Irish White Paper on the European Monetary System (December 1978)

Source: The European Monetary System. Dublin: Stationery Office, 1978. 31 p.

URL: http://www.cvce.eu/obj/irish_white_paper_on_the_european_monetary_system_december_1978-en-0d8c67e5-3d29-4f8c-a63d-a3a3f76de59b.html

Publication date: 21/10/2012

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The European Monetary System

The Bremen European Council, 6-7 July, 1978

1. At Bremen on 6-7 July, the European Council discussed a plan, first mentioned at a private meeting of the Heads of State and Government during the course of the European Council at Copenhagen in April, 1978, to stabilise the currencies in the Community and issued the following communiqué:

"Following the discussion at Copenhagen on 7 April the European Council has discussed the attached scheme for the creation of a closer monetary co-operation (European Monetary System) leading to a zone of monetary stability in Europe, which has been introduced by members of the European Council. The European Council regards such a zone as a highly desirable objective. The European Council envisages a durable and effective scheme. It agreed to instruct the Finance Ministers at their meeting on 24 July to formulate the necessary guidelines for the competent Community bodies to elaborate by 31 October the provisions necessary for the functioning of such a scheme — if necessary by amendment. There will be concurrent studies of the action needed to be taken to strengthen the economies of the less prosperous member countries in the context of such a scheme: such measures will be essential if the zone of monetary stability is to succeed. Decisions can then be taken and commitments made at the European Council meeting on 4 and 5 December."

A copy of the outline scheme referred to in the communiqué is attached as Appendix 1 to this Paper. The reference in the communiqué to the need for concurrent studies of the measures to be taken to strengthen the economies of the less prosperous member States and the fact that such measures were essential for the success of the system was included on the proposal of the Taoiseach.

Ireland's attitude to the proposed system

2. The Government expressed its support in principle for the proposed scheme from the outset. The establishment of a stable and durable monetary system is in the interests of all members of the Community, Ireland included. The instability of exchange rates in recent years has acted, together with other forces, to reduce the growth rate of the world economy. Fluctuating exchange rates have militated against the taking of long-term investment decisions by international companies. This has affected economic growth and has exacerbated the recession and consequential unemployment arising from large increases in oil prices in 1973. Economic growth in Ireland, and hence progress in reducing unemployment, is critically dependent upon the healthy development of the Community and world economies both to create bigger markets for Irish goods and to foster a climate favourable to job-creating investment. Furthermore the discipline involved in membership of a zone of monetary stability acts as a powerful aid in the fight against inflation. Again lower inflation rates facilitate investment planning and decision taking. Finally, the creation of a successful Community-wide system, by strengthening the internal cohesion of the Community, would not alone help to reinforce existing policies but would also produce a climate within which the further development of the Community could be accelerated. Each new proposal has to be viewed not only in its own particular context; it has also to be judged on its potential to contribute to the construction of European union. While the proposed EMS might, in the short term, be regarded as an end in itself because of the benefits mentioned above, it could also be a major step towards economic convergence and eventually towards the goal of economic and monetary union.

3. However, participation in the system would also, in the absence of offsetting Community measures, have

some adverse economic effects for Ireland. These are set out in paragraphs 6 to 13 which summarise the case the Government made for resource transfers to Ireland.

Follow-up to Bremen

4. On 24 July, the Council of Economics and Finance Ministers (ECO/FIN), in accordance with the instructions of the European Council, called upon:—

(a) the EEC's Monetary Committee and the Committee of the Governors of Central Banks to examine, in co-operation with the Commission, the proposed EMS outlined in the Annex to the Bremen communiqué;

(b) the EEC's Economic Policy Committee to undertake the "concurrent studies" on action needed to be taken to strengthen the economies of the less prosperous member States within the framework of the proposed EMS.

Monetary aspects

5. Reports on the technical aspects of the EMS were furnished by the Monetary Committee and the Committee of Central Bank Governors and were discussed at the ECO/FIN Council on 18 September, 16 October and 20 November. The main issues in these discussions were:

— the method to be used to define exchange rate and intervention obligations under the new system, i.e. whether directly in terms of individual currencies as in the "parity grid" approach used in the present 'Snake', or against the "basket" of currencies comprising the European Currency Unit (ECU), or using a combination of both of these approaches;

— the role to be played generally by the ECU, and

— the credit arrangements to operate during the transitional period prior to the setting up of the proposed European Monetary Fund (EMF).

