

THE EUROPEAN CURRENCY UNIT AND SPECIAL DRAWING RIGHTS

A Comparative Overview

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In March 1984 the ECU completed five years of operation and in this paper A. Senathirajah of the People's Bank examines how far this unit of account has fulfilled the objectives for which it was created. He takes a wider look at the growing interest in the performance of the international units of account such as the SDR and ECU and maintains that they mitigate the exchange risks created by unstable currencies.

The problem facing the International Monetary System and the need to provide exchange rate stability and sufficient liquidity to ensure expansion of economic activity internationally led in 1969 to the creation of the International Monetary Fund's Special Drawing Rights (SDRs). Ten years later almost similar circumstances for members of the European Economic Community led to the creation of a common currency unit in Western Europe with the establishment of the European Monetary System (EMS).

The EMS became operative on March 13, 1979, following a meeting of the European Council in July 1978 which resolved that closer monetary cooperation between the countries of the European Communities should be promoted through the creation of the EMS. Over the previous decade of floating rates there was increasing concern about what was regarded as excessive instability of exchange rate movements and the creation of the EMS was one response to this situation. By March 1984 the European Monetary System had been in existence for five years and it is apt to ask at this stage whether it had fulfilled its foremost objective of achieving a high degree of exchange rate

stability as a basis for further economic integration within the European Community.

There is no doubt that the EMS did bring a degree of exchange rate stability among the currencies of participating countries, although it was rooted in a wider range of concerns. Another significant contribution of the EMS was that it introduced an important new composite currency unit, the European Currency Unit (ECU). The parallels and differences between the ECU and SDR have often been noted in recent years.

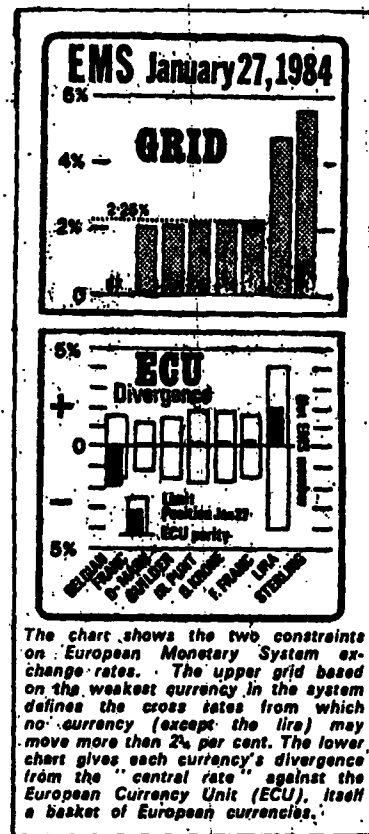
SDR and ECM Creation and Structure

The SDR (Special Drawing Right) was created by the International Monetary Fund (IMF) in July 1969 as an international reserve asset to be allocated to its members to supplement their reserves, subsequent to a great deal of discussion on insufficiency of international liquidity in the 1960s. In the previous 20 years of sustained growth in the world economy and rapid expansion in international trade, the Bretton Woods System of fixed but adjustable par values for currencies had worked quite well. But, in the 1960's the United States began to experience payments difficulties and there were large conversions of dollars into gold, which some economists attributed to the inadequate growth of gold reserves.

The IMF attempted to remedy this reserve problem by the creation of SDRs, through the First Amendment to the Fund Agreement. This helped to make the growth of international reserves less dependent on US Payments deficits, though it did not prevent a further deterioration in the US balance of payments and a further drain in US gold reserves. In August 1971

the US Dollar was devalued in terms of gold and the United States terminated the convertibility of the dollar into gold, the result being that the link between the US Dollar and gold was lessened. By the end of 1971 a new pattern of par values had been agreed for the dollar and other major currencies. The US balance of payments, however, continued to weaken, and after the failure of a second devaluation, the United States abandoned a par value for the dollar.

