EUROPEAN MONETARY SYSTEM
AND ITS INTERNATIONAL IMPLICATIONS

by

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INTRODUCTION

When President GISCARD d'ESTAING was Finance Minister in 1973, he is quoted as saying : "The problem "of money had been treated as a matter for the experts and formed "the subject of plans that were a delectable blend of sophistication "and obscurity. Now it has become a problem for Governments "and is even being debated by Statesmen. At stake is the expansion "of international trade, that is to say, the growth of the world "economy ".

At no time in the post war history of economic events has there been more truth in this statement than today. Take the Summit meeting of Heads of State and Government of the European Community in Bremen, last July, and in Brussels, last December. All these talks revolved around the monetary problem. And again at the Western Summit in Bonn, in mid-July last year, monetary issues were once more the main topic of discussion. Whenever President CARTER meets Chancellor SCHMIDT or the Japanese Prime Minister, monetary problems are on the agenda.

(x) These remarks, in no way, commit the organization to which the author belongs.

This is quite normal since the monetary situation has an increasing effect on international trade, economic activity and therefore the material well-being of our peoples.

It is within this political context that I wish to speak to you today of the European Monetary System.

In the first part, I would like to situate the European moves within the context of a world-wide initiative aimed at bringing back some sense of order into the international monetary system.

In the second part, I shall analyse with you the motives behind our efforts and the objections which are sometimes voiced.

I. - WORLD-WIDE CONTEXT

When we study the international monetary system, the first question we ask is how can balance of payments desequilibria be avoided, or, if they nevertheless occur, how can either surpluses or deficits be corrected. This is what is technically described as the adjustment process.

A) You know that in the Bretton Woods system, which served the world economy very well for over 25 years, it was essentially internal measures, monetary and budgetary policies, which were used to redress temporary balance of payments deficits. When a country had a deficit, a stricter budgetary and monetary policy was applied. By thus reducing domestic demand, goods became available for export, imports were reduced, and the balance was restored. It was only in cases of fundamental desequilibrium in its balance of payments that a country resorted to an external solution, changing the official parity.

This system, as we all know, deteriorated mainly because the external adjustment was not correctly implemented. On the one hand the United States, incurred for too long a fundamental deficit without devaluing its currency simply because financing was automatically available. This was due to the fact that the dollar is a reserve currency. At the other end of the scale, some countries with balance of payments surplus have similary resisted revaluing their currencies by trying to neutralize the monetary effect of their surplus. The Bretton Woods monetary system has therefore suffered by being too rigid at times.

B) So, from 1973 onwards, we went to the other extreme and allowed too much flexibility by letting the main currencies float. This solution had been favoured for a long time by academics. They believed that, if currencies were allowed to float, then any surplus or deficit in the balance of payments would disappear. A rise in the value of a currency would eliminate any surpluses, and a fall in the value of a currency would quickly remedy any deficits. It would no longer be necessary to take action on the domestic front. Monetary and budgetary policies would henceforth only be motivated by internal growth objectives, the employment situation and price stability, and not by balance of payments considerations.

In fact, over the past five years, there have been vast balance of payments disequilibria between industrialised nations. Aside from the effect of the oil crisis, the balance of payments of industrialised countries have been more influenced by differences in the growth rates at home than by fluctuating exchange rates.

This is due to the fact that the effect of exchange rates changes on imports and exports is gradual, while a boost or a squeeze on domestic demand is spontaneously reflected in the movement of goods and services.

The development of the Japanese economy is a striking example of this. Despite the spectacular appreciation of the yen, Japan has continued to accumulate a huge surplus in its current balance of payments. The same is true for Switzerland, and to a lesser extent, for Germany.

At the other end of the scale, a country like the United States has seen a depreciation in its currency and continues to register large deficits.

