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Exchange Rate Policy under EMU

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Non-participating EU currencies should be linked to the Euro through a new Exchange Rate Mechanism. The rate of the Euro against the $, etc. will be determined by action under Article 109 of the Treaty; by the European System of Central Banks' foreign exchange operations; and by international monetary cooperation.

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Introduction

Following the start of EMU Stage III, due on the 1st. January 1999, exchange-rate policy within the European Union will have three distinct elements.

1. Exchange rates between the countries participating fully in Stage III

Under Articles 109g and 109*l*(4) of the Treaty, these will have been "irrevocably fixed", both against each other and against the Single European Currency, the Euro. These rates will be legally enforceable to six significant figures.

2. Exchange rates between the currencies of the Euro area (including the Euro itself) and the currencies of other EU Member States.

In principle the currencies of the countries not initially participating fully in Stage III (the "pre-ins" or countries with a derogation) should be linked to the Euro through a new Exchange Rate Mechanism. However, two Member States - Sweden and the UK - have stated their belief that membership of this mechanism should be optional, and the Florence Summit concluded that "membership would continue to be voluntary".[1]

3. The exchange rate of the Euro against the currencies of third countries.

Under Treaty Article 109, primary responsibility for the *external* value of the Euro will lie with the Council. At the same time, the European System of Central Banks will be responsible for carrying out foreign exchange operations, either centrally through the ECB itself, or through the national Central banks operating within agreed guidelines. Other countries - notably candidate countries in Central and Eastern Europe - may also unilaterally link their own currencies to the Euro, most formally through a Currency Board.

ERM 2

The new Exchange Rate Mechanism - like the existing Mechanism - will rest upon "twin pillar" agreements between national governments on the one hand, and between Central Banks on the other. The main legal base will be a European Council Resolution.

Though membership will be voluntary, it was the conclusion of the Florence Summit that all EU countries would join once they had achieved a satisfactory degree of economic convergence.

[1] *"Conclusions of the Presidency on the European Council in Florence of 21 and 22 June 1996" (SN 300/96)*

The broad outlines of how the new ERM will operate are contained in the EMI report *"The Single Monetary Policy in Stage Three" (EMI, January 1997)*. The main features will be:

- central rates against the Euro for each participating non-Euro currency, (but no parity grid against the other currencies as in the present system);
- a standard and "relatively wide" fluctuation band around these central rates;
- rates and fluctuation band to be set by the ECB, the Ministers of the Euro area countries and the Ministers and Central Bank Governors of the non-Euro area countries, in a procedure involving the Commission and the Economic and Financial Committee[2].
- a possibility for participating non-Euro area countries to establish, on a bilateral basis, fluctuation bands narrower than the standard one (much as the Dutch florin maintains a 2.25% margin against the D-Mark in the current ERM);
- in principle, "automatic and unlimited" foreign exchange intervention and financing at the standard margins;
- possible suspension of intervention and financing, however, if they threatened price stability;
- intervention to support narrower bands for a particular currency to be negotiated bilaterally;
- possible coordinated *intramarginal* intervention to support a particular currency;
- the sustainability of each currency's central rate against the Euro to be closely monitored, so that "any adjustment of central rates is conducted in a timely fashion so as to avoid significant misalignments";
- all parties to the agreement, including the ECB, able to initiate "a strictly confidential procedure" for realigning central rates;
- the present Very Short-Term Financing facility to continue in a modified form;
- exchange-rate policy cooperation between the ECB and the Central Banks of non-Euro area countries to be strengthened.

On the basis of the European Council Resolution establishing ERM2, the operating procedures will be elaborated in an agreement between the ECB and the non-Euro area Central Banks.

[2] This will replace the existing Monetary Committee at the start of EMU Stage III.

The Euro and the currencies of third countries

The various responsibilities of Council, Commission and ESCB/ECB - and, to a very limited extent, the European Parliament - in the field of external exchange rate policy are in principle established by Article 109 of the Treaty.

1. Formal exchange-rate agreements

Article 109(1) first covers possible formal agreements on "an exchange-rate system for the ECU (i.e. Euro) in relation to non-Community currencies". The procedure would be:

- a recommendation from either the European Central Bank or the Commission;
- consultation with the ECB "in an endeavour to reach a consensus consistent with the objective of price stability";
- consultation of the European Parliament;
- a decision by Council, acting unanimously.

