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

Committee of Alternates

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REPORT ON THE FRENCH SUGGESTIONS FOR ADAPTATION OF THE COMMUNITY EXCHANGE RATE SYSTEM

In connection with its decision formally to rejoin the Community exchange rate system, the French Government has expressed the wish to open talks on ways and means of adapting certain of the operating conditions of that system. The French proposals were submitted to the Council of Ministers in May in the form of a memorandum dated 20th May 1975.

As requested by the Ministers, the Committee of Governors has studied these suggestions, some of which relate to matters requiring immediate attention while others could be deferred for later consideration. The Committee has concentrated on the first category of proposals and these are considered below under the same headings as those adopted in the French memorandum.

I. Adaptation of the rules of intervention.

1. In order to spread more equally the burden of support operations needed to keep currencies inside the margin of fluctuation within the joint float, the French proposals envisage symmetrical intervention in dollars by those central banks whose currencies come close to the upper and lower limits of the margin.

The more detailed reasons for this proposal are given in the French memorandum as follows:

"Since March 1973, the operation of the European agreement has hinged on the capacity of the country whose currency has appreciated the least to finance without limit from its reserves the defence of the European margin. This situation is inequitable from two points of view. Firstly, the responsibility for tension between two currencies sometimes lies with the strongest currency which, as the result of specific speculation, is the one which tends to diverge. Secondly, the obligation to intervene against the divergent currency lies only with the currency which happens to be furthest away from it, and not with any other currencies.

Furthermore, this system of intervention is not efficient enough. Interventions confined only to the two currencies reaching the limits of the "snake" may be too late. More timely symmetrical interventions in dollars against currencies closely approaching the two limits of the "snake" would offer the advantage of restraining market trends more effectively, without placing the burden solely on the weakest currency."

During the Committee's discussions, the French representative has proposed a mechanism whereby the diverging movements in the exchange rates of Community currencies could be moderated through dollar intervention. Such intervention would not replace that required under the Basle Agreement, but it would have the effect of delaying the latter and reducing its volume.

2. Under the present rules adherence to the agreed Community margins is ensured, in principle, by means of interventions in Community currencies at the intervention points communicated to the other participating central banks and the market.

In practice, however, it is possible to intervene within the margins not only in Community currencies but also in dollars. In particular, support interventions in dollars have been undertaken frequently in the past. Normally such interventions are subject to prior consultation between the central banks of the Community. However, it has not always (indeed far from it) been possible to observe this rule because of the rapidity with which the market situation has changed and because of the need for quick decisions. In such cases the process of concertation and information has taken place subsequent to the intervention.

Meanwhile, it should not be forgotten that the rules of the Basle Agreement, as far as dollar interventions are concerned, have been amended by the arrangement for a common policy with regard to the dollar, which provides that each central bank can intervene freely, within certain limits of variations in the rates, to stabilise the market. It is still understood that, despite this essential freedom of intervention policy in the exchange markets, every action of the central banks must be made in a spirit of concertation - that means explaining to the partners as quickly and as fully as possible the reasons for the actions already taken or about to be taken and not only informing them afterwards of what intervention has occurred.

3. Most Governors are of the opinion that the intervention rules should retain a flexible interpretation, so as to leave each central bank with the necessary discretion in its intervention policies to enable it to accommodate quickly to changing market conditions without jeopardising the general objective of the "snake" agreement. It is clear that appropriate interventions in dollars by the central banks of those currencies that are approaching the upper and lower limits may help to restrain divergent movements in the rates for community currencies and reduce interventions at the limits. Of course, for a central bank with a weak currency, this policy implies an immediate loss of reserves instead of recourse to the credit facilities provided for by the "snake" arrangement.

Thus, to the extent that it would be felt desirable to alleviate the burden as far as the countries of the weaker currencies are concerned, it might be considered appropriate for the central banks of the stronger currencies to co-operate by purchasing dollars, especially if it was clear that the strength of a currency was of a general nature (i.e. not only in relation to the other countries in the "snake"). However, in applying a dollar interventions policy, full account has to be taken of the trend of the dollar itself, which might be a factor limiting the freedom of the central banks to operate in this way.