It is therefore an illusion to rely solely on exchange rate movements to equilibrate the balance of payments and to believe that floating exchange rates as such will provide the answer to our problems. An adjustment in the exchange rates will only produce the desired effect if it is accompanied by internal measures.
In the case of countries with a chronic deficit and a high rate of inflation, a currency depreciation will only be effective if it is accompanied by measures to control demand at home.
This is what the United States is doing through budgetary and monetary policies.

Moreover, an appreciation of a currency will only effectively reduce a balance of payments surplus if it goes hand in hand with expansionist measures at home. Without the attendant boost at home, a currency appreciation will lead to a reduction in the profits of exporting companies, a slowing down of the economy, which, in turn, depresses imports and once more increases the surplus.

This is why the boost which Japan and Germany have given to their economies go in the right direction.

Ideally, the combined measures taken both by countries with a surplus and countries with a deficit should go a long way towards restoring their balance of payments situations and monetary stability.

C) The remarks I made earlier concerning a too rigid application of the Bretton Woods system, together with the obvious inadequacy of a monetary system which is too dependent on exchange fluctuations, as is the case at present, leads us on to consider a third way to reform the international monetary situation.

1) On the one hand, it seems obvious that excessive fluctuations in the exchange rate upsets international trade and increases the mood of uncertainty in business circles. It is at this level that executives are faced with the impossible task of estimating the cost in their national currency of imported materials to be used in their products, and also calculating the probable income, again in their national currency, of their sales abroad. These large-scale fluctuations are one of the causes - but not the only one of course - of the present economic crisis.

2) On the other hand, I think we must admit that it would not be realistic to assume that in the foreseeable future we could revert to a world-wide parity system. The increase in international capital movements which has resulted from the general "internationalisation" of present-day economies, has taken on such a dimension that it makes an early return to fixed parities world-wide such as we knew in the days of Bretton Woods, extremely unlikely.

So, what sort of reform do we have in mind ? There are in fact two aspects :

a) The first aspect of a gradual return to greater international monetary stability will be to create large stable monetary zones throughout the world, within which, thanks to more harmonious economic policies, more stable exchange rates can be maintained. Basically, three main zones are envisaged : a European zone, a yen zone and a dollar zone. At the European Council meeting in Brussels, the creation of a European monetary zone was decided.

b) The second aspect is an attempt to reduce to a minimum exchange rate fluctuations between these three zones, while ensuring a high level of economic activity by implementing better coordination of demand management policies between the zones, in particular where budgetary and monetary matters are concerned. We know monetary policies have a direct influence on the movement of capital, and budgetary policies play a decisive part in determining the domestic demand.

I will come back to this later.

II. - MOTIVATIONS OF THE EUROPEAN EFFORT

A basic economic motivation of the E. M. S. has been dissatisfaction which floating conditions in the last few years and the conviction that this monetary situation was having adverse effects on economic integration in Europe, and in general on growth and employment in the Community.

Expressed in a positive way, the basic objective of the European Monetary System (E. M. S.) is to contribute to a lasting improvement of the present economic growth and employment situation of the Community and its economic integration, thanks to a greater exchange rate stability.

.../...

This objective will be met only if the system is conceived in such a way that it will be durable and credible and contains neither a deflationary nor an inflationary bias.

1) Before explaining how it should contribute to more growth and employment, let me first talk about this greater exchange rate stability . How can E.M.S. help in this respect ? In two ways :

a) short term stability through ironing out excessive fluctuations ;
b) longer term stability through fostering greater convergence of the economies.

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a) First, the European system, with its intervention rules and credit mechanism should be able to fight effectively the phenomenon of overshooting. By this I mean movements of the exchange rate in excess of what would be warranted by differences in inflation rates between countries. This phenomenon of overshooting has often occurred in the past.

It can be initiated by strictly national causes. It can also be initiated - and it often has been - by movements of third currencies, particularly the dollar.

