

The Intervention and Financing Mechanisms of the EMS and the Role of the ECU *

1. Intervention Mechanisms and Reserve Assets in the Exchange Arrangements of the EMS under the 1978-79 Agreements

The core of the EMS is the exchange rate arrangements whereby participating countries have undertaken to keep their bilateral exchange rates within prescribed margins from mutually agreed central rates.¹ Although these central rates are expressed in terms of ECU, the compulsory intervention rates are defined on a bilateral basis — Deutschmark per lira or French franc in Frankfurt, lire per French franc or Deutschmark in Milan: this feature obviously has direct implications for the intervention and financing mechanisms.

Very few explicit rules concerning intervention in foreign exchange markets were introduced in the EMS legal texts; they basically incorporated the provisions in force within the “snake”. The European Council Resolution of 5 December 1978 “on the establishment of the EMS and related matters” (henceforth Brussels Resolution) states that “in principle interventions will be made in participating currencies” (Art. 3.3) and that “intervention in participating currencies is compulsory when the intervention points defined by the fluctuation margins are reached” (Art. 3.4). The Agreement of 13 March 1979 among the central banks of the EEC laying down the operating procedures for the EMS (henceforth Central Banks’ Agreement) further specifies that “interventions shall be

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¹ Central rates can be changed with the agreement of all participating countries and of the EEC Commission. Such changes, however, were expected to be infrequent and small, under the presumption that convergence of performance and policies would reduce and eventually eliminate the need for central rate realignments.

unlimited at the compulsory intervention rates" and that "other interventions (*i.e.* those not at the margins) shall be conducted in accordance with the ... guidelines adopted by the Committee of Governors ... or shall be subject to concertation among all the participating central banks" (Art. 2.2). These guidelines, in turn, basically stipulate the following:

a) interventions in Community currencies are carried out "on an automatic basis" at the compulsory intervention rates, but are subject to prior authorization (through concertation) when carried out within the margins, and should be discontinued if they produce undesirable effects on a partner's currency;

b) interventions in dollars are also in principle subject to prior authorization and concertation; the main purpose of this prescription is to avoid dollar interventions which could weaken EMS cohesion² or accentuate the dollar's trend in foreign exchange markets; it is recognized that in some of these cases a way out could be offered by interventions within the margins in EEC currencies.

One further provision regarding intervention should be mentioned. Art. 3.5 of the Brussels Resolution states that "an ECU basket formula will be used as an indicator to detect divergences between Community currencies", and Art. 3.6 stipulates that "when a currency crosses its threshold of divergence, this results in a presumption that the authorities concerned will correct this situation by adequate measures",³ including "diversified intervention": intramarginal interventions would thus appear to have a role in the regular management of the system. The relevance of this prescription, however, should not be overemphasized: intervention here is only one item in a long list of possible measures called for under a rather weak presumption of action. More important, systematic recourse to intramarginal interventions would undermine the very ability of the divergence indicator to identify — through the behavior of the exchange rate — the divergent country.⁴

The financing of interventions in EMS currencies is ensured by the very-short-term financing facility (VSTF): that is, by mutual credit lines

² An important case is that of "reverse" dollar interventions, that is of simultaneous interventions in dollars of opposite sign by two central banks in the system.

³ These provisions represent what is left, in the compromise solution adopted by the European Council in Brussels, of the so-called "basket approach" to the determination of central rates and margins in the EMS. This approach is discussed extensively in R. MASERA, *L'unificazione monetaria e lo SME*, Bologna 1980, Chapter 4 and Appendix 1. Cf. also P. BAFFI, "Il sistema monetario europeo e la partecipazione italiana", testimony before the Finance and Treasury Committee of the Senate, 26 October 1978.

⁴ Cf. MASERA, *op. cit.*, p. 103.

through which each participating central bank makes its own currency available to the others.⁵ Access to the facility is determined in practice by the rules of intervention. Since intervention is compulsory and must be carried out "on an automatic basis" and "for unlimited amounts" by each central bank in the currencies which have reached the exchange rate limits on its market, in these cases access to the VSTF is also automatic and unlimited. Intramarginal intervention in Community currencies is subject to the consent of the issuing central banks, and accordingly access to the VSTF can only be obtained with their agreement.

