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./. Til underretning for Folketingets Europaudvalg fremsendes vedlagt en "interimrapport fra Det Europæiske Monetære Institut (EMI) vedrørende valutaarrangementet mellem Eurolandene og ikke deltagende lande"

Poul Nyrup Rasmussen

EUROPEAN UNION
THE COUNCIL

Brussels, 29 May 1996

7737/96

CONFIDENTIAL

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COPY OF LETTER[1]

from	:	Mr Alexandre LAMFALUSSY, President of the European Monetary Institute
dated	:	28 May 1996
to	:	Mr Carlo Azeglio CIAMPI, President of the Council of the European Union
Subject	:	Monetary and exchange rate policy cooperation between the euro area and other EU countries - Interim report by the European Monetary Institute to the European Council session in Florence on 21st/22nd June 1996

Dear President,

In accordance with the mandate given by the Madrid European Council, the EMI has studied the future monetary and exchange rate relationships between the euro area and other EU countries. I have the honour to transmit to you a copy of the letter and its enclosure which I have addressed to the President of the European Council with a view to the meeting of the European Council in Florence on 21st/22nd June 1996.

(Complimentary close).

(s) Alexandre LAMFALUSSY

Encl.

(1) This document was forwarded to the General Secretariat of the Council in English, French, German and Italian only.

ANNEX

EUROPEAN MONETARY INSTITUTE

CONFIDENTIAL
28th May 1996
Final

Monetary and exchange rate policy co-operation between the euro area and other EU countries

Interim report to the European Council session in Florence on 21st/22nd June 1996

(Copy for the ECOFIN Council session in Luxembourg on 3rd June 1996)

Introduction

In accordance with the mandate given by the Madrid European Council, the EMI has studied the future monetary and exchange rate relationships between the euro area and other EU countries. The EMI Council has reached a high level of consensus on a number of important points.

I The need for close monetary and exchange rate policy co-operation

Close policy co-ordination between the euro area and the EU countries that will not participate from the start in the euro area is a matter of common interest and is an integral part of the completion of the EMU process. In order to ensure the efficient functioning and development of the Single Market, it is especially important to avoid real exchange rate misalignments between the euro and the other currencies within the EU, as well as excessive nominal exchange rate fluctuations, which would disrupt trade flows between Member States; hence the obligation under Article 109m to treat exchange rate policy as a matter of common interest.

It should be pointed out that the lasting convergence of economic fundamentals, in particular price stability, is a prerequisite for sustainable exchange rate stability. To this end, there is agreement that in Stage Three of EMU all Member States of the EU will need to pursue disciplined and responsible monetary policies directed towards price stability. The co-ordination of monetary policies within the framework of the ECB General Council will therefore play a central role. Sound fiscal and structural policies in all Member States are, at least, equally essential for sustainable exchange rate stability. Experience has shown that in the absence of convergence of fundamentals, any attempt to co-ordinate exchange rate policies is bound to be unsuccessful. Exchange rate policy co-operation cannot be a substitute for stability-oriented domestic policies.

Experience has also shown that a nominal exchange rate arrangement may provide a reference for the conduct of sound economic policies in countries striving to converge. It may help to establish a focal point for agents' expectations about future policies, thereby enhancing the credibility of the latter. Moreover, it may provide a framework for counteracting market pressures that are not warranted in the light of the underlying fundamentals. In particular, it may assist member countries whose currencies come under pressure to combine appropriate policy responses, including interest rate measures in the country whose currency is under pressure, with co-ordinated intervention.

There is unanimous agreement among EU central banks that the final objective is convergence on macroeconomic stability which would lead to exchange rate stability against the euro, and that there needs to be flexibility in the means whereby this is achieved. However, views still diverge on the extent to which EU countries should be expected to participate in an exchange rate arrangement of the kind which is outlined below. A majority of EU central banks would expect all EU countries to become members of such an arrangement, but countries would be allowed to join at a later stage, when they have achieved a satisfactory degree of convergence. A minority thinks that such an arrangement would not assist in the pursuit of stability-oriented domestic policies in all cases, so that it would not necessarily contribute to exchange rate stability.

II Principles for exchange rate policy co-operation in Stage Three

In assessing the principles that should guide the practical forms of exchange rate policy co-operation in Stage Three, the new economic and institutional environment which is expected to prevail at that time will have to be taken carefully into account. In particular, five elements must be underlined.

First, the statutory requirement for the ECB to maintain price stability needs to be safeguarded. It would be detrimental to the credibility of EMU if obstacles were to emerge as a consequence of exchange rate oriented measures which would hinder the newly created ECB in the pursuit of its primary objective.

These considerations would also apply to the NCBs of non-participating Member States, the primary objective of which will also be to maintain price stability.

Second, the euro is expected to play the anchor role in monetary and exchange rate policy co-operation in the EU. This will be the natural consequence, first and foremost, of the stability of the euro and the fact that member countries not initially participating in the euro area are expected to put in place the conditions to enable them to participate at a later stage. In this way, a focus on the euro could be of help to non-participating countries.

Third, sufficient flexibility would need to be allowed, in particular to accommodate the varying degrees of economic convergence of the non-participating countries; not only will the situation of the latter be heterogeneous, but so too will be the pace of their progress towards full convergence.

Fourth, it should be ensured that any adjustments of central rates are conducted in a timely fashion so as to avoid significant misalignments.