When people move out of the dollar because there is a lack of confidence in that currency, they do not move equally into all the European currencies. They often move specifically to one E.E.C. currency : the Deutsche Mark. This pushes the D-Mark up and it widens the relationships between the D-Mark and the French franc or Sterling. So, one can say that sharp fluctuations of the dollar have also, in a certain way, contributed to too sharp fluctuations, or overshooting, between European currencies.

Expressing the same idea in the economist's jargon, one can say exchange rates between large currencies has often been determined by portfolio adjustments. Such changes have often overshoot the purchasing-power parity level between these large currencies themselves and also between these currencies and others which are less used as instruments for financial assets.

These excessive movements tend to be accomodated ex post by price movements the more so, the more open the economies are, and thus tends to exacerbate inflation differentials.

The exchange rate system, with its provisions for interventions, and the available ressources to make these interventions, should contribute to prevent these overshooting movements.

b) Longer term stability. There is of course a more fundamental way in which the system should contribute to more exchange rate stability. Participation in this system as we will emphasize later, assumes that in the adjustment process, countries will have to give a high priority to internal policy measures rather than to exchange rate changes. Otherwise the effectiveness of the system itself would be jeopardized. So, participating countries have to realize that by adhering to this scheme, they compel themselves to aim at greater convergence of the fundamentals of their economies, by domestic measures.

This factor is sometimes called the discipline element of the system, but this word might sometimes be misleading as it might give the impression that adjustment is only in a restrictive way by deficit countries while adjustment should take place in a symmetrical way.

2) Now, second question, how should this greater exchange rate stability contribute to higher growth and employment ?

There are several ways in which it should do so :

a) First, it should allow a higher level of both foreign and domestic demand to develop. Monetary instability in Europe was felt to have a deflationary impact in the following way. In some countries, the excessive appreciation of their currencies contributed to deflationary pressures by reducing profits in export industries and reducing sale prospects. This was one of the causes of the downward revisions of growth in Germany in 1977 and 1978.

On the other hand, in the case of countries whose currencies have depreciated too much in relation to those stronger currencies, this downward overshooting has led to inflationary pressures via increased import prices and wage indexation. These inflationary implications act as a brake in economic revival. These countries are afraid to allow their economy grow faster, let this expansion increase pressures on balance of payments, and cause a further currency depreciation and inflation.

Greater monetary stability should have a positive impact on economic revival, it would allow a higher level of demand to develop. This would have important multiplier effects when we know how open our economies are, and the high proportion of intra-E.E.C. trade in total trade. Trade with other E.E.C. partners represents 69 % of total Belgian trade, between 45 % and 50 % of the trade of France, Germany, Denmark and Italy, and 38 % of British trade.

b) Greater monetary stability would also encourage business confidence and investment. In talks with European business executives, one often hears complaints that it is difficult these days to give their companies a full European dimension because of the ever present exchange risks and the uncertainty as to inflation rate. It is difficult these days to forecast correctly the cost price in national currency of inputs coming from abroad, or the revenue in national currency of exports. This uncertainty contributes to the fact that businesses are not harvesting the potential benefits of a large market the size of Europe, it reinforces also protectionist pressures and has a paralyzing effect on investment.

In fact, one can safely say that exchange rate fluctuations have managed to replace partly the old customs barriers in their negative effects on growth and the developing of a large European market and enterprises with such dimension. The dismantling of customs barriers and the progress towards integration was one of the elements of faster growth in Europe in the 1960ties. The instability and uncertainty as to exchange rate movements between Europe on currencies the last few years was felt to act as a brake on integration and growth.

In short, I would argue that it was a situation of monetary instability in Europe which had a deflationary bias and not the E.M.S. design as some have contended. I will come back to this later.

II. - OPERATING PRINCIPLES AND REQUIREMENTS FOR SUCCESSFUL FUNCTIONING

Having analyzed the economic motivation for the creation of E.M.S., described its contents in an Annex, let me now turn to the operating principles of the E.M.S. and te conditions for a successful functioning of it.

