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NOTE

Subject: Alternative numeraires for exchange rate guidelines

1. In setting exchange rate guidelines (or "target zones") for a currency it is necessary that the guidelines should be defined in relation to some specific point of reference or intervention numeraire.
2. This numeraire can be another currency - for example the dollar or the deutschmark. But in a world of floating rates there is a danger that the numeraire currency may prove highly unstable thereby causing instability for any other currency that is linked to it. This can be avoided by choosing, as the numeraire, an index based on the movement of a representative "basket" of currencies and managing the exchange rate in such a way that, compared to the base level, the weighted average movement against all the currencies in the basket is equal to zero or, if it is desired to introduce an element of flexibility into the system, that it does not exceed certain limits - say $\pm x \%$.
3. In the discussions that are at present taking place in the Community on the subject of exchange rate guidelines three different types of basket are under consideration as possible intervention numeraires, namely:
 - indices of effective exchange rate change
 - the European Unit of Account
 - a dollar/deutschmark basket as proposed by M. Van Ypersele.

The respective advantages and disadvantages of each of these alternative numeraires are considered in the following paragraphs.

4. An index of effective exchange rate change is the option favoured by the Services of the Commission. The way in which an effective exchange rate index is calculated is described in the accompanying note (Cal-

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ulation of effective, or trade-weighted exchange rate changes) and the way in which it might be used as numeraire for an exchange rate guideline regime is described in Annex II to the note "Recherche d'une plus grande stabilité dans les rapports de change entre les monnaies des états membres de la CEE (II/267/78). The essential features of the regime proposed by the services of the Commission are set forth in Part II A of that note, a copy of which is attached for ease of reference.

5. The main advantage of using an index of effective exchange rate change as the numeraire is that such an index provides the best single indicator of exchange rate stability, or instability, vis-à-vis the whole outside world, because the "basket" on which it is based includes all the major currencies, as opposed to just some of them, with weights which accurately reflect the importance of each of these currencies to the country for which guidelines are under consideration. This is an important advantage, if we are thinking of the contribution which greater exchange rate stability can make towards reducing inflation in member countries or avoiding excessive swings in competitiveness, because in this context it is stability vis-à-vis all major currencies, rather than vis-à-vis other Community currencies only, that is relevant.

6. A key feature of the proposals advanced by the services of the Commission is that not only the three independently floating currencies (franc, sterling, lira), but also the deutschmark, would be required to observe exchange rate guidelines based on indices of effective exchange rate change. This requirement would tend to limit exchange rate variation between the deutschmark and non-Community currencies (which, taken together have a substantial weight in the deutschmark's effective exchange rate basket), whereas under the alternative arrangements reviewed here (EUA and "Van Ypersele" type numeraires) the deutschmark would be allowed to float quite freely against all outside currencies.

7. The main disadvantage of an effective exchange rate index as an intervention numeraire is that the concept itself is somewhat abstruse and difficult for the layman to apprehend.

8. The EUA basket differs from the baskets on the basis of which effective exchange rate changes are calculated in that, firstly, it includes only Community currencies, and secondly, the weights assigned to each currency are uniform, whereas in an effective exchange rate basket they vary, according to the importance of the country concerned as a trading partner and competitor to the country for which the effective exchange rate index is calculated (e.g. Germany has a larger weight in France's effective exchange rate basket than in the UK's basket, because it is a more important trading partner to France than to the UK).

9. The main advantage of the EUA is that it has a more distinct identity than an index of effective exchange rate change. It can also be argued that the development of the EUA as a Community reserve asset and, in due course, as a European parallel currency would be facilitated if it was established as a numeraire, although it should be borne in mind that the two former functions are quite distinct from the latter and that it would be perfectly possible for the EUA to develop as a reserve asset and currency without ever being used as an intervention numeraire.

10. The main disadvantage of the EUA is that it consists only of Community currencies and does not therefore provide a good measure of stability against all major currencies.

11. The basket proposed by the Belgian authorities and which is generally associated with the name of M. Van Ypersele, since he was the first to advocate its use, in a recent article in "Tendances", is intended for application only by the countries with independently floating currencies. It is a very simple basket, with only two components, the dollar and the deutschmark, each with a weight of 50 %*. Thus, if the deutschmark were to appreciate against the dollar by 10 %, compared with the base period, a country which was aiming at stability of its currency vis-à-vis the basket would have to manage its exchange rate in such a way as to depreciate against the deutschmark by 5 % and appreciate against the dollar by 5 %. It is envisaged that over a period of time the weight of the deutschmark in the basket would be gradually increased to 100 %. When that point was reached

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* In subsequent variations on his initial proposal M. Van Ypersele has suggested that the weights could initially vary from one country to another, depending upon the relative importance of trade with the dollar and deutschmark areas.

the currencies operating the regime would in effect be pegged to the deutschmark and could then formally rejoin the snake.

12. The main advantages of the Belgian proposals are, firstly, that they are conceptually simple and, secondly that they provide explicitly, via the technique of progressively increasing the weight of the deutschmark, for a "rapprochement" between the independently floating Community currencies and the snake.

13. Their main disadvantage is that they provide no solution to the problem of instability between the deutschmark and currencies outside the Community, principally the dollar. They do admittedly contain a recommendation that the German authorities should pursue a "more active exchange rate policy" vis-à-vis the dollar, but it is not altogether clear what this rather vague phrase means, still less what would happen if there was disagreement within the Community concerning the appropriate level of the dollar-deutschmark exchange rate. This is a serious weakness, since if the franc, sterling and the lira are going to be pegged to the deutschmark or rejoin the snake they will want to have some say in determining the exchange rate between the snake/deutschmark on the one hand and the dollar on the other. The Commission proposals for target zones based on effective exchange rate indices represent an improvement in this respect, since the target zone for the deutschmark would be fixed in consultation with other member countries and the need to keep within it would place some limits on Germany's freedom of exchange rate movement vis-à-vis outside currencies. But Germany would still be free to adjust its target zone up (or down) if it wished to do so.