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EUROPEAN COUNCIL, LUXEMBOURG

27/28 APRIL 1980

THE EUROPEAN MONETARY FUND

Brief by HM Treasury

OBJECTIVE

1. To avoid a substantive debate while the options for the EMF are imprecise.

POINTS TO MAKE

2. (i) Too soon to have a substantive debate among Heads of Government while the options for different types of Fund and the possible roles for the ECU are still not definite. Agree with Commission proposal that the relevant Community bodies should pursue their work on the EMF.

(ii) UK has participated constructively in the discussions. No reason from our point of view why Fund should not be set up on schedule. However, if others want to postpone the March 1981 deadline, we could agree.

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(iii) If pressed on sterling's membership of the EMS (Brief 8)7. No technical reason why sterling's absence from exchange rate arrangements should affect either preparatory work on the Fund or delay its start.

BACKGROUND

References

3. Commission report (annex I), report of the Chairman of the Central Bank Governors (annex II), report of the Chairman of the Monetary Committee (annex III).

4. The resolution of the European Council in December 1978 which established the EMS further resolved to consolidate the EMS arrangements into a "final system" not later than two years after their start. This means March 1981. The final system would entail the creation of the European Monetary Fund, and the full utilisation of the ECU as a reserve asset and a means of settlement. The resolution also said that the final system would be based on adequate legislation at the Community as well as the national level. The European Council in Dublin agreed that the Commission should present a report setting out the progress made on the EMF, and the difficulties encountered. It also confirmed the timetable for setting up the Fund.

5. There has been considerable further discussion in the Community on the EMF since Dublin, but the options remain imprecise. No member state has yet expressed a firm view on the different possibilities that have been considered. The

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UK has argued for considering whether further development of the European Currency Unit (ECU) might benefit the development of the international monetary system, especially if the asset reached the point at which it was usable outside the Community.

6. As time before March 1981 is now limited it will be difficult to set up a very ambitious Fund on schedule. Some of the less ambitious options should still be possible, however. There are no particular difficulties about the timetable from the UK view point, but March 1981 is uncomfortably close (from their point of view) to the French and German elections and both would be happy to see a postponement of the deadline. The Germans have recently argued that they are committed to a "real advance" in the system in the final stage, and that because the institutional problems posed by such a real advance cannot realistically be solved by March 1981, more time was needed. A postponement would be unpopular with the smaller member states, and probably Italy, but pressure from President Giscard and Chancellor Schmidt, the two main architects of the EMS, will be certain to prove irresistible.

7. The Commission's report is a reasonable statement of the issues which have been raised in discussions on the Fund so far. But this report and the reports of the Chairmen of the Specialist Committees make it clear that a number of difficult technical issues remain to be resolved on some of the key points of the final stage of the EMS

HM Treasury
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ANNEX I

COMMISSION OF THE EUROPEAN COMMUNITIES

COM(80)146 final

Brussels, 20 March 1980

EUROPEAN MONETARY FUND

Report from the Commission to the European Council
(Brussels, 31 March and 1 April 1980)

COM(80)146 final

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I. At the Dublin meeting on 29 and 30 November 1979, the European Council invited the Commission to submit, for the meeting in March 1980, a report setting out the progress made in studying the establishment of the European Monetary Fund and pointing out any difficulties.

The studies on the European Monetary Fund were started by the Commission as early as May 1979. Since then, the Monetary Committee and the Committee of Governors have looked into this question, and their respective chairmen have reported to the Council on the progress of work. This work has not yet been completed; rather than producing specific guidelines, it has so far made it possible to identify problems and possible choices between solutions. However, as can be seen from the analysis below, the preliminary technical work has shown that, if it is to make a real extra contribution, the transition to the institutional stage of the European Monetary System can be carried out only if certain basic questions have been resolved which have not yet been fully clarified.

II. Current work is based on three main elements:

A. The first is the desire expressed by the European Council in Bremen and Brussels, to transform the European Monetary System into a "durable scheme" guaranteeing the creation of a zone of monetary stability in Europe. For the purpose of attaining this objective, the European Council defined the operating rules of the system in the first stage and indicated certain characteristics of the "final stage".

