

Group of Experts under the chairmanship
of M. Heyvaert

No. 43

EXAMINATION OF VARIOUS TECHNICAL ISSUES CONNECTED
WITH IMPLEMENTATION OF THE NEW EUROPEAN MONETARY SYSTEM



Application of the basic principles agreed on for the implementation of the new European monetary system raises a number of operational problems, which the Group of Experts set out to resolve. Some of the solutions proposed to the Committee of Governors were reached unanimously; others reflect a divergence of views.

The problems considered are:

I. The numeraire

1. Initial fixing of central rates in terms of the ECU
2. Method of calculating the subsequent values of the ECU in each currency

II. The intervention mechanism

1. Functioning of the indicator of divergence in cases of wider margins
2. Functioning of the indicator of divergence in cases of temporary withdrawal or non-participation

III. The very short-term financing mechanism

1. Arrangements for claims and liabilities in EMUAs outstanding when the European monetary system becomes operational
2. Rates for converting currencies into ECUs
3. Interest rate for borrowing under the very short-term financing mechanism

IV. The settlement mechanism

- A. Technical aspects relating to the creation of assets in ECUs against contributions of gold and dollars
 1. Conversion rates
 2. Operational procedures for the contribution of gold and dollars
 3. Other provisions
- B. Remuneration of ECUs
 1. Income of the EMCF
 2. Remuneration of assets denominated in ECUs
- C. Use of the ECU in intra-Community settlements
- D. Use of ECUs to purchase currencies
- E. Periodic adjustments

I. THE NUMERAIRE

It was agreed that the definition of the ECU will correspond to that of the European unit of account (EUA). The Group set out to settle the details of:

- the procedure for fixing each currency's initial central rates in terms of the ECU with a view to establishing the reciprocal "parity grid";
- the method of calculating the subsequent values of the ECU in each currency.

1. Initial fixing of central rates in terms of the ECU

The rates for the ECU on a day - D-day - to be determined (for instance the last business day before the entry into operation of the European monetary system) could be taken as initial ECU central rates. These would then be crossed to obtain the bilateral central rates of the grid, which would in practice correspond to the market rates ruling that day.

Direct reliance on the market rates ruling on a single day would, however, entail the risk of endorsing particular situations or factors; above all, the bilateral central rates for the "snake" currencies would be different from those linking them at present, which would imply a realignment of the parities ruling in that system.

The experts reject this solution, taking the view that the initial ECU central rates chosen should, so far as the "snake" currencies are concerned, ratify the bilateral central rates currently applied. As regards the other EEC currencies, they recommend that the procedure should be based on market rates and take account of the effects that any deviation from these would have on the divergences measured by the ECU.

The requirements of the system and in particular the operation of the indicator of divergence call for the establishment of bilateral and ECU-related central rates among all the currencies of the EEC; these rates would be fictitious for non-participating currencies.

The Group would like to recall that the intervention points between participating currencies will have to be announced to the market.



2. Method of calculating the subsequent values of the ECU in each currency

At present the Commission calculates the value of the EUA in each EEC currency once a day on the basis of the rates derived from the fixing in their respective markets. When crossed, these EUA rates show divergences which are mainly due to differences in fixing times from market to market.

The rôle of the ECU as denominator of operations executed under the intervention and credit mechanism and, perhaps, as indicator of divergence makes it preferable to adopt a uniform method of calculation to be applied as often as necessary and at least on the following principles.

At the start of each daily concertation session, that is to say at 9.30 a.m., 11.30 a.m., 2.30 p.m. and 4.05 p.m., each central bank would announce a representative dollar rate recorded on its market one minute previously; these various rates would be used as the basis for calculating the values of the ECU in each of the currencies in the system.

Likewise with a view to applying a uniform method and synchronising the rates used to determine the daily values of the ECU published by the Commission, the latter would receive each day at 2.30 p.m. from the National Bank of Belgium the dollar rates announced at the concertation session held at that time. When the Brussels market was closed, the Chairman for the day of the concertation session would supply the rates in question to the Commission, including the rate recorded on his market between the dollar and the currency whose market was closed.

To provide for a certain amount of transparency and possibly also to meet requests, the figures used for calculating the ECU rates published by the Commission could be disclosed to interested parties.

