Operational features of the new European exchange-rate mechanism

On January 1, 1999, at the start of Stage Three of European economic and monetary union (EMU), the currencies of eleven EU member states will merge into the euro, forming a common and independent currency where previously those eleven currencies had been linked by the exchange-rate mechanism (ERM) of the European Monetary System (EMS). On that date, the euro will supersede the European Currency Unit (ECU), which was defined in principle as a basket currency, in the ratio of 1:1, as provided in the EC Treaty; at the same time, the present EMS will cease to exist. However, in order to foster the convergence process in the member states that are not yet participating in the single monetary policy, and to strengthen and underpin the single market, the member states which are not introducing the euro from the outset (four countries at present) are being given an opportunity to prepare themselves for full integration into the euro area by linking their currencies to the euro in the context of a new, modified exchange-rate mechanism. The present article provides an overview of the structural and operational features of this new exchange-rate mechanism, known as "ERM II" for short.

Legal basis

In legal terms, the new exchange-rate mechanism rests on two pillars. The first is the

Resolution of the European Council and Central Bank Agreement form the legal basis of the new exchange-rate mechanism

"Resolution of the European Council on the establishment of an exchange-rate mechanism in the third stage of economic and monetary union" of June 1997, which defines the principles and objectives of the system and its main structural features. Secondly, the decision-making bodies of the European Central Bank (ECB) – the Governing Council and the General Council – agreed on September 1, 1998 on the text of an agreement between the ECB and the central banks of the EU member states outside the euro area which specifies the operating procedures of ERM II. Subsequently, that agreement was signed by the relevant parties, i.e. by the ECB President and the Governors of the central banks of the four non-euro-area member states.

Objectives

Even after the introduction of the euro, cooperation in the field of exchange-rate policy will remain in the interests of all EU member states

The introduction of the euro in eleven of the fifteen EU member states will give rise to a fundamentally new situation for European monetary policy. The vast majority of the member states will transfer their monetary-policy sovereignty to the European Central Bank, while Denmark, Greece, Sweden and the United Kingdom will continue to pursue autonomous monetary and foreign exchange policies for the time being. Even so, Article 109m of the EC Treaty requires those member states to treat their exchange-rate policy as a matter of common interest.

Linking the currencies of the member states which are not participating in the euro area from the outset (the "pre-ins") to the euro will give those countries a strong incentive to pursue stability-oriented economic and monetary policies. That is particularly important for those EU member states which are seeking to join the euro area in the foreseeable future but which have not yet reached the degree of economic convergence required by the EC Treaty. Equally, the new reference system is likely lastingly to counteract possible speculative exchange-rate fluctuations that are unwarranted, given the economic fundamentals. Thus, foreign exchange market turmoil within the Union – such as has often occurred in the past, been associated with significant misalignments, and hampered the proper functioning of the single market – can be largely avoided.

New exchange-rate mechanism creates incentives for convergence and fosters exchange-rate stability between the participating currencies

Principles

Participation in the exchange-rate mechanism is in principle voluntary, but is a prerequisite for introducing the euro at a later stage

In much the same way as in the present EMS, "pre-ins" are in principle free to actively participate in the new exchange-rate mechanism. Countries which do not participate from the outset can do so at a later stage. However, the European Council has drawn attention to the fact that member states with a derogation will be expected to join ERM II. Participation is compulsory for those EU member states which are seeking to introduce the euro in the foreseeable future, since the convergence criterion spelled out in Article 109j of the EC Treaty requires their participation in the exchange-rate mechanism for at least two years without devaluation and within the "normal" fluctuation margins. Some member states dispute this interpretation of the Treaty, arguing that this provision

has been nullified by the widening of the EMS fluctuation band from ± 2 ¼ % to ± 15 % in August 1993. However, a strict interpretation and uniform application of the convergence criteria of the Maastricht Treaty in all EU member states, irrespective of the date of their entry into the euro area, should not be dispensed with, if only on grounds of equal treatment.

Participation of Denmark and Greece in ERM II from January 1, 1999 already agreed

At their request, Denmark and Greece will participate in the new exchange-rate mechanism from January 1, 1999. This was the outcome of an informal agreement between the ministers of the euro-area member states, the ECB and the ministers and central bank governors of Denmark and Greece, involving the European Commission and after consulting the Monetary Committee, in September 1998. The Greek drachma will participate in ERM II with a fluctuation band of ± 15 % around its central rate against the euro, while a fluctuation band of ± 2 ¼ % has been envisaged for Denmark.

