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Suggestions for an exchange rate arrangement with third countries

1. Background

The EMS has become an integral part of the Community's efforts to achieve EMU. As such the EMS is no longer simply an exchange rate agreement as it perhaps was at its outset in 1979. It has become an economic and monetary policy system intimately linked with other Community mechanisms. The EMS is a principal element of Stage One of EMU; the convergence efforts through the Community's multilateral surveillance process revolve largely around the disciplinary effect it produces. Its smooth functioning within the Community framework is vital for the success of Stage One and for the whole EMU process.

It is in the Community's interest to be open and to seek to spread the area of monetary stability that has been created. The 1978 Brussels Resolution foresaw the possibility of third countries' participation in the EMS exchange rate and intervention mechanism. It is necessary to explore what an arrangement of a similar nature could involve now the nature of the EMS has changed so that it is no longer appropriate for non-Community countries to join the EMS.

This note therefore outlines possible forms for an exchange rate and intervention arrangement outside the EMS, which could be offered to third countries with particularly close economic and financial ties with the Community that have expressed their interest in closer exchange rate links with the EC.

2. Characteristics of a possible exchange rate arrangement

The main question is what reference to use for the arrangement.

2.1 A bilateral grid

One option would be to offer third countries *an exchange rate arrangement based on a bilateral grid* of central rates and fluctuation margins.

Such a system could be disassociated from the ERM of the EMS by excluding any reference to the ecu; this would reinforce the fact that there would need to be different rules

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for realignments, which would not have to involve mutual accord. Third countries would not be allowed to influence EMS realignments. On the occasion of EMS realignments, this would mean adopting a two-stage realignment procedure (first ERM, then third countries). Since third countries would have no say in EMS realignments, it would be unreasonable to expect Community countries to have a veto power over their exchange rate changes (as would be the case if they were to join the EMS).

An exchange rate and intervention arrangement based on a bilateral grid could involve wider margins than 2.25%; a +/-3% margin might be appropriate. The grid would be public. Participating central banks would undertake to defend the fluctuation margins by unlimited intervention, if necessary. Interventions at the margins would normally be effected in the currencies of the central banks concerned. Very short-term financing would be arranged through bilateral facilities (either limited or not), would be settled in national currencies and would not involve the EMCF.

But some indirect links to the ERM would be unavoidable. For example, an EMS realignment would have to be reflected in a new bilateral grid for third countries. These links would also be evident by the fact that only ERM participants would be included on the Community side. Moreover the fluctuation limits with third currencies in such an arrangement would, in certain exchange rate constellations, restrict the possibility of movements of EC currencies within the ERM band. A wider band for third countries would make this less likely, but would never eliminate the possibility entirely.

One advantage of an arrangement based on a bilateral grid is that it would offer third countries a *stability anchor.* In fact, the DM would probably be perceived as the effective anchor of the system (as it is in the ERM).

Disadvantages are, however, that a bilateral grid system would risk accentuating the asymmetry of the EMS and would fail to take into account the progress from the EMS towards EMU.

2.2 An ecu-based system

A second possibility would be to offer *the ecu as the reference currency.*

Such a system would involve each participating third country having *a central rate and fluctuation band vis-à-vis the ecu.* These would be public. Participating third country central banks would undertake to defend the fluctuation margins by unlimited intervention, if necessary. Community central banks would need to make an appropriate commitment concerning exchange rate fluctuations, but this need not extend to unlimited interventions. The EMS could, for example, enter into an agreement involving, say, target zones and including the presumption of intervention. There would be no bilateral fluctuation limits for Community national currencies (except those that are indirectly implicit from participation in the ERM).

Interventions at the margins would normally be effected in ecu or in Community currencies, after agreement of the Community central bank affected, against the third currency concerned. Very short-term credit facilities in ecu would be made available to third countries through the EMCF (limited or not). This ecu lending could be shared between Community central banks according to some key (reserve contribution to the EMCF, weight in the ecu or in the STMS mechanism). Community central banks would be able to lend their national currencies (through pre-arranged bilateral "swap lines"), or encourage purchases or sales of their national currencies in intervention operations by third countries, if and when so desired (i.e. if their ERM position warranted).

Third countries would, in this system, benefit from the stability of the EMS that is imparted to the ecu and from the ecu's place at the centre of EMU. The ecu would be the anchor of the system, but the ecu is not yet as stable as the core of the EMS, due principally to the effects of sterling non-participation in the ERM.

Advantages of an ecu-based system would include the possibility of treating the Community as a bloc vis-à-vis EFTA countries as a bloc. It would encourage common decision-making on the part of the Community countries, hence reducing the asymmetry of the EMS. Also it would be a forward-looking system in that it would be consistent with the future relationship between the ecu and its component currencies in EMU.

3. Convergence and links with Community bodies

Whatever the form of exchange rate arrangement that is chosen, it is important to encourage the spread of stability-oriented economic policies to third countries. It would then be appropriate to increase informal contacts with the Community on monetary and economic matters.