sector; short or long-term liabilities) could be deducted from the gross reserves? Could long-term official claims also be included in the basis of assessment? The first consideration mentioned above, the indication given in the annex to the Bremen communiqué and the complexity of the issues that would have to be resolved in defining a concept of net reserves seem to warrant using the data appearing in the monthly tables of the EMCF.

However, two further questions arise, namely:

- At what price should gold be valued in order to determine the total value of reserves?
- What is the situation as regards countries whose reserves comprise a large proportion of assets in SDRs and IMF reserve positions and which would thus have to contribute a relatively higher percentage of their assets in gold and dollars?

The Bremen communiqué suggests that the total contribution of the EEC central banks should amount to, say, 20 per cent. of the basis of assessment. As no scale is specified for apportioning this overall amount among the central banks, several combinations are possible. As regards the apportionment of the overall contribution, the following alternatives are conceivable:

- each central bank to contribute the same proportion (say, 20 per cent.) of its reserves, the size of the contribution being unaffected by other economic or financial criteria;
- the contributions to be apportioned according to a fixed key, taking into account economic importance or other criteria regarded as representative; those countries a portion of whose reserves are borrowed stress that even if any key other than one based on reserves were adopted for the contributions to the Fund, a periodic adjustment would still have to be made on the basis of reserve movements so as to enable these countries to recapture resources from the Fund when repaying their public-sector borrowing; such periodic adjustments would, of course, only apply to gold and dollar contributions or possibly even only to the dollar element.

In addition to the overall size of national contributions, agreement would also have to be reached on the respective proportions to be paid in gold and dollars: should this be the same for all countries or varied according to the relative size of each country's holdings of gold and dollars?

Four solutions may be offered:

(1) Each central bank to contribute 20 per cent. of the volume of its gold holdings and 20 per cent. of its gross dollar reserves. This solution would be straightforward, would eliminate the problem of how to value gold for the purpose of determining the basis of assessment, would

ensure that the assets to be subscribed were available (only one-fifth of holdings), but would not reflect the overall volume of the central banks' reserves.

(2) Each central bank to contribute 20 per cent. of the volume of its gold holdings and the dollar equivalent of 20 per cent. of all its other reserves. Equally straightforward, this solution would also eliminate the problem of how to value gold for the purpose of determining the basis of assessment and would reflect the overall volume of the central banks' reserves, but it would increase the contribution in dollars of countries with sizable holdings of SDR-denominated assets.

(3) The total amount of contributions to be established by common consent between the member countries. Its determination would, however, pose the problem of how to value gold in the unit used to measure the total amount. The choice of a key for apportionment among the individual countries (weight in the ECU, scale applied in respect of short-term monetary support, etc.) would have to be negotiated. Finally, each country's contribution would reflect the composition of its reserves, with the dollar share covering all components other than gold.

(4) Once the apportionment of the contributions among central banks has been fixed (either as a proportion of reserves or on the basis of a fixed key), for these contributions to be composed of uniform proportions of gold and dollars for all the central banks. This solution would simplify the problems of risk sharing and apportionment of interest, as the ECUs would represent contributions that had been identical at the time the Fund was established. On the other hand, it does not take account of the diversity of the composition of the central banks' reserves.

(c) Adjustment of the amount of assets deposited against ECUs

The scheme outlined at Bremen envisages continuous (20 per cent.) participation by the Fund in reserve fluctuations resulting from purchases and sales of dollars by the central banks.

The implementation of this arrangement could be simplified by providing for the exchange of ECUs against dollars between the Fund and the central banks to be effected not on the occasion of each purchase or sale of dollars by the central banks but at periodic, e.g. monthly, intervals. The question then arises as to which purchases and sales of dollars should be taken into consideration or whether it would not be simpler to take as the basis the change in the central banks' gross dollar holdings during the period in question.

It would also be conceivable to take this a stage further and for each central bank's assets in ECUs corresponding to deposits of reserves to be adjusted periodically in line with the development of the total of the reserves which constituted the basis of assessment adopted for its initial contributions. This question would, however, have to be examined in greater detail.

(d) Form of contributions

The Bremen guidelines refer to an initial supply of ECUs being created against, in particular, the deposit of dollars and gold.

Designation of this form of contribution seems to rule out the concept of transfer, which would, at least in the short term, raise legal problems both for the central banks and for the EMCF.

For the final stage, the form of contribution will have to be determined in the light of the effects it is desired to obtain with respect, on the one hand, to the capacity of the Fund to utilise its assets and, on the other, to the rights that the central banks may wish to retain over their contributions; it will also depend on the arrangements made with regard to exchange risks.

With a transfer, the exchange risk would pass to the Fund, thus giving rise to the problem of how this should be covered and distributed.

With a deposit, it would be the depositor that continued to bear the exchange risk. The creation of ECUs - by the EMCF once it had been duly empowered to do so - against reserve instruments could therefore, at least initially, be achieved without any major difficulties either in the form of deposits of ECUs against deposits of reserve instruments in sight accounts, or in the form of swaps which could be unwound if necessary before the agreed maturity. In both cases a conversion rate would have to be fixed. Both solutions would be suitable for gold as well as for dollars. The swap formula appears to be preferable because from the accounting point of view it better indicates the link between the deposit of reserve instruments and that of their counterpart in ECUs and it avoids any double-counting in the valuation of reserves.