These provisions obviously responded in the first place to the need to make credible resources available for the defense of exchange rate parities. They also reflected a balance between the interests of potential creditors and debtors in the system. In this regard, potential debtors needed to be assured that adequate credit lines would be available to help them meet their exchange rate commitments, while they adjust their external imbalances gradually. Potential creditors, on the other hand, were mostly concerned with the domestic monetary consequences of intervention and financing operations: their willingness to extend financial assistance for intervention at the margins was predicated on the assumption that under these circumstances the debtor country would be under greater pressure to introduce corrective economic policy measures. The guarantee against excessive liquidity creation was provided by strict time limits for assistance under the VSTF and by the introduction of conditionality rules for the extension of credit for longer periods.⁶

The Central Banks' Agreement devotes a great deal of attention to the rules for settling debts arising from interventions. It sets forth detailed regulations governing the order of repayment of claims (Art. 12), their mutual, automatic offsetting when feasible (Art. 13), their

⁵ The financing operations technically take the form of spot sales and purchases of Community currencies against the crediting or debiting of accounts denominated in ECUs with the European Monetary Cooperation Fund (EMCF). Financing operations fall due 45 days after the end of the month in which the interventions were carried out. They can be automatically renewed, at the request of the debtor central bank, for a period of three months, within an overall ceiling equal to the debtor quota under the short-term monetary support arrangement.

⁶ Art. 10(d) of the Central Banks' Agreement stipulates that "if a central bank has recourse to the additional automatic borrowing facility for six consecutive months, the Committee of Governors shall take steps to ascertain whether ... recourse to other means of financing, in particular short-term monetary support or medium-term financial assistance within the EEC, would be more appropriate"; access to these facilities entails in turn adoption of an economic policy program to redress underlying disequilibria.

advance repayment (Art. 14), the holding of Community currencies (Art. 15) and the assets which can be used in settlements (Art. 16).

One prime concern behind these provisions is to limit holdings of Community currencies by participating central banks. Art. 15 prescribes that "the central banks may hold working balances in Community currencies within the limits laid down by the Committee of Governors. These limits may be exceeded only with the consent of the central banks concerned". The provision for automatic offsetting of claims also seems directed to that end. Art. 14 stipulates that "any debtor balance ... may be settled in advance [of maturity] at the request of the debtor central bank ... at any time in the currency of a creditor in the EMCF", but only "on the monthly settlement date" when different means of settlement (*i.e.* those prescribed under Art. 16) are used; and Art. 16 contemplates the use of other reserve assets in settlement of maturing financing operations "insofar as this is not done in the first instance by means of holdings in the creditor's currency".

Settlement may also be carried out by transferring ECUs: however, the 1979 Central Banks' Agreement obliged creditors to accept settlement in this form only up to 50 per cent of their outstanding claims under the VSTF. Thus the right to use ECUs in settlement was restricted to just part of the interventions at the limits, although the possibility of more extensive use by agreement remained open.

Once again, this solution represented a particular balance between the interests of potential debtors and creditors. ECUs are created through 3-month revolving swaps with the EMCF against the deposit of 20 per cent of each central bank's gold and US dollar reserves. The possibility of spending the ECUs created *vis-à-vis* gold implied that these gold holdings could be mobilized, with an increase in international liquidity⁷ available to resist pressure in foreign exchange markets. From the standpoint of potential creditors, however, ECU credit balances were a rather unattractive asset: they carried a below-market interest rate,⁸ and in addition were inconvertible and virtually illiquid,

⁷ This effect on liquidity could be substantial, since approximately three fourths of outstanding ECUs is created against gold (cf. Table 3). There is no increase in liquidity for the ECUs created against US dollars: in fact, any central bank is entitled to unwind its swap transaction with the EMCF before maturity "for the purpose of meeting a decline in its dollar reserves" (Art. 18.3). In other words, the dollars contributed to the EMCF are for all practical purposes freely available.

⁸ The interest rate on creditor balances was set as a weighted average of official discount rates in countries whose currencies are included in the ECU basket (with weights equal to their weights in the basket).

since there was no provision to ensure their "repurchase" by the debtor central bank. Furthermore, the overall creation of ECUs remained subject to large oscillations, in connection with changes in the dollar holdings of participating countries, the dollar exchange rate *vis-à-vis* European currencies, and the price of gold.⁹ Thus, the restrictions on the acceptability of the ECU were a way of balancing the request for liquidity against fears of excessive accumulation of ECUs.

In sum, while these provisions offered a flexible and informal framework that can adapt to different circumstances and needs, they were predicated on the presumption that most interventions would be made in Community currencies at the limits; in fact, a formal obligation to intervene arises only in this case. Intramarginal interventions were seen as the exception rather than the norm, and the use of Community currencies for this purpose was hedged round by strict limitations and precautions. The buildup of reserves in these currencies was discouraged. As for the ECU, in the original Agreements it more closely resembled a non-negotiable instrument of credit than a reserve asset. Therefore, the system has no common freely available, liquid, fully convertible reserve asset but the US dollar. This is in a way surprising, since to a large extent the creation of the EMS stemmed from the desire to diminish Europe's dependence on the US dollar and its vulnerability to the consequences of US policies.

2. Developments since the Inception of the EMS

On the whole, the experience with the intervention and financing mechanisms of the EMS since its inception has been satisfactory. However, this seems to have been the result of the flexibility of the arrangements and of close cooperation between participating central banks rather than of full correspondence of actual developments to expectations.

