

COMMITTEE OF GOVERNORS OF THE
CENTRAL BANKS OF THE MEMBER STATES
OF THE EUROPEAN ECONOMIC COMMUNITY

GROUP OF EXPERTS UNDER THE
CHAIRMANSHIP OF MR. DALGAARD

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CONTENTS

	Page

INTRODUCTION	1
CHAPTER I ACTUAL AND POTENTIAL PROBLEMS AFFECTING INTRA-EMS COHESION	1-4
1. Structural and behavioural changes in financial markets	2
2. Liberalisation of capital movements	2
3. The international economic environment	3
4. Specific intra-EMS factors	3
CHAPTER II EXCHANGE RATE MANAGEMENT IN THE EMS	4-11
1. Realignment policies	4
2. Intra-EMS exchange rate management between realignments	5
CHAPTER III OPERATING MECHANISMS OF THE EMS	11-20
1. Exchange rate mechanism	11
2. Intervention mechanism	14
3. Very short-term financing (VSTF)	16
4. Short-term monetary support (STMS)	18
5. Role of the ECU	19
CHAPTER IV EXTERNAL RELATIONS OF THE EMS	20-23
1. Interplay between external relations of the EMS and intra-EMS cohesion	20
2. Policy response to external disturbances	21
CHAPTER V CONCLUDING REMARKS	23-26
1. Conclusions	23
2. Recommendations and proposals	23
* * *	
Annex I	MANDATE FOR THE GROUP OF EXPERTS UNDER THE CHAIRMANSHIP OF MR. DALGAARD
Annex II	EXPERIENCE IN COUNTERING SPECULATIVE ATTACKS ON THE EXCHANGE RATE
Annex III	THE POTENTIAL CONTRIBUTION OF THE PRIVATE ECU IN REINFORCING THE EMS
Annex IV	PROPOSAL FOR STATISTICS FOR THE MONTHLY MONITORING
List of participants	

INTRODUCTION

The present report has been drawn up by the group of experts (see attached list) in accordance with the mandate received from the Committee of Governors on 10th February 1987 (see Annex I). Part of this mandate has already been covered by the group's Report No. 58 dealing with the realignment procedure and presenting a preliminary assessment of the last realignment.

The present report is divided into five chapters:

- Chapter I analyses the actual and potential problems affecting intra-EMS* cohesion;
- Chapter II deals with appropriate policy responses to increased capital mobility in a climate of improved convergence;
- Chapter III examines technical aspects of the different mechanisms of the EMS;
- Chapter IV considers the external relations of the EMS;
- Chapter V presents some conclusions and proposals.

CHAPTER I ACTUAL AND POTENTIAL PROBLEMS AFFECTING INTRA-EMS COHESION

The group noted that overall the EMS has worked satisfactorily. It has helped to promote economic convergence within the Community and reduce volatility of exchange rates despite considerable shocks from outside the system. It has also avoided exchange rate movements which have departed from values consistent with economic fundamentals, a phenomenon which has characterised some major currencies outside the system. A number of realignments have been necessary but, although they have mostly been decided on after market pressure, they have tended to offset accumulated inflation differentials and have not been used actively to make competitive gains.

*As a general rule, the term "EMS" refers to the system as a whole, including, in particular, its exchange rate mechanism. Thus, in this report, EMS countries are those countries which participate in the EMS exchange rate mechanism.

Better convergence of fundamentals between EMS countries has resulted in more stable intra-EMS exchange rate relationships. Nevertheless, intra-EMS exchange rate management still gives rise to problems partly because capital flows have increased in size and mobility. This might be explained by a number of factors:

- structural changes in the financial markets and in the behaviour of market participants;
- liberalisation of capital movements;
- the present international economic environment;
- specific intra-EMS factors.

1. Structural and behavioural changes in financial markets

The rapid globalisation of financial markets in recent years has been accompanied by a growing sophistication of market participants and increasingly aggressive trading which may reflect heightened competition between market participants. This means on balance that any disequilibrium perceived by the markets will trigger much larger capital flows than was the case before.

Probably only a minor part of such capital flows is "speculative" in the sense that it is caused by market participants taking open positions. The major part is more likely to be the result of much more vigorous hedging by market participants of their open positions derived from world trade and - not least - from strongly increased international borrowing and investment.

2. Liberalisation of capital movements

The progressive liberalisation of capital movements has increased the scope for potentially disturbing intra-EMS capital flows. Statistical evidence suggests that speculative flows in the period before realignments have mainly been reflected in changes in the terms of payments, identified commercial credits and changes in banks' net foreign spot positions related to their cover of forward transactions with customers. In contrast, financial flows, especially those of a long-term nature, have increased much less dramatically.

Measures to liberalise capital flows taken since 1986 in France and, to a lesser extent, in Italy have contributed to outflows from these countries but part of these outflows must be considered as a once-and-for-all portfolio shift resulting from residents' use of the new forms of transactions which were formerly prohibited.

Further liberalisation of capital movements will concern mainly short-term financial flows, e.g. bank accounts in foreign currency, since capital flows related to commercial transactions and long-term financial transactions are now largely liberalised in almost all EMS countries.

3. The international economic environment

The international economic environment is characterised by large current account disequilibria related to shortcomings with respect to the economic policies of major industrial countries and their co-ordination. This has given the market the impression that the adjustment of these current account disequilibria is largely to be left to dollar depreciation against other major currencies. The EMS has been affected by these global difficulties in as much as the Deutsche Mark serves as a preferred alternative to the dollar for international investors.

Despite recent attempts to improve co-ordination of policies on a worldwide level, the problems are of such a scale that the international environment may continue to be a source of destabilising pressure on the EMS for some time.* In this connection it should be recalled that the EMS was set up to form a zone of stability in a basically unstable international environment.

4. Specific intra-EMS factors

Markets may not have perceived fully the fact that, given the increased convergence, accumulated differences in inflation rates can be offset through moderate changes in market rates and that realignments can, therefore,

*As far as the interplay of movements of the US dollar on the one hand and tensions in the EMS on the other is concerned, see Chapter IV below.

be small. Instead, they may still draw on the experience of the past when, under less favourable conditions with regard to convergence, realignments had to be substantial. Over-estimation of the effect on market rates of EMS realignments may also have been promoted by intense public debate before realignments and protracted negotiations during the realignment sessions. In addition, two general realignments and two individual adjustments within eighteen months (July 1985 to January 1987) may give the impression of increased intra-EMS exchange rate instability.

Domestic policy objectives may make it difficult to change interest rates enough to provide the differentials necessary to combat speculation. This problem may have been aggravated by the actual narrowing of interest rate differentials which has resulted from reduced divergences in price performances.

CHAPTER II EXCHANGE RATE MANAGEMENT IN THE EMS

The new challenge to the EMS should prompt an appropriate policy response with regard to both realignment policies and exchange rate management between realignments.

1. Realignment policies

The potential capital gains which may result from positions taken in expectation of a realignment should be minimised. This would have the direct effect of limiting capital flows, and at the same time it would make the instruments of daily exchange rate management more effective. To achieve this, two conditions must be fulfilled. First, market rates must not move much in a realignment. Therefore, changes in central rates should be of a moderate size. Fortunately, the improved convergence in the EMS makes a policy of small realignments possible. Second, realignments should be made less predictable. As long as underlying economic developments do not require an adjustment of exchange rates, speculative pressure should be resisted vigorously. Conversely, if and when a realignment is considered justified it should take place before the markets perceive it as unavoidable. One should,

furthermore, try to avoid giving the market the impression that there is a link between realignments and political events (e.g. elections, formation of new governments). Nevertheless, some degree of predictability is inevitable.

2. Intra-EMS exchange rate management between realignments

The short-run intra-EMS exchange rate management involves two dimensions:

- a national dimension, i.e. the appropriate policy mix to be implemented by each country;
- an international dimension, i.e. the co-ordination of national policies.

Both dimensions are analysed separately but it is clear that they are inter-related to some extent.

2.1 Policy mix

In the short run, exchange rate pressure can be combated by three types of action:

- interventions on the exchange markets;
- exchange rate movements within the band; this would have the effect of introducing a two-way exchange risk (if there is no realignment or only a small one and the currency strengthens subsequently the market makes a loss) or at least cutting part of the exchange gain which position-takers may expect;
- adjustment of monetary policies, making position-taking more expensive.

These instruments are intended to gain time for the implementation of other economic policy measures or to defend the parity when pressure is considered to be temporary.

In the longer run, other economic policy measures are necessary if tensions are caused by unsustainable imbalances in the economy concerned. In the absence of such measures, intra-EMS exchange rate stabilisation would rely unduly on monetary measures with unfavourable consequences for the level of economic activity in the economy of the country concerned.

The following analysis is confined to the short-term inter-relationship between interventions, exchange rate changes within the EMS band and monetary policy measures, whereas other economic policy measures (e.g. fiscal policy) which are outside the control of central banks are considered as exogenous variables.

Exchange rate pressure in general needs to be combated by a combination of different policy actions. The question to be examined, therefore, is that of the appropriate mix of different policy responses to exchange rate pressure within the EMS which may differ with regard to its strength and cause.

2.1.1 Historical review of national experiences

An historical review of national policy actions to combat exchange rate pressure (see Annex II) reveals that each case had its own characteristics depending upon, inter alia:

- the perceived degree of intensity of the pressure;
- the political and economic situation in the country;
- whether other economic policy measures were planned;
- the expected time before a realignment.

Policy responses have not been symmetric as the approaches have differed according to whether the currency was under downward or upward pressure.

In the early stages of a downward pressure the initial reaction of all central banks has been to use intramarginal interventions as a first line of defense. As pressure persists or even increases, however, the follow-up has varied between countries and in time.

The two basic approaches that emerge from the review can be broadly described as follows:

- in the first approach the tendency has been to rely on intramarginal interventions, sometimes for very large amounts, when central banks have considered it inappropriate to let their currency drop in the band or let their domestic interest rates rise significantly, partly because of the possible adverse publicity connected with such movements. Such policies have at times succeeded in preventing the pressures from developing into a crisis. In

some cases their effectiveness has been strengthened because foreign exchange restrictions have resulted in a sharp increase in euro-rates;

- in the other approach countries have tended to use the interest rate instrument more forcefully and at an earlier stage. If a crisis nevertheless developed, the policy has been to let the exchange rate drop to the limit and show restraint in accommodating the tightening of the money market resulting from the interventions at the margin. The resulting sharp rise in very short-term interest rates has raised the cost of position-taking and this policy has proved an effective means of ending speculation.

Many central banks have tended to lean towards the first approach, which, however, has not been used exclusively over a long period. More recently there has been an increasing tendency for central banks to favour the second approach as reflected by greater flexibility in the use of the fluctuation band and adjustment of interest rates. However, a sharp rise in domestic money market rates has rarely been allowed to occur, even under severe exchange rate pressure.

Cases of significant upward pressure have mostly involved the Deutsche Mark. The basic German approach has been to refrain from intra-marginal intervention and to neutralise the domestic monetary effect of interventions at the margin to protect monetary policy from unwarranted expansionary effects.

Periods of tension have sometimes ended in realignments, especially when the markets were not convinced of the political willingness to defend the existing parity grid. It should be stressed, however, that many periods of tension have been fought off effectively without realignment, even when tensions were quite severe.

2.1.2 Assessment

An assessment of these policies must take account of different general economic, institutional and political circumstances in EMS countries. First, the fundamental strength of the currencies being defended has differed; this has, of course, had implications for the efficiency of monetary policy action to stabilise exchange rate expectations. For example, the tightening

of monetary policy in Germany in February 1981 had an immediate effect on the exchange market, and the Dutch experience has also to be assessed against the background of a relatively strong current account position.

Second, policy choices have been influenced to some extent by factors outside the control of the central bank. In the absence of measures to reduce structural imbalances it has sometimes been judged inopportune to take restrictive monetary policy measures which would have the effect of increasing the debt service burden and impeding economic growth with drawbacks for the overall economy. Alternatively, other policy action has been taken (e.g. exchange controls) to check exchange rate pressure.

Third, the willingness of the public authorities to accept interest rate increases and the expected reaction of the market has differed.

There are, however, also divergent views about the efficiency of the different types of actions and the risks involved. All central banks are aware that any type of action could have positive as well as negative effects. The instrument of intramarginal intervention allows a spontaneous response to unforeseen pressure on exchange rates, which most experts feel should not generally be accommodated as long as the origin remains unidentified. Such interventions are often effective in quietening tensions, especially if they are minor and if the central bank can keep the market uncertain about the volume of its intervention, for instance, because it is permanently operating in the market.

The use of large and prolonged intramarginal intervention as the only tool involves risks to the extent that:

- the intervening central bank defends a specific intramarginal exchange rate for so long that it increases pressure if it ultimately has to give in to market forces;
- the market becomes aware of the size of interventions which in turn might reinforce speculation;
- interventions are not accompanied by a rise of interest rates.

In these cases there would be the risk that more appropriate measures would be taken too late or would have to be more incisive to combat speculation and the intervention volume would have to be more substantial than would have been the case if the authorities had reacted sooner through changes in exchange and interest rates.

Wider exploitation of the EMS band and greater flexibility of interest rates, if implemented at an early stage, could dramatise the situation as they may be perceived by the market as confirmation of potential speculative pressure. This could also extend difficulties to other EMS currencies. However, such action would, in many cases, be the most efficient way of combating severe speculative pressure on the exchange rate, and therefore of minimising the volume of interventions.

2.1.3 Conclusions to be drawn

It is difficult to formulate general rules which would be appropriate in all circumstances because of the large diversity of possible situations on the exchange markets and the fact that subjective and objective factors will continue to account for some differences between EMS countries in their exchange rate management. However, some basic principles can be identified:

- continued heavy intervention is a reason for reconsidering the combination of instruments used;
- more flexibility in the use of the EMS band and interest rates could be useful, especially if the two instruments are used in combination; such a policy would be particularly useful if the markets see it as normal practice which might be the case if all central banks demonstrate the same attitude.

The group proposes that these questions should be covered in the framework of a regular monitoring procedure (see Chapter V below).

2.2 Co-ordination of exchange market and monetary policies

2.2.1 General remarks

Stability within the EMS will be promoted by co-ordination of policy action by EMS member countries. Defined in positive terms, this means the pursuit of complementary policy action, while in negative terms, it means avoidance of conflicting measures. Co-ordination should be seen in a broad context and the question of where the burden of adjustment should fall has to be assessed in the light of the causes of exchange market unrest and the ultimate aims of the EMS.

Thus, co-ordination implies a common understanding on the aims to be pursued and the instruments to be used and it should apply to individual as well as to joint action. Principles for such co-ordination could be agreed at Governor level in the framework of a monitoring procedure (see Chapter V).

2.2.2 Co-ordinated interventions

Co-ordinated interventions have been carried out on several occasions. Although they were primarily designed to contribute to stabilising the EMS exchange rate vis-à-vis the dollar, they have also benefited cohesion within the system.

Co-ordinated interventions in EMS currencies are compulsory when the currencies concerned have reached the limits. Co-ordinated interventions within the margins are not excluded by the EMS Agreement but have never occurred in practice. The experts agree that the scope provided by the EMS Agreement for simultaneous intramarginal interventions by both the central bank with the strong currency and that with the weak currency should be exploited, although some experts believe that such intervention should be done on a purely voluntary basis. Such an approach could, in the right circumstances, strengthen the confidence of the market in the political will of the authorities to defend the existing parity grid. This would entail a reduction of the volume of interventions which in turn would be in the interest of both parties involved. However, such interventions should not exclude the use of other policy instruments.

Co-ordinated interventions would involve a certain burden sharing to the extent that such interventions were not settled immediately. The exchange risk would be shared between both parties involved and the possibilities for intervention would be enlarged.

Some experts feel that there is no need for additional means of financing interventions and that a diversification of currency holdings would raise problems (see Chapter III, section 2).

2.2.3 Co-ordination of monetary policy actions

There have been occasional co-ordinated interest rate moves in recent years but in general these have been part of a common strategy to bring about a general interest rate reduction. In contrast, in the case of tensions in the EMS, there have hardly been any specific actions designed to

increase interest rate differentials by means of simultaneous interest rate moves in opposite directions. It has generally been up to the weak currency countries to raise their interest rates in order to combat exchange rate pressure.

The group noted that in the short term any scope for the adjustment of interest rates in both countries with weak and strong currencies should be exploited but opinions differed on the extent to which such scope exists without compromising the principle that interest rate policies have to be consistent with the aim of ensuring monetary stability in the EMS. Co-ordination, which might be agreed in the framework of the monitoring process, is considered to be most effective if it is handled in a forward looking way so as to prevent the emergence of tensions in the EMS.

CHAPTER III OPERATING MECHANISMS OF THE EMS

1. Exchange rate mechanism

1.1 The extension of EMS exchange rate commitments to all EEC countries

Although the EMS was intended to encompass all Community countries, in fact full membership (i.e. participation in the exchange rate mechanism) is confined to only eight out of twelve countries. The United Kingdom, Greece and, as from May 1987, Spain have become parties to the Central Bank Agreement but only participate in the mechanism for creating and mobilising ECUs.

1.1.1 The reasons for non-participation

The reasons for non-participation differ.

In the case of the United Kingdom, the authorities have felt, particularly in view of the oil factor, that the time for full participation is not yet ripe. The reasons for the non-participation of Greece, Spain and Portugal are, in particular, inflation rates still well above the EMS average and high public sector deficits. Additional factors are, in Greece, less developed financial markets and in Spain and Portugal the necessary adjustment following accession to the EEC. The degree of domestic difficulty, however, varies. Spain seems to have moved relatively close to the average

economic and financial performance of EMS countries and the Spanish authorities are considering the possibility of joining the EMS exchange rate mechanism in the future.

1.1.2 The consequences of non-participation

Under present circumstances, the non-participation of the countries mentioned above has certainly saved the EMS exchange rate mechanism from greater tensions, whereas the short-run implications are limited. This applies especially to Greece, Spain and Portugal, but also to the United Kingdom. Indeed, the dramatic fall in oil prices in 1985/86 which affected the United Kingdom as oil producer differently from other EMS countries (which are either oil importers or, as in the case of the Netherlands, in energy equilibrium) would have caused tensions in the EMS if the United Kingdom had participated, and the downward adjustment of sterling in response to the oil price fall could not have been so gradual.

Given the volume of Ireland's sterling-denominated trade, the gradual downward adjustment of sterling outside the EMS, coupled with the fall of the US dollar, resulted in a strong appreciation of the effective exchange rate of the Irish pound. In particular, this combination of factors prevailed during the first seven months of 1986, before the Irish pound was adjusted downward by 8 per cent. on 2nd August 1986. Under these circumstances, participation of sterling in the exchange rate mechanism might have facilitated exchange rate management for the Irish authorities.

Since the pound sterling and the Greek drachma are represented in the ECU basket, changes in the exchange rates of these currencies affect the market rates of the ECU on the basis of which claims and liabilities in the very short-term financing mechanism resulting from intra-EMS interventions are accounted. In addition, the indicator of divergence has been distorted by these currencies. However, since the weight of the Greek drachma is very small (less than 1 per cent.), its distorting influence is very limited.