Following the ECO/FIN Council on 20 November there was general agreement on the basic features of the EMS, including the combined use of the "parity grid" and "basket" approaches in the new system and on the overall volume of credit. The main issues that were referred to the European Council were the obligations to fall on a "divergent" currency (see paragraphs 20 and 21) and the distribution of the total credit between the Community's two balance of payments credit schemes.

Case made for resource transfers to Ireland

6. The Economic Policy Committee (EPC) began its work on "concurrent studies" in August. The case made in the Committee and subsequently for resource transfers to Ireland in the EMS context can be summarised as follows. The need for Community action to strengthen the Irish economy in the context of the EMS arises from this country's level of development, low by Community standards, and the employment challenge facing it. The Irish economy is in the process of a fundamental restructuring, and added to its structural problems are the employment creation needs generated by population growth. The Government's thinking on the way it should tackle these problems has been set out in the White Paper "National Development

1977-1980" and in the Green Paper "Development for Full Employment". Ireland's determination to exert the maximum possible national effort to resolve its economic problems was stressed, and its Community partners accepted that it had made significant progress. It was pointed out that attainment of the aims of the Government's strategy could be considerably more difficult if Ireland were a full participant in the EMS, for the reasons set out below, and that this was justification for Community aid to assist Ireland's own efforts.

7. Participation in the exchange rate mechanism of the system would involve a formal obligation to hold the exchange rate for the Irish pound within narrow limits. In order to attain this, the balance of payments deficit on current account might well have to be reduced to lower levels more rapidly than envisaged in the Government's strategy. It would be completely at variance with economic and social needs in Ireland to do this by deflationary action, which would have the effect of reducing output and increasing unemployment beyond its existing level, which is high by Community standards.

8. Far from considering measures which could reduce investment, every effort should be made to increase it. This increased investment would lead, over time, to a reduction in the trade deficit, as the expansion of capacity led to an accelerated increase in exports, and the abatement of the rate of growth of some imports. Community aid would promote this medium-term adjustment process in two ways. First, it would facilitate the financing of the public capital programme on which the necessary investment is heavily dependent. Second, it would to some extent offset the effects on the balance of payments of the increased imports which would initially be induced by the necessary acceleration of investment. The fact that these increased imports would come, in large measure, from other Community countries illustrates the point that continued attainment of fast growth in Ireland in the context of full EMS participation would be in the interests of our Community partners.

9. Another consideration in Ireland's case was that, in the initial period of the operation of the EMS, the parity of its currency might be higher than it otherwise would be. This could impose severe strains on Ireland's competitiveness, leading to a possible loss of output and employment, and the necessary adjustment to the changed position would, as in any other economy, take time. Under the system as proposed Ireland could, of course, devalue, but this would be inconsistent with its basic aim of greater monetary stability. Devaluation, particularly if repeated, would call into question the credibility of Ireland's continued membership of the system. Departure from the system in such circumstances could cause Ireland major problems, and would weaken the system as a whole.

10. Ireland informed its Community partners that it was estimated that, on the assumption that all member States would participate fully in the system from its establishment, additional Community aid of the order of 200 million EUA (£130 million) a year over a five-year period would be required. They were also informed that this estimate — which was approximate — was arrived at after a detailed review of the programme of public investment aiding infrastructural and industrial development and the process of its implementation.

11. Because of the need to expand capacity and to improve the rate of growth of productivity, the Government specifically requested that Community aid should aim to support additional investment in infrastructure and industry.

12. Ireland indicated that grants were the preferred form of Community aid for the reason that it was the Government's aim to reduce the borrowing requirement as a percentage of GNP, an aim supported by the EEC Commission and in accordance with Community guidelines for Ireland. Its importance would, if anything, be greater in the context of EMS membership.

13. It was pointed out that the estimate of Ireland's requirement for Community aid was confined to the additional investment required in the immediate and narrow context of entry to the system. Ireland stressed throughout that it was not, in the context of the EMS, raising more fundamental questions, such as the budgetary structure and contributions, which had existed prior to the Bremen Summit, and would continue to exist after the establishment of the system.