Indeed, in examining intervention data for the period March 1979-June 1985 three main features stand out (Table 1). First, some two thirds of total interventions were in US dollars, even though a substantial share of these were undertaken to stabilize currencies within the EMS

⁹ The data in Table 3 show that changes in the value of gold holdings (almost entirely due to price changes) were indeed the major cause of changes in outstanding ECUs.

TABLE 1

FOREIGN EXCHANGE INTERVENTION BY COUNTRIES
IN THE EMS EXCHANGE RATE ARRANGEMENTS¹

		1979 ²	1980	1981	1982	1983	1984	1985 ³
US dollars	P	10.3	6.4	8.2	6.5	10.6	6.1	2.3
	S	12.2	20.9	34.1	32.1	21.7	17.1	9.4
EMS currencies ⁴								
– at the limits ⁵		2.5	3.9	11.1	3.0	13.3	1.9	—
– intramarginal	P	0.7	2.2	3.6	4.1	7.7	10.9	5.6
	S	4.7	2.3	5.8	5.8	5.4	2.8	1.5
others ⁶	P	—	—	0.1	—	—	—	0.9
	S	1.1	0.2	0.2	0.7	0.2	—	0.2
TOTAL	gross	31.5	35.3	63.1	52.2	58.9	38.8	20.4
	net ⁷	– 7.0	– 14.8	– 28.2	– 28.0	– 9.0	– 2.9	– 2.3
memorandum items								
– recourse to VSTF ⁸		3.3	2.5	9.0	2.3	5.4	1.8	—
– ECU spot settlements of intervention		0.9	3.1	2.3	0.1	0.5	—	—

Source: EMCF.

¹ In billions of US dollars. P = purchases; S = sales. ² March to December. ³ First semester. ⁴ Currencies participating in the exchange arrangements. ⁵ Purchases or sales. ⁶ The figure for 1985 includes some interventions in the private ECU market. ⁷ A minus sign indicates net sales. ⁸ Very-short-term financing facility.

band. Through most of the period the dollar was appreciating *vis-à-vis* European currencies. Under these circumstances it is appropriate (and consistent with intervention guidelines) to support weak currencies on their national market by selling dollars; given the restrictions on the use of Community currencies, recourse to dollar interventions thus offered a practicable alternative. However, the same results could have been obtained with smaller interventions in Community currencies, which have a larger impact on the composition of private portfolios in these currencies.

A second main feature is that only about 12 per cent of total interventions were carried out at the compulsory intervention limits. Taking into account EMS-related dollar interventions, it can be reckoned that some three fourths to four fifths of total interventions were intramarginal. A main objective of intramarginal interventions has been

to prevent the buildup of speculative pressures: in this regard experience has shown that when the exchange rate moves to its lower limit in the band these pressures can become very strong, in the expectation of an imminent realignment. Intramarginal interventions have also on occasion allowed central banks to reconstitute foreign currency holdings depleted during previous periods of pressure.

Third, a substantial and growing share of intramarginal interventions was carried out in Community currencies. As can be seen, this increase is due to the evolution of purchases; it reflects chiefly the support to weak currencies provided by central banks whose currencies were strong in the latter's national markets. Obviously interventions in dollars would not have been appropriate in this case. As a result, some 10 per cent of official reserves (including gold) of EEC countries is now made up of Community currencies (Table 2). This development appears to be largely the result of a somewhat anomalous configuration of exchange rates, whereby the currency of the country with the lowest inflation and strongest external position — Germany — has remained weak in the EMS band owing mainly to the sustained strength of the dollar.¹⁰ Under these circumstances, there is an added incentive to purchase the weak currency; for this reason the apparent symmetry of intervention burdens which has been observed cannot be considered a normal feature of the system.

For the time being, the prescription to keep only working balances in Community currencies seems to have been superseded by events; the constraint on the ability to sell these currencies, should the need arise, has also been eased. Therefore, the system's ability to reconcile member countries' interests depends more on its cooperative framework and channels of consultation than on the formal checks built into its charter. It should be noted that in the wake of these developments over half of the non-gold reserves of member countries consists of ECUs and EEC currencies (Table 2); the costs implicit in the restrictions on the free convertibility and usability of these assets are therefore substantial.

¹⁰ When the dollar is strong, the DM tends to be weak in the EMS band since it is a main substitute for the dollar in international financial portfolios, and is therefore affected by capital flows to and from US markets more than the other European currencies, which in addition are protected by foreign exchange controls. A weak DM also encourages expectations of exchange rate stability in the EMS; since high inflation countries in the system tend to maintain higher interest rates, nominal interest differentials in favor of their currencies accentuate the weakness of the DM. Cf. S. MICOSSI and T. PADOA-SCHIOPPA, "Can Europeans Control Their Interest Rates?", CEPS paper no. 17, Brussels 1984; and F. GIAVAZZI and A. GIOVANNINI, "European Currency Experience", unpublished paper, October 1985, prepared for CEPR Economic Policy Panel.