Major problems are created by non-participation only in a long-term perspective. Indeed, non-participation creates doubts about the further development of European monetary integration. It is therefore important to keep alive the idea of full EMS membership for all Community countries and to enhance efforts for bringing these countries closer together within the EMS.

1.2 Width of the margins

1.2.1 Reasons for wider margins in favour of the Italian lira and their use by the Italian authorities

Italy was the only country to make use of the option for currencies floating before the inception of the EMS to adopt temporarily a margin of up to 6 per cent. The decision was taken against the background of sizable inflation differentials between Italy and most other EMS countries, which could not be eliminated rapidly.

In practice, the wider margin in favour of the Italian lira has only been exploited to a limited extent; especially in the last few years the Italian lira has been kept mostly within the narrow EMS band or at least close to it as inflation differentials vis-à-vis the other EMS currencies have been narrowing. The reason for maintaining the wider margin now lies less in the desire to avoid the emergence of excessive competitive gaps between realignments than in the operational flexibility it provides for the central bank. Thus, for instance, in the days preceding the January 1987 realignment, the Italian authorities were able to accommodate exchange rate pressure by a drop in the lira of 2 per cent. against the Deutsche Mark without it reaching the floor of even the narrow EMS band. The effect was that exchange rate pressure on the Italian lira subsided before the realignment.

1.2.2 Consequences for other EMS countries and the EMS as a whole

Overall, wider margins in favour of the Italian lira have not caused problems for other EMS countries nor the EMS as a whole. They might even have saved the EMS exchange rate mechanism from greater tensions, especially in the first few years of the EMS. Neither have wider margins undermined the disciplinary effect of the EMS on policies pursued in Italy.

The reduction in inflation differentials between Italy and the other EMS countries, has weakened the argument for maintaining wider margins which, as stated in the Resolution of the European Council of 5th December 1978, "should be gradually reduced as soon as economic conditions permit so". Such a step could further enhance the credibility of Italy's anti-inflation strategy. In addition, it would mark more solidarity with other EMS countries

(at present the wider margin provides the Italian authorities with more operational flexibility than other EMS countries enjoy).

1.3 Double exchange markets in the BLEU

According to present rules, residents in the BLEU have to carry out foreign exchange transactions designed to cover direct and portfolio investment abroad on the "free" market. Exchange rates on this free market may differ from those on the regulated market which is subject to the commitment taken by Belgium and Luxembourg in the framework of the EMS exchange rate mechanism.

In practice the premium on foreign currencies on the free market has fluctuated around 1 per cent. in the last few years. This has been due to the fact that substantial net capital outflows have been more than offset by an abundant supply of foreign currencies derived from current transactions, which can take place on the free market and include the substantial repatriation of income from direct and portfolio investments abroad. Thus, the ~~Banque Nationale de Belgique has even been able to purchase amounts on the~~ free market with a view to their resale on the regulated market. Conversely, transactions linked to holdings of convertible francs by non-residents are carried out on the regulated market; changes in these holdings were a substantial source of capital outflows before the January 1987 realignment.

Under present conditions, the double-exchange market system in the BLEU does not entirely split the overall foreign exchange market and does not reduce to any great extent the significance of the EMS exchange rate commitments taken by the Belgian and Luxembourg authorities. However, the existence of the double-exchange market system may not be entirely consistent with the aim of recognition for the Belgian franc and the Luxembourg franc as strong currencies and with the standing EMS.

2. Intervention mechanism

2.1 Assessment of present rules

According to Article 2 of the EMS Agreement, all interventions other than compulsory interventions at the limits "shall be conducted in accordance with the relevant guidelines that were adopted by the Committee of Governors in its Report of 9th December 1975 or that may be adopted in the

future, or shall be subject to concertation among all the participating central banks".

In practice, intramarginal intervention policies are largely decentralised, except that:

- interventions in EMS currencies require prior agreement by the central bank issuing the intervention currency;
- interventions in dollars should in principle be avoided to the extent that they accentuate a strong unwarranted downward or upward trend of the dollar;
- from time to time there is some concertation about the choice of intervention currencies in order to make interventions within the system consistent with the policies pursued by some EMS member countries in the framework of international agreements on managed floating.

The group noted that overall present arrangements are adequate and have not led to undue delays in balance of payments adjustments. The rule according to which interventions in EMS currencies require the prior agreement of the issuing central bank may create some technical difficulties in certain circumstances (e.g. when there are sudden movements in the markets or at the fixing). These difficulties could be easily solved by flexible handling of the rule.

2.2 Diversification of intervention currencies

At present the bulk of intramarginal interventions are in Deutsche Mark and in dollars. Interventions in private ECUs or other currencies occur mainly to the extent that interventions in the main intervention currencies are not adequate for intra-EMS reasons or because of external factors.

Co-ordinated interventions mentioned in Chapter II, section 2.2.2 would result in a diversification of reserve currencies unless they were settled immediately or financed under the VSTF. According to present rules, diversification is possible if the issuing central bank agrees. Some experts advocate such diversification, although for currencies with less developed markets only for minor amounts. Other experts, however, feel that diversification would raise some difficult issues, in particular if the amounts involved were large. First, it would be impractical to accumulate large

amounts of assets in EMS currencies which were not normally used for intervention purposes. Second, some countries would be reluctant to agree to the accumulation of their currency as a monetary asset.

Increased use of the private ECU for intervention purposes in turn raises the issues described in the group's Reports No. 51 and No. 55 dated March 1984 and November 1986 respectively. For various reasons, such intervention can, in present circumstances, only play an accessory role.

3. Very short-term financing (VSTF)

The VSTF was conceived in order to finance compulsory intervention at a time when interventions were expected to take place essentially at the limits and the volume of intra-EMS capital flows, and thus interventions in the foreign exchange markets, were likely to be much more limited than has been the case in more recent periods.

3.1 Adequacy of the VSTF arrangements

According to present rules, recourse to the VSTF is unlimited in amount (Article 6 of the EMS Agreement) but the duration of initial financing operations is limited to between 1 1/2 and 2 1/2 months (Article 9 of the EMS Agreement). Automatic renewal of initial financing at the request of the debtor central bank is subject to a ceiling which corresponds to the debtor quota of the country concerned in the short-term monetary support (STMS) - these quotas have remained unchanged since the inception of the EMS - and to the provision that it can be used only once for a maximum of three months (Article 10 of the EMS Agreement). All other renewals have to be agreed between the debtor and the creditors of the EMCF (Article 11 of the EMS Agreement).

The increase in the volume of intra-EMS interventions reflects both more substantial interventions in support of a currency and repurchases of foreign exchange when tensions subside. However, the degree of reversibility of interventions has differed from occasion to occasion (e.g. after the January 1987 realignment reflows started more slowly than usual) and between countries, reflecting in part different policy choices. Indeed, sometimes countries have been more interested in lowering interest rates to a more

normal level or in achieving a position for their currency in the EMS band which prevented or limited speculation gains than in quickly restoring foreign exchange reserves after periods of exchange crisis.

The duration of initial VSTF operations has in some cases proved to be too short to bridge fully the period until the complete reversal of capital flows. Since the level of indebtedness vis-à-vis the EMCF has recently tended to rise in line with the increased volume of interventions at the margin, the unchanged ceiling on automatic renewal has bitten more than in the past.

To the extent that VSTF operations cannot be unwound out of the proceeds of reflows in the currency of the EMCF's creditor countries, the debtors of the EMCF have to make arrangements with the creditors of the EMCF for renewal of part of their debt by mutual agreement (this possibility, however, is used rather seldom) or they have to use their exchange reserves which would then often need replenishment by raising loans on the markets. Settlement of VSTF operations through the transfer of reserve assets other than creditor currencies means that the expansionary impact of the use of the VSTF on money market conditions in the creditor country is not automatically reversed.

The group noted that:

- the possibility of activation of the VSTF for unlimited amounts is an element which enhances the credibility of the exchange rate arrangements and a deterrent to destabilising capital movements;
- present arrangements have not been abused;
- the arrangements have never occasioned serious difficulties for debtor countries given the easy access to foreign currency financing on the market.

However, some experts consider that in the present circumstances of increasing capital movements the importance of the VSTF could be strengthened by improved modalities for the use of the facility. They therefore advocate an extension of the duration of initial financing operations and/or an increase in the ceiling on automatic renewal of initial VSTF operations. Such changes would be in the interest of both debtors and creditors of the EMCF, since they might reduce the need for market finance to bridge possibly very short periods and enhance the likelihood of settlements in creditor currencies.

Most experts feel this would not imply a softening of discipline under present conditions characterised by extreme ease of market finance.

3.2 Use of the VSTF for intramarginal interventions

Intramarginal interventions have evolved into "standard" practice with the result that their volume has become much greater than that of compulsory interventions which are more and more confined to situations of exceptional exchange rate pressure. Unlike compulsory interventions, the bulk of intramarginal interventions has been covered through changes in central banks' holdings of intervention currencies.

Some experts consider that the disparity in the treatment of the two categories of interventions is too great. They therefore suggest that intramarginal interventions should also enjoy access to the VSTF, subject to agreement in the framework of the monitoring procedure and to conditions which might be agreed in that context, such as significant prior use of reserves in the relevant EMS currency.

Such a step would, in particular, avoid the risk of a country - in the absence of holdings of EMS currencies - allowing its currency to fall to the limit in order to qualify for financing under the VSTF.

As already pointed out in Report No. 54 (page 12) the question of access to the VSTF for intramarginal interventions does not pose technical problems. The terms of Article 6 of the EMS Agreement do not preclude access to the VSTF in such cases and indeed the VSTF has already been used in this way in a few cases. There is, however, no agreement on the substance of this proposal. The main arguments against it are derived from the fact that the use of the VSTF for intramarginal interventions (as for interventions at the margins) involves creation of base money in the country whose currency is used for intervention sales, whereas the present practice of running down balances in the intervention currency held in the markets leaves money market conditions in the country issuing the intervention currency largely unaffected.

4. Short-term monetary support (STMS)

The STMS has not been used since 1974. The group attributes this fact mainly to the reluctance of EEC countries to finance balance-of-payments

disequilibria through recourse to official credit mechanisms in a period where market finance has been easily accessible. Conversely, to the extent that some EEC countries have encountered serious balance-of-payments difficulties necessitating recourse to official credit mechanisms, these difficulties were rather of a medium-term nature; this led to the use of more appropriate mechanisms like the Community loan mechanism (e.g. France in 1983, Greece in 1986).

Given the size of debtor and creditor rallonges, the amounts available under the STMS appear to be in line with potential credit needs and the system provides flexibility with regard to the currencies which might possibly be asked for. However, the debtor quotas, which, as already mentioned, have remained unchanged since 1978, set narrow limits to the amounts available under the automatic renewal of the VSTF.

5. Role of the ECU

The group noted a number of proposals designed to reinforce the status and the usability of the official ECU and to enhance the development of the private ECU. No consensus was reached on the substance of these proposals. The study on technical issues raised by a possible link between the official and the private ECU has been suspended for the time-being but will be taken up again as soon as possible.

5.1 Status and usability of the official ECU

Some experts proposed that the acceptance limit on the use of the ECU should be abolished and this would be a way of expressing a will to promote the official ECU. Other experts feel that this proposal would raise far-reaching issues related to the checks and balances of the EMS.

The representative of the Commission further proposed that:

- in order to reduce the precarious nature of the official ECU, the mechanism for the creation of ECUs should be increased to an indefinite period (at present, this mechanism expires every two years and has to be renewed by explicit decisions taken by the Governors of EMS central banks and by the Board of Governors of the EMCF);
- the volume of ECUs issued by the EMCF should be better controlled.

Since most experts felt that these latter proposals would not be of direct significance for the specific issues for which the group had received the mandate, they were not discussed in substance.

The group noted that the usability of the official ECU has been enlarged by the mobilisation mechanism introduced in July 1985. This mechanism has proved to be flexible and useful in certain circumstances. It also presents the advantage of being easily adjustable since under Article 18a.1 of the EMS Agreement of March 1979 the Governors may agree to change the multiplier.

5.2 Development of the private ECU

The Commission's document attached in Annex III deals in detail with the possible contribution of the private ECU to the completion of the internal market, integration of EEC countries' financial markets and the protection of the EMS against external disturbances.

The group shares the Commission's view that the main impetus towards developing the private ECU has to come from the market itself. It is important, however, that this development should not be hindered by specific restrictions on the use of the private ECU such as exist in Germany.

The question of more active use of the private ECU for interventions on foreign exchange markets is discussed in Chapter III, section 2.2 and Chapter IV, section 2.

CHAPTER IV EXTERNAL RELATIONS OF THE EMS

1. Interplay between external relations of the EMS and intra-EMS cohesion

Intra-EMS stability does not only depend on developments in fundamentals in EMS member countries and the appropriateness of their policies designed to achieve greater convergence but also on the external environment of the EMS. As far as international monetary factors are concerned, the main problems stem from the weakness of the US dollar exchange rate. In the recent past, developments with regard to the yen have added a further dimension. Whereas exchange rate movements of the Japanese yen vis-à-vis the EMS currencies may have significant repercussions on trading relationships between Europe and Japan, a direct impact on the EMS would result from

increased diversification of Japanese foreign portfolio investment out of the US dollar into EMS currencies.

External disturbances resulting from international portfolio shifts in the demand for currencies are in the first place a matter of common concern for all EMS countries. They lead to tensions in the EMS only to the extent that, because of differences in the real and financial fields, not all EMS currencies share the same degree of substitutability for the US dollar.

The correlation between movements of the US dollar on the one hand and tensions in the EMS on the other is often interpreted as evidence of a mechanical link between the two phenomena, i.e. that capital flows out of the US dollar necessarily also lead to a strengthening of the Deutsche Mark against the other EMS currencies. This could be true in the very short run, given the role of the US dollar and the Deutsche Mark as vehicle currencies on the markets. Subsequently, if markets do not expect a realignment in the near future, small changes in exchange or interest rates should be sufficient to trigger capital flows from the Deutsche Mark toward other EMS currencies, thereby ensuring that these currencies keep pace with the Deutsche Mark. The effectiveness of this mechanism was illustrated generally by the development in the EMS during the first year of the decline of the US dollar, and even after that by the behaviour of the Dutch guilder which remained rather stable against the Deutsche Mark with only occasional interventions and with moderate movements in interest rate differentials.

2. Policy response to external disturbances

In order to strengthen the EMS against external disturbances it is important to pursue efforts to increase the degree of substitutability between EMS currencies. This implies a further improvement of economic convergence. It was suggested that it would also require the development of a genuine European reserve asset but the group felt that this issue went beyond its mandate.

At present concertation with the authorities of third countries takes place indirectly through participation by some EMS countries in consultations and agreements within the framework of groupings of major industrialised countries (e.g. the Plaza Agreement of September 1985 of the G5,

the Louvre Agreement of January 1987 of the G7). As far as a common dollar policy is concerned, there have been a number of initiatives, e.g. the agreement between EEC central banks in 1975 on the desirability of limiting the daily fluctuations of the dollar rate in each exchange market to 1 per cent. either way and in September 1986 the understanding reached at Gleneagles. The effectiveness of these actions, however, was impaired by a lack of co-operation by the US and Japanese authorities.

The question of the external relations of the EMS is in the first place a matter of policy and in part even outside the scope of EMS countries. The contribution of technical devices on the part of EMS countries may, therefore, be limited but should not be under-estimated. In this respect, the group considered the following issues:

- improvement of the analysis of actual and potential problems resulting from external disturbances and evaluation, in a more systematic way, of the pros and cons of different policy choices in response to external disturbances. In this context, the group noted the Committee of Governors' decision of April 1980 to carry out a regular assessment of the dollar's performance. Such assessments have subsequently been undertaken annually on the basis of preparatory work by the Economic Adviser of the BIS. More recently, analysis of actual and potential external disturbances has been extended to questions relating to the yen. A more frequent and regular analysis of the external relations of the EMS might be involved by the operation of the monitoring procedure (see Chapter V, section 2 below);
- scope for action by EMS central banks in the framework of co-ordinated policies vis-à-vis third currencies. These actions cover mainly the use of interest rates and interventions. With regard to intervention, technically speaking various types or combinations are feasible, e.g. individual and simultaneous interventions in third currencies, combined interventions in third and in EMS currencies and even the development of new techniques such as purchases of dollars against yen. Interventions in ECUs against third currencies could perhaps also play a role but the implications of their extensive use would need careful reconsideration (see Report No. 51 and No. 55).

Any application of these techniques should rely on active concertation with the particular view of ensuring consistency, according to the circumstances, between the aims of fostering stability vis-à-vis third currencies and ensuring EMS cohesion.

CHAPTER V CONCLUDING REMARKS

1. Conclusions

The group concluded from its analysis that, overall, the EMS has functioned in a satisfactory way. However, whereas the significance of divergences in fundamentals as a source of potential tensions has decreased, the EMS is now confronted with a new challenge which stems from increased mobility of capital flows which, in turn, is the result of a combination of changes in the financial markets and in the behaviour of market participants, liberalisation of capital movements, the international economic environment and specific intra-EMS factors. These new developments should be taken into account in the operation of the system in order to preserve the satisfactory performance of the EMS.

The further smooth functioning of the EMS will depend on the quality of intra-EMS exchange rate management, co-ordination of monetary and intervention policies and concertation with the authorities of third countries. This could be achieved without introducing additional formal rules for the management of exchange rates which, in the view of some experts, would appear to run counter to the desired flexibility of the system.

2. Recommendations and proposals

2.1 Realignments

Realignments, which are bound to be necessary from time to time, should preferably be so small as to ensure that market rates need not move much. The predictability of realignments could be reduced by avoiding unnecessary delays and public debate among authorities. Realignment policies are mainly outside the scope of central banks; nevertheless, central banks' views on this matter should be presented to the authorities concerned.

2.2 Intra-EMS exchange rate management between realignments

Intra-EMS exchange rate management between realignments should exploit the existing instruments in a flexible way. In this respect, there was agreement that continued heavy intervention is a reason for reconsidering the combination of instruments used and that more flexibility in the use of the EMS band and interest rates could be useful.

At the same time action by individual central banks in the field of both domestic and external monetary policies needs close co-ordination. In this context, the group feels that it might be useful to consider:

- co-ordinated intervention in EMS currencies: its implementation however, would require the approval of the central banks concerned;
- co-ordinated interest rate moves in order to change interest rate differentials in response to emerging tensions in the EMS, taking domestic requirements into consideration.

Some experts think the management of the system could be further enhanced if member countries held a certain amount of their partners' currencies in their reserves. However, this presupposes the agreement of the issuing central banks concerned.

2.3 Co-ordination of policies vis-à-vis third currencies

Policies vis-à-vis third currencies including interventions and interest rate changes should be closely co-ordinated among EMS members in order to ensure consistency between actions taken in the wider international field and the objective of intra-EMS stability. As far as interventions are concerned, it might be useful to develop and refine intervention techniques, e.g. simultaneous interventions in third currencies, combined interventions in third currencies and in EMS currencies, and interventions in third currencies against third currencies or ECUs.

2.4 Monitoring

The group suggests improving multilateral surveillance of policies pursued by EMS countries in order to assist consistency of intra-EMS exchange rate management and co-ordination of policies vis-à-vis third currencies. This surveillance would rely on the monitoring system described below which would allow systematic discussion by Governors

in order to arrive at a common appreciation of prevailing circumstances and to reach agreement about appropriate policy responses.