I would stress three factors :

- the convergence of the economies, of the underlying economic conditions in the E.M.S. countries
- that the system be operated in a flexible enough way
- a greater stability between E.M.S. currencies and third currencies.

1). Convergence of the Economies

To be successful, the EMS will have to be accompanied by policies needed to achieve a greater amount of convergence between the economies of member states. The EMS cannot be durable and effective unless it is backed up by complementary policies. As there are still important divergences in the situation of member states, it will need great effort on the part of all countries and in all areas of policy if the system is to be durable.

Unless central rate changes are going to be very frequent, which would in itself limit the usefulness of the EMS, countries must in principle give a high priority to internal policy measures rather than to exchange rate changes.

a) Among these efforts, coordination of monetary policies deserves a special role. It is intended thereby to assure a compatibility of the internal monetary objectives of member states with the exchange rate objectives and with the larger economic objectives.

In this framework I believe one should focus attention more on the coordination of domestic components of money creation on domestic credit expansion, rather than on one or more measures of the money stock. ~~This~~ It would facilitate the monitoring of E. M. S. if members would follow broadly the principle of non sterilization through open market operations or otherwise, of their exchange-market interventions.

It involves for countries losing reserves, letting the liquidity effects of these losses to be broadly reflected in a tighter money supply and higher interest rates. This was already pratice for the smaller countries in the snake. Countries facing temporary accumulation of reserves will also have to keep their cool and not try to offset quickly and completely the liquidity effect of sudden inflows of reserves.

b) In this context of convergence one has also to focus on coordination of global demand management policies. The efforts aimed at a concerted economic action decided in Bremen (July 1978) and which modulated the strength of expansion of countries according the situation of countries both as regards balance of payments and price increases, are also an important element of convergence.

In this framework the strongest economy (Germany) took more expansionary measures. This helps also other countries to make the necessary adjustments and makes the whole present context more conducive to the right adjustment and convergence policies. This is one of the factors which is favourable to the present functioning of the E.M.S..

c) Other elements of domestic policy also have an important role to play. In fact, immediate issues affecting convergence these days are in the area of incomes policy. This is a question of immediate relevance in Ireland, Denmark and Italy where important wage negotiations are being discussed. The outcome of these negotiations will certainly affect the degree of convergence. The membership of these countries in the EMS certainly affects the authorities position in this area.

d) Let me also make a short comment here on the role of the divergence indicator which is the main novelty in the exchange rate system and which I have already described.

When we proposed it, our purpose quite clearly was not only to find a compromise between the two views about what to use as the trigger of mandatory intervention : the parity grid or the ECU.

Our purpose what to find an objective indicator as a trigger for policy coordination. This, the snake did not have, it did not indicate who should take measures. Thus the divergence indicator should become one element of a more equilibrated adjustment process, and should induce convergence.. It will be very important that all countries make this new element function effectively, as it could be of a great help in fostering real convergence. Its role is to help signal early in the game where divergences arise and induce countries to take corrective actions.

2) A second condition for successful operation is the necessary flexibility of the system. While the E.M.S. by itself should contribute to reduce differences in inflation rates among countries, it should not prevent remaining significant differences from being reflected in the exchange rate. One has to avoid the rigidity of the Bretton Woods system and dedramatize exchange rate adjustments. Experience in the snake during the last three years has been positive on that account. A number of adjustments were made, when exchange markets were calm. Several of these adjustments involved a general realignment. This was for instance the case of the October 1976 snake realignment which was a carefully planned readjustment of several currencies which gave new life to the snake when many outside observers were already forecasting its death. In a sense the realignment two years later was also a very successful one. It was a kind of presumptive strike which anticipated market tensions as one would come closer to the January 1 deadline to start the E.M.S.. This successful operation permitted the system to start in a quiet way, first unofficially in January, then officially in March.