TABLE 2

OFFICIAL NET RESERVES OF COUNTRIES
IN THE EMS EXCHANGE RATE ARRANGEMENTS¹

	1979	1982	1985 ²
Gold	77.5	86.9	80.0
Convertible currencies	55.0	36.9	58.5
– dollars	50.0	30.6	37.3
– EMS currencies	4.3	4.4	17.4
ECUs	38.2	37.6	35.2
Net position on the IMF ³	10.4	11.4	12.0
Others ⁴	– 6.3	– 14.6	– 12.1
Total	174.8	158.2	173.6

Source: BIS Monthly Statistical Series.

¹ Outstanding amounts in billions of US dollars at the end of the period. ² End of June. ³ Including SDRs. ⁴ Other assets minus official short-term liabilities.

Like interventions at the limits, recourse to the VSTF was sizeable during the early years of the EMS, but has become less frequent over time and has involved smaller amounts (Tables 1 and 3). No calls on the facility have been made since the first half of 1984. Only once, in 1979, was the facility activated in connection with intramarginal interventions. The average duration of financing operations has been between 3 and 4 months, with frequent resort to automatic renewal, and subsequent reimbursement taking place in most cases before maturity. The large majority of operations were unwound through automatic offsetting (*i.e.* as a result of reversed interventions) and advance repayment in creditor currencies. The possibility of bringing VSTF operations under the short-term monetary support was never utilized.

The use of "official" ECUs in the operation of the system was on the whole rather modest, and a large share of transactions was on voluntary basis. Nor was the right to use ECUs to settle up to 50 per cent of outstanding debts under the VSTF often utilized: ECU settlements at monthly maturity have been negligible except in 1982. Aggregate creditor/debtor positions have represented a modest proportion of outstanding ECUs (usually well below 10 per cent; cf. Table 3). And over time there has been decreasing use of ECUs; all outstanding positions were settled in the second quarter of 1985 (after the interest paid on these positions was brought up to market levels).

TABLE 3

ECU CREATION AND NET POSITIONS IN ECUS AND IN THE VSTF¹

		ECU creation			net ECU positions ²	net positions in VSTF ³
		against gold	against US dollars	total		
1979	II	13.3	10.0	23.3	0.3	0.2
	III	15.8	11.6	27.4	0.3	1.6
	IV	18.0	11.3	29.3	0.6	0.7
1980	I	22.2	10.7	32.9	1.5	—
	II	31.7	11.1	42.8	1.4	—
	III	35.9	9.6	45.5	1.3	—
	IV	36.3	9.9	46.2	1.9	1.6
1981	I	38.3	10.9	49.2	3.2	1.3
	II	37.7	12.0	49.7	3.2	3.9
	III	34.8	12.3	47.1	3.3	3.8
	IV	34.5	10.5	45.0	3.4	1.2
1982	I	31.5	10.7	42.3	2.9	0.9
	II	28.0	10.5	38.5	4.0	1.9
	III	27.8	10.3	38.1	2.4	1.0
	IV	31.5	10.8	42.3	3.2	1.3
1983	I	36.7	10.2	46.9	2.8	2.4
	II	38.8	11.2	50.0	1.3	0.6
	III	39.9	11.8	51.7	1.5	0.1
	IV	40.9	12.2	53.1	1.5	1.1
1984	I	39.5	13.1	52.6	2.2	1.8
	II	38.7	12.7	51.4	3.0	0.3
	III	39.4	13.3	52.7	1.7	—
	IV	38.9	13.6	52.5	0.8	—
1985	I	37.2	14.5	51.7	0.1	—
	II	38.5	12.6	51.1	—	—

Source: EMCF

¹ Billions of ECUs. ² Sum of all net creditor (or net debtor) positions in ECU. These positions are obtained for each central bank as the difference between initial allocation and actual holdings. ³ Sum of all net creditor (or net debtor) positions.

On the whole there has been no tendency of net positions in the VSTF or in the ECU reserve accounts to remain outstanding or to grow cumulatively; central banks have rightly considered these facilities as reserve management instruments to meet temporary liquidity needs rather than as credit available to cover their external imbalances. The

declining use of the specific facilities and channels set up within the EMS for supplying member countries with reserve assets to accommodate their intervention needs is to some extent a consequence of the general strengthening of participants' external and domestic financial positions since 1983; this improved performance is also reflected in the absence of major pressures in the EMS exchange arrangements (with no realignments for over two years after March 1983). However, certain inadequacies of existing mechanisms have also become evident. The VSTF is of limited usefulness in that interventions do not normally take place at the compulsory intervention rates; and the ECU's unattractiveness as a reserve asset, especially its illiquidity, has certainly discouraged its use among participating central banks.