II. THE INTERVENTION MECHANISM

The experts examined the problems that the application of wider margins for one or more currencies and the temporary withdrawal or non-participation of certain currencies raise simply as regards the operation of the indicator of divergence, as well as ways of resolving these problems. Their reference points were items 2.2(b) and 3.5 of the European Council's Resolution of 5th December 1978.



1. Functioning of the indicator of divergence in cases of wider margins

The calculation of the divergence thresholds is based for each currency on the maximum deviation of its daily value in terms of the ECU from its ECU central rate, allowing for the weightings and margins of fluctuation that are adopted.

The establishment of a wider margin for any one currency would result in the divergence threshold receding, not only for the currency enjoying greater flexibility but also for all the other currencies observing narrow margins. There would be little likelihood, therefore, of the latter currencies showing a divergence, except in cases where the currency applying wider margins was itself tending to approach one of its limits. Some experts find it acceptable that the divergence thresholds should recede, even for currencies with narrow margins.

Other experts consider that a corrective procedure is necessary to preserve the rôle of the indicator of divergence in the mechanism. This procedure would involve calculating the divergence thresholds for currencies with narrow margins as if all currencies participating in the exchange rate mechanism were observing margins of 2.25 per cent. Whenever one of these currencies diverged, it would be necessary to ascertain whether the divergence was exclusively attributable to the behaviour of the currency with wider margins; if this were so, the divergence would be disregarded. Conversely, it would be necessary to ascertain whether the behaviour of the currency with wider margins was not having the effect of masking divergence on the part of a currency observing narrow margins.

2. Functioning of the indicator of divergence in cases of temporary withdrawal or non-participation

In the event of currencies not participating in the exchange rate mechanism or withdrawing from it temporarily, the ECU would continue to be influenced by the unrestricted fluctuations of those currencies on the market. Four solutions to the problem of neutralising the effect of such fluctuations on the indicator of divergence have been put forward:



- The value of currencies absent from the exchange rate mechanism could be frozen at their ECU central rate.
- The behaviour of the absentee currencies could, at specified fluctuation thresholds, trigger adjustments in the same direction and of the same size to the ECU central rates of currencies still participating in the intervention mechanism. No change in bilateral central rates would ensue for these currencies.
- In line with the solution suggested in the case of wider margins for one or more currencies, steps could be taken to ascertain whether any divergence was attributable to, or being masked by, the behaviour of the absentee currency or currencies.
- A solution that is thought by some to be possible under the terms of item 3.5 of the European Council's Resolution of 5th December 1978 is one whereby a formula for a basket composed only of the currencies participating in the exchange rate mechanism would be used exclusively as an indicator of divergence solely among the central banks concerned.

The first option would completely eliminate the influence of fluctuations in the absentee currency or currencies but would have the effect of introducing into the basket an inertia factor proportionate to the weight of these currencies: it would necessitate the daily calculation of two different baskets, one of them separate from the ECU.

The second option would prevent the ECU central rates and the market value of the ECU moving abnormally far apart but might entail frequent adjustments of the ECU central rates with potential consequences in other areas, in particular the common agricultural policy. Between two adjustments of central rates the absentee currencies would continue to influence the detection of divergence.

The third option is based, like the preceding one, on the ECU's market values, but it could require frequent checks if the absentee currency had a strong influence on the value of the ECU or if several currencies were absent.

The effect of the fourth option would be to introduce a basket, separate from the ECU, with a view to avoiding some of the effects



of the other solutions (inertia of the divergence indicator - frequent adjustments of the ECU central rates - complexity of calculations); it would also involve the daily calculation of two different baskets.

III. THE VERY SHORT-TERM FINANCING MECHANISM

In this connection, the experts devoted their attention to the three questions set out below.

1. Arrangements for claims and liabilities in EMUAs outstanding when the European monetary system becomes operational

In view of the "snake" central banks' present positions on account with the EMCF it seems highly likely that there will still be claims and liabilities in EMUAs outstanding at the time the new European monetary system becomes operational.