The aim of monitoring would be to identify at an early stage possible signs of tension in the EMS and to discuss action to cope with tensions or, preferably, prevent them from developing. Monitoring should, in the first place, focus on:

- the position in the EMS band;
- movements in interest rates in EMS countries and interest rate differentials;
- the volume of interventions.

These indicators, however, need interpretation in the light of information relevant to the achievement of stability both of intra-EMS exchange rates and domestic monetary conditions.

Monitoring should be a continuous process. It would normally be carried out on a monthly basis during the meetings of the Committee of Governors. In case of need, the Governors could hold ad hoc meetings on the telephone; the technical infrastructure for such meetings will be available in the autumn of this year when the new teleconference system has been installed. In addition, it might be useful to have ad hoc telephone meetings at a lower level (head of department level) in order to follow the developments closely in periods of tension and to monitor the implementation of co-ordinated actions agreed by the Governors.

Monthly monitoring should be based on up-to-date statistics in the areas mentioned above. These data should first be examined by the group of EEC foreign exchange experts. On the basis of these discussions, the Chairman of the group would report salient features to the Committees of Governors and Alternates. A specimen of the statistics mentioned above is attached as Annex IV.

The envisaged system would not necessitate the development of complex new procedures. It would be based on present procedures which would be adjusted in order to improve the availability of data and their presentation with a view to allowing policy-orientated discussions at Governor level.

2.5 Amendments to the mechanisms of the EMS

The group discussed a number of proposals designed to adjust the EMS mechanism in the light of new developments without, however,

being able to reach full agreement. These adjustments concern the following areas:

- Some experts consider that it would be worthwhile to review the duration of initial financing under the VSTF and/or the ceiling on automatic renewal of initial financing operations. The proponents of this proposal think an extension of the duration and/or an increase in the ceiling would reflect the increased volume of capital flows and, therefore, of interventions in the EMS and would be in the interest of both debtors and creditors. It would not compromise discipline in the EMS.
- It was also proposed that the VSTF should be made available for intramarginal interventions in EMS currencies, subject to certain conditions, i.e. prior use of existing holdings of the intervention currency and agreement on the intervention in the framework of the monitoring procedure. According to some experts, this adjustment, which would require no amendment to the EMS Agreement, would be in line with the increased role of intramarginal interventions in intra-EMS exchange rate stabilisation. Other experts pointed particularly to the far-reaching monetary consequences of such a step for the countries issuing the intervention currency.
- Some experts suggested that the acceptance limit for the official ECU should be abolished. Other experts felt that this proposal would raise issues related to the checks and balances of the EMS.

2.6 Participation in the exchange rate mechanism

The group noted the reasons for some EEC member countries not participating in the exchange rate mechanism or for participating on special terms. They consider that it is desirable to work towards full participation by all EEC countries on an equal footing.

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

10th February 1987

MANDATE
FOR THE GROUP OF EXPERTS
UNDER THE CHAIRMANSHIP OF MR. DALGAARD

The group has been invited to examine:

- the realignment procedure, in particular procedures to be followed in the case of small realignments;
- circumstances and developments surrounding the recent realignment, in particular as regards
 - . the evolution of interventions and their linkage with the utilisation of the exchange rate fluctuation band and with short-term interest rate differentials,
 - . the part played by recent liberalisation measures in the tensions within the EMS;
- the extension of EMS exchange rate commitments to all EEC countries;
- problems arising with regard to intervention currencies and the sharing of the burden of interventions; in this context the rôle of the ECU could be re-examined;
- the consequences for the system and its mechanisms of dollar (and yen) exchange rate fluctuations;
- the short-term credit facilities, with particular regard to the following problems: the adequacy of the amounts available, the degree to which the provisions governing access correspond to the needs of the system and, as regards the short-term support mechanism the means of financing; taking into account in all these areas the impact of the liberalisation of capital movements.

Since the Chairman of the Committee of Governors will present a preliminary report to the informal ECOFIN meeting at the beginning of next April, the group should aim at reaching some preliminary conclusions on the questions mentioned in the two first indents in time for the next meeting of the Committee of Governors on 10th March 1987.

EXPERIENCE IN COUNTERING SPECULATIVE ATTACKS
ON THE EXCHANGE RATE

1. The present note summarises the experiences of the central banks participating in the EMS exchange rate mechanism in dealing with speculative attacks on their exchange rates. It focuses on the conclusions drawn by individual countries with regard to the use of interventions, interest rates and the band-width.

2. The Banque Nationale de Belgique distinguishes three periods with respect to the Belgian franc's position within the EMS, which correspond to the prevailing current account position. Although it is now a declared policy of the Belgian authorities no longer to resort to devaluation, non-residents in particular continue to speculate against the Belgian franc in times of tension within the EMS. This shows that it takes a considerable time to restore confidence in a currency and that such a task requires a long-term systematic approach.

Political events have significantly affected the timing of realignments. There is a need to reduce the effect of "elections" on the operation of the EMS and unavoidable exchange rate adjustments must not be postponed. Where the latter is concerned, the latest realignment constituted an improvement in comparison with those in March 1983 and April 1986. The fact that the Belgian franc is still invariably in the lower regions of the system is due to:

- the monetary policy pursued, which aims at exploiting the possibilities for lowering interest rates;
- the exchange rate policy, which aims at ensuring that at a realignment the Belgian franc holds a middle position; consequently, after a realignment the franc is in the lower half of the band, in line with the strong currencies;
- the fact that, as more EMS partners have fully oriented their currencies towards the Deutsche Mark, it becomes more difficult for the franc to rise within the band.

The fact that the franc is invariably in the lowest position may create the impression that it is a weak currency. The room for downward manoeuvre is also limited, thus increasing the likelihood of compulsory interventions. However, the policy pursued is gradually succeeding in shedding the weak-currency image.

Although the improved balance-of-payments position permits more flexible use of the margin for fluctuation, the policy is to avoid, if possible, a slide to the bottom of the band so as to "dedramatise" interventions (this is possible because the market is not aware of the volume of intramarginal interventions). On the other hand, a particular position in the band is not maintained at all costs by means of intramarginal interventions.

With regard to the use of the interest rate instrument, the Banque Nationale de Belgique notes that:

- events have shown that it is powerless if the current account is fundamentally ill-balanced;
- sharp rises of very short-term rates, such as those induced by the Banque Nationale in March 1983 with the help of exchange control measures, can only be maintained for short periods;
- the financing needs of the public sector are an important constraint on the use of this instrument;
- a small country is unable to use this instrument to combat general tensions in the EMS, especially in the absence of a common determination to do so.

Consequently, there is a natural tendency to prefer interventions to increases in interest rates, in the hope of being able to offset the loss of reserves after the realignment. The domestic resistance to the use of the interest rate instrument could be eased if interest rate policy were co-ordinated at the EMS level.

3. Danmarks Nationalbank has identified ten periods of pressure against the Danish krone since the start of the EMS. They vary widely as to their origin. In some cases they were mainly caused by domestic developments but in most cases the direct cause was external, for instance an expectation of a general realignment in the EMS. Even in these cases the size of the tensions depended on the level of confidence in the Danish krone.

In most cases a mixture of all three policy responses was used. Intramarginal interventions have been used in all situations, although to varying extents. Interest rates have been increased in most cases - in one situation short-term interest rates briefly reached 30 per cent. In a few situations when a rise in interest rates was considered unwanted for domestic reasons, short-term interest rates were increased only at a late stage or not at all. Movements inside the EMS band have been used throughout the periods but the Nationalbank has gradually become more willing to accept a weakening of the exchange rate within the band.

The results of the attempts to counter speculative attacks have generally been satisfactory, even if interventions sometimes have been very big. In particular, since the autumn of 1982 a number of attacks have been resisted without a weakening of the market rate of the Danish krone, i.e. with a loss for those taking positions against the Danish krone.

4. The Banque de France identifies four situations in which speculative attacks on the franc have been successfully countered with the aid of intramarginal interventions. Such interventions have constantly been part of exchange rate policy. The continuous presence of the central bank in the foreign exchange market has meant that its operations have not automatically been interpreted as interventions. In so far as, in these conditions, the size of the interventions is masked, they are dedramatised. French policy has sought to avoid major fluctuations within the band. The existence of exchange controls has meant that the use of the domestic interest rate instrument could often remain limited while the rise in euromarket rates dampened speculation by non-residents. However, as in practice conditions are highly specific (each currency has its own characteristics, the size and composition of reserves differ, the causes of pressure on the exchange rate vary, some central banks are less independent than others), it is not possible to formulate general rules determining an optimum policy mix. A pragmatic response to the particular circumstances, therefore, is necessary. In certain cases, a policy aimed at discouraging speculation by increasing its cost may have some negative effects. For example, a move in the spot rate may appear to be a signal for the market and bolster speculative behaviour. The same risk exists on the the forward market - also carefully watched by the operators - as the result of a change in interest rates. In these circumstance pressures allowed to develop on one currency may spread to others.

5. So far, the Central Bank of Ireland has preferred intramarginal interventions. This reflects a belief that letting the Irish pound fall to the intervention limit would, on balance, encourage rather than discourage speculation. However, experience shows that increasing use has been made of the interest rate instrument, both by allowing the tighter liquidity conditions associated with speculative pressure to be reflected in rising money market rates and by supporting this by increases in official rates. This attitude was evident in the substantial rise in official interest rates in response to the renewed exchange rate pressure in September and October 1986, which, backed by a strengthening of the sterling and dollar exchange rates, appeared to be successful in stemming outflows.

6. The Banca d'Italia has resisted speculative pressures with the aid of a varying policy mix, depending on circumstances. Generally, the first line of defense has been intramarginal interventions. When they proved insufficient, interest rates were changed and/or the lira was allowed to move within the band. In specific periods, direct credit and/or exchange controls were also adopted.

In early 1984, pressures on the lira were successfully resisted by means of intramarginal interventions and, subsequently, by some downward movement within the band. On that occasion, disappointing domestic economic developments made an increase in interest rates, which were already very high in real terms, undesirable.

At the end of 1985 and at the beginning of 1986, persistent tensions pervaded the whole system because of market participants' anticipation of the general realignment which took place after the political elections in France. In December 1985, intramarginal interventions and a downward movement of the lira in the band were used in an attempt to combat speculative pressures. However, since the pressures persisted and it was not considered appropriate to allow the lira to slip further within the band because market participants would have interpreted this move as a sign of weakness, short-term interest rates were raised in January 1986 and direct credit and exchange controls were also introduced. This allowed the Banca d'Italia to restore foreign exchange reserves by as early as March and in the April 1986 realignment the lira was able to hold a middle position. Shortly after the realignment direct controls were removed.

7. The Nederlandsche Bank has found by experience that a combination of appropriate money market policy and use of the fluctuation band is a powerful weapon in combating speculative exchange rate pressures. Such action may result in a sharp rise in very short-term interest rates, but these high levels usually last only a couple of days. The impact on longer term rates is very much muted and hence the adverse consequences for the economy would appear to be limited. To the extent that they nevertheless occur, they should be weighed against the long-term benefits resulting from increased confidence in the currency. Such confidence will discourage future speculation and will in the longer run contribute to a lower level of interest rates. The policies followed when the guilder was under attack in the 1970s have probably helped to avoid subsequent tensions by contributing to market confidence that the authorities are committed to defending the exchange rate. It is the Bank's view that such confidence is essential when defending the rate against temporary speculative pressures. As long as it remains intact, relatively modest measures (intervention combined with interest rate adjustments) will suffice to stabilise the exchange rate. The main instrument used for this purpose is the short-term interest rate differential between guilders and deutsche mark.

3rd April 1987

THE POTENTIAL CONTRIBUTION OF THE PRIVATE ECU IN REINFORCING THE EMS

1. All available data bear witness to the fact that the ECU has established itself firmly as an important international currency, and is treated as such by all the Member States (Germany and Spain excepted). The ECU's recognition and use extend far beyond Europe.
2. Important advantages would flow from the development of the ECU as Europe's foreign currency, i.e. the vehicle currency that European nationals would increasingly use in their intra-Community dealings, as well as with third countries.
3. These advantages would pertain to the following areas :
 - a) By the end of 1992, the Customs Union is to make way for a truly internal market on which goods and services should be free to move as on a domestic market. The unity and price transparency on this market would be greatly enhanced if the ECU were generally to be used for the pricing of the intra-Community transactions. Invoicing in ECU would, moreover, share the (hopefully small) exchange risk between importers and exporters, while actual payment in ECU would be cost saving (less need for cash-balances and exchange transactions in a variety of national currencies).
 - b) The movement of capital liberalisation now underway in the Community will result in the co-existence of open, national capital markets, each with its own different size, cost (interest rate) and risk (exchange rate). The ECU would add the European dimension by integrating these markets. The emergence of an ECU denominated European capital market would generate significant advantages in terms of size, depth and resiliency of the market itself and in offering uniform conditions (risk and interest rate). These characteristics would foster a more rational and efficient allocation of capital resources within the Community.
 - c) The growing international role of the ECU could also reinforce the cohesion of the EMS. At present, trade with third countries is predominantly priced in dollars; the same holds for almost 3/4 of the international capital market transactions. Consequently, the exchange and interest rate fluctuations of the dollar affect the economic and financial situation of the EMS members to a varying but significant extent. The dollar's impact would be lessened if the

ECU were to be increasingly used by the European operators in their operations with the rest of the world. Moreover, if speculative shifts out of the dollar were deflected, at least in part, towards the ECU instead of the DM, the resulting exchange rate effects would be diffused over the whole of the EMS currencies. This would shield the DM and the EMS from the strains that are presently associated with the traditional "balancing act" between the dollar and the DM.

- d) At present, the link between the EMS and the international monetary environment is established by the DM : it is the DM/dollar rate that positions the System against the dollar. From a Community point of view, the situation would be more balanced if the ECU were to assume this function. To foster this goal, EMS participants would have to start using the ECU for coordinated intervention operations vis-à-vis the dollar. This would, of course, imply a certain development of the private ECU as a reserve asset.
4. The main impetus towards developing the ECU as Europe's foreign currency has to come from the market itself. Indeed, international currencies cannot be imposed by decree, their growth or decline are decided by the operators in the commercial and financial markets;
5. However, the attitudes and policies of the Community's monetary authorities do matter for the ECU's further development.

Thus, for example :

- reinforcing the EMS would improve the stability of the ECU, a quality that proved important in its development so far;
- the participation of sterling in the exchange rate mechanism would further improve this characteristic;
- the recognition of the ECU in Germany is a necessary condition for the larger use of the ECU in the commercial area. The present situation hampers the ECU's use in trade as well as financial operations and agreements, not only at the European level but also in the rest of the world;
- this recognition is also necessary if the ECU is to develop as a significant intervention- and reserve currency within the EMS.

PROPOSAL FOR STATISTICS FOR THE MONTHLY MONITORING

The basic statistics could be presented in a series of graphs such as those shown in the following pages.

They illustrate for each EEC country, the United States and Japan recent developments in exchange rates, interest rates, and interventions, based on daily information.

The main consideration has been to show the development very clearly, so that any deviation from the trend will be easy to see.

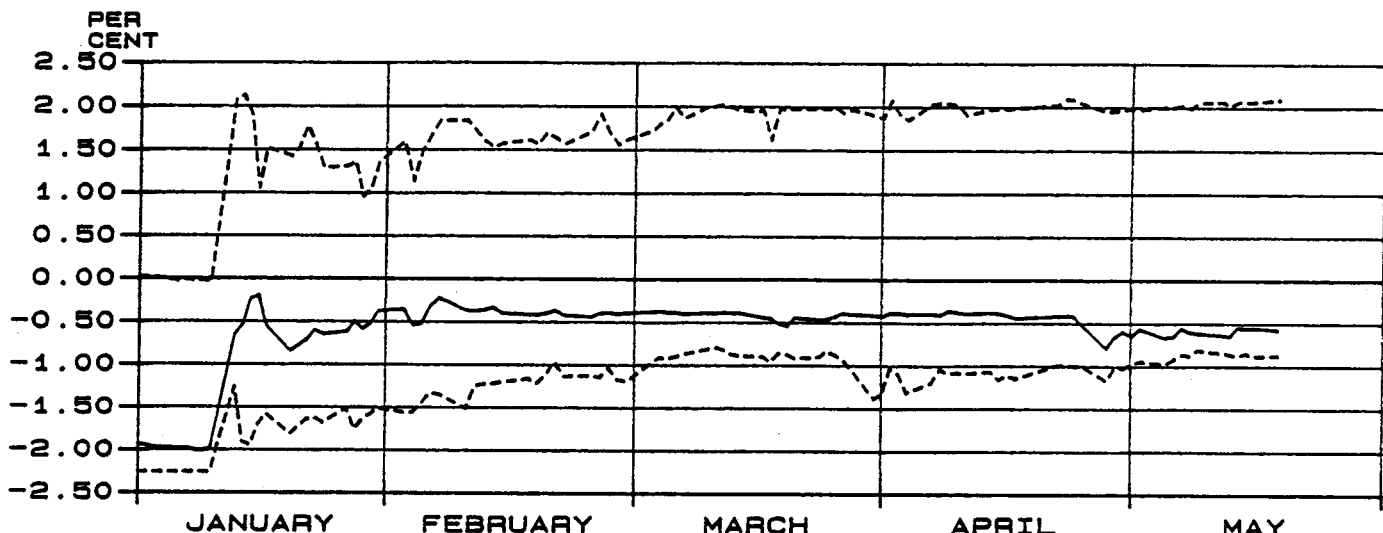
Developments in exchange rates of EEC currencies are presented using the Deutsche Mark as the reference currency. For currencies participating in the exchange rate mechanism the deviation from the Deutsche Mark central rate is shown, together with the maximum and minimum Deutsche Mark rates possible for the currency, given the positions of the other currencies.

Interest rate developments are shown in the form of changes in interest rate differentials, generally against the Deutsche Mark. The differentials shown are calculated on the basis of interest rates considered to be most important for the two currencies concerned.

The intervention graph shows total daily net sales (+) and purchases (-) of the currency concerned, including interventions made by other central banks. For the Deutsche Mark, US dollar and Japanese yen, where interventions by other central banks are important, the total is divided into interventions made by the issuing central bank and those made by other central banks.