B. The second is the lessons to be learnt from the first year of operation of the European Monetary System and from monetary and exchange rate developments in the Community since 13 March 1979.

The assessment of the operation of the European Monetary System in its first year is largely positive. The procedures for consultation between the authorities of the Member States in the various Community bodies have been improved. Despite sharp economic and monetary disturbances which entailed interest rate increases ranging from 3 to 5 points according to the country, the group of participating currencies maintained a greater degree of cohesion than that recorded since 1972. Two adjustments of central rates in September and

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November 1979 were carried out in good time and fairly smoothly. Lastly, the monetary compensatory amounts were reduced appreciably, reflecting progress towards the objective of uniform prices on the European agricultural market.

In stressing the positive factors, the Commission is expressing its conviction that it would have been much more difficult to achieve these results if there had been no European Monetary System. However, between the end of 1978 and the end of 1979, the average rate of inflation in the Community rose from 6.9% to 9.0%, and the spread between the lowest and the highest rate of inflation in the Member States widened from 10 to 17 points. Although progress has thus been made towards exchange rate stability, the same has not been the case in the field of prices. Consequently, the European Monetary System must be consolidated and strengthened so as to make its own active contribution to better economic equilibrium in Europe. Economic policies for their part will have to be brought to converge more closely to ensure the stability of the monetary system.

C. The third element is the developments in the international economic, financial and monetary situation. In 1978, the serious disruptions of exchange rates, payments balances, prices and financial markets caused by the 1971-74 monetary and energy crises, seemed to be about to ease. Today, the threat of renewed disequilibria in international payments relations is growing.

The future development of the European Monetary System must therefore be such as to contribute actively to the overall stability of the international financial and monetary system and to meet the Community's general interests in the trade and financial fields - both its own interests and those of the countries with which it has particularly close relations.

III. The Commission and the committees concerned have primarily concentrated on the role of the ECU and on the organization of the credit mechanisms in the European Monetary Fund. They have examined the institutional aspects, which will be largely governed by the solutions adopted to the questions of substance discussed above.

1. The credit mechanisms

Two features of the credits granted under present agreements should be noted: to a large extent they are bilateral credits, the accounting procedures for which are handled by a Community body, the EMCF; and since the body which issues the ECUs - the EMCF - is only an accounting intermediary in the credit operations, these do not give rise to the direct creation of ECUs.

Two problems have been studied in particular: first, the consolidation of existing credits (short-term and medium-term) and of very short-term credit facilities. It became clear that, whatever solution is adopted, this is not a fundamental problem in the transition to the institutional stage of the European Monetary Fund.

Second, the EMF's ability to create ECUs against credits, which is a crucial issue. This ability raises the problem of the limits and conditions under which these ECUs could be created or the credits could be granted, and therefore that of the means which would be available to the European Monetary Fund to impose tighter monetary discipline in the Community. The solutions to this problem will depend to a large extent on the role of the ECU in the institutional stage of the European Monetary System.

2. The ECU

(a) In the present system, the ECU serves as the numeraire for the exchange rate mechanism, as the basis for the divergence indicator, as the denominator for intervention operations and as a means of settlement between the Community's monetary authorities.

However, the ECU lacks the principal features of a currency: it is not an instrument of payment; there can be no autonomous creation of ECUs through the credit operations; and though it appears in the central bank's balance-sheets,

this does not mean that it is a genuine reserve instrument, since it is merely the expression in the accounts of the assets (dollars and gold) against which it has been issued and whose movements it reflects automatically.

(b) The decisions taken at Bremen and Brussels, certain fundamental considerations and recent monetary trends together mean that the development of the ECU will be the locomotive for transition to the institutional stage of the European Monetary System: it is by expanding the role of the ECU that the Community will be able to organize internally the coordinated action necessary to achieve a greater degree of monetary stability and establish its monetary identity at international level.