Inherent flexibility of the system in the areas of intervention and central rate adjustment is consistent with the objective of price stability and takes due account of the different national states of convergence

Against the background of the experience gained with the existing EMS, the new exchange-rate mechanism was designed to be more flexible in a number of areas. The underlying motive here was that the objective of maintaining price stability, which will be given priority by the ECB and the national central banks, must in no circumstances be jeopardised. Thus, the generally automatic and quantitatively unlimited obligation to intervene in support of exchange rates, once the limits of the fluctuation bands have been reached, may be suspended if there is a risk of conflict with the ESCB's primary objective. In addition, all the parties involved in central rate decisions, including the ECB, have the right to initiate a confidential procedure aimed at reconsidering central rates, in order that necessary adjustments can be carried out in good time. Furthermore, it is now possible for different degrees of progress in convergence on the part of the "pre-ins" to be taken into consideration. There is a fixed procedure enabling member states whose economic performance has converged very closely with that of the euro-area member states to agree with the ECB on fluctuation bands for their currencies that are narrower than the standard bands envisaged in the Central Bank Agreement.

Structural features: central rates and fluctuation bands

The euro as a reference currency for fixing the central and intervention rates; standard fluctuation band of ± 15 %

Unlike the situation in the existing EMS, which provides for reciprocal central and intervention rates in the form of a parity grid for all the participating currencies (although the D-Mark has often been assigned the function of an anchor currency), in the new exchange-rate mechanism, the euro has expressly been given the role of the anchor currency. Central and intervention rates are all defined in terms of the euro. Hence, the new system is sometimes likened to a "hub and spokes approach". Around the central rate of the currency of every "pre-in" country vis-à-vis the euro, a ± 15 % standard band for exchange-rate fluctuations is fixed. In the case of the standard fluctuation band, the intervention rates are determined by simply adding the 15 % margin to or subtracting it

from the bilateral central rates, and subsequently rounding the result to six significant digits. The central and marginal rates are quoted as the countervalue of one euro and are announced in the markets.

Greater transparency by dispensing with the calculation of inverse rates

However, the definition and announcement of the respective inverse rates, i.e. in relation to a fixed amount of the "pre-in" currency, are dispensed with. This restriction to what is termed "indirect quotation" simplifies the system relative to the existing EMS and avoids possible rounding differences between the original rates and the inverse rates. For future participants, a further implication of the new system is that the assessment of their currencies' exchange-rate stability within ERM II depends only on the relation to the euro. Under the old system, a currency's exchange-rate stability was assessed by reference to what was termed a "divergence indicator", which was based on the deviation of the ECU market rates from the ECU central rates, and therefore incorporated weighted deviations from all other participants in the system.

ECB participates in all decisions on central rates and the standard fluctuation band

According to the Resolution of the European Council, decisions on central rates and the standard fluctuation band are taken by mutual agreement between the ministers of the euro-area member states, the ECB and the ministers and central bank governors of the "pre-in" member states participating in the new exchange-rate system, as part of a joint procedure involving the European Commission (without voting rights) and after consultation of the future Economic and Financial Committee. The ministers and central bank governors of the "pre-in" member states not participating in the exchange-rate mechanism will take part in the procedure but will not have voting rights.

Narrower fluctuation bands may be agreed

A similar procedure to that described above will be applied if a "pre-in" country applies for the formal fixing of bands which are narrower than the usual standard band. This option of a closer linking to the euro primarily serves to demonstrate to the markets the sustainability of the progress already achieved in convergence and a country's willingness to defend the central rates within the narrower fluctuation bands. Informal bilateral agreements between the ECB and a "pre-in" central bank on a closer exchange rate linkage are also possible, but they are likely not to be made public.

Interventions and central rate adjustments

Interventions are automatic when the marginal rates are reached, but are only meant to be supporting measures

As a matter of principle, the central banks concerned will automatically intervene when the upper or lower intervention points are reached. In the euro area, such operations will normally be carried out by the central banks of the "ins", acting on behalf of the ECB. In each individual case, the initiative for such support measures, which are generally unlimited in amount, proceeds from the market participants, who offer their central bank, at which they are required to maintain an account, the weak currency at the marginal rate, or seek to buy the strong currency at the intervention rate. However, the notion underlying the Resolution of the European Council and the Central Bank Agreement makes it

clear that foreign-exchange-market interventions to defend central rates are only designed to bolster other policy measures. A stability-oriented monetary and fiscal policy must be at the heart of any central rate stabilisation. In particular, the interest-rate instrument should be employed flexibly in this context in order to stabilise exchange rates. As described above, the central banks involved may suspend intervention if the overriding objective of maintaining price stability appears to be at risk. Any decision to suspend compulsory intervention would have to take due account of the particular circumstances and of the credible functioning of ERM II.

Settlement procedure for compulsory interventions avoids settlement risk

In order to avoid settlement risk posed by compulsory intervention for the ECB and the euro-area central banks wherever possible, a payment procedure termed "payment after payment" is being introduced. Under this procedure, in the event of intervention at the intervention points, the "in" central bank concerned or the ECB would not authorise payment for a given transaction until it had received confirmation that the amount due had been credited to its account. In this context, the central banks of the "pre-in" countries act as correspondent banks of the ECB and of the "in" central banks. Commercial banks are required to pay the intervention amounts not later than 1 p.m. (ECB time) on the value date.