A development not envisaged in the EMS charter which must nonetheless be considered of major significance is the rapid growth of private uses of the ECU, notably (but not exclusively) in financial transactions.¹¹ The combined amount of outstanding ECU-denominated bonds and banks' assets, virtually nil in 1980, has now reached some 40 billion dollars; of this amount, approximately one fourth is in bonds and three fourths in banks' assets.

The reasons for this rapid expansion are still not fully understood and there is considerable controversy on the matter. It seems that in the main the impulse to the expansion of this market has come from borrowers,¹² with a very active role played in the bond market by international institutions (EEC, EIB and IBRD) and member-country public agencies.¹³ Political, legal and administrative support has also been provided in various other ways by the EEC Commission and by some European governments and central banks, creating an essential condition for greater use of the ECU by private agents.¹⁴

However, political and institutional support alone would not be sufficient to explain the rapid increase in the demand for ECU borrowing and in the willingness of investors to hold these claims. A

¹¹ The markets have adopted the official definition of the ECU and have dealt in open baskets almost from the beginning, thus assuring that the private and official ECU could not be different owing to changes in the latter basket. See P. REYNOLDS ALLEN, "Birth of a New Euro-currency: the ECU", paper prepared for the Group of Thirty, August 1985.

¹² Cf. BIS, *55th Annual Report* (1984-85), pp. 127-133.

¹³ Over 50 per cent of outstanding issues is accounted for by these borrowers in the bond market.

¹⁴ The key role of official support in fostering the use of a currency is emphasized by D.F. LOMAX, "International Monies and Monetary Arrangements", in *International Money and Credit: The Policy Roles* edited by G.M. von Furstenberg, Washington, D.C., 1983.

main incentive, in this regard, has been the composition of the basket: at times of high interest rates in the US and high variability of the dollar, the ECU has allowed international borrowers to reduce their costs and risks while offering investors an attractive alternative to the dollar. The combination of yield and exchange risk provided by the ECU also compares favorably with that of "hard" European currencies (DM or guilder). From the standpoint of borrowers this is true particularly for residents of high-inflation European countries: in fact the bulk of private ECU-denominated borrowing was undertaken by residents of Italy and France, encouraged to borrow abroad by high interest rates and tight credit conditions at home. In this sense there is some truth in the view that the private ECU market is the offspring of lack of convergence and instability within the EMS.¹⁵

This interpretation, however, does not do full justice to the role of the EMS exchange arrangements in enhancing the attractiveness of the ECU. Indeed, the ECU is a basket of currencies linked by an exchange rate arrangement; this arrangement implies that the burden of adjustment falls mainly on domestic stabilization tools, and that exchange rates do not fully accommodate inflation differentials. This in turn requires an appropriate structure of interest rates in member countries. As long as inflation rates diverge and the system represents an element of discipline in the sense described above, the (ex-post-) exchange-rate-adjusted yield (or cost) of the high-inflation currencies will tend to be higher than that of low-inflation currencies. Also, the yield/cost of the ECU will tend to exceed that of the "hard" currencies in the system, while the exchange rate risk (standard deviation) of ECU-denominated assets will in general be lower than that of component currencies.

The data in Table 4 provide some evidence in this regard: the ECU outperforms the DM in both yield and risk on all national markets except in Germany (where the ECU's yield is higher, but so is its standard deviation), and in terms of the combination of risk and return fares generally better than the high-interest-rate currencies in the system.¹⁶ On all European markets the dollar shows higher yields, but also much higher yield standard deviation.

¹⁵ Cf. L. GLESKE, "Europe and the ECU", speech delivered at the 30th Conference on Credit Policy organized by the *Zeitschrift für das gesamte Kreditwesen*, November 1984.

¹⁶ On the US market the lira shows a higher yield and a lower yield standard deviation than the ECU; this is a reflection of the higher correlation between lira and dollar exchange rate *vis-à-vis* third currencies than between dollar and ECU. Part of explanation can be found in the effects of dollar oscillations on EMS currencies (cf. note 13 above).

TABLE 4

YIELD/COST AND RISK OF ASSETS DENOMINATED IN ALTERNATIVE CURRENCIES FOR VARIOUS COUNTRIES' INVESTORS¹

	April '79 to March '85		April '84 to March '85	
	mean covered yield/cost	standard deviation	mean covered yield/cost	standard deviation
final yield in Deutschmark				
of assets denominated in \$	20.8	22.8	23.9	24.2
DM	8.2	2.4	6.0	0.2
FF	8.3	6.7	12.2	0.6
Lit	11.0	6.7	11.6	6.5
ECU	9.8	4.5	10.1	2.5
final yield in French francs				
of assets denominated in \$	25.6	23.6	23.1	24.2
DM	13.0	8.8	5.3	0.5
FF	12.9	2.2	11.4	0.7
Lit	15.6	8.3	10.9	6.6
ECU	14.5	7.8	9.4	2.5
final yield in lire				
of assets denominated in \$	26.8	21.0	26.9	20.9
DM	14.3	8.1	9.2	6.1
FF	14.2	6.5	15.4	5.8
Lit	16.8	2.7	14.7	0.7
ECU	15.8	6.3	13.3	7.7
final yield in US dollars				
of assets denominated in \$	12.0	3.2	9.9	1.2
DM	0.8	22.0	- 6.2	23.0
FF	0.9	21.6	- 0.1	22.6
Lit	3.4	18.5	- 0.7	19.0
ECU	2.3	20.3	- 2.1	24.3