Most countries were of the view that less weight should be given to the purchase (or sale) of foreign currencies in order to stabilize the exchange rates and accordingly, exchange rates should be given greater freedom to move. This view provided the fundamental rationale behind the widespread adoption of floating rates in that period of December 1971. According to the Smithsonian Agreement



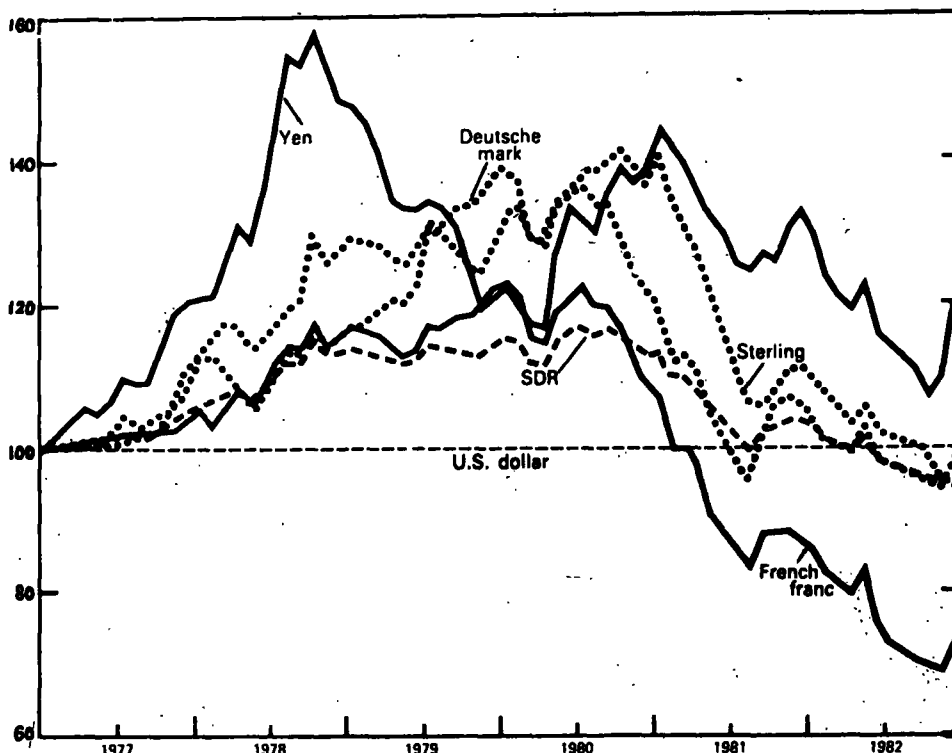
of December 1971 a margin of 2¼% was allowed either side of the central rate with the US dollar to enable other world currencies to float. In 1973 all the world currencies floated out of this margin.

Originally the value of the SDR was tied to gold, but with the advent of the floating exchange rates and the decision to allow the price of gold to be set by the market, the value of the SDR came to be determined by a basket of currencies from July 1, 1974. The original basket consisted of 16 leading currencies in international trade and payments. But partly because of the large number of currencies in the basket it was considered a serious handicap for the wider use of the SDR outside the IMF. The IMF therefore decided from January 1, 1981 to reduce the number of currencies in the basket to what it regarded as the five most important internationally used currencies with the weights of each as follows:

Currency	Weight
US\$	42%
Ger. DM	19%
Fr. Franc	13%
Jap. Yen	13%
UK. £	13%
Total	100%

The exchange system that evolved after March 1973 did not conform to the provisions of the Fund Agreement. A Second Amendment, therefore, was adopted (effective April 1978) which gave legitimacy to the then existing exchange arrangements. Specifically the official price of gold was abolished and members could maintain a par value for their currencies in terms of the SDR or another denominator, except gold; they could have cooperative arrangements for

SDR and component currencies: foreign exchange rate indices (monthly, 1977-82)
(In terms of January 1977 U.S. dollars per foreign currency)



Source: IMF data.
Note: The calculations underlying the chart assume that the SDR basket existed in its 1981 form from January 1977 onward.

Both exchange rate changes and interest income have been more stable for the SDR than for individual currencies. The exchange rate is more stable since changes in the exchange value of the currencies in the basket are generally completely or partially offset by smaller or opposite changes in the values of other currencies in the basket. Thus, the SDR's variability in terms of a particular currency will be less than the weighted average variability of its five individual components in terms of the same currency.

maintaining the foreign exchange value of a group of currencies in relation to each other, as in the European Monetary System; or they could have floating rates. Members were still obligated to collaborate with the IMF and with its other members to assure orderly exchange arrangements and to promote a stable system of exchange rates.

The three main principles recognised by the Articles of Agreement of the IMF were that the SDR is to become the principal reserve asset in the international monetary system; members are free, since the par value system had been abrogated, to choose their exchange arrangements and to determine the external value of their currencies; the role of gold in the inter-

national monetary system is to be gradually reduced.