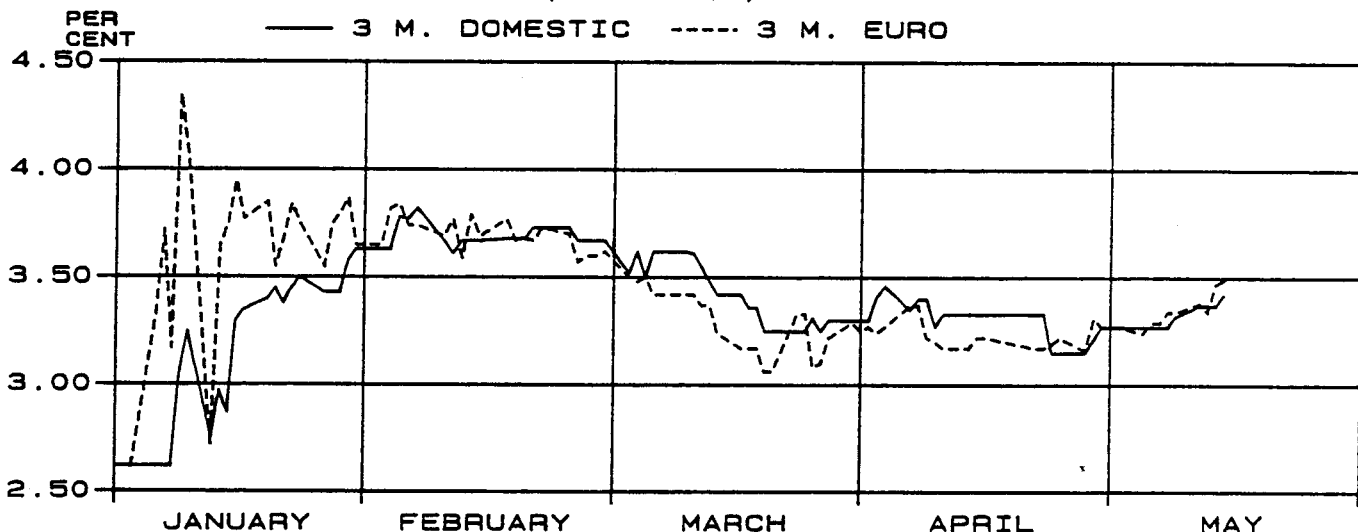
The form of the graphs should be developed in the light of experience.

BELGIAN FRANC



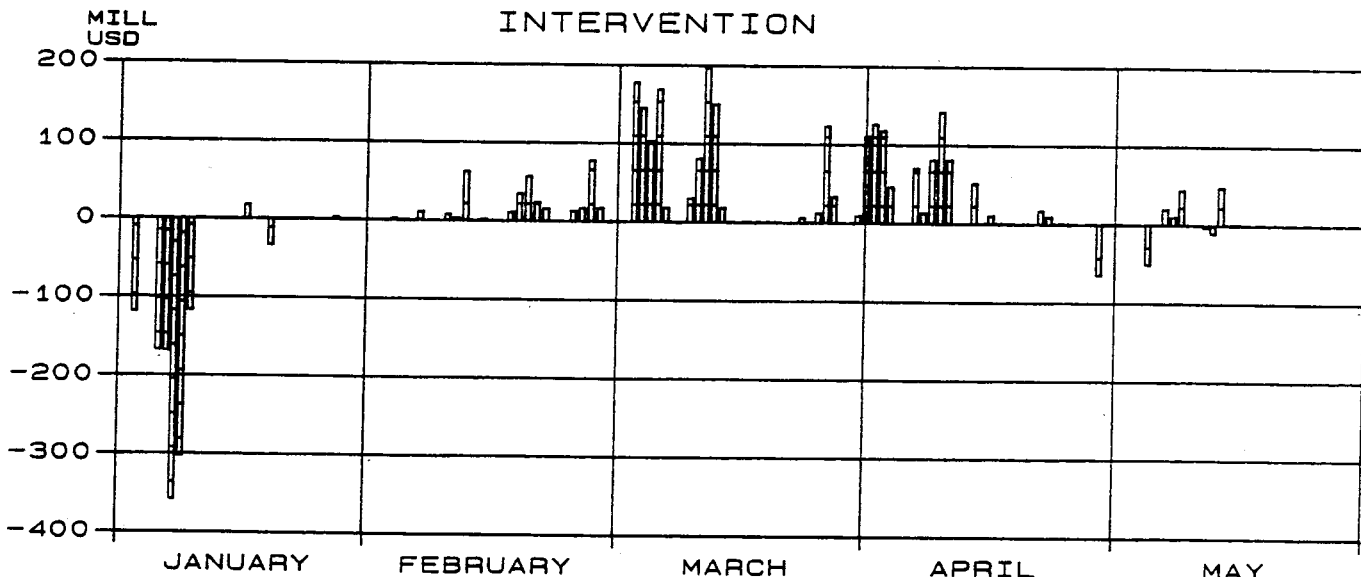
POSITION IN THE NARROW EMS-BAND, VIS-A-VIS THE DEM. --- UPPER AND LOWER LIMITS FOR DEM RATE. LATEST INFORMATION 18TH MAY 1987 (MORNING)

INTEREST RATE DIFFERENTIALS (BEC-DEM)



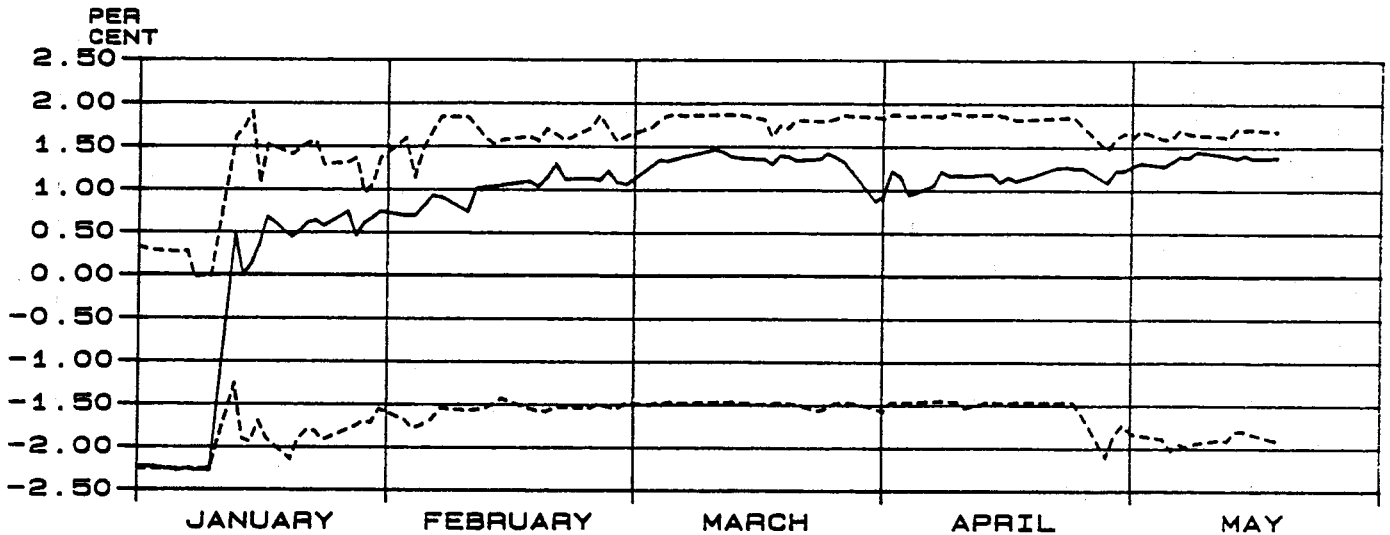
LATEST INFORMATION 14TH MAY 1987

INTERVENTION



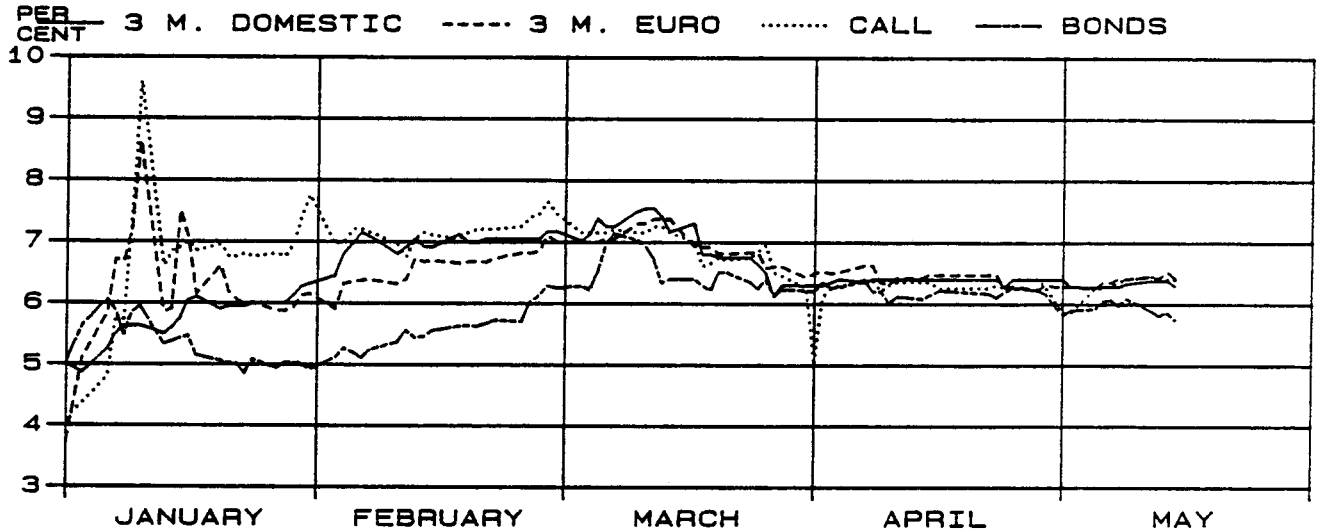
TOTAL NET INTERVENTION IN BELGIAN FRANCS. DAILY OBSERVATIONS.
- SALES OF FOREIGN CURRENCY. + PURCHASE OF FOREIGN CURRENCY
BASED ON INFORMATION UNTIL 15TH MAY 1987

DANISH KRONE



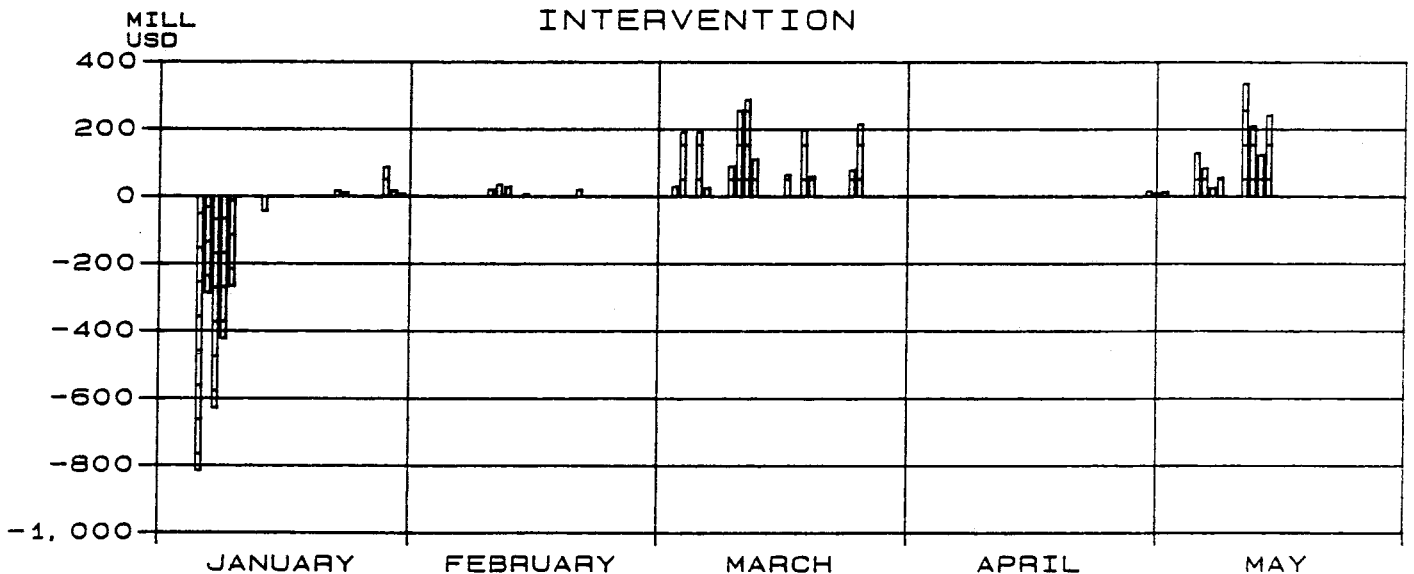
POSITION IN THE NARROW EMS-BAND. VIS-A-VIS THE DEM. --- UPPER AND LOWER LIMITS FOR DEM RATE. LATEST INFORMATION 18TH MAY 1987 (MORNING)

INTEREST RATE DIFFERENTIALS (DKK-DEM)



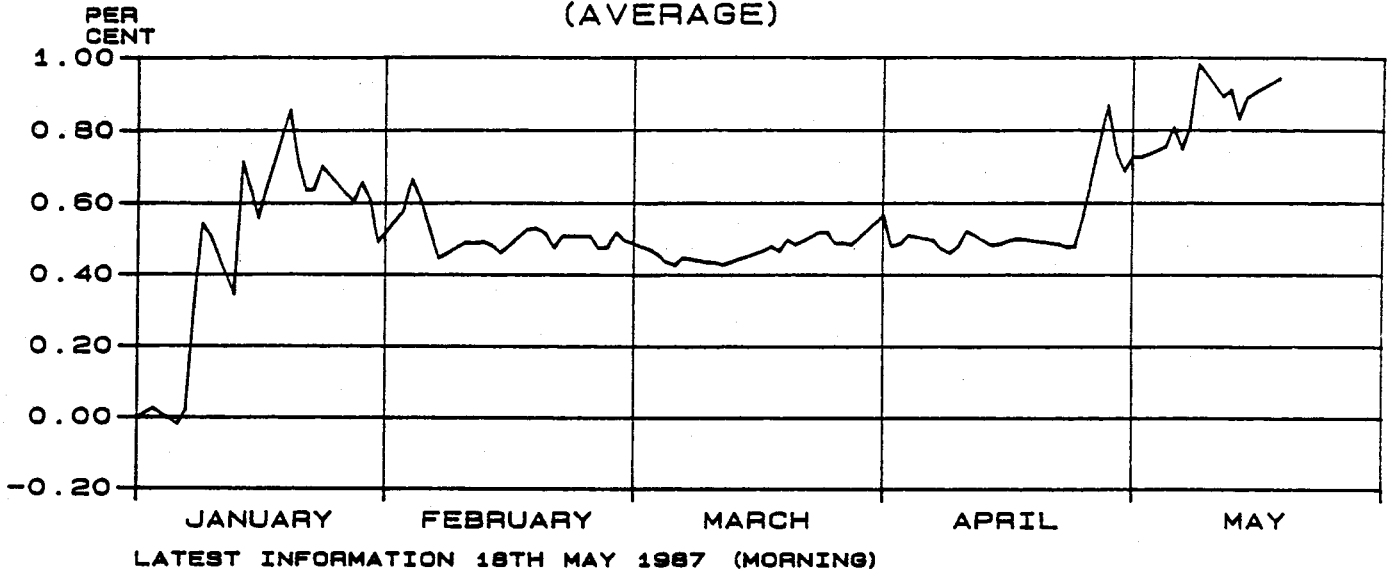
LATEST INFORMATION 14TH MAY 1987

INTERVENTION

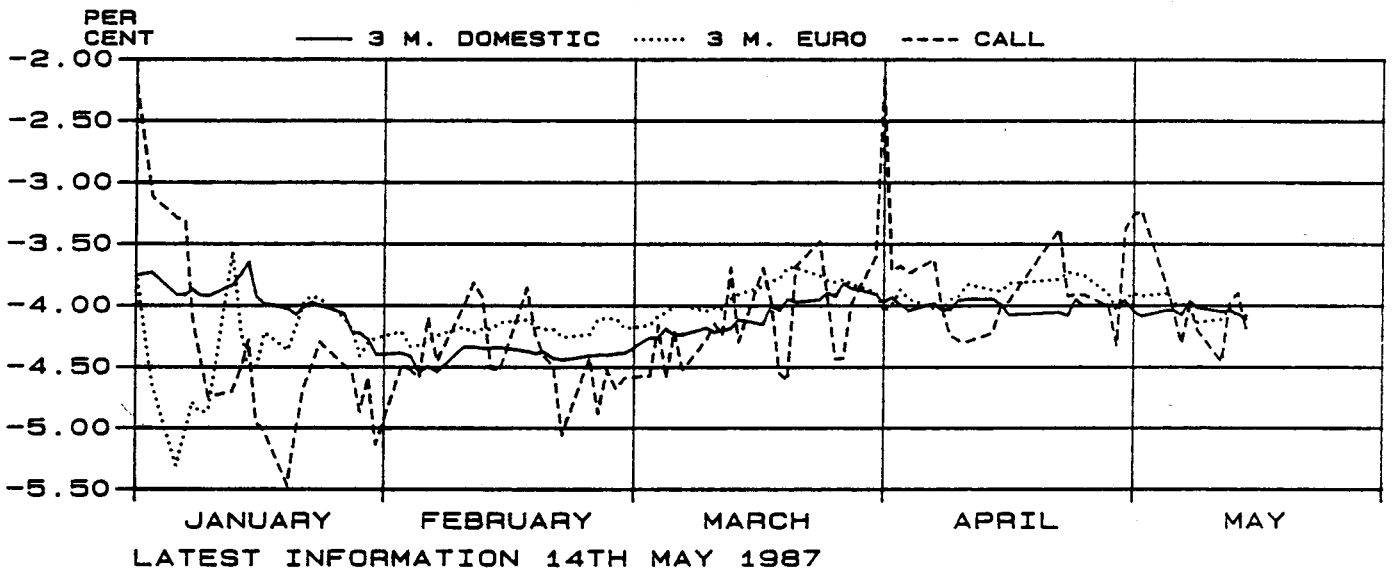


TOTAL NET INTERVENTION IN DANISH KRONE. DAILY OBSERVATIONS.
- SALES OF FOREIGN CURRENCY. + PURCHASE OF FOREIGN CURRENCY
BASED ON INFORMATION UNTIL 15TH MAY 1987

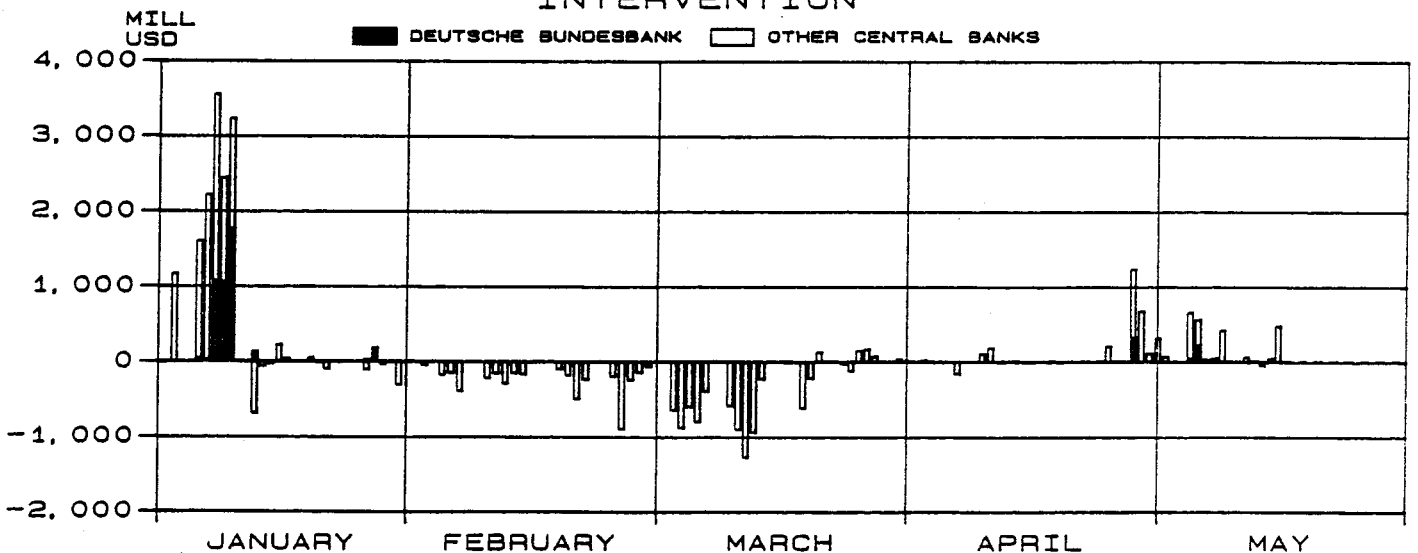
GERMAN MARK
AGAINST EMS CURRENCIES
(AVERAGE)