(c) The full and complete use of the ECU as a means of payment and the regulation of the creation of ECUs to serve the objective of monetary stability raise the question whether, to what extent and under what conditions the future Monetary Fund could possess an independent power of money creation.

If it were given such power, the future European Monetary Fund could create ECUs in two ways: against a contribution of reserves (as is done under the present agreements), or through credit operations; these two methods could even be combined.

The full use of the ECU as a means of payment or reserve instrument within the Community would require that several conditions be met:

- first, certain legislative measures would have to be taken to abolish the limits to the acceptability of ECUs to the central banks, to provide that a certain percentage of reserves must be held in the form of ECUs, and possibly to impose the exclusive use of the ECU as an instrument of settlement between the Community's central banks;
- if the limits to the acceptability of the ECU were abolished, the ECU's inherent characteristics (convertibility and yield) would have to be strengthened to make it as attractive as the other possible reserve instruments;

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(d) Apart from the role to be performed by the ECU in the areas described above, a second major decision of principle will have to be taken; this concerns the wider use of the ECU outside the system of Community central banks, both on the private financial markets and by the authorities of non-Community countries, so as to ensure the full negotiability of the ECU and to enhance its status as a reserve asset. In this context, the question arises as to whether the strengthening of the role of the ECU might allow it to play a part in recycling the surpluses of the oil-producing countries.

IV. Once the European Monetary System enters into its institutional stage, consistency between domestic monetary policies, credit mechanisms and exchange rate agreements will have to be ensured within a single system of procedures, so as to provide a full and proper basis for the smooth operation of the system and the achievement of monetary stability.

This raises the question, firstly, of the institutional powers with which the Fund will be endowed in order to administer the system itself and, secondly, of the back-up measures which will have to be taken so as to ensure the smooth working of the system, including measures such as the coordination of exchange rate policies vis-à-vis non-Community currencies and the achievement of a sufficient degree of convergence in the economic and monetary policies pursued in the Member States.

Examination of the institutional aspects has already begun. It has started from the principle that a Fund endowed with increased powers should be integrated into the institutional system of the Community and of the existing international monetary organizations on the basis of clear and precise legal arrangements. Fuller examination of the institutional aspects must necessarily be carried out in parallel with the basic questions raised above; it is on the solutions arrived at with regard to these basic questions that the powers of the European Monetary Fund and the nature of the bodies running it will to a large extent depend. It will at all events be necessary to work out a balanced system of tasks, responsibilities and safeguards for the European Monetary Fund; this is essential to the exercise of any function of a monetary nature. A balanced system of this kind is, moreover, to be found in all the Member States, though the features of each system differ in accordance with national legal and institutional circumstances.

Some of the functions or tasks allotted to the European Monetary Fund once it is established will probably have to be taken up only gradually depending on how the relevant political authorities assess the way in which the situation is developing and on whether they find the mechanisms suitable.

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In conclusion, the Commission proposes that the European Council request the relevant Community bodies to pursue their work along the lines set out in this report. The Commission is ready to provide the European Council with further information on the progress achieved and difficulties encountered in setting up the European Monetary Fund proposed in the texts that were released after the meetings of the European Council in July and December 1978.

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

(Translation)

11th March 1980

STATEMENT FROM THE CHAIRMAN OF
THE COMMITTEE TO THE COUNCIL ON QUESTIONS CONCERNING THE
CREATION OF THE EUROPEAN MONETARY FUND

At its meeting on 29th and 30th November 1979 the European Council asked the Commission of the European Communities to present a report for its next meeting in March 1980 describing the progress made in studies on the establishment of the European Monetary Fund and pointing to the difficulties encountered in this connection.

In this context, the Committee of Governors has drawn up this statement, which is confined to presenting a number of general considerations concerning the European Monetary System and its future development and outlining the type of institution to which the consolidation of the existing provisions and procedures might lead and the main problems posed by the transition to an initial stage of the definitive phase of the EMS.