Finally, as a matter of principle, continuity and equal treatment with respect to the fulfilment of the convergence criteria, including the exchange rate criterion, need to be ensured.

III Main features of an exchange rate arrangement

When examining a possible scheme for an intra-EU exchange rate arrangement for Stage Three, it is natural to take as a starting-point the ERM. In the light of the above-mentioned principles, the new arrangement should be designed along the following lines.

1. Structure

Given the respective competences and responsibilities, it seems appropriate to retain from the present ERM the two-pillar structure, based on two parallel agreements among governments and among central banks (i.e. in the latter case between the ECB and non-participating central banks). In this context, it should be recalled that, in any forum dealing with the exchange rate between the euro and other EU currencies, the euro area would have to speak with one voice.

In the light of past and present experience in the ERM, the mechanism should be characterised by relatively wide margins around central rates, while not precluding closer exchange rate co-operation with the ECB (see below).

2. Setting of central rates

Central rates should be set by mutual agreement. This might be ensured through a co-decision procedure, whereby agreement between the political authorities, the NCBs of non-participating Member States and the ECB would be achieved. In practical terms, the ECB's agreement could be secured through the ECB's participation in ministerial meetings and in the meetings of the Economic and Financial Committee,[1] - the successor to the present Monetary Committee - where it could convey its views.

3. Monitoring of the sustainability of exchange rates

The sustainability of exchange rate relations will need to be closely monitored on a permanent basis. In the Treaty, the intra-EU monetary and exchange rate policy co-ordination exercises between the euro area and the non-participating Member States are conceived as being a continuation of the present arrangements. The Economic and Financial Committee will be the body which will be involved, together with the European Commission, in the preparatory work and the implementation of the economic policy co-ordination. Furthermore, if and as long as there are Member States with a derogation, the Economic and Financial Committee will keep under review the monetary and financial situation of these Member States.[2] At the level of central banks, the ECB General Council will act as a forum for monetary and exchange rate policy co-ordination, monitor the functioning of the exchange rate arrangement and take decisions relating to the administration of the respective mechanisms.[3] While close co-operation in the conduct of these various exercises will naturally be necessary and useful, the division of responsibilities will need to respect the independence of the ECB and the NCBs.

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[1] In the present realignment procedure, when the Monetary Committee meets to conduct negotiations on exchange rates its members have a special status as personal representatives of their Ministers and Governors. Consequently, decisions reached in this ad hoc format are considered as having been taken by the Ministers and Governors and are published on their behalf. In Stage Three, a similar approach might be followed with respect to the Economic and Financial Committee's role. The ECB will be represented in the Economic and Financial Committee by (up to) two members (see Article 109c (2)).

[2] Cf. Article 109c (4).

[3] Cf. Article 44 of the ESCB/ECB Statute in combination with Article 4.1 of the EMI Statute.

While co-ordinated procedures for a regular monitoring of economic developments are indispensable, they may by themselves not prove sufficiently effective in triggering a discussion on the appropriateness of a realignment, if need be. Therefore, the ECB - as well as all the other parties involved - should have the right to initiate a confidential procedure aimed at reconsidering central rates if it feels that this is warranted and may help to avoid market unrest. Details of such a procedure, including the prior informal notification of the other parties concerned, will have to be agreed upon by all parties directly involved in it.

4. Intervention

Intervention at the wide margins should in principle be automatic. However, it must be clear that the ECB cannot be committed to supporting currencies if this entails actions that enter into conflict with its primary objective of maintaining price stability in the euro area. Therefore, the ECB would need to have the possibility to suspend intervention if it were to hinder its control over domestic monetary conditions; the same would apply to the NCBs of non-participating Member States, which will pursue the same primary objective. Although it would appear neither advisable nor possible to define formally and ex ante the specific circumstances under which the ECB might resort to such a possibility, it would be understood that due account would be taken of all relevant factors, in particular the primary objective of maintaining price stability and the credible functioning of the new exchange rate arrangement. While the ECB would base its assessment on factual evidence and, in this context, would give consideration to the conclusions reached and assessment made by other competent bodies, this would, in line with Articles 105 and 107 of the Treaty, be without prejudice to its independent assessment as to whether there is a risk to its primary objective. Details relating to the procedure for the suspension of intervention, in particular the prior notification of the other parties concerned, will have to be agreed upon by all parties directly involved in it.

The possibility would be retained for co-ordinated intra-marginal intervention on a discretionary basis, decided upon between the ECB and the respective NCB, in parallel with other appropriate policy responses by the latter. The various options and their technical and operational implications are currently being examined by the EMI.

5. Closer exchange rate co-operation with the ECB

Countries not initially participating in the euro area and with a good convergence track record would, as part of their own convergence strategy, have the possibility of further strengthening their exchange rate co-operation with the ECB. This closer co-operation can be envisaged as taking various forms, depending on specific policy objectives and the particular circumstances prevailing in Stage Three. The various options and their technical and operational implications are currently being studied by the EMI.

Concluding remarks

The basic features of a successor arrangement to the present ERM should be announced ahead of the decision on the first wave of participants in the euro area. This could help to allay incipient market fears about the future evolution of the exchange rates of non-participating EU currencies. The specification of the operational details will have to await the establishment of the ECB.

The EMI will continue its studies on the technical and operational features of the new arrangement. To this effect the EMI has instructed its Foreign Exchange Policy Sub-Committee to carry out preparatory work. The EMI Council intends to present specific proposals by September 1996.