The Group unanimously recommends that such claims and liabilities should continue to be governed by the terms of the Basle Agreement as currently applied, including those relating to their liquidation. In particular the form of settlement of these liabilities should correspond to the composition of the debtor's gross reserves, although, as at present, this rule could be waived by mutual agreement with a view, for example, to including reserves in ECUs.

If the Governors support this recommendation, the Group suggests that they formulate a decision accordingly, to be adopted by the Board of Governors of the EMCF.

2. Rates for converting currencies into ECUs

For financing or settlement purposes, "snake" currencies are converted into EMUAs at a fixed rate and dollars at a Community rate. Item 2.2 (c) of the European Council's Resolution of 5th December 1978 provides that the ECU will be the unit to be used for the booking of intervention and credit operations. Some experts have, however, expressed doubts as to whether the ECU would be suitable for this function if several EEC currencies were not participating in the exchange rate mechanism.



If the ECU were nevertheless adopted for this accounting function, the Group unanimously proposes that the rates taken for converting currencies into ECUs should be the daily rates for the ECU as established by the Commission on the basis of the rates recorded at 2.30 p.m. (see Section I,2 above). This would accord with the logic of the new system and would adequately balance the chances of debtor or creditor making an exchange gain or loss.

3. Interest rate for borrowing under the very short-term financing mechanism

A large majority of the experts are in favour of retaining the existing procedure under which the interest rate charged to the debtor in respect of initial very short-term financing is equal to the simple arithmetic mean of the discount rates applied by the central banks participating in the exchange rate mechanism. In order to preserve symmetry between the ECU's capital value and its yield, one delegation has proposed that this mean should be based on the discount rates of all the EEC central banks and weighted according to the currency structure of the ECU basket.

IV. THE SETTLEMENT MECHANISM

A. Technical aspects relating to the creation of assets in ECUs against contributions of gold and dollars

It was agreed that the contributions of gold and dollars would be made in the form of three-month renewable swaps against ECUs. There are a number of outstanding problems regarding the way in which these operations would be carried out that will have to be settled by the Board of Governors of the EMCF.

1. Conversion rates

So far as the dollar is concerned, the Governors have already decided in favour of the market rate (see Report of the Committee of Governors dated 14th November 1978).

As regards the rate for conversion of gold, the Governors in the same report expressed their preference for a rate "close to and derived from market prices, on a basis agreed by the Governors".



It is suggested below that the adjustment of the contributions will be made every three months. Consequently, the experts unanimously recommend that the actual gold prices as recorded daily at the two London fixings, converted into ECUs, should be taken as the basis for valuing gold in terms of the ECU. They differ, however, in their views as to which price in ECUs should be applied for the swaps. Three solutions have been suggested:

- the lowest price recorded during the previous three months,
- the average of the prices observed during the previous three months,
- the formula advanced in Report No. 39, i.e. 75 per cent. of the above-mentioned average.

All the experts stress that the gold conversion prices so defined would be applicable only to swap operations, and that they would not prejudice the choice to be made as regards other operations.

2. Operational procedures for the contribution of gold and dollars

Several different procedures have been proposed for the delivery of gold and dollars to the EMCF under the swaps. One reason for this is that assessments of the practical and political implications vary, but there are also disparities in the legal and accounting limitations imposed on the central banks. It may therefore be difficult to apply a single technique to all the central banks.

In considering the delivery procedure the Group looked at the two reserve assets in question separately.

(a) Gold contributions

One method would be an actual transfer of gold bars to the EMCF, the contributions to be credited to earmarked accounts opened in the name of the EMCF either with one of the EEC central banks or with the Federal Reserve Bank of New York in New York.

Alternatively, the central banks could transfer the gold to sight or earmarked gold accounts opened in the books of the Agent for the account of the EMCF; this technique might be chosen provided it did not lead to duplication of the central banks' gold reserves.



One central bank has suggested as a further possibility crediting an earmarked account opened in its own books in the name of the EMCF, with the gold in question no longer being booked in its reserves.

The deposit of a quantity of gold for the account of the EMCF with a depositary situated outside the EEC may raise a number of problems connected with recognition of the legal personality of the owner of the gold bars, in this case the EMCF.

(b) Dollar contributions

Some of the central banks see no legal or accounting difficulties in making their dollar contributions by crediting a sight dollar account opened in their books in the name of the EMCF.