2. Adopting, adjusting or abandoning the Euro's central rate

Article 109(1) is also explicit on how changes in the Euro parity would be made within such a system. The procedure would be:

- a recommendation by the ECB or the Commission;
- consultation with the ECB "in an endeavour to reach a consensus consistent with the objective of price stability";
- a Council decision by qualified majority;
- the European Parliament to be informed of the change.

3. "General orientations" for exchange rate policy

In the absence of a formal agreement on exchange-rates with non-EU countries, Article 109(2) provides for the formulation of "general orientations for exchange-rate policy in relation to these currencies". The procedure would be:

- a recommendation from the Commission or the ECB;

- consultation of the ECB on a Commission recommendation;
- a Council decision by qualified majority.

The orientations would have to be "without prejudice to the primary objective of the ESCB to maintain price stability". The European Parliament would play no formal role.

4. Negotiations on monetary or foreign exchange regime matters

Possible negotiations between the European Union as a whole and one or more third countries, or international organisations, are covered by Article 109(3). The arrangements for the negotiations, and the conclusion of any agreement, would be determined as follows:

- a recommendation from the Commission;
- consultation of the ECB;
- a decision by the Council, acting by qualified majority.

The objective of the procedure would be to ensure that "the Community expresses a single position". The Commission would be "fully associated with the negotiations" (but not the Parliament).

5. Representation of the Community, and the Community position.

Finally, Article 109(4) establishes a procedure for deciding a common position for the Community at international level "as regards issues of particular relevance to economic and monetary union"; and for deciding the representation of the Community. The procedure would be:

- a proposal from the Commission;
- consultation of the ECB;
- a Council decision, by *qualified majority*, on the Community position;
- Council decision, by *unanimity*, on Community representation.

In the case of representation, the Treaty draws attention to the allocation of powers laid down in Treaty Articles 103 and 105, which gives the Council primary responsibility in the fields of *internal economic and fiscal policy*, but the ESCB and the ECB primary responsibility for *internal monetary policy.*

Community and "Euro area"

These Treaty provisions give rise to several questions.

For example, the Article defines in some detail the procedures for taking action in the field of exchange-rate policy at *Community* level. However, it is now virtually certain that not all Community Member States will form part of the Euro area in 1999; and possible that a minority will remain outside for several years afterwards. In such circumstances, the *Euro area* will not be co-terminous with the Community, and will have certain separate decision-making procedures: for example, within the field of fiscal policy (Treaty Article 104c on "excessive deficits", and the "Growth and Stability Pact").

This situation could well create problems for representation and the development of a negotiating position at international level. Article 109(5) already envisages that

> *"Member States may negotiate in international bodies and conclude international agreements";*

provided that this is

> *"without prejudice to Community competence and Community agreements as regards economic and monetary union".*

Within an overall Community framework, however, asymmetry might develop. At Central Bank level, for example, would the countries with a derogation from Stage III continue to be represented by their national Central Banks; but those countries within the Euro area by the ECB? What would be the position at governmental level?

Finally, divergences of opinion might arise between a *Community* position (on, for example, the Euro/Dollar exchange rate) and a *Euro area* position. Under the provisions of Article 109k(4), only "Member States without a derogation" are entitled to vote on arrangements under Article 109. Nevertheless, problems might arise either in the context of international negotiations at which both "in" and "out" countries were represented, or in that of other Community policies.

Foreign Exchange Operations

From the start of EMU Stage III, the ESCB will hold and manage the official foreign reserves of those EU Member States fully participating in the Euro area. Using these, it will be able to conduct foreign exchange operations, in particular exchange market intervention.

Such operations will be of two kinds:

- Centralised action, carried out by the ECB itself using foreign reserve assets transferred to it by the National Central Banks. Initially, a sum up to ECU 50,000 million, denominated in non-EU currencies and gold, will be available, with the possibility of further calls.

- Decentralised action, carried out by the National Central Banks upon instructions from the ECB.

In addition, there will be other operations carried out by the National Central Banks when, for example, they act as the fiscal agents of national governments in external debt servicing. Above a certain limit, such transactions would need ECB approval, and all would be subject to guidelines covering permissible operations, the monitoring of operations, the use of foreign exchange working balances, etc.

A number of issues are currently under examination by the European Monetary Institute, notably:

- criteria for the selection of market counterparties in the countries participating in the Euro area, and possibly other EU Member States and third countries;

- the monitoring of counterparty risk and settlement procedures;

- data exchange systems;

- the ECB's reserve asset composition;

- the allocation of monetary income within the ESCB;

- the consequences within the Euro area of transforming *foreign reserve assets* denominated in, for example, D-Marks, into assets denominated in the *domestic currency* (i.e. the Euro);

- operational objectives (e.g. risk and portfolio management, the choice of investment instruments, etc.).