Unilateral or coordinated support operations within the fluctuation bands are possible

What are known as "intramarginal support operations" may likewise be conducted within the margins of fluctuation of exchange rates, either unilaterally or by means of coordinated action on the part of the ECB and the "pre-in" central banks concerned. In this way, individual fundamentally unwarranted developments in the foreign exchange market may be halted in good time. Such interventions, which are implemented voluntarily by the affected central bank on its own initiative, are subject to the prior approval of the bank of issue of the partner currency used if certain amounts are exceeded. When drawing on the very short-term financing facility (described in more detail below) in the context of intramarginal interventions, these financing options between central banks are limited in amount.

Initiator rights of central banks facilitate central rate adjustments

In the event of shifts in the economic fundamentals between participants in the system (such as changes in the purchasing-power parities), thereby applying pressure to the currencies participating in ERM II, central rates are to be adjusted to the new economic situation faster than has been the case in the EMS. Thus, all the parties involved in decision-making have the right to initiate a confidential procedure aimed at reconsidering central rates. This new element of granting initiator rights to the ECB and national central banks is designed to help de-politicise central rate adjustments and to accelerate adjustment procedures, which have occasionally been sluggish in the past.

Very short-term financing

To enhance the credibility of the intervention commitments assumed, automatically accessible "very short-term financing facilities" are being established between the ECB and the

Central bank loans with short maturities enhance the credibility of compulsory interventions

central banks of the "pre-ins" participating in the exchange-rate mechanism. They serve to ensure that all participants in the system have access to a sufficiently large amount of partner currencies so as to be able to intervene in the foreign exchange market in favour of their currencies, if necessary. However, central banks which seek recourse to short-term financing are required to make appropriate use of their own foreign reserve holdings for their support operations before taking up such loans. In the event of compulsory intervention, the financing is in principle unlimited in amount, has an initial maturity of three months and is denominated in the currency of the creditor central bank. In much the same way as the interventions, it may be suspended if the target of stability would otherwise be at risk.

Concerning intramarginal interventions, recourse to lending is limited by individual ceilings

This very short-term financing facility may also be used in the event of intramarginal interventions, but only up to specified ceilings fixed for the central banks of the "pre-in" member states. These ceilings for cumulative borrowing are defined as twice the amount formerly made available to the respective national central banks in the context of the short-term monetary support mechanism.[1] Under this arrangement, the ceilings for the central banks amount to euro 520 million for Denmark, euro 300 million for Greece, euro 990 million for Sweden and euro 3,480 million for the United Kingdom. These amounts are notional for the central banks of the member states which are not participating in ERM II. The ceilings for the ECB and the central banks of the "ins" have been set at zero, which also indicates that the ECB, as the anchor central bank, and the other central banks of the "ins" will not engage in intramarginal intervention as a matter of principle.

Very short-term financing may be renewed in case of need

Loans under the very short-term financing facility are remunerated at a representative three-month money-market rate of the creditor's currency ruling on the date when the facility is drawn on or renewed. At the request of the debtor central bank, the maturity is automatically extended once for another three months on the due date, within the limits of the ceilings agreed for the financing of intramarginal interventions. Exceeding that limit is contingent on the consent of the creditor central bank. All amounts which have been automatically extended once for a period of three months may be extended again for not more than three months, subject to the agreement of the creditor.

Monitoring

General Council of the ECB is given special monitoring and coordination duties

The General Council of the European Central Bank (which comprises the central bank governors of the "ins", the ECB's president and vice president, and the central bank governors of the "pre-ins") monitors the functioning of the new exchange-rate mechanism. Equally, the General Council serves as a forum for monetary and exchange-rate policy coordination between all EU central banks, and for assessing the administration of the intervention and financing mechanisms specified in the Agreement. In addition, it has to monitor, on a permanent basis, the sustainability of

1 The short-term monetary support mechanism will be abolished as from December 31, 1998.

exchange-rate relations between every currency participating in ERM II and the euro. However, these duties assigned to the ECB General Council will not affect the general responsibility of the EU Council of Ministers for exchange-rate-policy issues.

Prospects

New exchange-rate mechanism contributes to the convergence process within the Community and must be judged in the light of the planned EU enlargement

The introduction of the new exchange-rate mechanism as from January 1, 1999 adds another element of stability to the process of European integration. Its benefits will lie primarily in supporting the convergence efforts of those EU member states which are seeking to join the euro area in the medium term. However, the new exchange-rate mechanism is also likely to be of significance in the light of the expected enlargement of the European Union to include a number of countries in central and eastern Europe. Once these countries have joined the EU, they will be able in principle to adjust their currencies to the euro by participating in the exchange-rate mechanism. It remains to be seen how fast the individual countries will be able to adapt their economic and monetary policies to conditions in the euro area, thus meeting the requirements for adopting the euro at a later stage.