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CONFERENCE ON THE EMS

Introductory statement

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I thought it would be a useful introduction to this policy panel if I briefly recalled the changes in the EMS mechanisms recently decided upon by the Committee of Governors of the EEC, the considerations that led the Governors to adopt them, and the underlying analytical framework.

1. Changes in the environment and their impact on EMS mechanisms

The good performance of the EMS has been due above all to the policies of its members, notably their willingness to take account of the requirements of the exchange rate constraint in setting domestic objectives.

The EMS has also benefited, however, from certain factors and circumstances whose influence on the system may be less favourable in the future. In fact:

1) Because of the DM's role as a dollar substitute in international portfolios, as long as the dollar was strong and expected to remain strong, capital flows from Europe to the US tended to depress the DM relative to the other EMS currencies, and to strengthen EMS cohesion. The opposite has occurred since the dollar started to decline: weakness in the dollar has caused strains and tended to amplify tensions generated within the EMS by actual or perceived divergencies in economic performances and policies.

2) The priority assigned to reducing inflation and external deficits was an important cohesive factor in the early years of the EMS; there is a risk that the increased importance now attributed by member countries to "real" macroeconomic performance may lead to less consensus on policy objectives.

3) While inflation differentials have narrowed to their lowest values since the late sixties, there remain significant differences between EMS countries in fiscal positions as well as in unemployment, demographic trends, and potential GDP growth.

4) The acceleration of financial integration and the removal of many of the exchange controls in France and Italy have increased capital mobility in Europe. As a result, the external constraint on domestic policies has become more stringent and the potential repercussions on exchange rates of divergent monetary conditions in EMS countries have been enhanced.

These developments have a bearing on the management of the EMS. The combination of reduced inflation differentials and increased mobility of capital means that financial factors must have recently played a major role in the determination of interest rate differentials that are appropriate from the standpoint of exchange rate stability. At the same time, the "real" cost of adjusting interest rates in the light of external objectives is potentially higher. In other words, the potential conflict between the external and domestic objectives of monetary policy may have become more acute.

The technical functioning of the EMS has not developed exactly along the lines anticipated and some of its mechanisms seem to require adaptation. In fact, contrary to expectations, interventions have mostly been intramarginal. In addition, there has been a marked increase in the use of Community currencies for such interventions, notably since the dollar started to decline. The availability of these currencies was limited, however, since such interventions did not qualify for access to the very-short-term financing facility.

2. Changes in EMS mechanisms and management techniques

The Governors have now agreed on a number of changes in EMS arrangements and mechanisms. One of their main purposes was to prevent the new conditions from loosening exchange rate cohesion and causing the EMS to degenerate into a crawling peg. The changes are thus designed to strengthen the system and enhance its ability to forestall and cope with exchange rate pressures.

It has been agreed that making fuller use of the exchange rate fluctuation band can help enhance operators' perception of the exchange rate risk inherent in taking speculative positions.

More active use of interest rates and flexible management of exchange rates within the EMS band should help reduce the need for intervention in foreign exchange markets.

Appropriate use of all the instruments available for maintaining exchange rate stability will be assessed within a strengthened procedure for joint monitoring of member countries' economic performances and policies.

While agreeing that monetary policies will have to remain geared to price stability in the medium term, this objective will be pursued flexibly in the short term, leaving greater room for exchange rate considerations in the determination of interest rate policies.

At the same time, the Governors have agreed to increase the means available within the system for combating exchange rate pressures. Specifically:

(i) there is now a presumption that when intramarginal interventions in EEC currencies are acceptable to the issuing central banks, they will also be eligible for very-short-term financing within certain limits (i.e. twice the debtor quota of the debtor central bank in the short-

term financing mechanism); the duration of financing under the VSTF has been extended by one month (to a maximum of three and a half months), and the amount that can be automatically renewed has been doubled (it will now be equal to twice the debtor quota in the short-term financing mechanism);

(ii) moreover, it has been agreed that, without altering the formal rules that govern use of the official ECU, the settlement in ECUs of outstanding claims in the VSTF will be accepted beyond 50 per cent, and up to 100 per cent, provided that this does not result in an imbalanced composition of reserves or in excessive debtor and creditor positions building up within the EMCF. After two years of experience with this arrangement the formal rules relating to the official ECU will be reviewed.

It should be noted that the increase in the acceptability of the ECU resulting from these changes is considerable. Indeed, to the extent that the VSTF is drawn upon in connection with intramarginal interventions, it will be possible to use ECUs for the settlement of the resulting debtor positions. The main obstacle previously hampering the use of the ECU -- its de facto restriction to the settlement of debts incurred for interventions at the compulsory intervention limits -- has thus been removed.

3. The philosophy underlying the Governors' decisions

It is worth stressing that:

1) The restrictions on the use of EEC currencies and the ECU for intramarginal interventions have now been greatly reduced. However, this is basically meant to increase the system's flexibility and to adapt it to changed circumstances; it is not meant to lead to systematically increased resort to EMS credit or to a build-up of net positions with the EMCF.

2) The Governors have stressed the need for improved and more

closely coordinated management of the EMS, as a way of preventing strains from developing and avoiding the need for intervention. They see the expanded scope for interventions primarily as a deterrent; there is a clear implication that greater use will have to be made of domestic monetary instruments to maintain exchange rate stability.

3) Increased availability of EEC currencies and strengthened coordination of interest rate policies seem to imply greater symmetry in burden sharing, at least in the short-term. The reaffirmation of the commitment to monetary stability in setting medium-term objectives for monetary policy is the necessary counterweight, ensuring that the expanded facilities of the system do not endanger the stability-oriented policies of strong-currency countries.

A specific safeguard has been introduced by allowing a creditor central bank whose currency has been provided through the VSTF for intramarginal intervention to ask for repayment in its own currency. In this way any monetary effects of intervention on creditor countries will be entirely offset.

4) Of course, only continued adherence by all EMS members to the objectives of low inflation and exchange rate stability can provide the ultimate safeguard. Indeed, in the medium term fuller convergence in key fundamentals is essential; it is not so much a question of mechanisms but of policy adequacy.