INTEREST RATE DIFFERENTIALS
(DEM-EMS)

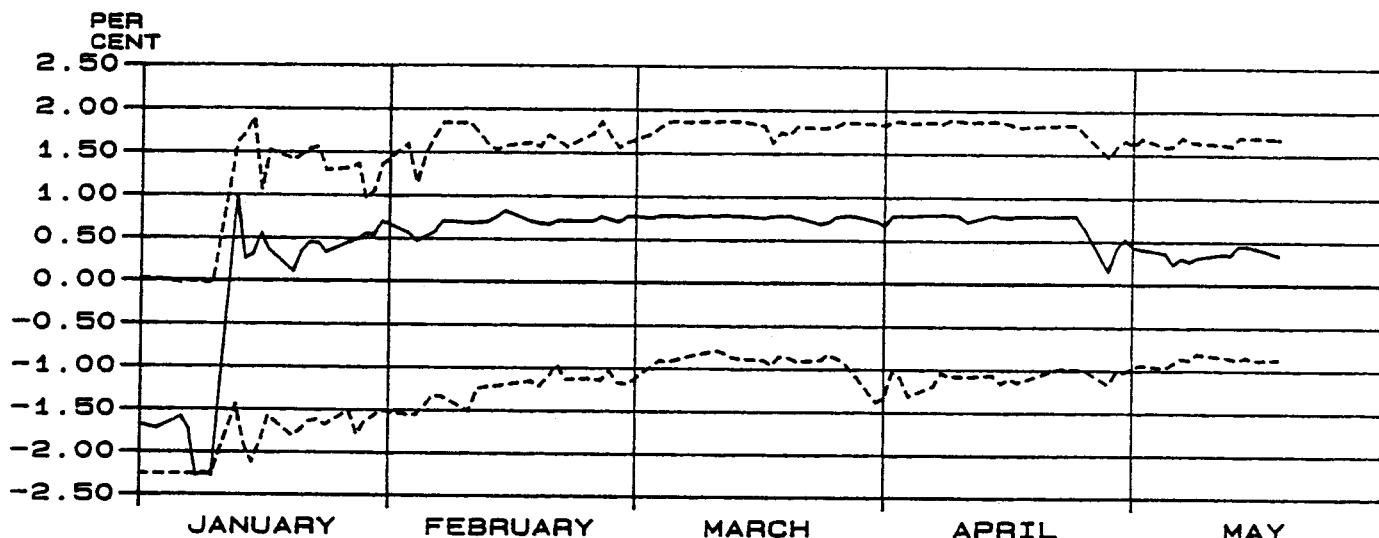


INTERVENTION



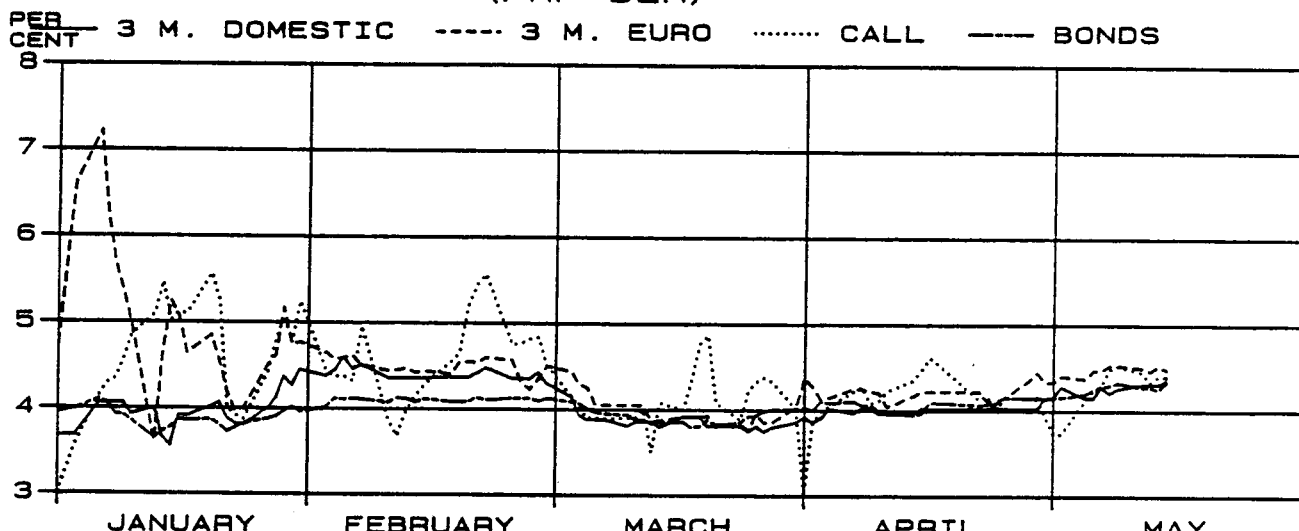
TOTAL NET INTERVENTION IN GERMAN MARKS. DAILY OBSERVATIONS.
- SALES OF FOREIGN CURRENCY. + PURCHASE OF FOREIGN CURRENCY
BASED ON INFORMATION UNTIL 15TH MAY 1987

FRENCH FRANC



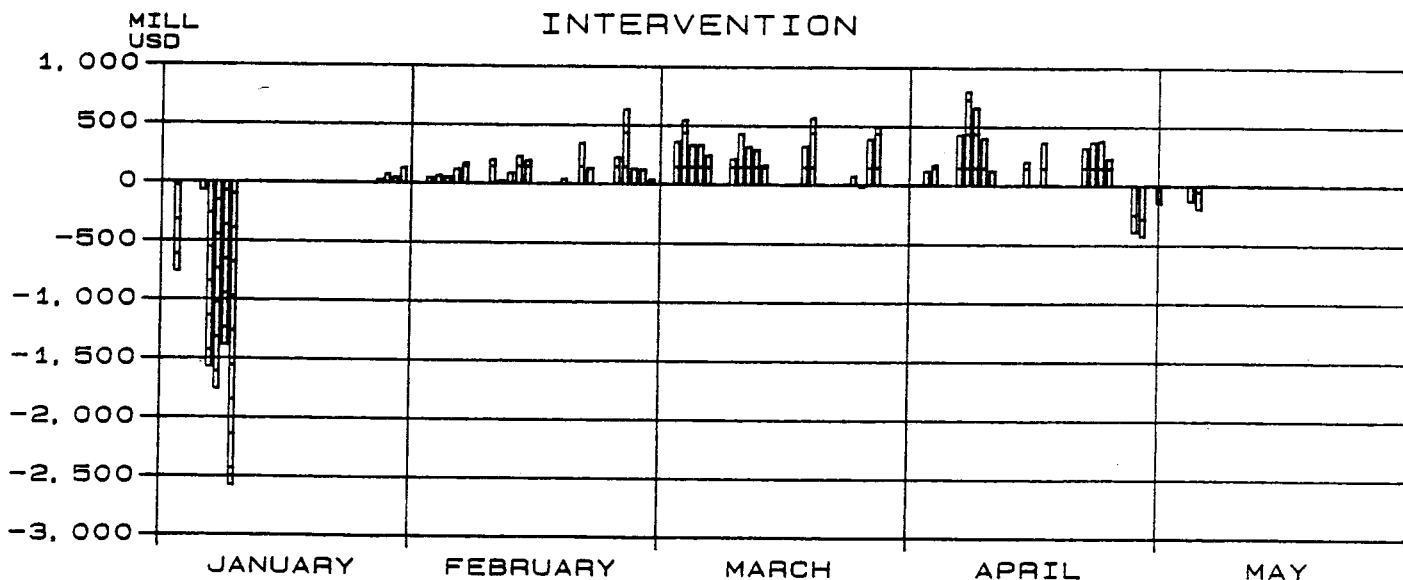
POSITION IN THE NARROW EMS-BAND. VIS-A-VIS THE DEM. --- UPPER AND LOWER LIMITS FOR DEM RATE. LATEST INFORMATION 18TH MAY 1987 (MORNING)

INTEREST RATE DIFFERENTIALS (FRF-DEM)



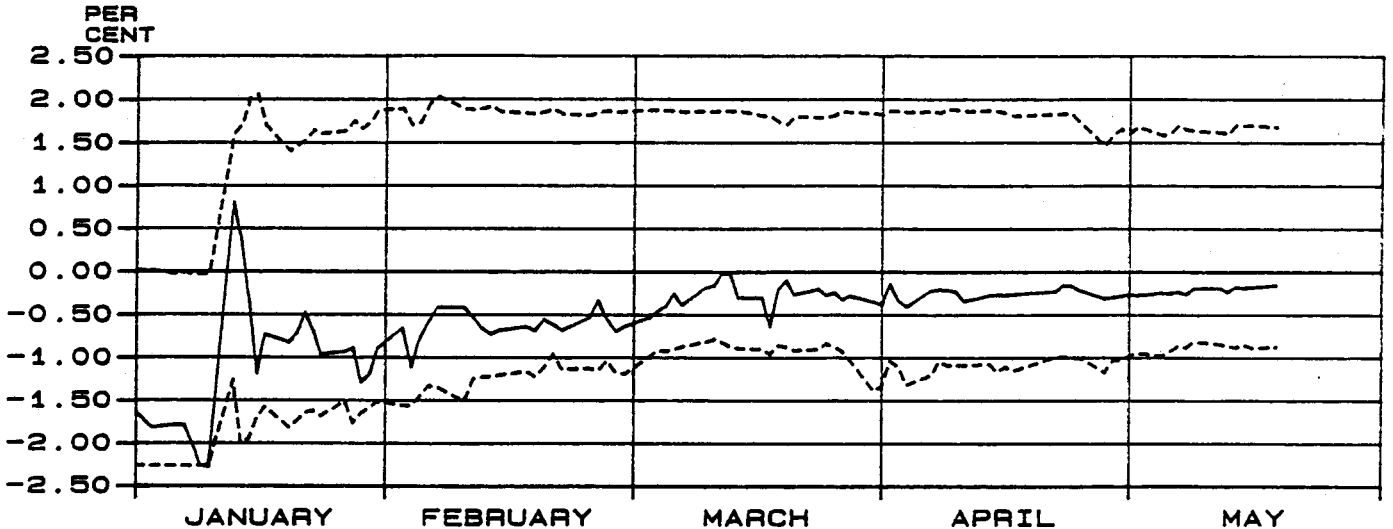
LATEST INFORMATION 14TH MAY 1987

INTERVENTION



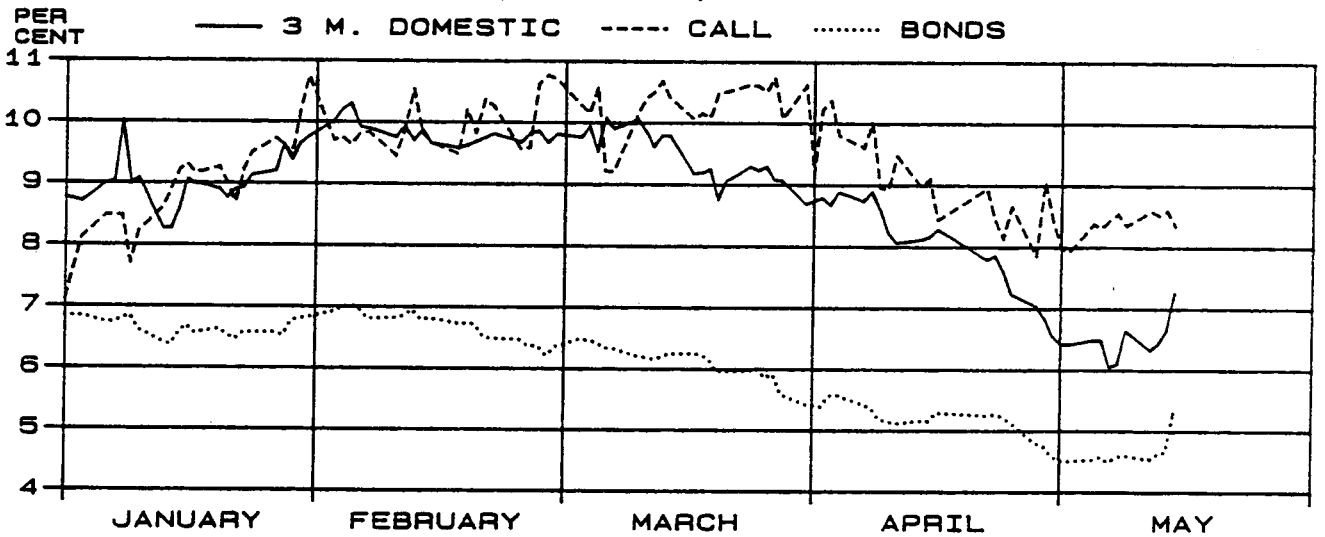
TOTAL NET INTERVENTION IN FRENCH FRANCS. DAILY OBSERVATIONS.
- SALES OF FOREIGN CURRENCY. + PURCHASE OF FOREIGN CURRENCY
BASED ON INFORMATION UNTIL 15TH MAY 1987

IRISH POUND



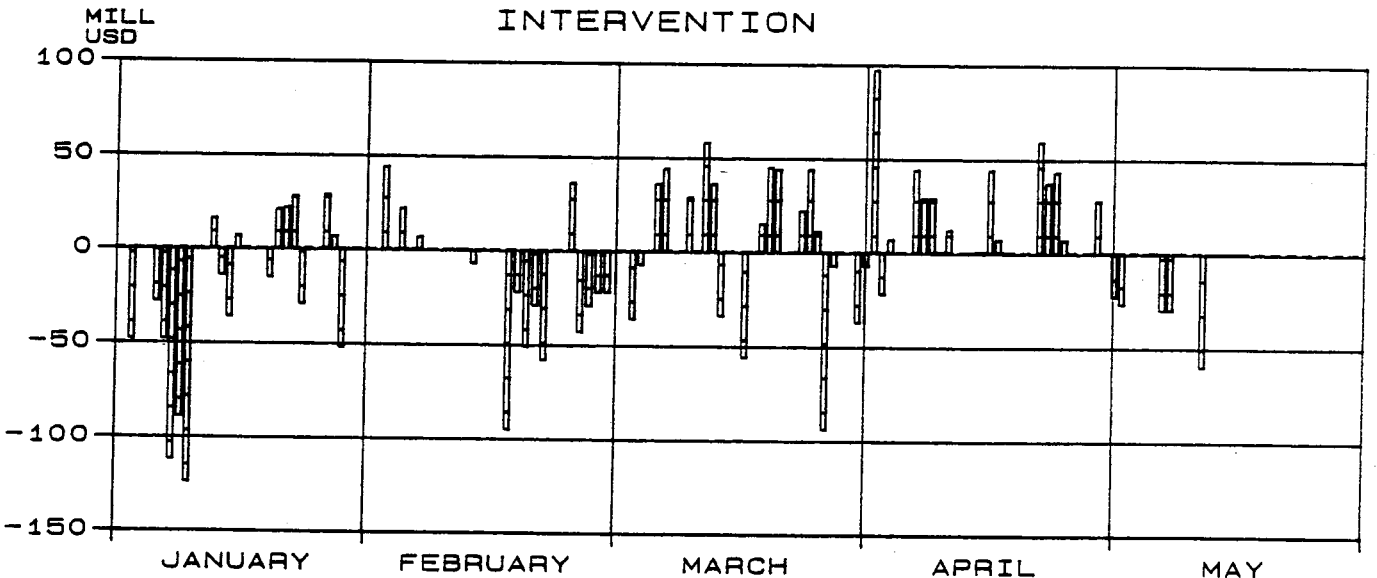
POSITION IN THE NARROW EMS-BAND. VIS-A-VIS THE DEM. --- UPPER AND LOWER LIMITS FOR DEM RATE. LATEST INFORMATION 18TH MAY 1987 (MORNING)

INTEREST RATE DIFFERENTIALS (IEP-DEM)