I. GENERAL CONSIDERATIONS

To begin with, the Governors wish to stress that the first year's experience of the European Monetary System is positive; it has functioned satisfactorily and has helped to strengthen monetary co-operation.

The future development of the EMS, in which care should be taken not to jeopardise this achievement, should proceed in an evolutionary way, with the EMF evolving according to circumstances and to the progress made in economic, monetary and financial integration within the Community, without a predetermined timetable. Institutional innovations can play only an auxiliary rôle in the lasting success of the EMS.

It is not to be excluded that this evolutionary approach could, at the start, be confined to some adjustments to the existing arrangements of the EMS within the present legal framework in the light of experience to date. However, those arrangements are already approaching the point where further evolution would demand a certain qualitative jump which would involve institutional changes and raise a number of major technical, legal and political questions, such as the need for parliamentary ratification or fresh national legislation.

The Governors are looking at the technical, and to some extent the legal, aspects of these questions; they intend to continue their studies and at this stage have therefore confined themselves to presenting a number of remarks on some of these questions.

II. INSTITUTIONAL FRAMEWORK FOR THE EVOLUTIONARY PROCESS

Several institutional approaches are conceivable for the EMF. It could, for example, be a body:

- of the central-bank type, which would exercise functions essentially, and even exclusively, of a monetary nature and would steer towards the creation of a Community central bank and a Community currency;
- of a regional IMF type, with powers centring more on the administration of medium and long-term conditional credit;
- of a "sui generis" type, which would broadly combine the two formulae above.

The objectives and implications of these various options are obviously very different. The Governors have begun by studying the main questions raised by the "central-bank" approach, as the existing procedures of the EMS, especially the very short-term and short-term credit mechanisms, fall within the domain of the central banks. In this context the Committee of Governors proposes to examine arrangements to ensure control over money creation and avoid any conflict between the Fund and the national monetary authorities.

Whatever the institutional approach envisaged, the Governors are of the opinion that the development of the ECU into a reserve instrument and means of settlement is the most important problem in the transition to the definitive phase of the EMS.

III. DEVELOPMENT OF THE ECU

The development of the ECU raises the two major questions of its creation and use.

1. Creation of ECUs

The contributions of reserve assets to the Fund, as a counterpart of which the ECUs are created, should be in such a form as to give the ECU a more independent and so more intrinsic existence than at present and to endow the Fund with resources at its own disposal.

With this objective in mind, a number of different formulae are conceivable for the contributions of reserve assets, for example sales to the Fund against ECUs, a share in the capital of the Fund, indefinitely renewable swaps. These formulae, which are not mutually exclusive, constitute in practice a definitive transfer of assets and, as such, would have analogous legislative and legal implications.

2. Utilisation of ECUs

In order to promote the full use of the ECU, it would be necessary both to abolish any acceptance limit in intra-Community settlements, such as the present 50 per cent. rule, and to improve the unit's qualities as a reserve asset.

This last could be achieved by giving the ECU one or more of the following characteristics:

- full institutional convertibility, giving the central banks an absolute right to convert ECUs accumulated over and above a certain threshold into foreign exchange through outright operations with the Fund;
- mobilisation facilities with the Fund through reversible operations (for instance, swaps);
- greater voluntary negotiability between central banks by eliminating the restrictions that apply under the present arrangements.

None of these formulae can be considered in isolation from other aspects of the creation and use of ECUs; consequently their differing implications will have to be carefully studied before a choice can be made.

IV. CONCLUDING REMARKS

The Governors will examine in greater depth the questions outlined above. They will concentrate in particular on defining the rôle and use of the ECU within, and possibly also outside, the Community. They will also consider the rôle that the inclusion of enabling clauses, to be activated under specific conditions, could play in the evolutionary approach.

In doing so the Committee of Governors will pay due regard to the economic and institutional environment, the constraints imposed by that environment and the precautions, especially of a legal and institutional nature, that should accompany the establishment of the Fund.