Source: IMF *International Financial Statistics* and *ECU Newsletter*.

¹ Yields are measured (in per cent on a yearly basis) as 3-month nominal interest rates on national markets adjusted for actual exchange rate changes in the ensuing three months (all calculations on the basis of monthly averages of interest and exchange rates). For the ECU, interest rates on 6-month deposits.

While lack of convergence and the possibility of exchange rate changes within the EMS have been factors fostering the demand for ECU-denominated financial instruments by private agents, controls on international capital flows and institutional limitations on the use of the

ECU in national markets have represented an important obstacle and are also largely responsible for the imbalances in the structure and geographical distribution of ECU-denominated assets and liabilities.¹⁷

3. Recent Changes in EMS Mechanisms

In the Spring of 1985 the Committee of Governors of the EEC agreed on a number of measures to improve the characteristics of the official ECU. In themselves these measures are already a positive response to the developments described in Section 2; and they indicate the direction for further progress in the future.

The main novelty is a mechanism for mobilizing ECU holdings whereby, subject to a requirement of need, participating central banks can obtain dollars or Community currencies for a limited time period without restrictions on the type of intervention involved.

The new provisions stipulate that "in the event of a need of intervention currencies, a central bank may mobilize ECU holdings against dollars" up to a ceiling which is determined as a fraction¹⁸ of the initial allocation of ECUs,¹⁹ plus or minus any outstanding credit or debt position in the ECU reserve accounts (Art. 18a.1 of the Central Banks' Agreement). An important consequence is that ECU credit positions become liquid in case of need; symmetrically, any other use of ECUs reduces potential recourse to the mobilization facility.

The mobilization operations take the form of three-month swaps against dollars with the other central banks, through the intermediary of the EMCF; each operation can be renewed once "in the event of continuing need for intervention currency". The temporary nature of the operations is consistent with the purpose of increasing the system's

¹⁷ German residents (banks and non-banks) cannot issue ECU-denominated liabilities, and the ECU does not have the status of foreign currency in Germany. Controls on international capital flows effectively constrain purchases of ECU-denominated assets in France, Ireland and Italy. The ECU's limited use in commercial transactions is also a factor in reducing private agents' demand for ECU denominated deposits.

¹⁸ This fraction (n) is determined by the formula $n = mxDR/ET$, where DR are the total dollar reserves (valued in ECUs) swapped to the EMCF against ECUs under Art. 17 of the Central Banks' Agreement, ET is the total of ECUs created under the same article, and m is a multiplier whose value has been set initially at 1.5. For values of $m > 1$, a fraction of (ECUs created *vis-à-vis*) gold holdings becomes mobilizable.

¹⁹ That is of ECUs created against dollars and gold under Art. 17 of the Central Banks' Agreement.

ability to resist pressures in the short-term rather than providing balance-of-payments financing. Past experience with the use of EMS financing mechanisms seems to confirm that a time-horizon between three and six months offers adequate room to absorb a temporary shock in foreign exchange markets or to fund a longer-term requirement in financial markets.

An important feature of the new facility is that the proceeds of mobilization "may be converted immediately fully or in part into the currency of a participating central bank, subject to its agreement. In this case, the conversion request will be met by the central bank issuing the currency requested..." (Art. 18a.3). It is thus now possible to obtain Community currencies for interventions within the margins. What has made this acceptable is the temporary nature of the mobilization operations: the central bank providing its currency will suffer no permanent effects of the interventions on its domestic monetary conditions.

The acceptability of the ECU in settlement has also been somewhat improved: the 50 per cent limit does not apply when the recipient central bank has an overall net debt position in the ECU reserve accounts, for settlements smaller than or equal to the net debt position; once the debt position is eliminated, the 50 per cent rule is restored.