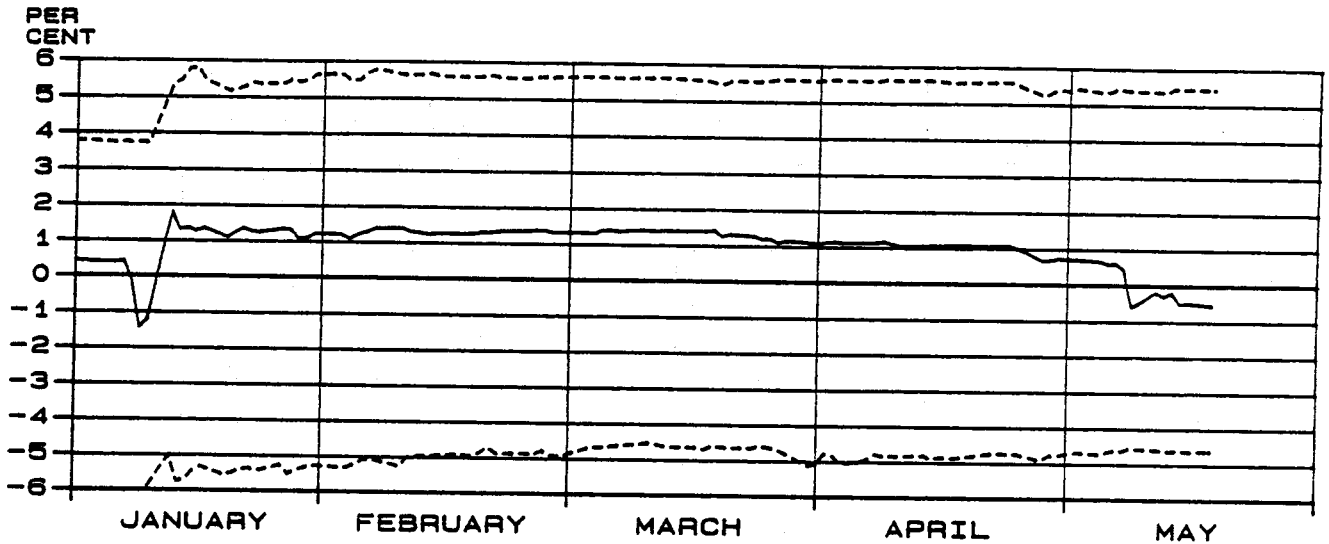
LATEST INFORMATION 14TH MAY 1987

INTERVENTION



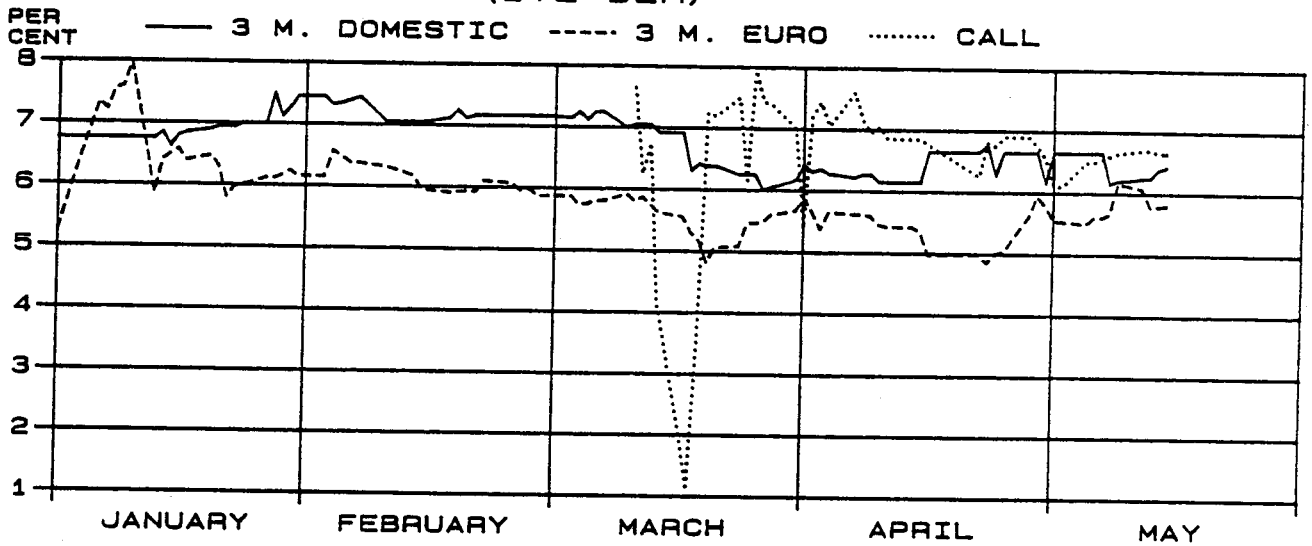
TOTAL NET INTERVENTION IN IRISH POUNDS. DAILY OBSERVATIONS.
- SALES OF FOREIGN CURRENCY. + PURCHASE OF FOREIGN CURRENCY
BASED ON INFORMATION UNTIL 15TH MAY 1987

ITALIAN LIRA



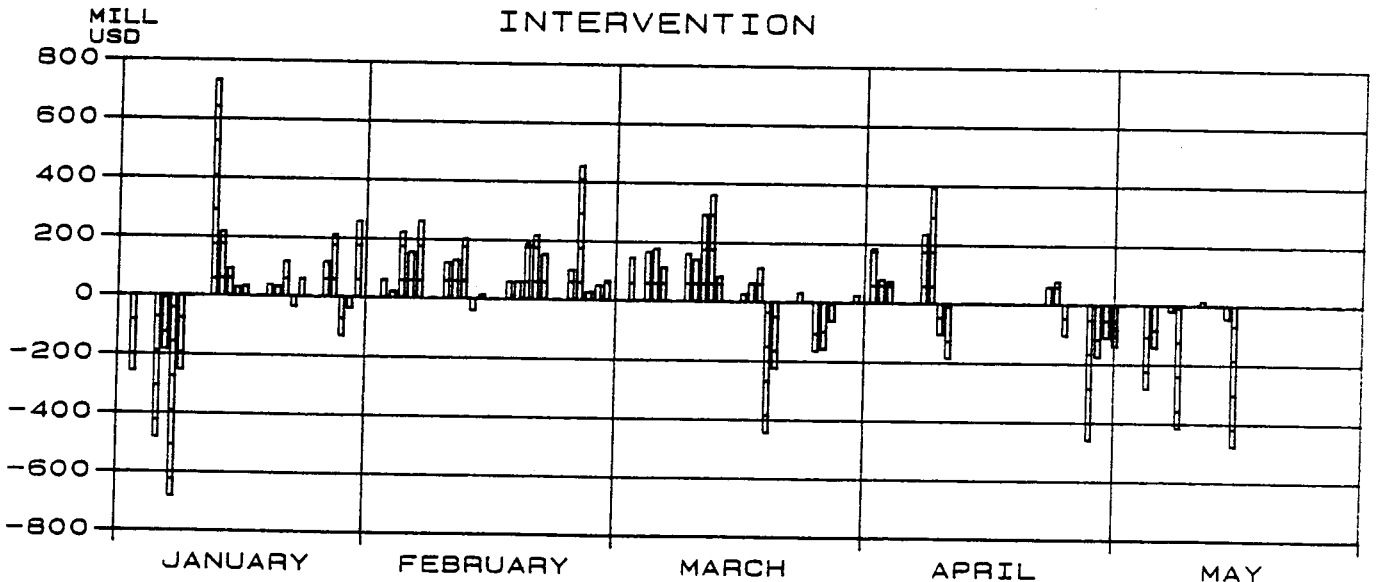
POSITION IN THE EMS-BAND. VIS-A-VIS THE DEM. --- UPPER AND LOWER LIMITS FOR DEM RATE. LATEST INFORMATION 18TH MAY 1987 (MORNING)

INTEREST RATE DIFFERENTIALS (ITL-DEM)



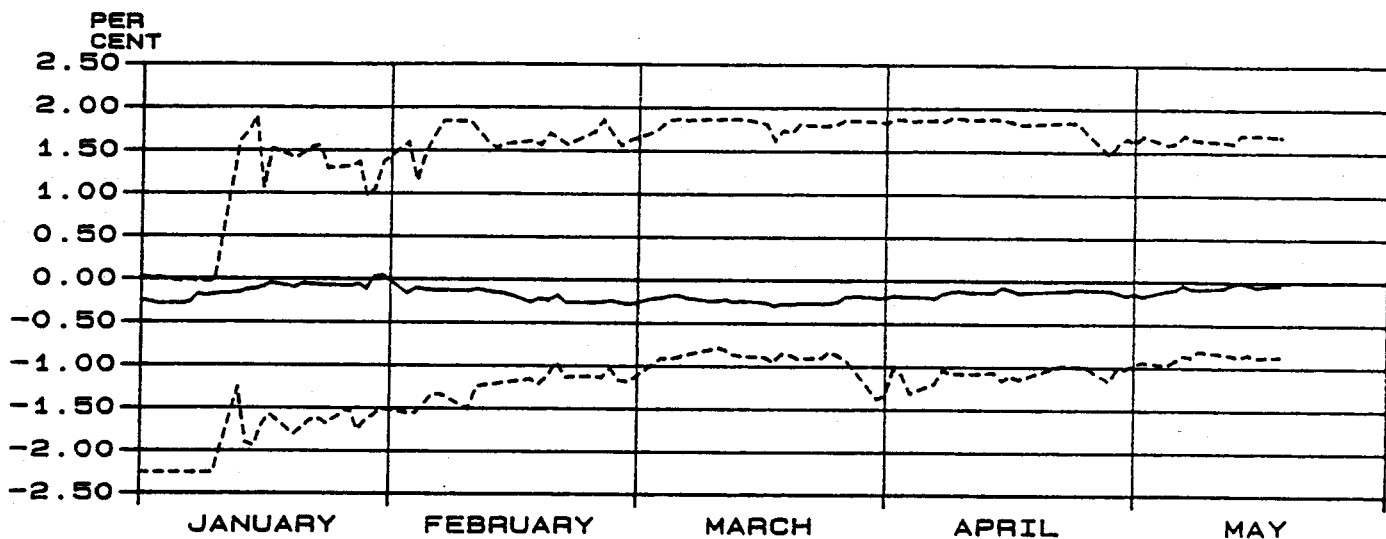
LATEST INFORMATION 14TH MAY 1987

INTERVENTION



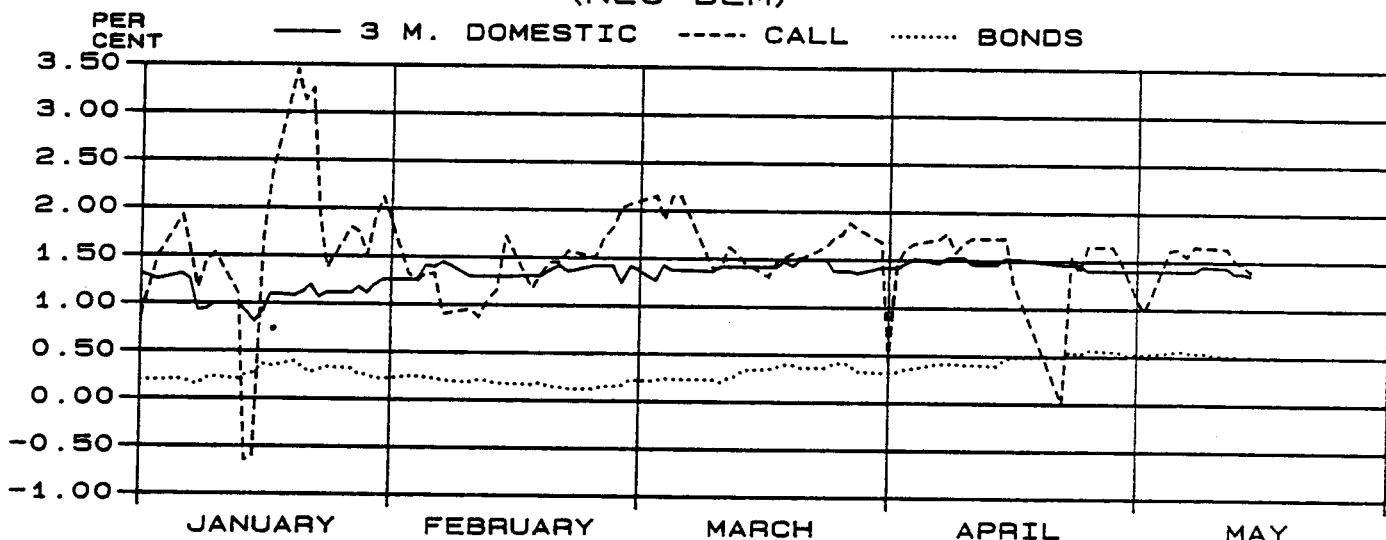
TOTAL NET INTERVENTION IN ITALIAN LIRA. DAILY OBSERVATIONS. - SALES OF FOREIGN CURRENCY. + PURCHASE OF FOREIGN CURRENCY. BASED ON INFORMATION UNTIL 15TH MAY 1987

DUTCH GUILDER



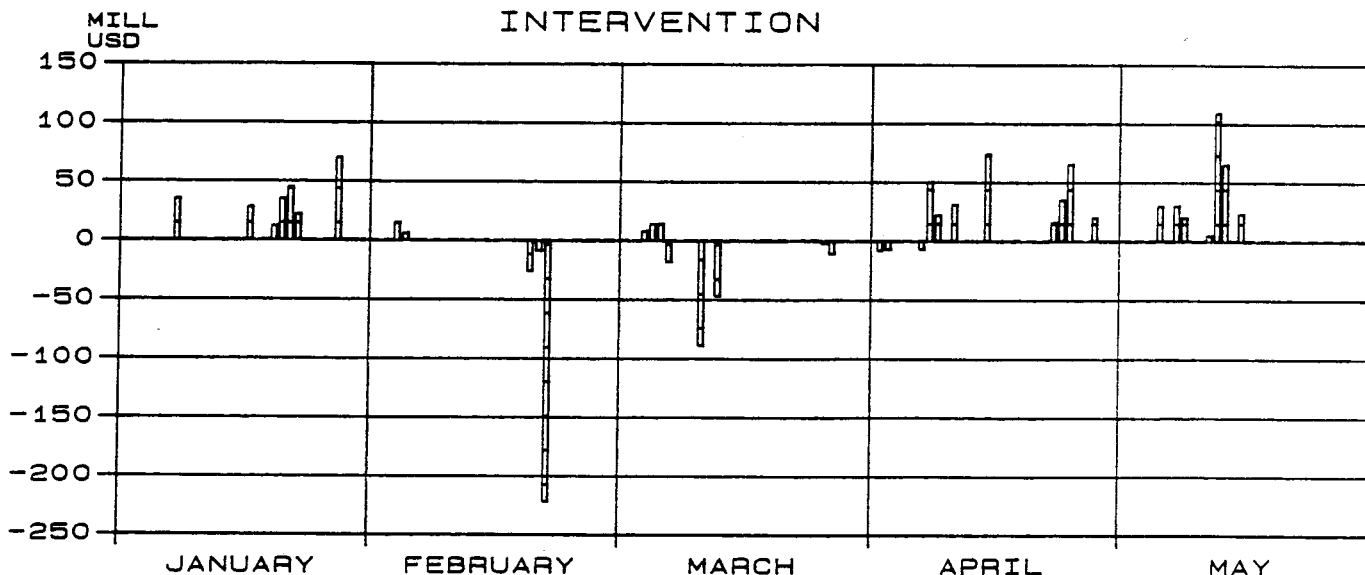
POSITION IN THE NARROW EMS-BAND. VIS-A-VIS THE DEM. --- UPPER AND LOWER LIMITS FOR DEM RATE. LATEST INFORMATION 18TH MAY 1987 (MORNING)

INTEREST RATE DIFFERENTIALS (NLG-DEM)



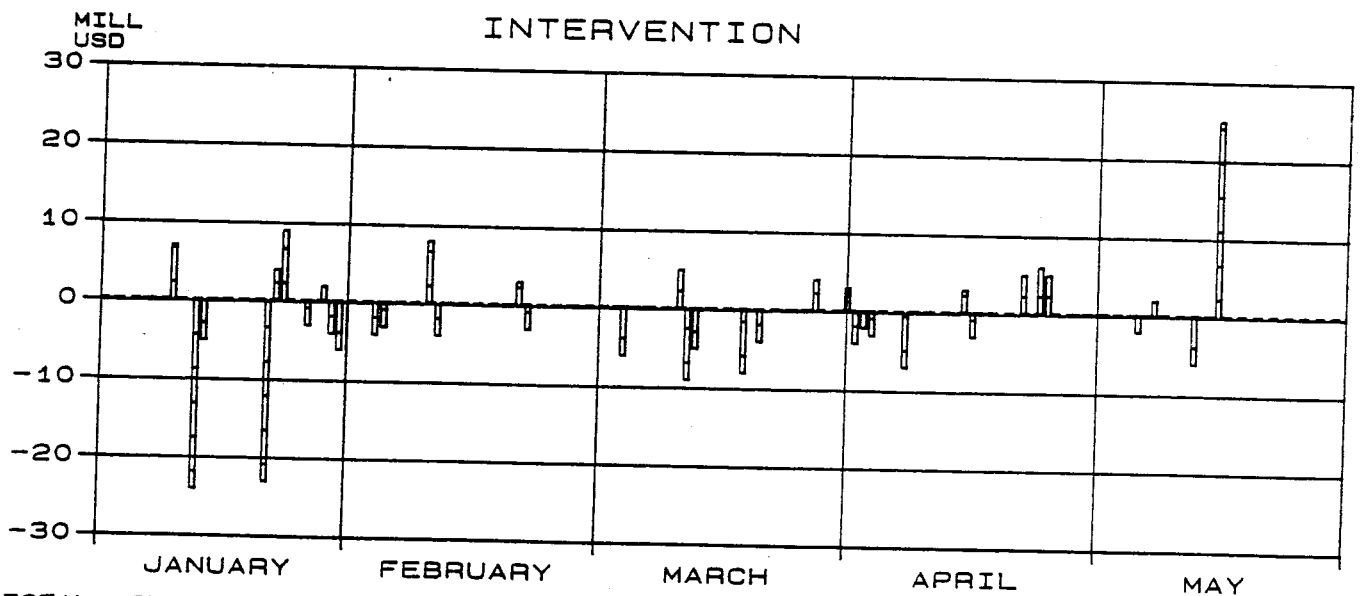
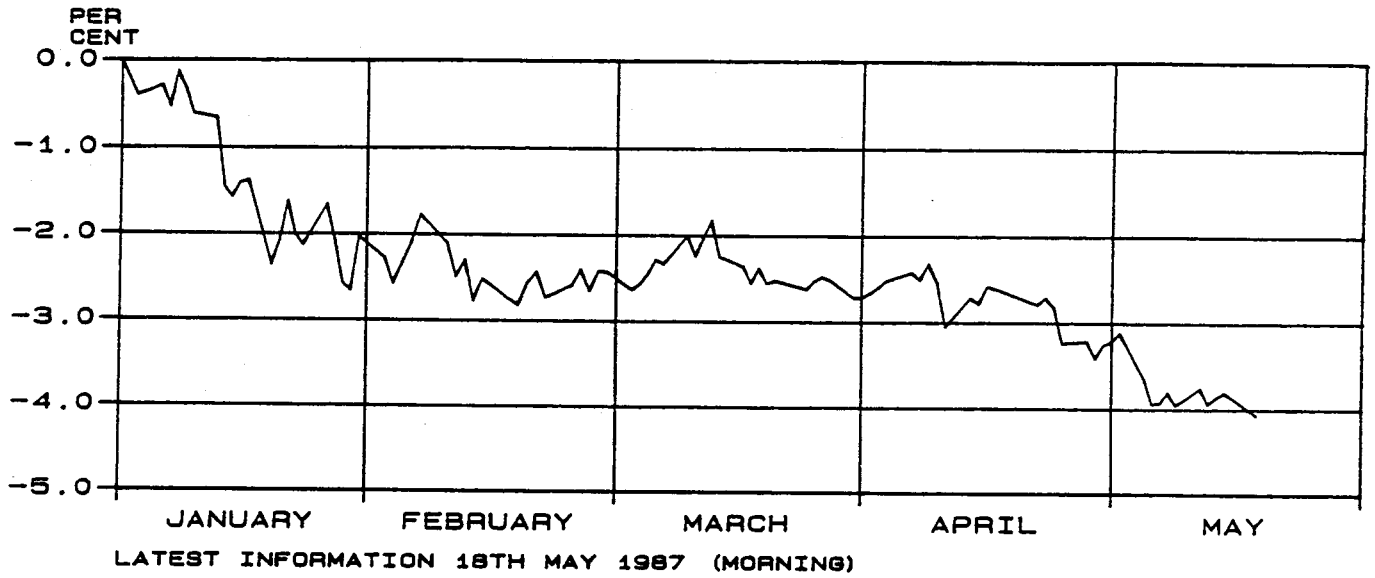
LATEST INFORMATION 14TH MAY 1987