Cooperation between the Euro area and other EU countries

These arrangements for foreign exchange operations, however, will only apply within the Euro area. Those EU Member States outside it might theoretically conduct quite separate policies, with adverse consequences for the stability of the Euro itself.

As the European Monetary Institute pointed out in its 1995 Annual report[3], "the *Treaty does not*

[3] *Annual Report 1995 (EMI, April 1996),* p. 59

provide a comprehensive and systematic treatment of the issue". However, the Institute draws attention to provisions which "*suggest the need for monetary and exchange rate policy cooperation between the euro area and the non-participating EU countries from the start of Stage III*".

- Under Article 109m of the Treaty, non-participating Member States are required to treat their exchange rate policy as "a matter of common interest".

- One of the qualifying criteria for eventual EMU membership is exchange-rate stability, and specifically membership of the ERM.

- The General Council of the ECB established under Article 45 of the ESCB/ECB statute (not to be confused with the *Governing* Council established under Article 106(3) of the Treaty) will include the Governors of all EU Central Banks. Among its tasks will be the monitoring and strengthening of monetary policy cooperation, and preparations "*for irrevocably fixing the exchange rates of the currencies of Member States with a derogation against the currencies, or the single currency, of the Member States without a derogation*".

- Non-participating EU Member States "can *be expected to gear their economic policies towards economic convergence, in particular towards the central objective of achieving and maintaining domestic price stability*".

Clearly, though, no Member State outside both the Euro area and the ERM can in the last resort be compelled to follow a particular exchange rate policy.

International Monetary Cooperation

A number of organisations, both formal and informal, exist at international level in the monetary field. The European Monetary Institute's 1995 Report draws attention to those with which it has itself been in contact:

- the International Monetary Fund;

- the World Bank;

- the Bank for International Settlements;

- the "concertation procedure" which provides a forum for the exchange of data on exchange market developments, intervention, etc., between EU Central Banks and those of Canada, Japan, Norway, Switzerland and the US.

In addition, discussions on monetary and exchange-rate matters take place in a number of other international bodies, in particular:

- The Organisation for Economic Cooperation and Development (OECD), the membership of which covers most developed countries; and

- the "G-7", which brings together the Heads of State or Governments, the Finance Ministers and the Central Bank Governors of the US, Japan, Germany, France, the UK, Italy and Canada.

Since the severing of the $/gold link and the collapse of the Bretton Woods system in 1971/2, however, the world's monetary system has essentially been one of market-driven, floating exchange rates. No systematic attempts have been made to fix or even to manage them.

Nevertheless, apart from the European Community's own moves towards fixed parities (for example, the 1972 European Common Margins Agreement and the 1979 European Monetary System itself), there *have* been agreements from time to time to limit exchange rate volatility, or to guide rates in a particular direction - notably that of the $. The Plaza Agreement of September 1985 (which followed a period in which the Dollar was perceived to be overvalued), and the Louvre Accord of 1987 (the primary objective of which was to stop any further decline in the Dollar) were attempts to provide a stable structure for exchange rates in a world of increasing capital mobility.

Volatility in exchange rates can be reduced in at least two ways:

- by fixing, linking or managing the exchange rates themselves; or

- by reducing the number of currencies, and hence the number of exchange rates.

EMU, once completed, will therefore be a major step towards improved world currency stability *via* the second route. It is widely predicted, indeed, that the post-EMU monetary world will in effect be tri-polar: Dollar, Euro and Yen.

Any strategy for a stable Dollar/Euro/Yen relationship will, however, require the cooperation of all parties - it will not be possible, for example, for the EU to pursue a policy of stabilising the Dollar/Euro exchange rate if the US authorities are not in agreement, nor if any agreement can be circumvented *via* other currencies.

Following the creation of a Single Currency, the desirability and achievability of such an agreement will therefore become a major political issue. As Commissioner Sir Leon Brittan has observed, "*we will need .... to think not merely in terms of European monetary conditions but of global liquidity, global activity levels and global price stability"*.[4]

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[4] *"The Imperative of World Cooperation"* in *"European Monetary Union in a Turbulent World Economy" (Association for the Monetary Union of Europe, 1991).*