Bilateral discussions

14. The report of the Economic Policy Committee was submitted to the ECO/FIN Council prior to its meeting on 20 November. During the course of the Committee's discussions it had become increasingly apparent that the Committee's report would be inconclusive on the question of resource transfers. Accordingly, between 6 and 20 November, the Tánaiste had bilateral discussions with his colleagues from all of the other member States to discuss the technical details of the EMS and, in particular, the Irish case for resource transfers. During the discussions, there was general acceptance of the principle of Community action to help Ireland to participate in the EMS. However, there was no firm commitment about the type or volume of aid which might be made available, nor was there at the ECO/FIN Council on 20 November.

15. In order to further press the need for resource transfers to Ireland, the Taoiseach in late November met the French President, the German Federal Chancellor and the British Prime Minister. Ireland's case was given a sympathetic hearing in all three capitals. The German Chancellor indicated a willingness on the part of Germany to accept that significant resource transfers to the least prosperous member States at the outset of the EMS were necessary for their successful participation in the system. It was hoped that there could be a special division in the Regional Fund from which Ireland could be paid proportionately higher grants, increases in the lending capacity of the European Investment Bank and provision in the Community Budget for payment of interest subsidies to the less prosperous member countries. It was also mentioned that Germany, in its capacity as current President of the Council, would consult with other member States to endeavour to ensure acceptance of these proposals. A draft resolution to this effect was placed before the European Council by the German Presidency — see paragraph 29 following.

The Brussels European Council, 4/5 December, 1978

16. The formal resolution of the Brussels European Council on the establishment of the EMS with effect from 1 January, 1979 and related matters, including the offer on resource transfers to the less prosperous member States, is reproduced in Appendix 2. While the new system incorporates most of the provisions of the present scheme for narrowing of exchange rate margins (the so-called 'Snake' system — in which the Benelux countries, Denmark and Germany participate, with Norway as an associate member), a number of new features have been introduced. These include the use of the European Currency Unit (ECU) as the basis of an indicator to pinpoint currencies diverging from the average trend of participating currencies, the placing of special obligations on a country whose currency has been identified as divergent, and an expansion of Community credit facilities.

The basic monetary system

17. The purpose of the EMS is to minimise the fluctuations between the exchange rates of the currencies of participating countries. Each currency will have a central rate or starting point defined in terms of the ECU. The latter will be a unit of account, made up of given quantities of all Community currencies, the amount of each currency broadly reflecting a country's share of Community GNP and of intra-Community trade. At the start of the system the ECU will be identical to the European Unit of Account (EUA), but there will be a procedure for periodic review and revision of the weights of currencies in the ECU "basket". The central rates expressed in terms of the ECU will be used to establish a grid of exchange rates between each pair of currencies in the system. Central banks will be obliged to keep their currencies within agreed margins of fluctuation of these exchange rates. The normal margins will be ± 2¼% as in the present 'Snake'. However during a transitional period the other four countries (Ireland, France, Britain and Italy) will have the option of wider margins of ± 6%. A member State which does not participate in the exchange rate mechanism at the outset may join at a later date.

Changes in central rates

18. There will be provision for a country to change its central rate (i.e. to revalue or devalue) where this no longer reflects the underlying economic circumstances. Changes in central rates will be settled by mutual agreement. They will be effected in good time so as not to unsettle the exchange markets. Any change in central rates would provide a new starting point for calculating a currency's fluctuation limits. There will be consultation with member States not participating in the EMS about exchange rate policy.

Intervention and role of ECU as divergence indicator

19. The participating central banks will have to intervene in the foreign exchange markets — by buying or selling their own currencies in exchange for other currencies — to ensure that the agreed fluctuation limits are respected. Where two currencies reach the fluctuation limits against each other (i.e. the bilateral limits for their currencies), an obligation to intervene will apply to the two central banks concerned. Intervention in the market by the central banks will mean that they will acquire balances of each other's currency. Thus, intervention will give rise to debits and credits which will have to be settled in due course between the central banks.

20. The intervention system outlined in the preceding paragraph is basically the same as that used in the present 'Snake'. The proposed use of the ECU as the basis for an "indicator of divergence" represents an important modification of the arrangements. The indicator will identify the currency that diverges most from its central rate in terms of the ECU. Where this divergence exceeds a specified limit (which would normally occur *before* the currency reached its bilateral intervention limit against another currency) it will result in a *presumption* that the authorities of the country concerned should take adequate corrective action. Such action can be in the form of intervention in the exchange markets, monetary policy measures, changes in central rates or other measures of economic policy. If, because of special circumstances, the country concerned took no action, the reason for this would have to be given to the other countries and, if necessary, special consultations could take place.