INTERVENTION



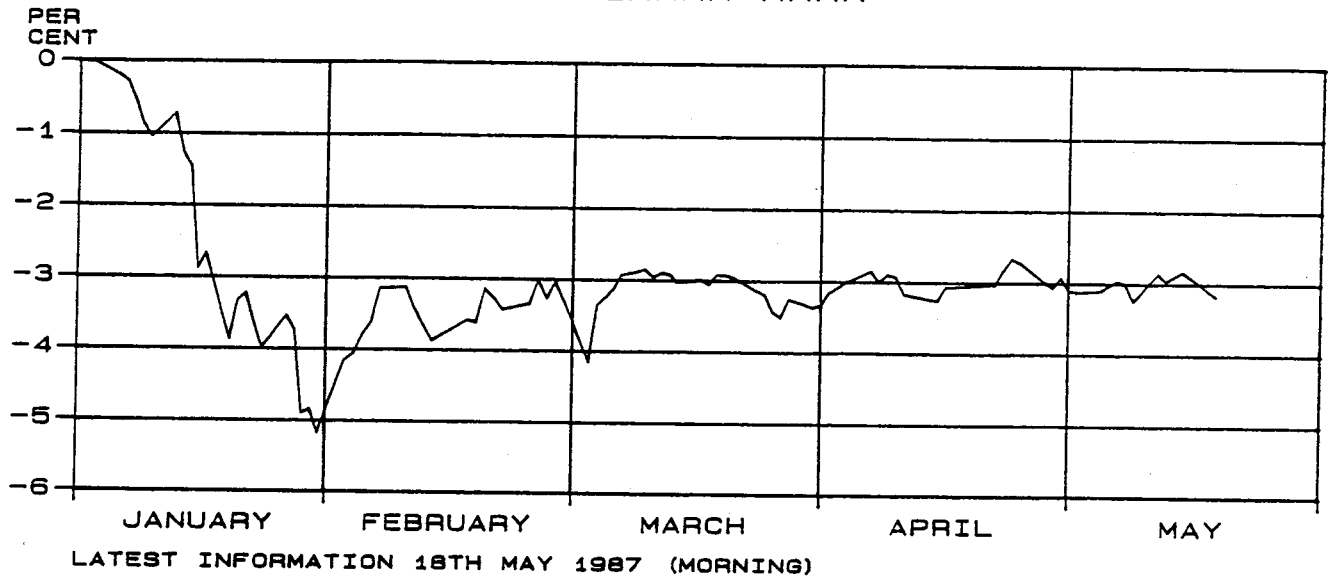
TOTAL NET INTERVENTION IN DUTCH GUILDERS. DAILY OBSERVATIONS.
- SALES OF FOREIGN CURRENCY. + PURCHASE OF FOREIGN CURRENCY
BASED ON INFORMATION UNTIL 15TH MAY 1987

GREEK DRACHMER AGAINST GERMAN MARK

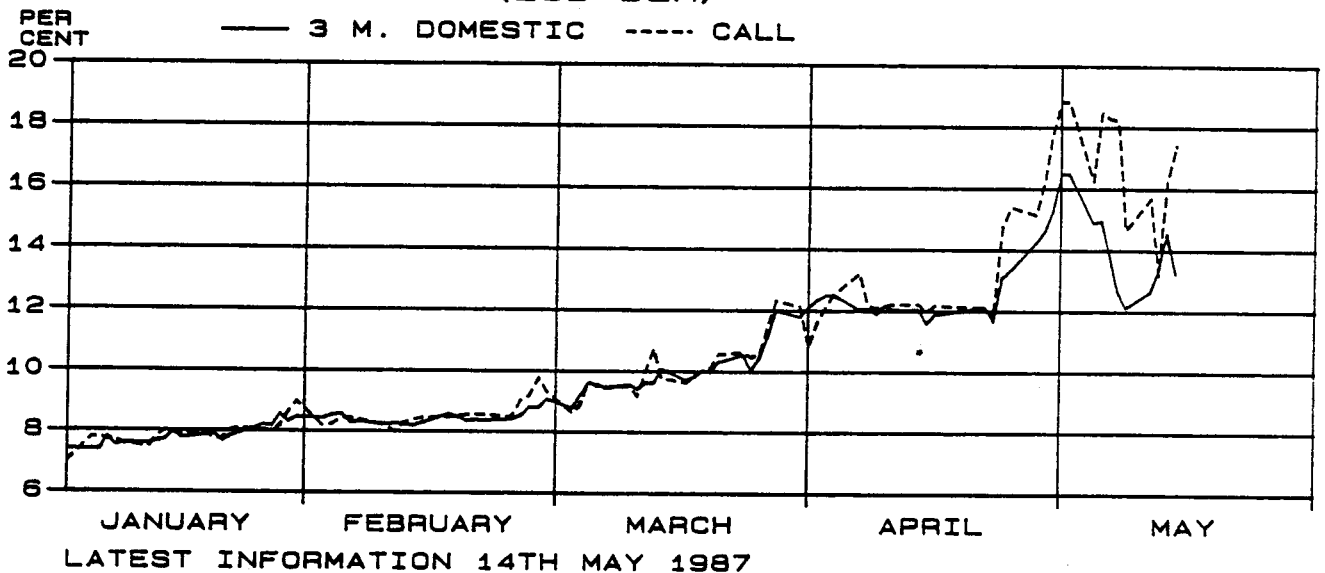


TOTAL NET INTERVENTION IN GREEK DRACHMER. DAILY OBSERVATIONS.
 - SALES OF FOREIGN CURRENCY. + PURCHASE OF FOREIGN CURRENCY
 BASED ON INFORMATION UNTIL 15TH MAY 1987

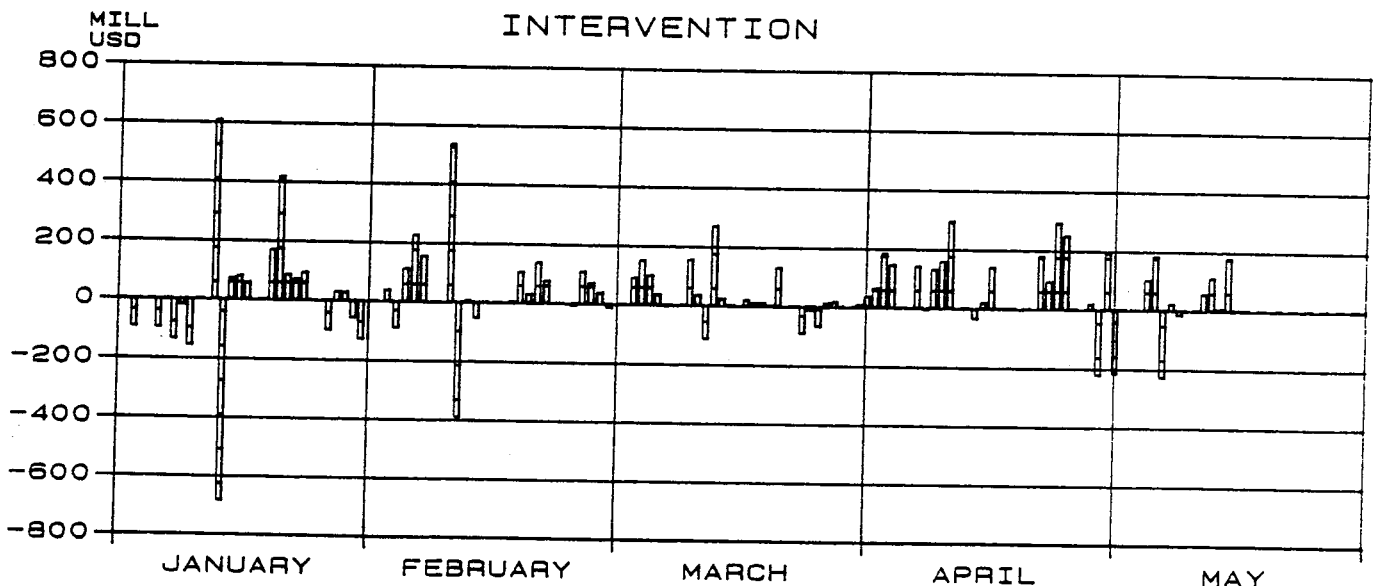
SPANISH PESETA AGAINST GERMAN MARK



INTEREST RATE DIFFERENTIALS (ESB-DEM)

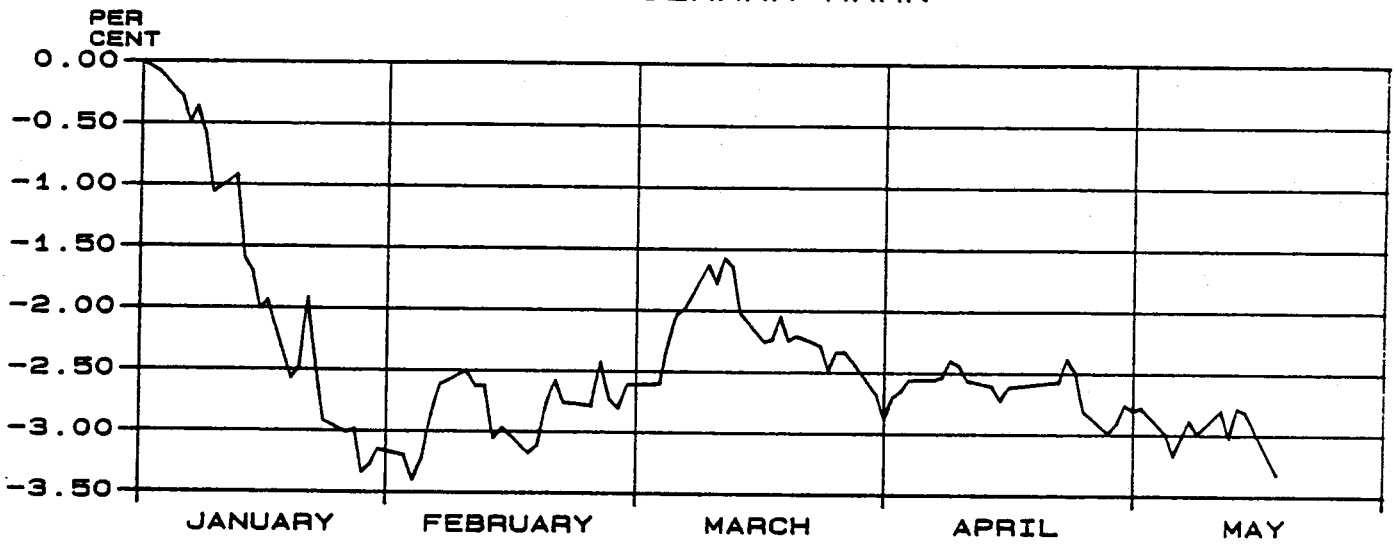


INTERVENTION

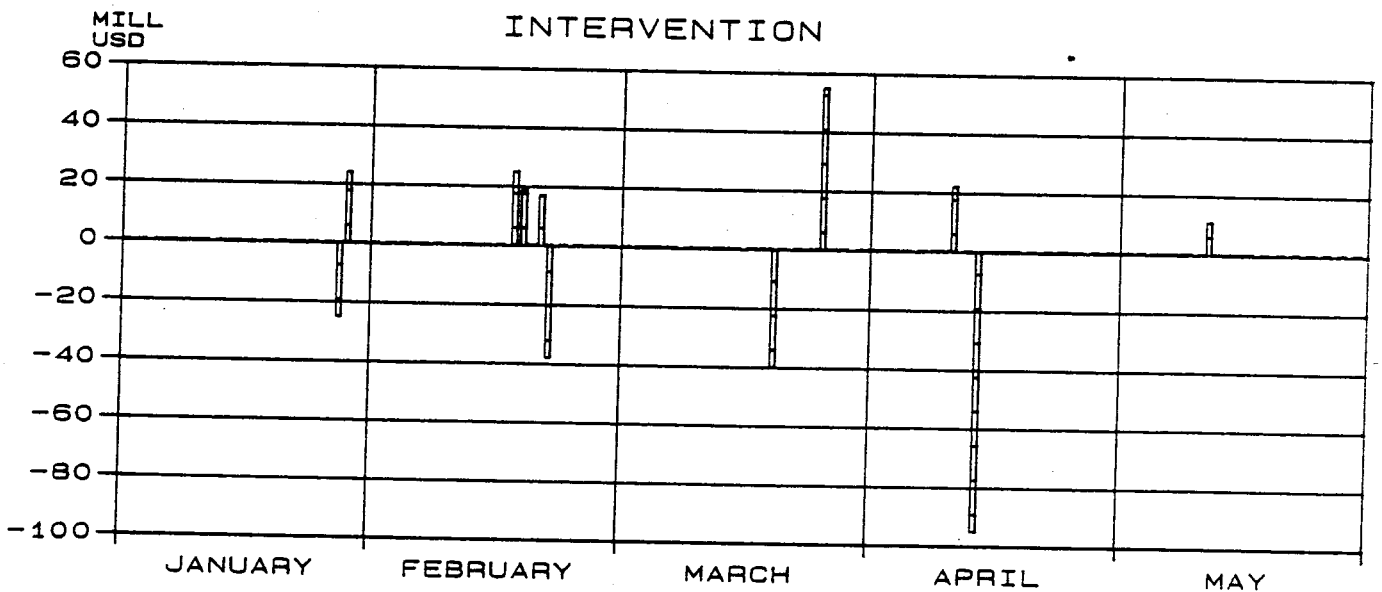


TOTAL NET INTERVENTION IN SPANISH PESETAS. DAILY OBSERVATIONS.
 - SALES OF FOREIGN CURRENCY. + PURCHASE OF FOREIGN CURRENCY
 BASED ON INFORMATION UNTIL 15TH MAY 1987

PORTUGES ESCUDO AGAINST GERMAN MARK

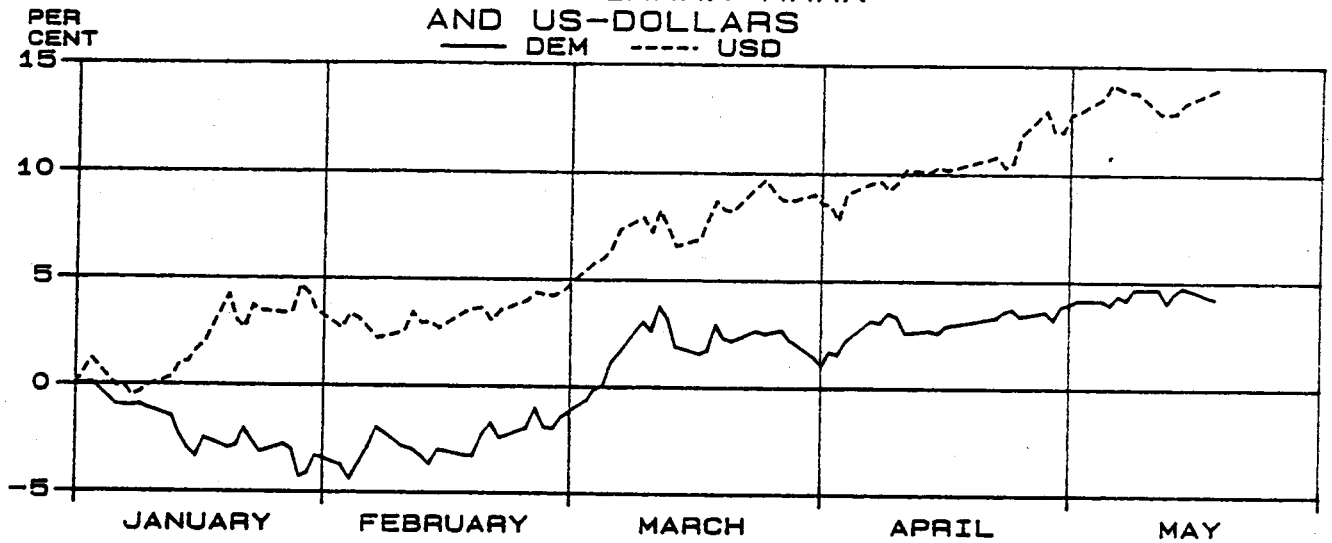


LATEST INFORMATION 18TH MAY 1987 (MORNING)



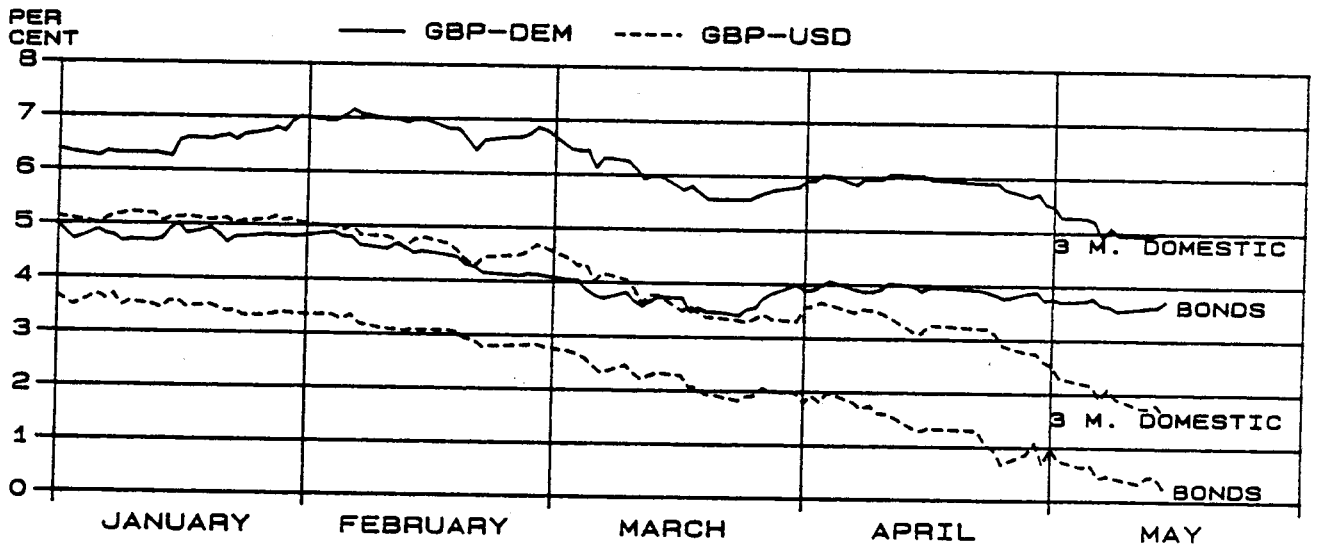
TOTAL NET INTERVENTION IN PORTUGUESE ESCUDOS.
 - SALES OF FOREIGN CURRENCY. + PURCHASE OF FOREIGN CURRENCY