SDR allocations began to be made from 1970 to member countries who wished to participate in the scheme. Over the years the SDR came to be extensively used as a medium of exchange and settlement between the Fund and its members; and in addition, to be held and used by 14 official institutions, the so-called prescribed holders. Also, about 15 countries have pegged their currencies to the SDR, and about the same number of international or regional organizations use the SDR as a unit of account. A number of international conventions also use the SDR to express monetary magnitudes, notably liability limits in the inter-

national transport of goods and services.

The ECU

When the European Monetary System became operative in March 1979, six participating countries - West Germany, France, Italy, the Benelux countries, Denmark and the Republic of Ireland - agreed on fixed, but adjustable, exchange rates, which were to be secured through a coordinated stability policy in the individual countries.

Attempts to create an European currency were started with the 'Snake' system when in 1972 six original members of the EEC, namely: West Germany, Belgium, Netherlands, Luxembourg, Denmark and Norway agreed to keep their currencies pegged within a margin of 1 1/8% either side of the US Dollar rate instead of the 2 1/4% allowed by the Smithsonian Agreement of 1970. This arrangement was called the 'Snake'. The intention was that the narrower margin might be the precursor of a new EEC currency. Just as the IMF's SDR was dominated by the US Dollar, the 'Snake' had tended to be dominated by the German Deutsche mark. In 1973 the floating of all the world's currencies affected the valuation of the SDR as well as the 'Snake' which burst out of its tunnel - i.e. the margin. The European Monetary System has tried always to keep these currencies floating within narrow bands of each other.

The chief monetary objective of the EMS according to an official declaration was to achieve a "zone of monetary stability in Europe" through a closer cooperation on monetary policy. Besides stabilizing the trends in exchange rates, there was a second objective relating to integration, namely to accelerate the "convergence of economic policy in the individual countries with a view to achieving greater stability"

The motives for setting up the EMS were the chaotic international currency situation in the mid seventies and the fact that European integration had begun to

falter, especially in the field of monetary policy. The beginning of the seventies had seen the collapse of the Bretton Woods System which had on the whole, to the satisfaction of the Western World, regulated the international relationships of currencies on the basis of fixed exchange rates for approximately 25 years.

Many governments then went for floating exchange rates. More confidence was placed in the markets in the hope that they would help to arrive at fair exchange rates and remove disruptions in the monetary system. However, these hopes soon proved to be an illusion. The exchange rate movements became increasingly vehement - so that the Bank for International Settlements ended up talking about "complete confusion" on the foreign markets in 1978. Governments, too, became increasingly concerned about the trends in exchange rates.

Many European politicians watched the erratic exchange rate fluctuations with anxiety. Exchange rate instability frustrated the efforts to coordinate national policies and fostered protectionist trends in Europe.

Finally, the European countries joined together to form a European system of linked currencies although this has not solved the problems of effective cooperation on monetary policy in Europe.

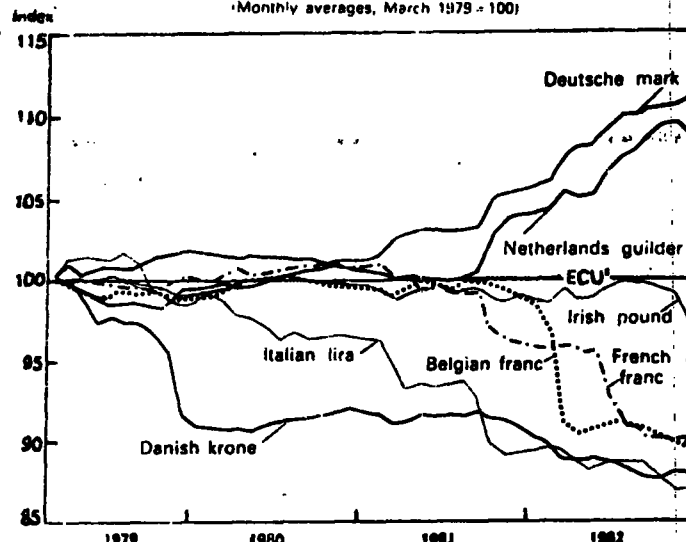
Components of the EMS

The European Currency Unit (ECU) is at the centre of the EMS. The ECU is defined as a "basket of currencies" that consists of fixed sums in the currencies of the nine EC members (excluding Greece). The share of an individual currency in the basket is among other things, determined by the respective share of the country's foreign trade and national product within the European Community (EC). The ECU

serves above all as reference value for fixing the central rates, as a denominator for operations within the intervention and credit mechanism and as a reserve instrument for the settlement of accounts between the EC's monetary authorities. The use of a basket of currencies for those purposes has the advantage that none of the currencies participating in the EMS has to assume the role of a key currency (as was the bad experience of the US dollar within the Bretton Woods System).