21. It is hoped that the use of the ECU as an "indicator of divergence" will result in a fairer balance in the obligations falling on the weaker and the stronger currencies than under the present 'Snake' arrangement. That arrangement obliges the weaker currency country and the stronger currency country to intervene simultaneously. The obligation can bear more heavily on the former country, since it would be losing reserves and could well be obliged to take measures to deflate its economy. In the EMS, the divergence indicator will pinpoint the country whose currency is placing the strain on the system and that country alone will at that point be required to take action — and at an earlier stage than under the basic 'Snake' arrangement. For example, if the appreciation of a strong currency were the source of the problem, the country concerned would normally be expected to intervene in the exchange markets to buy other Community currencies or to take other action (e.g. measures to stimulate its economy or, if necessary, a revaluation of its currency to correct the position).

European Monetary Fund

22. The European Council has confirmed that, not later than two years after the start of the new system, a new institution, the European Monetary Fund (EMF), will be established. The EMF will replace the present European Monetary Co-operation Fund (EMCF) which, in the interim, will continue to manage the settlements arising out of foreign exchange interventions by the central banks. In the interim period also, the ECU will be developed as a reserve asset and as a means of settlement between central banks.

23. Pending the setting up of the EMF, an initial supply of ECUs will be created and the proposed expansion of credit will be based on the Community's existing schemes. The arrangements that will apply during this transitional period are described further in the following paragraphs.

Deposits of reserves

24. Each participating central bank will deposit 20 per cent of its gold and 20 per cent of its dollar reserves with the EMCF. In return it will receive a supply of ECUs which may be used in settlements between central banks. A member State not participating in the exchange rate mechanism may participate in this deposit arrangement.

Credit arrangements

25. From the start of the new system an amount equivalent to 25 billion ECU (£17 billion approximately) will be available in credit under the Community balance of payments schemes. This figure refers to the amount of credit effectively available to debtors, i.e. taking account of the fact that debtors do not themselves have to provide credit. It has been decided to distribute the amount as follows:

14 billion ECU will be available under the short-term facility. This is an inter-central bank arrangement under which countries may draw credit to cover temporary balance of payments difficulties. The duration of the credit will be increased to a maximum of 9 months (6 months at present). Only those member States that participate in the exchange rate arrangements will be involved in the financing or use of the increase in credit under this facility. Other member States will continue to take part in this facility up to the present ceiling (i.e. about 5.8 billion ECU in effective credit);

11 billion ECU will be provided under the Community medium-term scheme. This is an inter-governmental facility which provides balance of payments assistance for periods of 2 to 5 years, subject to compliance with economic policy conditions. All member States may participate in the increased credit under this scheme.

In some countries parliamentary authorisation will be required for an increase in the medium-term scheme. Pending the completion of formalities in such cases, the increased amount of medium-term credit will be made available by an interim financing agreement of the central banks concerned. No additional legislation would be required by Ireland in respect of the medium-term scheme.

26. As in the present 'Snake' arrangement, central banks will provide very short-term credit facilities to each other for the purposes of financing interventions. The amount of such credit will be unlimited, but in the normal course it will have to be repaid within 45 days (30 days at present) from the end of the month in which credit is obtained.

Associate members

27. Other European countries with particularly close economic and financial ties with the Community may participate in the EMS exchange rate and intervention arrangements. Associate members would not have access to the Community credit facilities.

Community legislation

28. The European Council has requested the Council of Ministers to take decisions at its meeting on 18 December, 1978 on legislative proposals related to the introduction of the EMS.

The European Council and resource transfers

29. The European Council discussed resource transfers to the less prosperous member States on the basis of a document presented by the German Presidency. That document suggested that resource transfers might take the form of both (a) additional loans for a 3-year period with an interest subsidy of 3 per cent, the interest subsidy allocation being divided as to 60 per cent for Italy, 20 per cent for the United Kingdom and 20 per cent for Ireland, and (b) grants through a special section of the European Regional Development Fund for a period of 3 years allocated as to 50 per cent for Italy, 30 per cent for Ireland and 20 per cent for the United Kingdom.