EUROPEAN COMMUNITIES

Secretariat of the
Monetary Committee

Brussels, 17 March 1980
II/162/80-EN
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STATEMENT BY MR. HABERER, CHAIRMAN OF THE MONETARY COMMITTEE
TO THE COUNCIL ON ECONOMIC AND FINANCIAL AFFAIRS HELD ON 17 MARCH 1980

Last December, my predecessor at the head of the Monetary Committee, Mr. van Ypersele, informed you of the various problems seen by the Committee at the start of its study of the questions posed by the establishment of the EMU; he presented you with a range of possible technical formulae, and stated that the Committee would undertake to record and evaluate their respective advantages and disadvantages.

This work is now under way, and rather than expounding its technical details, I feel it more appropriate to try to outline the concerns shared, it seems to me, by all members of the Committee, at this stage in their work.

The objective set by the European Council is to proceed, at the end of a transitional phase of at least two years, to an institutional phase of the EMS. Moreover, and not surprisingly, the European Council described the characteristics of the transitional phase with much greater precision than those of the final phase. Nevertheless, the Bremen Annex and the Brussels Resolution indicate that

- (a) the ECU will be at the centre of the system; its utilisation as a reserve asset and means of settlement must be "full";
- (b) participating countries will co-ordinate their exchange rate policies vis-à-vis third countries;
- (c) the existing arrangements and institutions will be consolidated in the future Monetary Fund.

It must be recognised that since the Bremen and Brussels meetings of the European Council in 1978, the international environment has changed considerably and that in 1980 it is very different from what could have been imagined in 1978. Thus I must stress five new facts, the importance of which is considerable :

1. The rise in oil prices has appreciably swollen the OPEC countries' balance of payments surpluses and this casts a different light on the problem of recycling and reserve assets.
2. The rise in commodity prices and in the price of oil is reflected in a deterioration in the Community's terms of trade, and a turn-round in the current account balance which has moved into deficit for the Community as a whole and for all its members, save one.
3. Inflationary strains have worsened dramatically and, in the Community, the gap between national inflation rates is widening.
4. The price of gold has soared.
5. All in all, the volume of international liquidity has swollen sharply and this appreciably increases the vulnerability of exchange rate policies.

All these changes combined with a wish for diversification which seems to be felt by the OPEC countries - at a time when their surpluses are again becoming considerable - inevitably affect views on the future of the EMS.

First of all they constitute a threat to the EMS in its present form, and for this reason a challenge. They also dictate a change of emphasis in our concerns : the problem of credit mechanisms - volume, conditions - now takes second place to that of reserve assets, since the need for a stable and credible international asset is becoming increasingly urgent. Consequently, the problem of the ECU, and in particular the question of its external role, is seen in a new light; work must continue on this point.

It is, moreover, the ECU on which the Committee's studies are primarily concentrated : we know that its utilisation as a reserve asset and a means of settlement must be unrestricted, which implies the removal of the restrictions at present imposed on its acceptability. This is a major problem, and the Committee is paying particular attention to all its implications.

Linked to the acceptability of the ECU is its convertibility, and therefore the question of the liquidity of the future European Monetary Fund. In this connection, I should like to stress an equally major point : the reverberations which would be caused if the EMF were given the power of money creation. In each of our countries, this central bank power is balanced by the action of the compensating powers exercised by other authorities in conditions which, moreover, vary from country to country. A careful study has still to be made on the implications of such an undertaking at European level.

In conclusion, I should like to mention two areas in which the Committee also intends to advance its studies. These are :

- (a) the relations of the EMS with third-country currencies and in particular Community policy vis-à-vis the dollar, which has still to be defined;
- (b) the relative role to be played by the recourse to credits and the adjustment of central rates in the institutional phase; use of the adjustment (by realignment and not by the adoption of appropriate economic policies) must not be preferred to recourse to the ample means of financing available to the system, and we ought to consider the means of ensuring a balanced use of the different possibilities afforded by the system.

I do not claim, in these few remarks, to have given a full picture of the Committee's work. In the near future, I hope to be able to present you with documents in which the Monetary Committee sets out coherent and well-defined options as clearly as possible.