

PRELIMINARY REPORT
BY THE CHAIRMAN OF THE COMMITTEE OF GOVERNORS
ON THE STRENGTHENING OF THE OPERATING MECHANISMS OF THE EMS

Since the ECOFIN Council meeting of 9th February 1987, the Committee of Governors has begun consideration of the issues raised by the last realignment of EMS central rates and of the monetary policy implications of the liberalisation of capital movements within the Community.

A. ISSUES RAISED BY THE LAST REALIGNMENT

The Governors are of the view that, in evaluating the last realignment, account should be taken of the fact that it was largely determined by factors unrelated to economic fundamentals. They also noted that there had been an excessive dramatisation of the event before and during the realignment negotiations.

1. Realignment procedure

The Governors consider that the existing realignment procedure is, in itself, broadly satisfactory and that it provides the flexibility necessary to de-dramatise realignments. Some of the problems experienced in January could be avoided by stricter discipline over public statements and discussions.

The Governors discussed the possibility of entrusting the conduct of "small" realignments to a technical committee: in their view such an approach does not seem to offer any real advantage. Indeed, while recognising that it might allow more timely decisions, thereby limiting the size of capital movements, the Governors consider that such a move would raise a number of problems. In particular:

- (i) it would be difficult to identify the type of realignment to be made subject to such a procedure;
- (ii) there would be a risk of giving the market the impression that small realignments are of minor importance;
- (iii) there would be complications with regard to the agri-monetary implications of these realignment decisions.

The Governors also stressed that all realignments should normally be accompanied by supportive economic policy measures to strengthen convergence.

2. Functioning of the operating mechanisms of the EMS

Turning to an evaluation of the developments that led to last January's realignment, a number of reasons led the market to re-assess the sustainability of intra-EMS exchange rate relationships after the comprehensive adjustment of central rates of April 1986, despite improved convergence. The weakness of the US dollar had been a major influence in this regard. The impact of external factors was reinforced by political and economic developments in individual EMS countries as well as by some remaining disparities in their economic policies and performances, in a context of progressive liberalisation of capital movements and increasing sophistication of market participants. Markets also had a perception that there was a lack of co-ordination by EEC member states in approaching the emerging tensions. These various factors gave rise to heavy capital movements in the period running up to the January realignment.

The Governors agree on the necessity for continued progress towards convergence of economic fundamentals. They stress that the strains that might stem from increased capital mobility should normally be dealt with without resorting to realignments. They recognise that interventions alone cannot be sufficient to counter exchange rate pressures, and that they should be accompanied by measures to make speculation more costly and risky.

To achieve these objectives, various issues are being examined by the Governors. In particular:

- (i) how to bring about a more flexible use of all instruments available for defending the system's cohesion in the short term, i.e. more

- timely adjustments of interest rate differentials; wider use of existing exchange rate margins within the band; and closer co-operation in conducting interventions;
- (ii) how to strengthen the monitoring and joint evaluation of short-term developments in the system, with a view to agreeing on prompter and more closely co-ordinated action;
 - (iii) how to achieve greater co-ordination of exchange rate policies of the EMS countries vis-à-vis the United States and Japan.

B. MONETARY POLICY IMPLICATIONS OF LIBERALISATION

The Committee of Governors has also started to look into the broader implications of global liberalisation of capital movements for monetary policy and exchange rate management. The process of integration of EEC capital markets is already under way, although the points of departure for this process differ from country to country. The Governors reiterate their support for the programme of liberalisation; they stress that while liberalisation will not change the nature of the difficulties of managing the system, it will reinforce the external constraint in exchange and interest rate management.

Liberalisation increases financial interdependence and potentially enlarges short-term capital movements. This may have the effect of reducing the autonomy of national monetary policies. In principle, it is not possible to combine complete freedom of capital movements and fixed exchange rates with autonomous national monetary policies. However, this problem may be rendered somewhat less acute insofar as it is possible to maintain and, where necessary, further increase the degree of convergence hitherto achieved in economic performance and in the stance of economic policy.

There are also a number of technical problems that need to be examined in this context, relating notably to the effects of liberalisation on:

- (i) the identification of monetary targets and the management and transmission mechanism of monetary policy;
- (ii) the harmonisation of regulations affecting financial markets (e.g. prudential controls, tax treatment of financial assets).

Beyond these technical problems, the liberalisation process will require closer co-ordination of monetary policies. Otherwise, there is the risk that larger capital movements might entail strains and possibly force a relaxation of the exchange rate mechanism to cope with market pressures.

Strengthened monetary co-ordination must be placed in the context of the aims of achieving a maximum degree of domestic price stability and of extending the exchange rate mechanism of the EMS to the other EEC members. Such co-ordination, however, will be ultimately ineffectual if not supported by greater convergence of overall economic developments and policies (especially fiscal policies) in member states and by enhanced efforts to reduce structural disparities.

The Committee of Governors will also examine whether the existing financing mechanisms are adequate to forestall speculation and to meet the likely needs of the system in the new environment of free capital movements.

In conclusion, the Governors underline that their examination of the functioning of the EMS and of the implications of liberalisation is at a preliminary stage. They will keep these issues under active consideration in the coming months, with a view to strengthening the system.