Others, however, for whom this method is not feasible, wished to elaborate two further procedures involving:

- first procedure: actual transfer of the dollars to the EMCF and management of those dollars by the EMCF or the Agent;
- second procedure: actual transfer of the dollars to the EMCF which would appoint the respective transferors to manage the funds in question.

Before going into these two procedures in detail the experts agreed that, in order to avoid the considerable drawbacks involved if large volumes of investments had to be wound up, the dollar contributions, which should at all events correspond to 20 per cent. of the central banks' gross dollar reserves as reported to the Agent of the EMCF, should be met by surrendering US Treasury or US Treasury-backed paper (Treasury bills, notes, bonds, Federal agencies' paper, etc.). If certain central banks were to encounter difficulties in delivering the necessary amounts in this form, the central banks in question would endeavour to find a means of satisfying these requirements as quickly as possible.

The current value of the contributions on the day on which the swap was to be concluded would be calculated by the Agent on the basis of the list of security holdings.

First procedure

The dollar assets as defined above would be transferred to a deposit opened in the name of the EMCF with the Federal Reserve Bank of New York.



Alternatively, transfer could be to the Agent (the BIS) acting on behalf of the EMCF.

The extent to which third countries, and the United States in particular, may recognise the EMCF's legal personality and competence and how the income on the assets it would be managing either directly or through the Agent will be treated for tax purposes are questions that will need to be clarified.

The policy that is to govern the management of the EMCF's assets, notably liquidity and profitability criteria, will have to be laid down in a Decision of the Board of Governors of the EMCF. In application of that Decision the Agent will receive detailed Directives, the execution of which will be supervised by the Board of Governors of the EMCF.

Second procedure

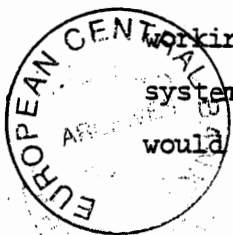
The same dollar assets might be delivered to the EMCF and transferred back to each central bank, in the same form as its contribution, under a management contract between the two parties.

This procedure would likewise avoid double booking of the amounts in question in the central banks' balance sheets and would enable the central banks to apply the same management criteria (liquidity and remuneration) to these assets as to their overall reserves.

An agency relationship would normally mean that the return earned by the agent (mandataire) would be made over in full to the principal (mandant). However, the experts from one central bank who advocate this second procedure would prefer to pay the EMCF a rate of interest fixed by the Fund's Board of Governors on the basis of the return on those assets administered by the EMCF.

3. Other provisions

The experts recommend that the gold and dollar contributions be determined on the basis of the gross reserve position recorded on the last working day before the date chosen for bringing the new European monetary system into operation. A similar rule would apply to the adjustments that would follow at three-monthly intervals.



In view of the time required to calculate and notify positions and, if appropriate, to make the actual transfers of gold and dollars, the contributions would be effected by not later than the tenth working day of January 1979.

B. Remuneration of ECUs

1. Income of the EMCF

A compensatory fee would be levied on gold contributions at a rate equal to the return on the dollar investments.

The return on the dollar investments will depend on the operational arrangements adopted for the contributions in dollars (see Section A, 2 above).

The EMCF would receive the interest charged to debtors under the very short-term financing arrangements.

The rate of interest payable by countries receiving short-term monetary support would continue to be set by the Board of Governors of the EMCF.

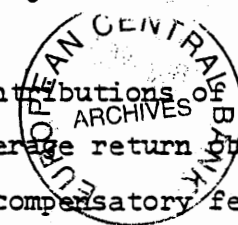
2. Remuneration of ECU assets

In their Report to the Council dated 14th November 1978 the Governors stated that they were, "for the time being, of the opinion that all ECU-denominated assets or claims held by a central bank either as a result of very short-term financing or in the form of claims under short-term monetary support or reserves corresponding to deposits of gold and dollars should be uniformly treated from the point of view of remuneration."

The Group is divided in its views as to how this text should be interpreted as regards the remuneration of ECU assets.