(e) Conversion rate

Exchanges of dollars against ECUs could be effected at the rate ruling on the day in question.

As regards the choice of a conversion rate for gold against ECUs, the following considerations and requirements would have to be borne in mind:

- certain EEC central banks enter gold in their balance sheet at the former official price, while others enter it on the basis of the market price;
- the rate chosen for conversion against ECUs should not convey the impression that a specific gold price is being made official;
- the product of the conversion into ECUs of the gold contributed must not be out of proportion to the market value of that gold; if it were too little, the scope for the mobilisation of gold in this form would lose much of its significance, and if it were too large it would result in a perhaps excessive creation of liquidity.

In these circumstances, it would seem logical and reasonable for the gold/ECU conversion rate to be fixed initially at a certain percentage (say, 75 per cent.) of the average of the daily rates during the three preceding months, and then for a review to be carried out and necessary adjustments made every three months, applying the same criteria to the immediately preceding period.

(f) Exchange risks and interest payments

The problem of sharing exchange risks would not arise if contributions were made in the form of swaps instead of transfers. Moreover, it seems difficult, at least in the transitional period, to do other than leave the cost of individual exchange risks with the central banks.

In this way, the problems that any Community-wide collectivisation of exchange risks might create under present circumstances - for instance the transfer of ownership rights to the Fund and the fixing of a key for apportioning exchange gains or losses among the central banks - could be avoided.

The Fund could pay a uniform rate of interest on all assets in ECUs corresponding to deposits of gold and dollars. This rate would be fixed periodically by the Board of Governors on the basis of the average dollar yield. Until the collectivisation of risks has become effective, and in order to avoid giving an unfair advantage to countries making proportionately larger deposits of gold, it would be sufficient to make gold subject to a compensatory charge, payable by the depositor, at the ruling rate of interest. Another possibility would be to apply the fourth solution suggested at the end of (b) above.

Interest on creditor balances in ECUs corresponding to the initial very short-term financing would be covered by the interest charged to debtors.

The procedures for the payment of interest (in ECUs or in dollars) would have to be laid down in due course.

(g) Management of the reserves by the Fund

If management of the reserve assets were entrusted to the EMF (the EMCF in the initial stages), it would entail responsibilities both in connection with investment risks and with regard to the maintenance of equilibrium in the markets. Appropriate instructions would therefore have to be formulated in this regard.

B. Use of ECUs issued against deposits of reserve assets

The ECUs received by member countries as a counterpart to their reserve assets could be used:

- as an instrument for settling intra-Community interventions;
- as a means of financing at least a portion of dollar interventions by participating central banks in the interval between successive periodic adjustments of ECU-denominated assets;
- to effect voluntary transfers between central banks (conditions to be laid down subsequently).

On the other hand, the use of ECUs would be subject to certain restrictions:

- prohibition for third countries on the holding of ECUs, and thus the receipt of ECUs in settlement;

- restrictions on the conversion of ECUs into other reserve assets simply to diversify reserves.

C. Creation of ECUs against national currencies

The Bremen communiqué provides for the issue of ECUs by the Fund against national currencies to be deposited with it by member countries - ECUs whose use would be subject to certain conditions.

While the overall contribution would have to be limited to an amount comparable to that of ECUs issued against reserve assets, the principles applied in apportioning this contribution among individual member countries would not necessarily have to be the same in both cases, in view of the different objectives pursued. Since the contribution of national currencies is intended to serve as the basis for a credit system reorganised at Community level, it would be more appropriate to base the distribution key on the quotas fixed for the existing credit arrangements.

From a technical standpoint the actual depositing of national currencies does not, however, seem to be essential either for the initial very short-term financing of interventions or for the integration or expansion of existing credit arrangements.

The requirements in terms of Community currencies would, indeed, be covered up to an unlimited amount, but for a limited period, by the initial very short-term credit facilities. In general, the central banks' requirements would be expressed either in ECUs, at the time of settlement, or in dollars.

In broader terms, some experts nevertheless point out that the creation of a fund of national currencies - which would accord with the wishes expressed by the Heads of State and Government - would increase the credibility and flexibility of the arrangements for priority intervention in Community currencies.

Three possibilities may therefore be considered in this respect which differ from each other as regards both the mode of creating and the conditions for using ECUs:

- The contributions in national currencies would take the form of credit lines extended to the Fund by the central banks and activated in accordance with the Community credit procedures. The majority of the experts favour this formula.
- Other experts consider that the contributions in national currencies should take the form of an actual payment to the Fund in exchange for ECUs that would remain temporarily unutilisable. They would become utilisable if and when the Community credit arrangements came into operation. In the opinion of these experts, this would give the EMCF, and later the EMF, the means to finance certain types of assistance directly before calling upon the central banks.