Two additional measures have been introduced. First, the remuneration of net ECU positions has been brought up to market levels (on the basis of national money market interest rates). Second, it is now possible for certain institutions to become "third holders" of ECUs: these institutions may include the central banks of countries with close economic and financial links with the EEC and international monetary institutions, in particular the BIS. Since the "official" ECU is a "precarious" asset acquired through a swap, it cannot be sold outright, but can only be made available to third holders in a similar temporary manner. These contracts, however, will be concluded at freely agreed prices, so that the official ECU will compete on an equal footing in the market with assets of comparable nature and will be traded at market prices. To the extent that a demand for this asset by third holders materializes, the liquidity of the ECU will be enhanced and the reluctance to use it and hold it within the EMS will diminish. Payment of a market interest rate on ECU positions has removed another disincentive in this regard. As a result of these changes the ECU has acquired more of the features of a reserve asset and has become less of a (subsidized) credit instrument.

It must be stressed that agreement could be reached on these changes because they preserve the balance of interests between potential creditors and debtors in the system. The circulation of the ECU in the official circuit has been made easier by making it more attractive and liquid; the possibility of using Community currencies in interventions has been extended, while avoiding permanent effects on domestic monetary conditions in countries whose currency is used.

Two further proposals were discussed in the negotiations but did not gain the required consensus precisely because they would have altered that balance.²⁰ These involved broader acceptability of ECUs in settlement and the possibility of access to the VSTF for intramarginal interventions. Both proposals would have considerably relaxed the restrictions on the use of national currencies for intervention, entailing however a risk that the reserve-intervention mechanisms of the EMS could be used (improperly) for balance of payments financing. Regrettably failure to find an acceptable compromise in this area means that the EMS continues to lack a full-fledged international reserve asset of its own.

4. Further Progress: Developing the ECU as a European International Currency

The long-term objective for Europe is full economic and financial integration and monetary union. Progress towards that goal can only be founded on increased convergence of economic policies and performance and on strengthened coordination in policy-making. The EMS is a main framework and working mechanism to foster coordination, notably (but not exclusively) in the monetary field. Development within the EMS of a common European currency would increase pressure for convergence and integration²¹ as well as provide a natural vehicle for monetary policy coordination.²²

²⁰ Similar proposals had been already considered in the negotiations on the "deepening" of the EMS in 1982, which eventually failed to reach any agreement.

²¹ Cf. B. KLEIN, "Competing Monies, European Monetary Union and the Dollar", and R. VAUBEL, "Minimizing Imbalances in Monetary Union", in *One Money for Europe*, edited by M. Fratianni and T. Peeters, London 1978.

²² This aspect — coordination, in fact centralization of monetary policy — was central to Mundell's classical statement of the optimum currency area problem (cf. R.A. MUNDELL, "A Theory of Optimum Currency Areas", *American Economic Review*, September 1961).

Money, however, cannot run too far ahead of other key aspects in the process of integration. It is not possible to proceed to a common currency world without an "institutional leap" setting up a central authority to manage it; and political conditions are not ripe for such a leap. On the other hand, if a common European currency, be it the ECU or a "hard" national currency, were allowed to circulate freely as a parallel currency for domestic transactions, existing differences in economic, financial, and fiscal structures and in regional resource endowments and factor productivity could generate destabilizing tendencies.²³ These dangers could be limited or controlled by keeping the expanded functions of the common currency within the domain of foreign currency transactions.

Also, experience shows that progress within EMS arrangements becomes feasible when it responds to well identified interests and objectives of EEC members and at the same time does not alter the balance of these interests, to the extent that they are potentially in conflict. Some telling examples have been given earlier in this paper.

As illustrated above, EMS mechanisms for the financing and settlement of interventions are based on the coexistence of several reserve currencies. A principal role is still performed by the dollar even for intra-EMS purposes. Taking Europe as a whole, the dollar is also the main vehicle currency and unit of account in commercial and financial transactions. Large changes in the dollar exchange rate *vis-à-vis* European currencies can thus have important repercussions on the European economy (including output level and composition, inflation, the external constraint and foreign position, etc.).²⁴ Since European countries differ in their degree of dollar dependence and dollar substitutability of their currencies, dollar oscillations may also accentuate divergences in economic performance and strain EMS cohesion. Attempts to moderate these oscillations imply "importing" the US monetary policy or policy-mix.²⁵ These undesirable effects can be attenuated by fostering greater use of European reserve currencies.

²³ Cf. D. LAIDLER, "Difficulties with European Monetary Union", and R. MASERA, "Comment on Vaubel", both in the volume *One Money for Europe* cited above.

²⁴ The vulnerability of Europe to dollar oscillations and U.S. policies has been stressed during the past twenty years by R. TRIFFIN. Cf. his recent study "The Future of the European Monetary System and the ECU", CEPS paper no. 2, Brussels 1984.

²⁵ The issue of policy independence is discussed extensively in MICOSSI-PADOA SCHIOPPA, *op. cit.*, and in A.K. SWOBODA, "Exchange Rate Regimes and European-U.S. Policy Interdependence", *IMF Staff Papers*, March 1983.