Most of the experts favour differential remuneration of ECUs according to their origin, particularly in view of the fact that probably not all the EEC countries will be participating in the exchange rate mechanism and hence in the very short-term financing arrangements. These experts propose:

- that the remuneration of ECUs created against contributions of gold and dollars should be set on the basis of the average return obtained by the EMCF on the dollar investments and gold (compensatory fee);



- that, so far as ECUs corresponding to very short-term financing and to short-term monetary support are concerned, the remuneration should equal the rates of interest charged to debtors under these two credit mechanisms.

The other experts advocate that all ECU assets should be uniformly remunerated so as to avoid the creation of two sorts of ECU. They also refer to the Committee of Governors' Report to the Council of 14th November 1978, which states that ECUs would be remunerated "on the basis of the average return obtained by the EMCF on its dollar investments, the gold contributions and its ECU-denominated claims".

Whatever method is chosen, the Group suggests that the remuneration should be paid, monthly, in dollars and in ECUs in accordance with the composition of the EMCF's income.

C. Use of the ECU in intra-Community settlements

According to the Report of the Committee of Governors dated 14th November 1978, the main function of the ECU will be for intra-Community settlements.

This acknowledged primacy of function is interpreted in three different ways, though none of the three interpretations prejudices the debtor's acknowledged right to settle in the creditor's currency.

1. Some feel that the ECU should be the first-line instrument of settlement. Any central bank that had exhausted its ECU assets - short of recourse to the credit mechanism - would have to make a further contribution of gold and dollars to the EMCF in order to secure the necessary means of settlement.

2. Another view is that the ECU is a means of settlement that has to be accepted by the creditor, though this does not deprive debtors of their right to use their other reserve assets, in particular those that cannot be used for making contributions to the EMCF. Consequently, debtors would have the option of settling their debts either entirely in ECUs or in accordance with the composition of their reserves, ECU assets being included in the composition. Settlement would also be possible in any other way mutually agreed.



3. A third proposed approach is that 20 per cent. of the amount of any intra-Community settlement should be made in ECUs, the balance being paid in SDR and foreign currency denominated assets in accordance with the composition of the debtor's reserves. This arrangement would prevent large net creditor and debtor positions from arising during the transitional period, and would make it easier to unwind the swaps at the end of that period. It would also mean that debtors would not be obliged, for the purpose of obtaining the necessary means of settlement, to make further gold and dollar contributions to the EMCF and hence to increase the volume of ECUs to more than 20 per cent. of reserves - which the proponents of this view consider would be undesirable because of its effect in inflating net creditor and debtor positions. Consequently, whatever settlement mechanism was adopted, the debtors would have to obtain the necessary additional ECUs from partners and not from the EMCF.

Some experts consider that, to the extent that methods 2 and 3 provide for settlement in accordance with the composition of the debtor's reserves, gold assets should be included in calculating their composition; this would involve determining the gold transfer price on a basis agreed in advance.

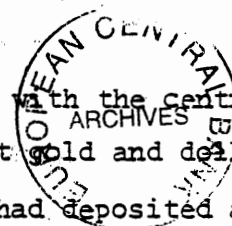
D. Use of ECUs to purchase currencies

Transfers of ECUs against dollars or EEC currencies by mutual agreement between central banks should be freely permitted.

To meet any requirement for dollars a central bank could obtain dollars against ECUs from the EMCF between two periodic adjustments, initially by unwinding a swap operation. Such operations could not be undertaken for the purpose of altering the composition of a central bank's reserves; and they would also be automatically limited by the EMCF's liquidity position and by the obligation to restore the required proportion of dollars held at the EMCF when each periodic adjustment took place.

E. Periodic adjustments

At the end of each quarter the EMCF would carry out with the central banks the necessary adjustments to the swaps of ECUs against gold and dollars with the dual objective of ensuring that each central bank had deposited at



least 20 per cent. of its gold and dollar reserves with the EMCF and taking account of value changes since the first contribution or the previous adjustment.

Subject to these adjustments, the swaps would be renewed every three months until the transitional period of two years came to an end, when the swaps would have to be unwound unless a unanimous decision to the contrary had been taken. To that end, central banks that were net users of ECU assets would have to reconstitute these assets, and the required amounts would have to be transferred to them - either direct or through the EMCF - by net accumulator central banks. The discharge of these obligations would be effected by the transfer of the currencies of the net holders of ECUs or reserve assets.