Under either of these formulae the conditions governing the actual use of the ECUs would have to be laid down in conjunction with the integration of the short-term credit facilities.

- Yet other experts maintain that deposits of national currencies and deposits of reserve assets should both give rise to the creation of ECUs of the same type, to be used as an instrument for intra-Community settlements. Control over the liquidity effects of such a creation of ECUs, and adjustment of the size and duration of the Community credits based upon it, would be effected by imposing a reconstitution obligation on holders of ECUs. The extent of this obligation would be determined in accordance with the amounts of credit deemed essential in the new system and the decision taken with regard to existing credit facilities.

## D. Relationship between the new provisions and existing credit facilities

Until the actual establishment of the EMF, the new provisions would apply to the issue of ECUs against deposits of gold, dollars and national currencies. Since the existing credit arrangements have to be incorporated in the Fund not later than two years after the EMS has come into operation, the question arises whether, apart from the facilities created or pledged against deposits of national currencies, the existing arrangements would already need to be modified during the transitional period.

If the amount of the initial very short-term financing - which would have to be entered in ECUs in separate accounts from those, also in ECUs, corresponding to reserve deposits - is to remain unlimited, problems regarding the acceptance by "involuntary creditors or debtors" of an expansion or contraction of their money markets may arise in a system in which the margin of fluctuation is expressed in relation to the ECU. These problems could only be resolved by laying down clear and precise rules for the choice of intervention currencies that took this consideration into account.

Some experts consider that the very short-term character of this financing facility should be maintained in order to ensure that creditor countries remain prepared not to limit or not to avoid claims in member currencies; this holds good for any intervention system. These experts add that they see absolutely no reason for prolonging the duration of financing as provided for at present in the "snake" and even consider that there would be little justification for maintaining the present length. They hold that the period of time allowed under the "snake" arrangement for the settlement of balances in reserve components is due to a large extent to the complicated settlement procedure based on the composition of the debtor's reserves. Under the new system, however, settlement in assets will be greatly simplified by the use of ECUs.

Other experts feel, however, that the duration of the initial very short-term credit facility of unlimited amount should be prolonged by one month, that is to say to 60 days from the end of the month instead of 30 days as at present.

Furthermore, they point out that under the "snake" arrangements the automatic prolongation of the initial very short-term financing is limited in duration to three months and in amount to the debtor quotas for short-term monetary support, any other prolongation, in amount or duration, being subject to agreement between the parties concerned.

Problems also arise for "involuntary debtors" with regard to the settlement of the initial very short-term financing (it should be recalled in this connection that in a system based on a basket of currencies involuntary debtor or creditor positions would probably occur frequently, unless interventions were effected in dollars).

Some experts consider that these problems could be partially resolved if the liabilities incurred by such a debtor were subject to easier repayment terms than those applied to a debtor whose currency was at its lower limit vis-à-vis the ECU. In order to maintain equilibrium in the Fund's balance sheet and make a contribution to the symmetry of adjustment, these experts propose the following formula:

If, when its own currency had diverged and reached its upper limit, a strong-currency country intervened in a member currency that had not reached its lower limit, it would receive a "restricted" asset that it could not use until its position had totally reversed.

Similarly, in such a case the "involuntary" debtor country would not be called upon to repay its "restricted" liability until its position had reversed and it was itself a creditor.

The symmetry introduced in this way could be taken a stage further by providing that a creditor country that had substantial "restricted" assets outstanding for a long period should be subject to a consultation, just as is a debtor country that is asking for finance for a longer period.

If, on the other hand, the divergent currency were at the lower limit against the ECU and the country concerned intervened in a currency that had not reached its upper limit, it would incur an "unrestricted" liability and the involuntary creditor would receive an "unrestricted" asset.

Other experts suggest that the above-mentioned problems relating to the involuntary debtor might be solved by stipulating that its liabilities would not be subject to interest, so that the creditor would therefore receive no remuneration.

Several experts raise objections, however, to the special provisions described above. They consider that if an exchange rate system is accepted advisedly, procedures for financing and settling interventions in European currencies should be uniform, subject to the normal criteria, at the risk of encouraging interventions in dollars.

## E. Proposals for simplifying the system

A number of experts put forward a proposal (see Section II, 5) for simplifying the working of the European exchange rate system, at least during the transitional period.

Other experts add that during the transitional period the working of the Fund could also be simplified. In their opinion, the objectives of the Fund were not clearly stated in the annex to the Bremen communiqué; those that the Group has attempted to determine at the beginning of this section could all in fact be carried out without the existence of the Fund. Similarly, it has been difficult to pinpoint reasons to justify contributions to the Fund in national currencies. In these circumstances it would seem helpful to use the two-year transitional period to work out the objectives and their consequences for the Fund more fully. In the meantime, that is to say during the transitional period, it would be perfectly possible to satisfy the remaining objectives laid down in the annex to the Bremen communiqué by establishing a settlement system along the lines of the European Payments Union, based on a chosen unit of account and on debtor and creditor quotas. It would still be possible to complement this EPU-type system with the concept of "restricted" liabilities and assets as outlined in sub-section D above.