BRITISH POUND
AGAINST GERMAN MARK
AND US-DOLLARS
— DEM ——— USD



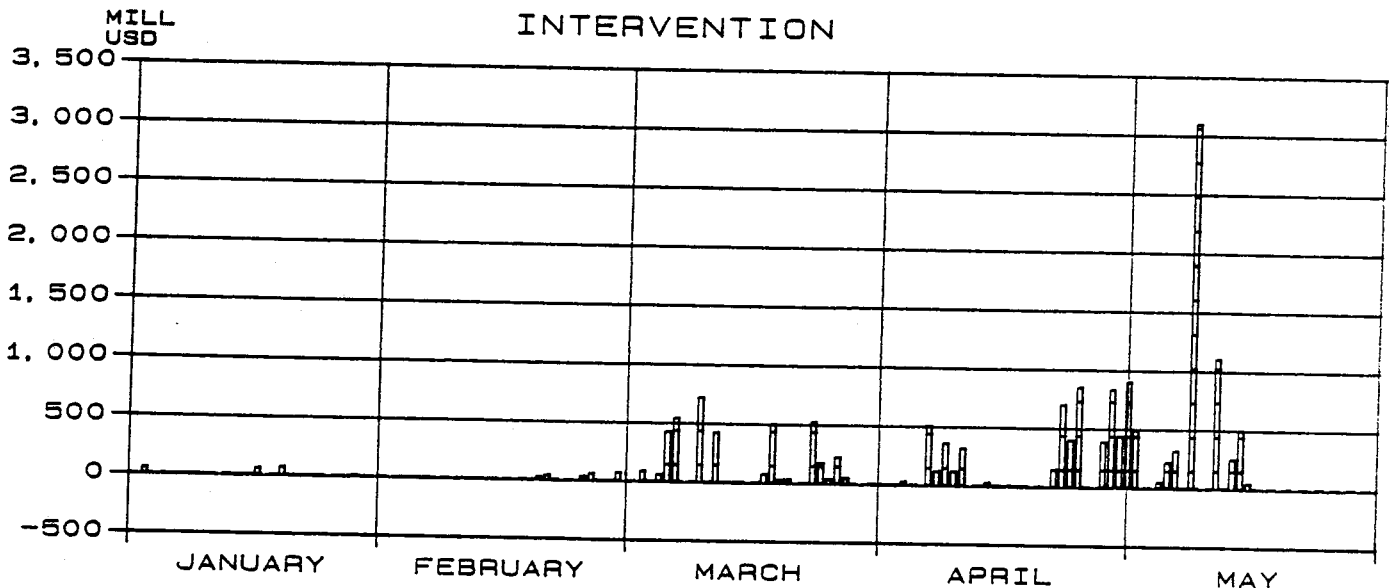
LATEST INFORMATION 18TH MAY 1987 (MORNING)

INTEREST RATE DIFFERENTIALS



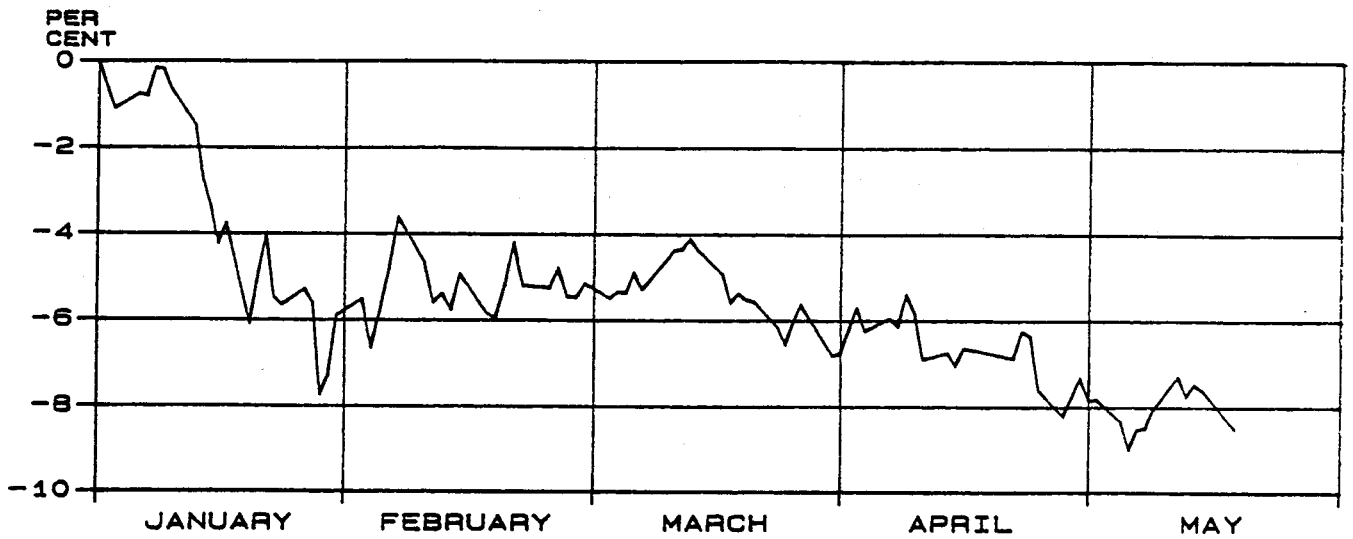
LATEST INFORMATION 14TH MAY 1987

INTERVENTION



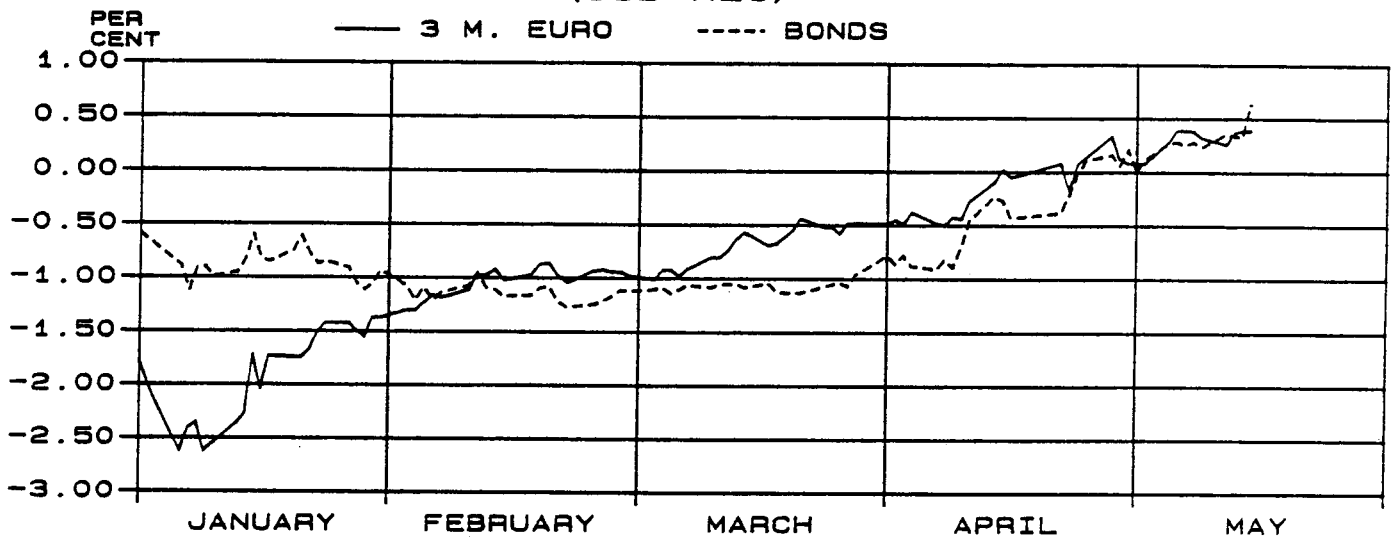
TOTAL NET INTERVENTION IN STERLING. DAILY OBSERVATIONS.
- SALES OF FOREIGN CURRENCY. + PURCHASE OF FOREIGN CURRENCY
BASED ON INFORMATION UNTIL 14TH MAY 1987

US-DOLLARS AGAINST XEU



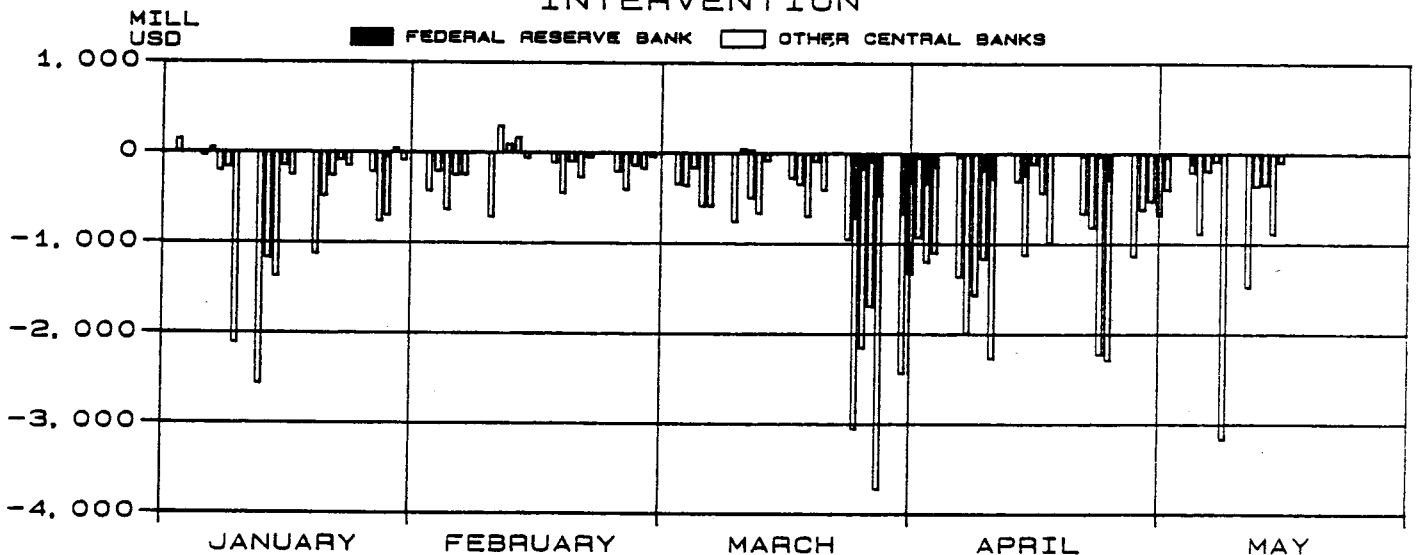
LATEST INFORMATION 18TH MAY 1987 (MORNING)

INTEREST RATE DIFFERENTIALS (USD-XEU)



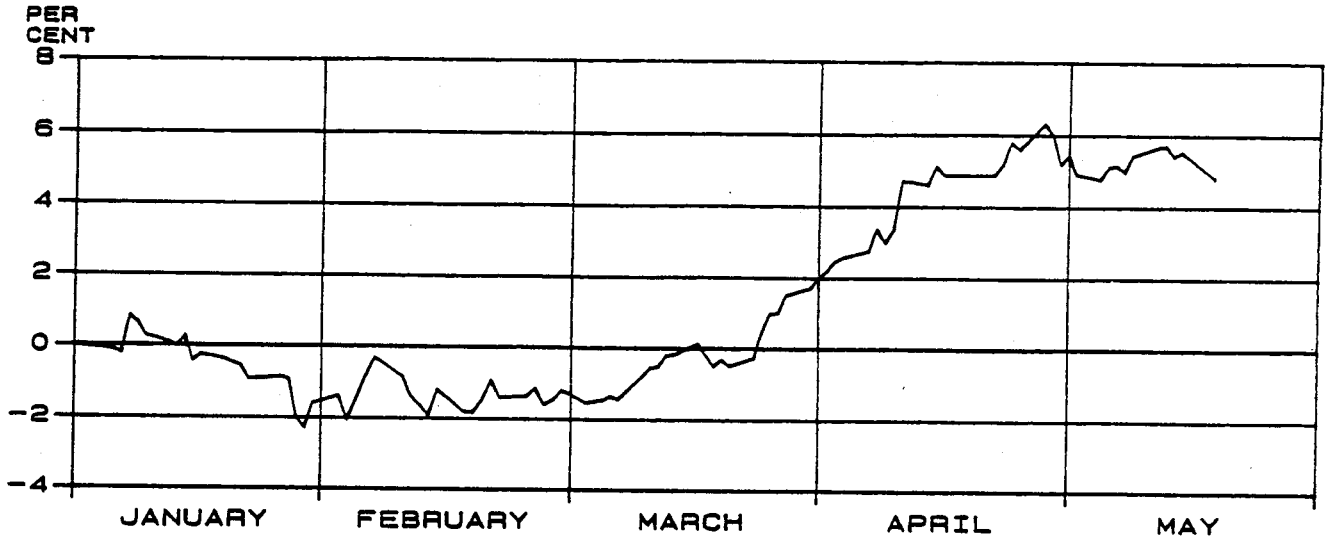
LATEST INFORMATION 14TH MAY 1987

INTERVENTION



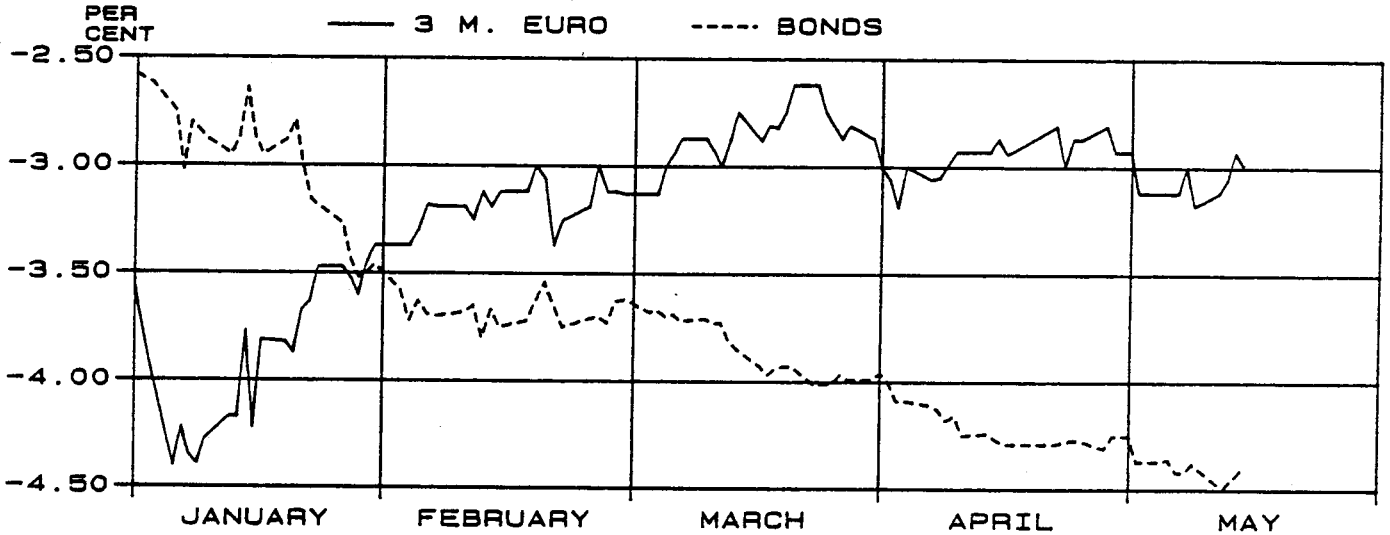
TOTAL NET INTERVENTION IN US-DOLLARS. DAILY OBSERVATIONS.
- SALES OF FOREIGN CURRENCY. + PURCHASE OF FOREIGN CURRENCY.
BASED ON INFORMATION UNTIL 15TH MAY 1987

JAPANESE YEN AGAINST XEU



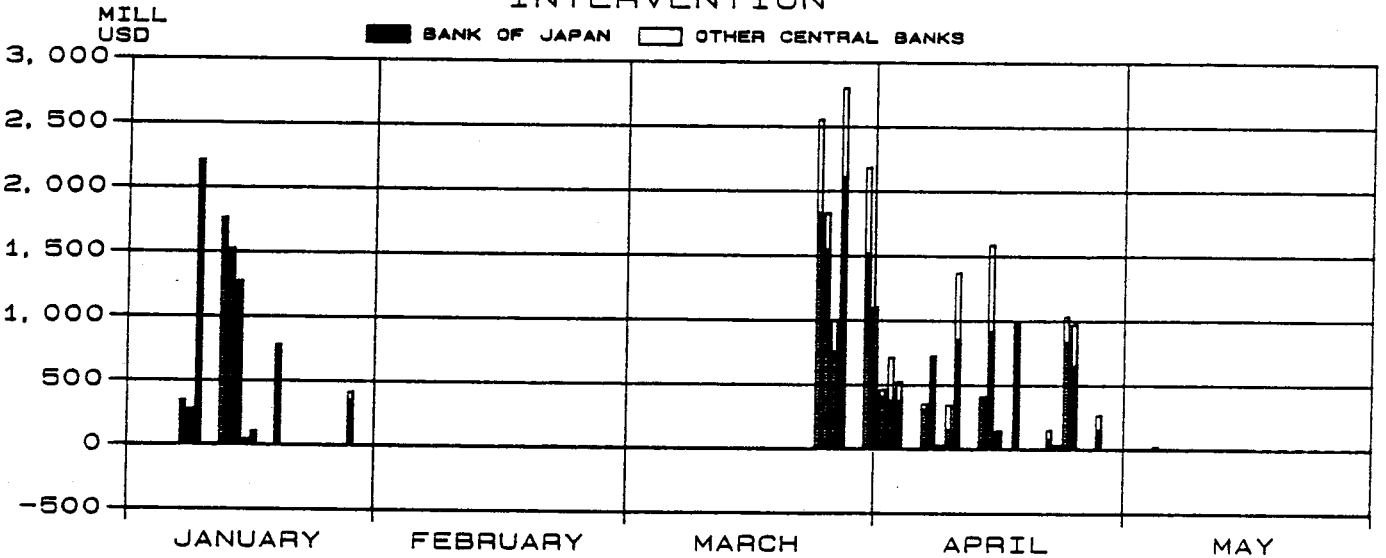
LATEST INFORMATION 18TH MAY 1987 (MORNING)

INTEREST RATE DIFFERENTIALS (JPY-XEU)



LATEST INFORMATION 14TH MAY 1987

INTERVENTION



TOTAL NET INTERVENTION IN JAPANESE YEN. DAILY OBSERVATIONS.
- SALES OF FOREIGN CURRENCY. + PURCHASE OF FOREIGN CURRENCY

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

GROUP OF EXPERTS UNDER THE CHAIRMANSHIP OF Mr. DALGAARD

List of Participants

Chairman	H. Dalgaard
Banque Nationale de Belgique	H. Bussers J. Michielsen
Danmarks Nationalbank	H. Fosgaard O. Jensen
Deutsche Bundesbank	K. Weber H. Rinke A. Müller
Bank of Greece*	P. Pliatsikas N. Karamouzis
Banco de España	L. Linde G. Gil
Banque de France	B. Marillia J.P. Redouin
Central Bank of Ireland*	B. Daly T. Grimes J. Cummins
Banca d'Italia	F. Saccomanni S. Vona
Nederlandsche Bank	J.W. Brockmeijer A.F.P. Bakker
Banco de Portugal	F. Alves Marques A. Domingues
Bank of England*	T. Smeeton I.M. Erskine R. Lindley
Institut monétaire luxembourgeois	J. Guill
Commission of the European Communities*	A. Louw J. Bozzi
Secretariat of the Monetary Committee	R. Barthélémy
Agent for the EMCF	J.C. Dagassan
Secretariat of the Committee of Governors	A. Bascoul H.K. Scheller N.K. Cook

The group held two meetings: on 6th and 7th April 1987, and
on 19th and 20th May 1987.

*The composition of this delegation was not the same at each meeting.