

## INFORMAL ECOFIN COUNCIL

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(September 1987)

1. In the Communiqué issued on the occasion of the realignment of 12 January 1987 the Ministers of Finance requested the Committee of Governors and the Monetary Committee to examine measures to strengthen the operating mechanisms of the European Monetary System. Pursuant to that request, preparatory work for the Committee of Governors was conducted by the Committee's expert groups and the Alternates. I have submitted two oral reports on this work to the Council of Ministers of Finance, respectively to the informal Knokke meeting in April and to the ECOFIN meeting in June. I now have pleasure in presenting the Governors' final report, which focuses primarily on the matters within their competence.

2. The complexity of the problems and the broad scope of the study requested are reflected in the length of the report, an exception to the Committee of Governors' tradition of conciseness. ~~The difficulties encountered during the last realignment suggested,~~ <sup>or was considered</sup> however, that a thorough review of the whole system would be desirable and that the Committee should submit to the Ministers not only its decisions on how to strengthen the system but also a complete account of the analysis upon which these are based, which will also provide a framework for the further development of the system.

The report is divided into two parts: the first sets out the analysis of the working of the system, ~~in part~~ <sup>in</sup> with the aim of confirming the validity of the manner and methods of proceeding in the past; the second contains the Governors' assessments and describes the changes that will be made to the mechanisms of the EMS that are within their competence.

3. The overall judgment on the working of the EMS exchange rate agreements is naturally positive. The system has been effective in promoting exchange rate stability, discipline in monetary and fiscal policies, and convergence of the economic fundamentals. It has to be recognized, however, that the performance of the EMS benefited from a number of factors and circumstances whose influence on the system is likely to be different in the future.

In the first place, the Governors stress that the considerable reduction achieved in inflation differentials must not be allowed to weaken the priority given to the objective of curbing inflation and narrowing the remaining divergences in fiscal and other economic policies. In addition, for many years the strength of the dollar contributed indirectly to the cohesion of the EMS exchange rates. As long as large payments imbalances between the major countries persist and their economic policies do not appear fully consistent with correcting them, strains in their exchange rate relations may generate destabilizing pressures within the EMS. Such pressures, in turn, will tend to be accentuated by the remaining differences in the performance and policies of the EMS countries.

The increasing integration of financial markets, coupled with the speedup in the liberalization of capital movements, is fostering convergence and strengthening the discipline inherent in the system. On the other hand, these developments accentuate the risk of external shocks giving rise to destabilizing capital flows and of member countries' following divergent policies.

The Governors therefore strongly emphasize the need for all the EMS partners to pursue, in a closely coordinated manner, policies that promote both the convergence of prices and costs and external balance as the foundation for lasting exchange rate stability. In particular, countries should agree that central banks will continue to give priority to the objective of price stability in the conduct of monetary policy.

4. In the light of these considerations on the development of the international financial environment and economic policies, the Governors have identified some fields in which appropriate action by national governments would help to reinforce the stability and cohesion of the exchange mechanism. In particular, they stress:

(i) the need for monetary policy to be fully supported by other economic policies, and especially fiscal policy, in pursuit of greater economic convergence and exchange rate stability;

(ii) the desirability of all the EEC countries accepting the discipline of the exchange rate mechanism on an equal footing; and

(iii) the importance of changes in central rates being made in such a way as to discourage speculation. To this end, operators must be led not to expect large changes in market rates in the wake of realignments and the authorities must avoid giving the impression that they are prepared to yield to speculative pressures. This objective can be promoted by reducing the size and frequency of realignments. These should also be made less predictable, by avoiding both excessive delay in deciding to realign when fundamental disequilibria develop and the impression that realignments are somehow linked to domestic political calendars.

5. Finally, the Governors are in complete agreement on a number of changes to be made to the mechanisms and methods of managing the exchange rate agreements, changes that will strengthen the system and enhance its ability to forestall exchange rate pressures and cope with them when they do arise.

(a) While in the medium term monetary policy will have to remain geared to reducing inflation, in the short term it will be possible to pursue this objective flexibly with consideration also being given to the maintenance of exchange rate cohesion, partly in view of the need for closer coordination of monetary conditions implicit in increased mobility of capital.

(b) The Governors have accordingly agreed that in the new environment there is scope for a more active and flexible use of all the instruments available to central banks for defending exchange rate stability. As well as confirming the importance of interventions, they also stress the key role of interest rates, which it should be possible to adjust more promptly and rapidly in the face of exchange rate pressures. It has also been agreed that ~~make~~<sup>as</sup> fuller use of the exchange rate fluctuation band could help to enhance operators' perception of the exchange risk inherent in speculative positions.

To promote this more flexible use of the instruments available for maintaining exchange rate stability within the EMS, the Governors have agreed to strengthen the procedure for joint monitoring of member countries' economic performance and policies with the aim of arriving at common assessments of the sources of exchange rate pressures and appropriate action to cope with them.

(c) Finally, the Governors have agreed to make a number of modifications in the mechanisms of the EMS with the aim of increasing the resources available within the system for combating any exchange rate pressures that develop. Specifically:

(i) while the Governors reaffirm their belief that it would not be desirable to introduce automatic financing of intramarginal interventions (by way of the very-short-term facility), they accept a presumption that such financing shall be available when the interventions are made with the agreement of the issuing central bank on the following conditions:

- the cumulative amount of such financing does not exceed the double of the debtor quota of the debtor central bank in the short-term financing facility;
- the debtor central bank is also prepared to use its existing holdings of the currency to be sold for intervention in amounts to be agreed;
- the creditor central bank reserves the right to request payment in its own currency if this appears necessary in the light of its own monetary conditions, taking into the reserve position of the debtor central bank.

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(ii) The duration of very-short-term financing will be extended by one month (from two and a half months to three and a half months). Initial financing operations will remain automatically renewable for three months, but the ceiling on automatic renewal will be raised to twice the debtor country's quota in the short-term monetary support mechanism.

(iii) Lastly, without altering the formal rules governing the use of the official ECU, the settlement in ECUs of outstanding claims in the VSTF will be accepted ~~up to 100 per cent instead of 50 per cent~~, provided this does not result in an unbalanced composition of reserves or in excessive debtor and creditor positions building up with the EMCF. After two years of experience with this arrangement, the Governors will consider the desirability of changing the formal rules relating to the official ECU.

beyond 50 per cent and up to 100 per cent