A ready substitute for the dollar could be the Deutschemerk, which has indeed been taking up a larger role internationally; the German authorities, however, seem reluctant to accept full responsibility for providing the reserve currency, in view of the constraints that would result for their monetary and exchange rate policy. Other European countries are also reluctant to move too far along this route, since it might compromise the objective of finding cooperative solutions for policy-making; from their standpoint monetary and exchange policies would still be largely dictated from abroad, although at least greater stability would obtain in their currencies' exchange rates *vis-à-vis* the reserve currency.

Another possibility is the ECU. As a basket of European currencies the ECU would help foster cooperative solutions in policy-making; the burden of providing the reserve currency would also be shared. At least in principle the ECU is a superior instrument for foreign exchange market intervention *vis-à-vis* third currencies (the dollar) since the consequences of intervention on official reserves and domestic monetary conditions would be spread among all the basket currencies. To the extent that the ECU established itself as an international reserve currency, the cohesion of the exchange arrangements would be less affected by portfolio shifts out of and into European assets.

Of course, in any realistic scenario for the foreseeable future different reserve currencies will continue to coexist; the practical objective can be to alter their relative importance, away from the dollar and towards the ECU.

At this stage this goal can only refer to use of reserve currencies by private agents. Indeed, the preceding discussion of EMS mechanisms makes it clear that there is little room to expand use of either the ECU or the DM in the official circuit: the main constraint in broader use of EMS reserve facilities is now insufficient convergence of performances and policies. In the case of the ECU, an additional impediment is represented by its inconvertibility and by the lack of any effective check on the total amount that can be created.²⁶ A solution to these difficulties can hardly be envisaged before transition to the "institutional" phase of the EMS.

There is, however, scope for progress in the domain of private uses of the ECU. Their continued expansion should be recognized as a main

²⁶ Cf. TRIFFIN, *op. cit.*

requirement for the ECU to take up a full reserve status: the liquidity and convertibility of a reserve asset ultimately depend on the existence of broad and deep financial markets. Well developed financial markets and extensive use in private transactions are also an obvious prerequisite for the ECU to serve as an intervention currency.

ECU markets have already shown strong vitality: is official action to foster them necessary and warranted, then? After all, the markets themselves ought to be the best judges of the qualities of a reserve asset, and official action in this area could be seen as a factor of distortion.

A first reply is that today use of the ECU by private agents is hindered by official regulations: the ECU cannot compete effectively with other reserve currencies as long as it is not a recognized foreign currency in all EEC countries and its use is limited by controls on capital transactions. Removal of these constraints deserves top priority in the policy agenda. To the extent that this accelerates the process of liberalization, it will serve the interests both of those who see the ECU as an instrument of cooperation and of those who emphasize convergence and sound policies as a prerequisite for advancement in the EMS.

Furthermore, the establishment of a new (reserve) currency involves large initial costs for spreading information and creating confidence, which is typically an area for public intervention;²⁷ in fact, political and institutional support is already playing an important role in explaining the success of the ECU, as pointed out earlier.²⁸

The functions now performed by the ECU are only a fraction of those which an international currency must fulfil (means of payment, unit of account and store of value). It should be stressed in this regard that the real and financial effects stemming from use of a reserve currency are mainly linked to its functions as unit of account and store of value. These functions can be developed, at least during a (possibly long) transitional phase, independently of the function of means of payment, which is the most difficult to acquire. Therefore, benefits from greater use of the ECU can materialize even before confidence in this instrument as a full-fledged "money" is established in the market.

The role of the private ECU as a unit of account in commercial transactions is still marginal: here official action could be mainly geared

to spreading information. A more direct encouragement would be provided by promoting use of the ECU in large long-term contracts involving the participation of governments or public enterprises. ECU-denominated issues by EEC institutions and national governments could be further extended. A further improvement in the functioning of private ECU markets will also be brought about by the realization of a clearing system for banks' operations, which is under way with the support of the BIS.

Finally, another aspect of the development of the private ECU markets deserves the attention of the authorities. So far the rapid, spontaneous growth of ECU financial operations has not involved any major drawback despite the lack of supervisory bodies to oversee the functioning of the market. It seems appropriate at least to start monitoring developments in the banking and bond market; this role could be entrusted to the EMCF. Such an initiative could place the private ECU market on a sounder basis and contribute to market confidence.²⁹ Moreover, regular discussions of current developments in the EMCF Board could form an initial nucleus of the functions that a European Monetary Fund will be called on to perform.

Roma

STEFANO MICOSI

²⁷ The money industry is a high-fixed-cost, negligible-marginal-cost industry or, in other words, a natural monopoly. This provides a strong case for public intervention on theoretical grounds. Cf. B. KLEIN, *op. cit.*

²⁸ Cf. Section 2.

²⁹ This aspect has been stressed by the Governor of the Bank of Italy in his Concluding Remarks to the *Annual Report for 1984* (cf. *Abridged English Version of the Report*, p. 135).