30. There was no agreement to an increase in the Regional Fund as a means of resource transfers. Despite strong pressure by a number of delegations, the principle of grants either through the Regional Fund or through a special new heading in the Budget was not acceptable to all members.

31. An increase in the lending capacity of the European Investment Bank and the new financial instrument (Ortoli facility), amounting to 2,000 million EUA per year for three years by way of loans for the less prosperous member States, was suggested by the Presidency of which 20 per cent would be available to Ireland. Following discussions it was decided that a total of 1,000 million EUA per year for five years would be made available to less prosperous member countries by way of loans. The Council requested the Commission to submit a proposal to provide interest rate subsidies of 3 per cent for these loans, subject to an annual limit of 200 million EUA and an overall limit of 1,000 million EUA for a period of 5 years. It was agreed by the Council that Ireland, if participating fully and effectively in the system, would receive one third of the subsidy. Member States not participating effectively and fully in the EMS would neither benefit from nor be required to contribute to the financing of the scheme.

32. The funds provided under the scheme would be concentrated on the financing of selected infrastructure projects and programmes, on the understanding that any direct or indirect distortion of the competitive position of specific industries within member States would have to be avoided.

33. The European Council requested the ECO/FIN Council to take a decision on these proposals so that the relevant measures could become effective on 1 April, 1979 at the latest. There would be a review of the measures at the end of the initial phase of the EMS.

34. The full details of the scheme are not included in the resolution. However, they would provide for a 15-year loan term, with a moratorium on principal repayments of 3 or 5 years. The present capitalised value of a 3 per cent interest subsidy for a 15-year loan with a 3-year moratorium on capital repayments is equivalent to 19.4 per cent of the amount of the loan. This assumes that the principal is repaid by a fixed annuity from the 4th to the 15th year of the life of the loan. A discount rate of 9 per cent is used to calculate the present value of the interest for future years. The corresponding capitalised value of the subsidy where the moratorium is for 5 years is 20.1 per cent.

35. The loans would be subject to the conditions that the borrowing country would have to provide part of the overall cost of projects or programmes and would be limited to infrastructure development. While the operating criteria for the Ortoli facility have not yet been finally agreed, indications are that the facility may be combined with EIB financing to reduce the borrowing country's own contribution significantly below normal levels. The interest subsidies constitute a real transfer of resources. The amount of interest subsidies available to Ireland under the offer would be 67 million EUA (£45 million) per year for 5 years — a total of about £225 million. It is expected that the subsidies would be payable in a lump sum when the loan was drawn The subsidies would represent borrowing by Ireland of a total of 333 million EUA (£225 million) each year over the 5-year period from the EIB and the Ortoli facility.

36. At the European Council, the United Kingdom indicated that it would not be joining the system for the present. Italy was unable to agree to membership of the system at the Council because of the disparity between the resource transfers requested and those offered. However, the Italian Prime Minister stated that the matter could be considered further and a decision would be conveyed within a week or so.

37. The fact that the United Kingdom has decided not to join the EMS for the present means that any

decision by Ireland should take account of the implications for the relationship between the Irish pound and the pound sterling. If Ireland remains outside the EMS, existing financial arrangements can continue. Irish membership would call for the introduction of exchange controls on capital movements between Ireland and the United Kingdom similar to those which both countries operate at present with the other EEC member States. Membership might not, however, in practice involve a divergence from one-for-one parity with sterling for some time at least, depending on the degree of success of the policy of he United Kingdom Government with regard to maintaining the exchange rate stability of sterling, and particularly to the extent that this is reflected in stability *vis-à-vis* EMS currencies. It should be noted that even within the EMS Ireland could, if it so chooses, opt for the 6 per cent fluctuation margin available to countries with presently floating currencies. These factors could enable the Irish pound to retain parity with sterling over a range of exchange rate movements. Any decision to avail of the option of a wider fluctuation margin could be made in the light of the resource transfers or other facilities that would be available to Ireland in the event of membership.

Conclusion

38. The Government are satisfied that there are no inherent drawbacks in the European Monetary System, as settled by the Brussels Council, that would preclude Ireland's membership provided agreement could be reached on the transfer of adequate resources to Ireland. The Government will keep the issue under continuing review and will maintain a flexible attitude as regards possible participation in the scheme in the light of developments.