In conclusion, the general view of most Governors is that it would not be feasible to apply mechanical rules in this context, given the changing conditions on the markets. They consequently felt that with regard to intervention it would only be possible to proceed pragmatically, carefully observing market trends, as has in practice been done within the "snake" arrangement up to now.

The French member feels that, in order to make the conditions of intervention both more efficient and fair and despite the fact that a measure of flexibility is essential to regulate the markets in changing conditions, the existence of certain automatic rules to moderate the speed of divergence of the Community currencies by dollar intervention could only reinforce the narrow margins system without removing its original features.

The Committee agreed to review in six months time the question of the adaptation of the rules of intervention in the light of experience during the meantime, taking account of the French proposals.

II. Emergence of a Community level for the dollar.

1. The French memorandum states that:

"It would be appropriate to resume co-ordinated intervention against the dollar. For monetary and commercial reasons the authorities of the various countries cannot remain indifferent to the way the relationship between their currency and the dollar develops. But it is important that their aims should be as closely aligned as possible. Consideration should therefore be given to having zones of intervention vis-à-vis the dollar which could be agreed upon by way of frequent concertation between the central banks, that is to say which would be adjustable. Concertation with the United States itself is of course also desirable."

2. The Committee agrees that the development of the rate for the dollar has at times created problems which call for special consideration. This holds true for the daily fluctuations in the rate and may also be true for certain medium-term movements that appear to exaggerate underlying trends.

As far as the first problem is concerned, the central banks of the Community agreed three months ago "to undertake on an experimental basis a tentative effort to gain partial control of the foreign exchange markets without, however, resisting significant underlying trends." By intervening in dollars, it is intended to ensure that the fluctuations in the rate for the dollar do not exceed, in principle, certain margins per day in either direction.

The French representative proposes that the margins against the dollar should be halved in order to obtain better control of the market. Another suggestion was that the daily margin should be flexible so as to be able to increase the pressure against a movement in the rate for the dollar which was generally considered undesirable; e.g. in a period of extreme weakness of the dollar, the daily margin could be lowered for downward dollar movements and raised for upward movements.

3. Interventions to prevent excessive daily fluctuations in the rate for the dollar will also have a certain impact on the movements of the dollar in the longer run, but it will not be possible by this means to hold the dollar at a predetermined level. Establishing a Community level on the basis of the currently ruling market rates would mean that the Community would take upon itself alone the task of defending the present rate for the

dollar. This is quite impractical, for the strength of the dollar is determined both by its world-wide use in commercial and financial transactions and by the economic and monetary policies pursued by the United States itself. Defending a given rate for the dollar would therefore be beyond the power of the Community countries alone and it would mean a de facto return to the former dollar standard, with its damaging effects on domestic economic policies. Active assistance by the United States could moreover not be relied upon.

Furthermore, in view of the considerable uncertainties bearing upon the markets, particularly on account of the large overhang of dollars and volatile Euro-market funds, it would be impossible to defend a given level for the dollar even for a short period of time. Under these circumstances it would frequently be impossible to agree on a new level for the dollar quickly enough. Constant adjustments of the "Community level" to changing fundamental trends in the market, as provided for in the French proposals, cannot avoid these basic problems.

In the light of these difficulties and dangers, the majority of the Committee concluded that a return to mandatory support for the dollar would not be justifiable.

However, some Governors feel that in view of the particularly erratic fluctuations of the dollar in recent weeks, it would be appropriate to conduct a more active concerted policy in respect of the US dollar by being careful not to neglect the various possibilities for intervention at the successive levels which the Governors have agreed under the common dollar policy established in March 1975.

III. Adjustment of the conditions governing settlements of interventions in Community currencies.

1. The French proposal envisages the following adjustments:

"In the first place, it could be understood that EMCF creditors would not oppose a three-month prolongation of the present very short-term financing (one month after the end of the month of intervention) if and when the debtor requested it; however, a second extension of three months would require the creditors' agreement. Since positions within the "snake" can be reversed, it could thus be possible that certain debts and claims would cancel each other out before falling due. To counterbalance these revised extension facilities, ceilings could be imposed on creditor and debtor positions so as to allow the position of countries persistently building up debts or claims to be re-examined if required.

