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## SECOND ANNIVERSARY OF THE EMS

The European Monetary System (EMS) came into force on March 13, 1979 and is now approaching its second anniversary. The aim was to create "a zone of monetary stability in Europe" and, after two years, to consolidate the system by establishing a European Monetary Fund (EMF) and utilizing the European Currency Unit (ECU)\* as a reserve asset. The system was also designed to provide some relief for a dollar by working as a shelter against movements of speculation. The general view is that the system has worked well over the last two years, but the impetus to move onto the second stage has waned.

### Background

The principle of establishing a European Monetary System was adopted by the European Council of heads of government meeting in Bremen in July 1978. The main lines of the system were set out in a Resolution at the Council's December meeting in Brussels, and practical measures to implement the EMS were taken shortly after the Council of Ministers.

The essential components of the EMS are: (i) A European Currency Unit (ECU), "the pillar of the system"; (ii) an exchange rate and intervention mechanism, (iii) a credit mechanism, and (iv) measures designed to strengthen the economies of the less prosperous states in the EMS.

### The ECU

At present the ECU has the same value as the European Unit of Account (EUA) being made up of a "basket" of Community national currencies. Within the EMS it acts as the numeraire (denominator) for the exchange rate mechanism and is used as the basis of other financial transactions within the EMS.

### The exchange rate and intervention mechanism

Each of the participating countries has an ECU-related central rate, and these rates are used to establish a grid of bilateral exchange rates. (A notional central rate has been assigned to the £ sterling).

\* 1 ECU = \$1.24 as of March 19, 1981.

Under the system, fluctuation margins of  $\pm$  2.25 percent from the central rate have been established for seven currencies (Belgium, France, Denmark, Germany, Ireland, Luxembourg, Netherlands) and of  $\pm$  6 percent for the lira (Italy). Greece, while she has signed all the basic agreements of the EMS, is not a member, and the drachma is not included when calculating the value of the ECU.

The margins set the limits at which official exchange market intervention is obligatory, although intervention within the margins is not excluded. In addition to the grid of central rates there is a "divergence indicator", which serves as an early warning device signalling whether a currency diverges in its development from the average of the others. For this purpose "divergence" is measured by the divergence threshold" expressed as a specified percentage divergence from its central value in terms of the ECU.

#### Credit facilities

The EMS incorporates and expands three previously existing Community credit facilities, namely: the very-short-term financing and the short-term monetary support (STMS), both of which are the responsibility of the central banks, and medium-term financial assistance (MTFA) which may be granted by the Council of Ministers to any member country in difficulties, or seriously threatened with difficulties as regards its balance of payments.

There are limitations on the UK benefitting from these credit facilities as she is not a full member of the EMS.

#### Helping less prosperous members

An underlying principle of the EMS is to encourage convergence of economic performance in the member countries. It therefore includes measures for the granting of 3 percent interest rate subsidies for loans made available to the less prosperous countries, such as Italy and Ireland, from Community sources and the European Investment Bank. These loans may amount up to 1,000 million EUA a year for a period of five years for the financing of investment projects which are in line with Community policy in the energy, industry and infrastructure sectors.

The UK cannot benefit from these subsidies.

#### The European Monetary Fund

The European Council Resolution of December 1978 envisaged the establishment of a European Monetary Fund (EMF) to consolidate the EMS, and there were initial hopes that this might be introduced in 1981. Meanwhile, the old

European Monetary Co-operation Fund (EMCF), created in 1973 was empowered to receive monetary reserves from the central banks and to issue ECUs against such assets.

All Community countries, including the UK but not yet Greece, deposited 20 percent of their reserves of gold and 20 percent of dollars with the ECMF in return for ECUs. These deposits are on a swap basis under national control and arrangements depend on mutual consent. This imparts a temporary character to the system and to the role of the ECU. The second stage - the creation of the European Monetary Fund - would provide a firmer basis for the ECU and mark an important stage in its development as a reserve currency within the Community. Although the Commission has prepared studies on the implications of the EMF, for the present the political will is lacking among governments to press onto the second stage.

#### Some assessments of the EMS

Both the Commission and independent observers consider that the EMS has, on the whole, worked smoothly and well in its two years of existence. Currency fluctuations within the system have been lower than before and, though the EMS cannot take all the credit, it has provided a framework for governments to stabilize their currencies and create a zone of monetary stability. Divergent inflation rates could put a strain on the system in future, however, unless governments seek to bring these under control.

Since the EMS came into force in March 1979, the British position has changed. Originally the UK rejected full membership on the grounds that participation in the exchange and intervention mechanism - sometimes called the "super-snake" would have kept the pound sterling at an artificially high rate, hindering economic activity, and requiring intervention at a rate that conflicted with a tight monetary policy. Now that inflation is coming down and the £ has substantially appreciated anyway against other Community currencies, the conflict of interest has lessened and, as noted, the Governor of the Bank of England, among others, has suggested that Britain might well benefit from full participation in the EMS.

If such were to be the case it seems likely that currency fluctuation margins for the £ sterling would follow that of the lira, namely a  $\pm$  6 percent range from the central rate.

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