Subject: The choice of a numeraire for the European Monetary System

1. Although the official communique issued after the meeting of the
   European Council at Bremen is not entirely explicit on this point, it
   appears that the choice for the numeraire fonction of the ECU (1) has now
   been reduced to two options, namely:

   a) a "parity grid" of the kind currently applied in the snake(2),
   b) a "basket of currencies' definition" to be equivalent in its composition
      and weighting to the Europen Unit of Account (EUA).

2. There is some presentational advantage in having the same unit performing
   both the role of numeraire and that of main reserve and settlement instrument
   in the system.

3. The advantages of the basket of currencies' approach as compared with a
   parity grid may be briefly summarized as follows

   i) in principle, for any given width of margins, a "basket-type" numeraire
      offers rather more flexibility than a parity grid with uniform margins
      of permissible fluctuation against all other participating currencies.
      With margins of x % against the basket it is possible for one member
      currency to move by more than 2 times /x % against another, provided that this
      movement is offset, at least to some extent, by movements in the opposite
      direction against other currencies, without the intervention limits
      against the basket being breached. However, if the basket contains only
      a small number of currencies, as the EUA does, and if half of those
      currencies maintain narrow bilateral margins between themselves and
      therefore tend to move up and down together, as the snake currencies
      do in the EUA, the additional flexibility as compared with a straight-
      forward snake-type parity grid system is not very significant;

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(1) "The European Currency Unit (ECU) will be at the centre of the system,..."

(2) It would be possible, but not necessary, to retain the European Monetary
    Unit of Account (EMUA) as the numeraire of the system. All that is necessary
    with a snake-type regime is that each participating central bank should
    declare mutually consistent reference rates, with upper and lower inter-
    vention limits, between its own currency and those of all the other
    participants.

ii) a regime with the EUA as numeraire might be a little <u>less vulnerable</u> <u>to speculation</u>, since, although market operators would know <u>when</u> a particular currency had reached its upper or lower intervention limit, they would not know for certain <u>in which currency</u> the central bank concerned would intervene. Speculation would thus be <u>very slightly</u> <u>riskier</u> than under a snake-type regime.

4. The main <u>disadvantages of the "basket" approach</u> as compared with a parity grid appear to be that:

i) it would be unacceptable to have as <u>numeraire</u> of the system a unit whose value could be <u>affected by</u> the behaviour of <u>a currency</u> or currencies which were <u>not participating in the system.</u> Since it is not yet certain that all the countries whose currencies are included in the EUA would join in the system from the start, or that they would stay in it if they did join it, this could pose very awkward practical problems. It would mean, presumably, that <u>if a country did decide to withdraw from the system</u>, it would be <u>necessary to create a new unit</u> to serve as numeraire for those remaining in the system. This problem would not arise with a parity grid system.

An invers problem appears for an associated non EC currency to the EMS which is not included in the basket and which therefore cannot influence the baske but only its relations to member currencies.

ii) with a basket-type numeraire one currency may <u>reach its upper-lower</u> <u>intervention limit</u> against the basket <u>without any</u> of the other partici-pating <u>currencies reaching their lower:upper intervention limits.</u> This has two consequences:

- firstly, that the <u>"burden" of intervention</u> falls, or at least may fall, <u>on one central bank</u> alone, whereas under a parity grid system at least two central banks must be involved in intervention at the margins, one as seller of its own currency and the other as buyer. The latter system is considered, at least by some member countries, to be more equitable;

- secondly, that the <u>choice of the currency</u> in which to intervene is <u>not</u> <u>determined automatically</u>, as it is under a parity grid system. Instead the foreign exchange dealer of the central bank in question would have to use his discretion in the matter and would have to consult in advance with the other central bank or central banks whose currencies he wished to use. This kind of procedure does not appeal to central bank foreign exchange dealers who often have to react very quickly to market deve-lopments.

Another problem consists in the definition of the basket when enlarging the Community to further members. Each change in the definition of the basket represents the application of a new UA and interrupts statistical series in terms of a given numeraire;

iii) <u>the permissible margin of bilateral fluctuation</u> between participating currencies would <u>not be identical for all of them</u>. The larger the weight of a currency in the basket, the more it can fluctuate against the other participants without breaching its intervention limits against the EUA. Thus it can be claimed that a system of this kind confers a "priveleged" position on the larger as compared to the smaller participating countries

5. Concerning the relation between the numeraire of the new European Monetary System (EMS) and those of the international monetary system, the following approaches can be considered as principal options:

   a) "basket of currencies approach" or effective rate system:
      1) 1 ECU = 1 EUA (on daily rates)
             = 1 SDR (basket) 1.7.1974
             = 1,20635 USD (1973/74)

      In this case the ECU is defined by means of a basket of fixed amounts of currencies composing the European Unit of Account (EUA) and valued on the basis of daily market rates in terms of any currency.

   b) "parity grid approach" or nominal rate system:
      2) 1 ECU = 1 EUA (conversion rates frozen on a specific day in terms of each currency)
             = x SDR (date of reference)
             = y USD (date of reference)

      In this case the ECU is defined by means of a basket of fixed amounts of currencies composing the EUA and valued on the basis of the central rates applied for each of them in the new European Monetary System (EMS

      3) 1 ECU = 1 EMUA (based on central rates actually applied in the European Monetary Cooperation Fund)
             = 1 SDR (numeraire)
             = 1 USD (until 1971)

      In this case the ECU is defined by means of the applied central rate (or parity) of each participating currency in the EMS.