If changes in exchange rates are kept small this will be an important element in deterring speculation. Often one hears that speculation cannot but gain by the system of stable and adjustable exchange rates. That is not right. To the extent that changes in central rates are smaller than twice the width of the margin, it is not sure at all that speculation will gain. If before the change of the central rate a currency is at the floor rate, and after the change, at the ceiling, speculation will not have gained, provided the change in central rate is smaller than twice the margin.

The experience in the snake has shown that central rates may be adjusted by as much as 4 % without affecting the market rate much, if a depreciating currency manages to shift position with the past strongest currency inside the regular E.M.S. band.

Some commentators of the E.M.S. have criticized it on the ground that it did not indicate clear criteria for adjustments of central rates.

I would disagree with this. If you set specific criteria about what should be allowed, you will trigger market forces to push you to make those changes. As soon as a country will move towards the indicator speculations will be triggered. There are many cases in which you might want justifiably to resist a move even if a sophisticated indicator tells you something else. I have often mentioned the case of Belgium in this respect where if we had followed indicators we would have been led to adjust in a more significant way vis-à-vis the DM in the last few years. Our policy of staying close to the DM has allowed us on the contrary to decrease rapidly our inflation differential with Germany which in 1975 was still high (7 %) to less than 0,5% now.

This of course is not to say that we do not accept the role of an objective indicator, as is evidenced by our initiative in proposing the divergence indicator. However this latter indicator can trigger different kinds of action, among which I would especially emphasize domestic policy actions. It is true that adjustment in rates is also one of the possible actions to be taken, but it is by no means the only one.

3) Let me now move to a third factor of stability for the EMS ; it is not an absolute condition of success but it would greatly contribute to it : a stable relation between the dollar and European currencies. Obviously this is an element which is to a large extent outside the direct control of Europeans.

Erratic movements of the dollar have often in the past contributed to the phenomenon of "overshooting" between European currencies . By this I mean movements of the exchange rate in excess of what would be warranted by differences in inflation rates between countries.

From this point of view, the smooth start of the EMS has been helped by the relative stability of the dollar. This reflects largely the new and effective concern of the U.S. authorities concerning the dollar. It has been manifest in monetary policies since November 1 of last year and also in budgetary policies since then. Continuation of such policies by the U.S. authorities will be helpful for EMS.

In this framework I am wondering whether in the future one should not try to formalize somewhat the effort on both sides of the ocean to continue this effort aimed at greater stability.

I am wondering whether it would not be feasible here also to devise a kind of divergence indicator which should induce the divergent country or regional grouping to take action. This divergence indicator could be based on the Special Drawing Right of the I. M. F.. If the dollar, the ECU, or the Japanese yen, diverged by a certain percentage against the S. D. R., this would trigger consultations, where possible action by the divergent country or group would be considered.

III. - OBJECTIONS

Many objections have been heard in the Community as well as outside it vis-à-vis the E. M. S.. I will deal with some of them realizing fully however that the best answers will not come reasonings in abstracto but rather from the behavior of the new system.

1) The first and most important objection lies in the fact that the economic situation in Europe is too divergent as to build up a system of stable exchange rates among the European currencies. Those who raise this objections remind us that the inflation rate in the Europe of the Nine varies at the present between some 3 p. c. in Germany, and 13 in Italy.

This objection should not be easily dismissed but should be examined seriously.

A part from the fact that comparisons of consumer price indices are in my view not the ~~last~~ best criterion to measure existing inflation differentials. I think the answer to this objection is threefold :

a) One must recognize the fact that exchange mechanisms, if they are the only instrument of coordination, are of limited use. It seems to us to be essential for the introduction of a system which will stabilize exchange rates to go hand in hand with effective coordination of economic policies, in particular in the sectors of internal monetary and budgetary policies, but also incomes policies. It is not so much a question of imposing this convergence from outside. I believe countries have come to realize better in the last few years that it was in their own interest to take domestic measures towards convergence. They have all come to realize that floating rates did not grant independence for domestic policy.