Movement of EMS currency exchange rates against the ECU, 1979-82

(Monthly averages, March 1979 = 100)



Sources: Commission of the European Communities and Fund staff calculations
Excluding the pound sterling component

The exchange rates in the EMS are fixed in such a way that an ECU - related central rate is fixed for each currency. These central rates determine the bilateral exchange rates of the participating currencies. Upper and lower intervention points are laid down for these bilateral exchange rates, determining margins of fluctuation of +/- 2.25 percent (+/- 6 percent for the Italian lira). Adjustments to the central rates may be made by mutual agreement.

The composite values of the component currencies of the ECU is as follows:

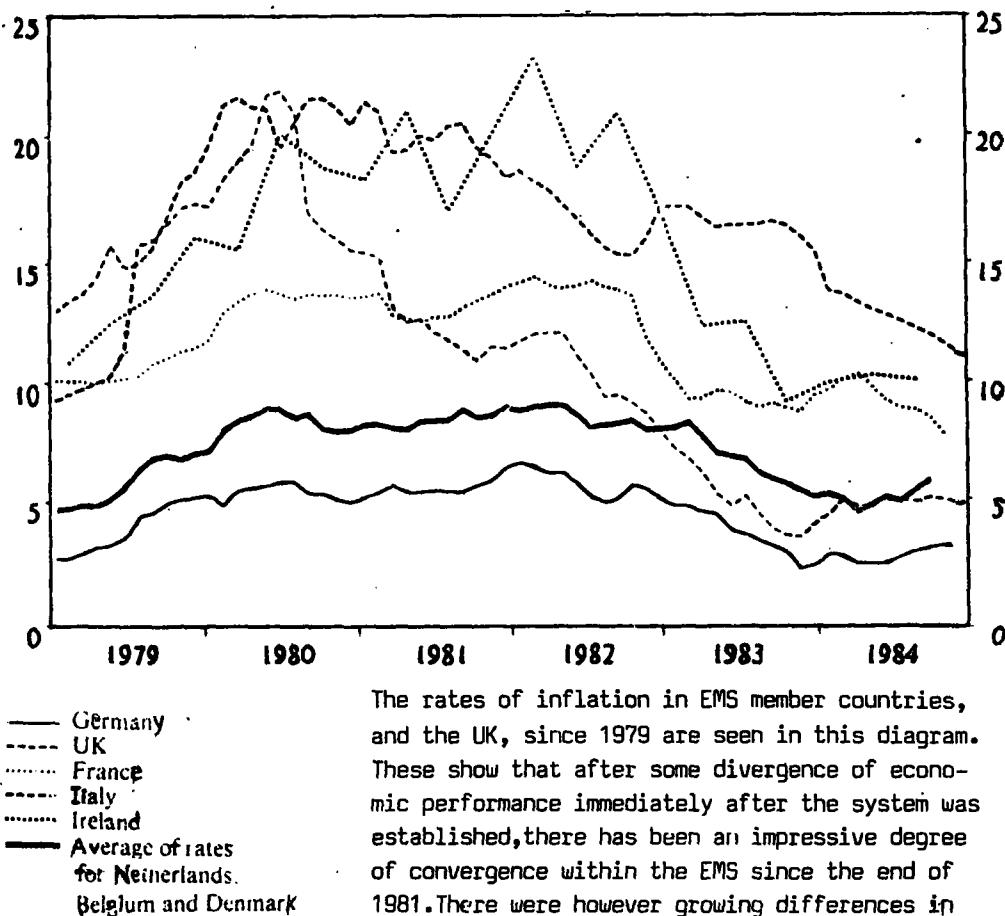
Currency	Composite Value
Ger. DM	0.828
Fr. Franc	1.15
It. Lira	109.0
Bel. Franc	3.66
Lux. Franc	0.14
D. Kr	0.217
Ir. £	0.007

As soon as a currency reaches the intervention points, determined by the margins of fluctuation on the foreign exchange market, the Central Banks are required, by intervening to prevent that currency from exceeding the intervention points. Interventions are made in the currencies of the participating countries.