Secondly, the present principle whereby settlements have to be effected in proportion to the reserve assets held by the debtor (gold and IMF position on the one hand and foreign currency on the other hand) cannot appropriately be applied owing to the absence of settlements in gold. It would thus be advisable to abandon this principle. This would not preclude the possibility of debtor countries settling their debts in gold, at a market-related price, if they so wish and if the partner involved is in agreement."

2. According to the rules laid down in the Basle Agreement, the very short-term financing of interventions in Community currencies is without limitation as to amount but limited as far as the length of the credit is concerned to 30 days after the month in which the interventions take place. The average period of credit is thus 45 days. Subject to the creditor's consent this period can be extended by three months.

Experience has shown that creditor and debtor positions are often reversed, but generally after a period of four to five months; therefore, an extension of the present automatic credit periods could enable certain outstanding debts to be offset before they have to be settled and thus reduce the volume of reserves transferred between central banks.

For this reason, certain Governors are in favour of an automatic three-month extension of the present very short-term credit without any limit on the amount.

On the other hand, such an automatic extension of financing with unlimited amounts involves the risk of a country becoming heavily indebted in a matter of months. For this reason, two different proposals have been put forward:

- Some Governors consider it necessary to envisage an upper limit to the total outstanding under the automatic three-month extension. This limit would be equivalent to the debtor quota under the short-term monetary support arrangement. Furthermore, they consider that there should be a time limit to the continuing use of this facility in order to prevent a persistent debtor being able to have semi-permanent recourse to automatic intervention credit instead of arranging financing more appropriate to its situation.

- Other Governors equally agree to set as an upper limit for the automatic three month extension the relevant debtor quota under the short-term monetary support, but consider that this automatic extension could be granted to the debtor country for three months in succession up to the limit of the ceiling in force. This would imply the possibility, quite independent of the short-term monetary support arrangement, of an extension for a maximum of five months, which might involve, in the third month, a credit of up to three times a debtor's quota.

If several oentral banks are creditors and if the credits obtained under the intervention arrangements exceed a country's debtor quota, the automatic extension of credits could be divided between them in proportion to their claims.

3. Under present arrangements, balances arising from interventions in Community currencies have to be settled in proportion to two main categories of reserves held by the debtor country - gold-based assets (i.e. gold, IMF reserve positions and SDRs) on the one hand and foreign currencies on the other. In practice, no gold has been used for settlement purposes with the result that IMF positions and SDRs have had to be drawn upon exclusively to meet the share accounted for by the gold-based assets. This can lead, on the part of the debtor country, to the premature exhaustion of its IMF position or SDR holdings, or to the creditor country exceeding acceptance limits. Moreover, placing gold, IMF positions and SDRs on the same footing has now become obsolete.

It would therefore seem appropriate, and even essential, to change the settlement rules. It is suggested that gold, and only gold, should be excluded from the present reserve calculation as a basis for settlements and as one of the means of settlements for which there is an acceptance obligation on the part of creditors. Settlements would thus be made, in principle, with IMF positions or SDRs on the one hand and with foreign exchange on the other, according to the share of both categories in the reserves of the debtor. Gold could be used on a voluntary basis and on mutually agreed conditions to replace any other settlement instrument.

In conclusion, the majority of the Committee wishes to emphasise that it fully recognises the difficulties that arise from the movements in the dollar rate, but for the time being it would hardly be possible to go much beyond marginal improvements in the intervention policy as agreed a few months ago. All the same, it would be natural to reconsider this set of problems in the light of experience. In this connection, the French decision to rejoin the Community exchange system provides a useful opportunity for such a re-examination.

Indeed, it is the general opinion of the Committee that the rules of the Basle Agreement are still provisional in character and must therefore be adapted in the light of changing circumstances. Indeed, such adaptations have already been carried through in the past, for instance by changes in interpretation and through adjustments within the existing framework.

Finally, it must be recalled that the EEC members of the "snake" attach great importance to prior consultations regarding any substantial changes in monetary policies or in exchange controls.