With other words one can say quite rightly that those who adhere to the exchange rate system should be ready to adjust their internal monetary and economic policies accordingly.

b) The agreement on this point does not imply that one should wait for a complete disappearance of these differences in inflation rates before adhering to the system. One should act to reduce them, but they should not be completely eliminated before the system can become operative. This system itself has a sufficient flexibility and it should not prevent remaining real disparities from being reflected in exchange rates.

This has happened within the ~~present~~ past snake mechanism which functioned well and where remaining divergences were reflected in changes of the exchange rates, carried out efficiently in the last few years.

c) Finally, the E.M.S. includes an element of supplementary flexibility on behalf of the Member States of the E.E.C. which do not participate in the snake in 1978. These countries could opt for wider margins (6 %) around central rates. As you know, Italy has done so.

2) Another objection partly linked with the first one says that the system will necessarily be deflationary and will be adversely affecting employment.

a) A reasoning leading to this conclusion is as follows : the countries with a higher inflation rate will be forced to reduce it and to adopt more restrictive monetary, budgetary and income policy which will be detrimental to growth.

We cannot agree with this objection. based really on what economists call : "the PHILIPS curve", assumption implying a positive corrolation between growth rate and price increases.

What it comes down to is to say that a greater inflation is necessary to a greater growth. This is not the case. On the contrary, in many cases countries with a low inflation rate, where confidence was greater, have produced better results in the matter of growth.

British policy of the past years has been compelled implicitly to recognize the error of this kind of objection. Only after introducing anti-inflationary monetary, budgetary and income policy, has the performance of the British economy improved.

This is not to say however that there would not be problems of transition for the poorer E.E.C. countries when they adhere to this system. Demand management policies might be more difficult to apply in these countries. It is to meet this kind of difficulty that the problem of transfer of ressources to these poorer countries has been raised. This applies especially for Ireland and Italy.

b) Another reasoning holding the same fear for deflationary effects is as follows : in reality, the D-Mark will draw up the other currencies above their purchasing power parity value, which will will involve necessarily deflationary effects through decreased competitivity.

The second objection cannot be met in abstracto. It would only be valid if one assumes that the country with a strong currency will refuse to take internal measures in order to prevent an excessive increase in the value of its currency and in addition will refuse to have its currency revalued with respect to other currencies whose economy had evolved less favourably.
One can answer to this that the ECU divergence indicator is designed to induce countries whose currency is diverging to take the necessary domestic measures in order to prevent the persistance of divergence. On the other hand, experience of the snake has already proved that changes of the central rates can be carried out efficiently and flexibly.

3) A third objection claims that the European system will have an inflationary bias. The simplified reasoning is as follows : the differences between the inflation rates continue to exist, great speculations will take place. Germany will be obliged to grant important credits in order to support the weaker currencies ; these credits will raise the German money supply and lead to high inflationary pressures in that country.

An answer to this cannot be given in abstracto either.

This objection assumes that inflation differentials will remain high and that adequate changes in central rates will be resisted.

Let us repeat here that a major element of the efficient functioning of the system will have to be greater effective coordination of economic policies so as to reduce differences in inflation rates. Let us repeat also that while the E. M. S. itself ought to contribute to reducing divergences in economic performance it should not prevent remaining real disparities from being reflected in exchange rates. The experience of the snake in the last few years points that the normal adjustments have not been resisted. There have of course been periods of heavy intervention to fight speculation but these movements have then be reversed most of the time within a short period.

CONCLUSION

An important initiative has been taken in Europe to move towards greater exchange rate stability. To function effectively, the E. M. S. will have to foster convergence of the economic situation of member countries and be operated in a flexible enough way.

This movement should also be seen as an element to bring greater monetary stability at the world wide level. In this context the continuance of the recent American efforts towards a greater relative dollar stability is an important element.