Central Rate Realignments

In the first five years of the EMS the central rates have been realigned seven times. The adjustments comprise upvaluations of the D-Mark and the Dutch guilder and devaluations of the remaining currencies. Thus, two groups of currencies have developed within the system, namely, the relatively "strong" currencies (D-Mark and guilder) and the relatively "weak" currencies (lira, French franc, Belgian franc, Danish krone and the Irish pound).

Inflation rates in the EEC (per cent)



The rates of inflation in EMS member countries, and the UK, since 1979 are seen in this diagram. These show that after some divergence of economic performance immediately after the system was established, there has been an impressive degree of convergence within the EMS since the end of 1981. There were however growing differences in inflation levels of individual member countries upto 1982

A recent review of the ECU's performance in its first five years of operation indicates that in comparison to the floating dollar, yen and pound sterling, the fluctuations around the trends between the EMS currencies remained within narrow limits, namely within the comparatively narrow permissible margins of fluctuation. Moreover, not even the substantial short-term movements in the exchange rate of individual EMS currencies, for instance, against the U.S. dollar, could throw the exchange rate structure between the EMS currencies into disorder. The EMS was able to shield itself successfully.

Accounting Device

The SDR is accepted mainly as an accounting device. Despite its intrinsic stability and its diversified coverage (over the three most important currency zones of US, Europe and Asia), the SDR has not

attracted international market operators, particularly in private markets. Organisations involved in international transactions have not started to use the SDR partly because of the extra cost involved in introducing another currency. Also, there is difficulty in using private SDRs since no international clearing arrangements for SDRs exist and transactions have to be made in another currency or in the five constituent currencies of the unit.

The ECU on the other hand seems to have been more acceptable. It is used as an accounting unit by corporations, firms, banks and governments. It replaced the European Unit of Account (EUA) from January 1981 as the European Community's book-keeping unit. The use of ECU for issuing Eurobonds had increased to ECU 1 billion in 1983 compared to only ECU 244 million in 1981. It is the third currency used next to the US dollar and DM in the Eurobond

Market, while the SDR ranks only next to ECU in this field. The ECU is observed to have grown more rapidly than that of the SDR as it has been regarded as a less complex unit of exchange. Furthermore, the ECU is often treated as a currency in its own right and a clearing system for this unit is being formalised.

Future Challenges

The ECU's success is partly due to the fact that all of its component currencies are in a homogeneous trading area, but is principally the result of official support given by European Community (EC) institutions, which triggered demand for it by the private market. The initial use of the ECU in private markets was officially accepted by the European Communities as a whole, the European Investment Bank (EIB) and EURATOM have all launched bond issues in ECUs and been active depositors in ECUs. The EIB has, in addition, extended part of its loans in ECUs and made it a precondition for obtaining these loans that the amount be deposited in ECU accounts. The EC Commission initiated the establishment of a banking group to study the possibility of a clearing situation in ECUs; but similar promotion has been completely lacking for the SDR.

Other factors attributed to the success of the ECU are that the ECU has its own interest rate structure; it is being traded in the forex market as an independent currency; and it is accessible and available at a moderately easy interest rate.

A point to be noted in this respect is that the German Deutsche Bundesbank (the Central Bank) has not expressed much encouragement for the use of ECU.

The DM was playing a major role under the 'Snake' System and this might have been the reason for its attitude. However, there is far greater pressure from EEC members for the ECU than the Deutsche Bundesbank's cool attitude.

Contrary to the gloomy predictions made by many of its early critics, who feared that it would quickly collapse under both internal and external pressures, the European Monetary System has survived intact. This is itself regarded a considerable achievement, given the turbulence in the international monetary system since 1979. The system has demonstrated an ability to overcome certain difficulties, not least through the agreement of major exchange rate realignments. The reason is that from the beginning, the operation of the EMS has been characterized by efficient and smooth management by the participating central banks and a high degree of flexibility.

The flexibility of the System was seen to be necessary because of varying institutional settings and different approaches to many common problems among the participating central banks; it is workable because the central banks, concerned are limited in number and have a long-standing tradition of close cooperation in foreign exchange matters, stemming in particular from the operation of the "snake".

There has been a growing interest in international units of account such as the SDR and ECU. A fundamental reason for this interest in the new units of account is the need to search for a greater certainty and stability in international economic and financial relations, than what can be provided by the individual currencies that are now permitted to float and fluctuate in value. These new international units of account can, because they are made up of different currencies, help to an extent to mitigate and distribute more fairly the exchange risks created by the unstable exchange rates of individual currencies.

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