'An improved "snake"', from Le Monde (9 March 1979)

Caption: On 9 March 1979, in anticipation of the entry into force of the European Monetary System (EMS) four days later, the French daily newspaper Le Monde lists the key financial measures which accompany the EMS.

Source: Le Monde. dir. de publ. Fauvet, Jacques. 09.03.1979, n° 10 608. Paris: Le Monde. "Un serpent amélioré", p. 41.

URL:
http://www.cvce.eu/obj/an_improved_snake_from_le_monde_9_march_1979-en-b0aa4b65-d098-4c77-ae05-72f3e02bfcd0.html

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An improved ‘snake’

On 5 December 1978, the European Monetary System (EMS) was approved with the aim of limiting and controlling the fluctuations of the participating currencies — those of the nine Member States except for the United Kingdom. The system was scheduled to enter into force on 1 January but was delayed because of uncertainties surrounding the sensitive issue of monetary compensatory amounts (MCAs). The compromise reached on Tuesday evening gives reason to think that the EMS will soon be up and running.

One of the new features of the system is the European Currency Unit (ECU), which is similar in some ways to the Special Drawing Rights (SDR) created by the International Monetary Fund (IMF). Like the SDRs, the value of the ECU is calculated by adding together the value of all the participating currencies, with each one being assigned a coefficient based on the size of the gross national product and the external trade of each Member State.

When the EMS becomes operational, the ‘central rates’, which are, in effect, fixed parities, will be set for each currency in relation to the ECU. These central rates will then determine the bilateral parities, or cross rates, which will, in practice, be the linchpin of the system. For example, the German mark might be fixed at 2.3 French francs. The currencies could then fluctuate in relation to each other above or below parity by as much as 2.25 %. At the outset, Italy’s currency will be allowed to fluctuate up to a maximum of 6 %.

Similar to the ‘snake’ currently in force, intervention rates — ceiling and floor rates — will therefore be fixed for all the currencies in the system. Returning to the example quoted above, if the parity between the German mark and the French franc is fixed so that 1 mark equals 2.3 francs, then the intervention rates will be 2.35175 French francs (the ceiling rate) and 2.24825 French francs (the floor rate). If the rate for the mark were to increase to 2.35175 francs, then the Banque de France would have to intervene by selling German marks and purchasing French francs. It would do so either by dipping into its foreign exchange reserves or by borrowing German marks from the Bundesbank, repayable in 45 days. At the end of that period, the Banque de France could obtain help for repayment from the European Investment Fund (see below) for a six-month period, renewable once.

A 120 000 million franc intervention fund

One important innovation is also the creation of a ‘divergence indicator’ designed to detect movements in one currency in relation to the system as a whole. Such movements, if they were to gain momentum, might destabilise the entire system. How will this divergence indicator work? It will come into play when the rate of a Member State currency fluctuates by three quarters of the maximum deviation allowed, which is around 1.7 % in relation to the group of all currencies in the system, which together make up the ECU. At that point, the authorities of the country concerned will be expected to take appropriate action (known as the ‘presumption to act’), which might consist of intervening on the foreign exchange market, requesting assistance from the European Investment Fund, making domestic monetary or economic policy adjustments, or, where necessary, amending the central rates, which is tantamount to changing the exchange rate of a currency. If no steps are taken, the Member State will be required to provide an explanation. This mechanism will act as a ‘red flag’ or ‘warning signal’, and will be subject to review every six months.

Another key feature of the system is the creation of an Intervention Fund, endowed with 25 000 million ECU, which is around 120 000 million French francs or 32 500 million dollars, divided into 14 000 million ECU for short-term (less than one year) currency support and 11 000 million ECU for medium-term financial assistance. The Fund will be financed by the transfer of 20 % of assets in gold or dollar reserves from the central banks of the Member States taking part in the EMS.