ANNEX

CONTENTS OF THE E.M.S.

The E.M.S. agreement contains three parts : an exchange system, the creation of a European currency : the ECU, and finally the first steps towards a European Monetary Fund.

A) Exchange system

1) Central rates and intervention rules

Each currency has an ECU-related central rate. These central rates have been used to establish a grid of bilateral exchange rates around which fluctuation margins of ± 2,25 % are established. E.E.C. countries whose currencies did not belong to the snake in December 1978, could opt for wider margins up to ± 6 % at the outset of the E.M.S.. Italy has availed itself of this possibility. This wider margin should be gradually reduced as soon as economic conditions permit to do so.

A Member State which does not participate in the exchange rate mechanism at the outset, this is the case of the United Kingdom, may participate at a later stage.

Adjustments of central rates will be subject to mutual agreement by a common procedure which will comprise all countries participating in the exchange rate mechanism and the Commission. When the intervention points defined by the fluctuation margins are reached, intervention in participating currencies is compulsory.

It is also allowed to intervene before the margins are reached. In principle, intervention there also will be made in participating currencies. But intervention in third currencies is not excluded. The agreement on E.M.S. provides also for "coordination of exchange rate policies vis-à-vis third countries and as far as possible, a concertation with the monetary authorities of these countries.

2) Indicator of divergence

One of the new elements of the E.M.S. compared to the snake which involved only the parity grid system, is the creation in addition of an indicator of divergence. It is a kind of warning system which will signal whether a currency has a different movement from the average.

The indicator is based on the spread observed between the variable value of the ECU and the ECU numeraire. It flashes when a currency crosses its "threshold of divergence". The formula chosen to calculate this threshold is the following one : 75 % x (2,25 % or 6 %) x (1 less the weight of the currency in the ECU basket).

This means that the threshold is set at 75 % of the maximum spread of divergence allowed for each currency

It is calculated also in such a way as to eliminate the influence of the weight of each currency on the probability to reach the threshold. If this had not been done, currencies which have a large weight in the ECU would reach the divergence indicator later than other currencies since they affect the ECU more than the currencies with smaller weight.

Before you measure the effective divergence compared to the threshold , you adjust the effective divergence so as to eliminate the effect of movements of some currencies, the lira and the pound sterling, in excess of 2,25 %. Indeed the lira has a margin of 6 % and the pound sterling is subject to no margin. This is done so that for instance a wide movement of the pound Sterling would not by itself lead a currency across its divergence threshold.

When a currency crosses its "threshold of divergence", this results in a presumption that the authorities concerned will correct this situation by adequate measures, namely :

a) Diversified intervention :

This means intervention in various currencies rather than only in the currency which is furthest apart from the currency of the intervening country. Diversified interventions allow a better spread of the burden of intervention between currencies of the E.M.S..

b) Measures of domestic monetary policy :

This includes of course - among others - measures affecting the interest rate which have a direct effect on the flows of capital. In the snake system interest rate movements were an important instrument to alleviate tensions.

c) Changes in central rates :

While the E.M.S. itself ought to contribute to reducing divergences in economic performance, it should not prevent remaining real disparities from being reflected in exchange rates.

d) Other measures of economic policy :

This could include for instance measures in the field of budgetary policy or incomes policy.

In case such measures, on account of special circumstances, are not taken, the reasons for this shall be given to the other authorities, especially in the "concertation between Central Banks". Consultation will, if necessary, then take place in the appropriate Community bodies, including the Council of Ministers.

After six months, these provisions shall be reviewed in the light of experience.

To summarize this first part, let me say that the present situation in the exchange system differs from the snake especially in the following way :

a) membership has increased by the inclusion of the French franc, the lira and the Irish pound in addition to snake members ;

b) one currency has a larger margin : 6 %, than the 2,25 % ;

c) the system is not only based on parity grid but contains also a new element : the divergence indicator.

B) The ECU and its functions

A EUROPEAN CURRENCY UNIT (ECU) is at the center of the E.M.S.. The value and the composition of the ECU is identical with the definition of the European Unit of Account.

The relative weights of the currencies in the ECU was the following in early March :

Deutsche Mark	33,02 %
French franc	19,89
Pound Sterling	13,25
Dutch gulde r	10,56
Italian lira	9,58
Belgian franc	9,23
Danish kroner	3,10
Irish Pound	1,11
Luxemburg franc	0,35

The ECU will be used :

a) as the denominator (numéraire) for the exchange rate mechanism

b) as the basis for a divergence indicator

c) as the demoninator for operations in both the intervention and the credit mechanism

d) as a means of settlement between monetary authorities of the E.C..

The weights of currencies in the ECU will be re-examined and if necessary revised within six months of the entry into force of the system and thereafter every five years or, on request, if the weight of any currency has changed by 25 %.

Revisions have to be mutually accepted ; they will, by themselves, not modify the external value of the ECU on the day of the change. They will be made in line with underlying economic criteria.

To serve as a means of settlement, an initial supply of ECU will be provided by FECOM against the deposit of 20 % of gold and 20 % of dollar reserves currently held by Central Banks.

This operation will take the form of specified, revolving SWAP arrangements. The deposits will be valued in the following way :

- for gold, it will be the lower of the two following prices : the average of the price, converted in ECU, noted each day at the two fixings in London during the last six months - or the average of the two fixings noted the day before the last one of the period, so as to avoid that the price used would be above the present market value ;

- for dollar, the market rate two days before the date of value.

Every three months when they renew the SWAP arrangements, Central Banks will make the necessary adjustments to maintain deposits with FECOM corresponding to 20 % at least of their reserves. This will be done to the extent that their reserves in gold and dollars have changed.

Also the amounts of ECUs issued will also be adjusted according to the changes in valuation of gold or fluctuation in the exchange rate.

A Member State not participationg in the exchange rate mechanism (the U.K.), may participate in this initial operation on the basis described above.

C) <u>The European Monetary Fund and present credit mechanisms</u>

The agreement of December 1978 provided that :

"We remain firmly resolved to consolidate, not later than two "years after the start of the scheme, into a final system the provisions "and procedures thus created. This system will entail the creation "of the European Monetary Fund as announced in the conclusions "of the European Council meeting at Bremen on 6/7 July 1978, "as well as the full utilization of the ECU as a reserve asset "and a means of settlement. It will be based on adequate legislation "at the Community as well as the national level".

In the meantime, present financing and credit mechanism will continue to exist and they have been adjusted in the following way :

- The very short term financing facility of an unlimited amount will be continued. Settlements will be made 45 days after the end of the month of intervention with the possibility of prolongation for another 3 months for amounts limited to the size of debtor quotas in the short term monetary support.
  Under the snake system, settlements had to be made 30 days after the end of month of intervention. We will see also that the debtor quotas in the short term monetary support which serve as ceiling for the prolongation for three months have been multiplied by about 2,5.

<u>The credit mechanisms</u>

The existing credit mechanisms with their present rules of application will be maintained for the initial phase of the E. M. S.. They will be consolidated into a single fund in the final phase of the E. M. S..

The credit mechanisms will be extended to an amount of 25 billion ECU of effectively available credit. This is about 2,5 times the previous amount. The distribution of this amount will be as follows :

- Short term monetary support = 14 bn ECU
- Medium term financial assistance = 11 bn ECU.

The short term credit mechanism extended between Central Banks were extended before for three months with the possibility of a three months prolongation. Under the agreement of E.M.S., the duration of the short term monetary support will be extended for another 3 months.

The substantial increase in the amounts of credit available and the extension in the duration of some credit mechanisms, are an important element for strengthening the credibility of the system by providing the guarantee to countries that in case of need, large means could be made available to them to fight speculative movements.