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To: Members of the Executive Board

From: The Secretary

Subject: Change in the Currency Composition of the ECU (European
Currency Unit)

The attached paper prepared by the staff provides information on the decision of the EC Council of Ministers to change the currency composition of the ECU (European Currency Unit) effective September 17, 1984.

If Executive Directors have technical or factual questions relating to this paper, they should contact Mr. Ungerer (ext. (5)8808) or Mr. Nyberg (ext. (5)8864).

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INTERNATIONAL MONETARY FUND

Change in the Currency Composition of the
ECU (European Currency Unit)

Prepared by the European Department
(In consultation with other Departments
and the Office in Europe)

Approved by L.A. Whittome

October 11, 1984

1. Decision to change the composition of the ECU

The Council of Ministers of the European Communities (EC) has decided to change the currency composition of the ECU (European Currency Unit) as of September 17, 1984. 1/ At the same time, at the request of the Greek government, the drachma has been included in the ECU basket. The ECU is a composite monetary unit with a standard basket, defined in a regulation of the EC Council of Ministers 2/ as the sum of a fixed amount of all EC currencies. According to the declaration of the Council (see attachment), the revision was carried out "taking into account the underlying economic criteria, as well as the need to ensure the smooth functioning of the markets". It offset the effect of past realignments of exchange rates in the European Monetary System (EMS) on the percentage weights of the currencies in the ECU and brought them more in line with the relative economic importance of EC countries.

Table 1 shows the amounts of the currencies defining the ECU, and their percentage weights on March 13, 1979, when the EMS started operations, and on September 17, 1984.

The EC Commission calculates an ECU equivalent in dollars and in the currencies of the EC member states on the basis of daily U.S. dollar rates for EC member currencies. 3/ This rate is for official purposes. In recent years, a private market for ECU-denominated assets has arisen (see below); the ECU rates quoted by banks for this market may vary from the official one.

1/ Council Regulation (EEC) No.2626/84 of September 15, 1984.

2/ Council Regulation (EEC) No. 3180/78 of December 18, 1978.

3/ The central bank of each EC member state communicates to the National Bank of Belgium a representative rate for its currency against the U.S. dollar from their exchange markets at 2.30 pm. These rates are then communicated to the EC Commission.

Table 1. Composition of the ECU

	National Currency Units		Percentage Weights 1/	
	March 13, 1979	September 17, 1984	March 13, 1979	September 17, 1984
Belgian franc	3.66	3.71	9.3	8.2
Danish krone	0.217	0.219	3.1	2.7
French franc	1.15	1.31	19.8	19.0
German mark	0.828	0.719	33.0	32.0
Irish pound	0.00759	0.00871	1.1	1.2
Italian lire	109	140	9.5	10.2
Luxembourg franc	0.14	0.14	0.4	0.3
Dutch guilder	0.286	0.256	10.5	10.1
Pound sterling	0.0885	0.0878	13.3	15.0
Greek drachma	--	1.15	--	1.3
			100.0	100.0

Sources: Council Regulation (EEC) No. 3180/78 of December 18, 1978; and Council Regulation (EEC) No. 2626/84 and Declaration of September 15, 1984; and staff calculations.

1/ Based on market rates.

2. Development of the European Currency Unit

The ECU was introduced in 1979 in connection with the creation of the European Monetary System, and it was accorded an important role in the operations of the EMS. It was also intended to replace gradually the various units of account used in the European Communities, in particular the European Unit of Account (EUA). The EUA was established in 1975, as a basket of currencies which was determined by taking into account general economic criteria 1/; the same basket was used for the ECU. The EUA served as a unit of account for the European Coal and Steel Community, the European Development Fund, the European Investment Bank and the European Community budget; for the Common Agricultural Policy and the operations of the European Monetary Cooperation Fund other units of accounts were used. Effective January 1, 1981, the ECU fully replaced those units of account in all relevant areas of EC activity.

1/ These criteria included the share of each country, whose currency is included in the basket, in EC gross national product, its share of Western European trade and in the quotas of the Short-Term Monetary Support. However, no formal weighting scheme of such economic criteria had been established.

In establishing the ECU, provision was made for periodic re-examinations and revisions of its composition to take account of changes in member countries' economic situations and exchange rates. According to the Resolution of the European Council on the establishment of the EMS of December 5, 1978, revisions of the composition of the ECU have to be mutually accepted, 1/ must not by themselves modify the external value of the ECU (as expressed in any one currency), and must be made in line with underlying economic criteria. The first re-examination and possible revision could be made within six months after the EMS entered into force and thereafter every five years or, on request, if the weight of any currency had changed by 25 percent. The first re-examination of the ECU basket, which took place in September 1979, did not lead to any change in its composition. Since the changes in the weights of currencies in the basket had in no case reached 25 percent (see Table 2), the next regular re-examination was therefore scheduled for September, 1984.

A need for revision can also arise because of changes in the membership of the EC. When Greece joined the EC in January 1981, it was decided that the drachma would be included in the ECU basket at the latest by December 31, 1985, and earlier if a revision of the basket took place in accordance with the above-mentioned provisions.

3. Official use of the ECU

As already mentioned, the ECU is officially in use in the context of the EMS and other EC activities. With respect to the EMS, the ECU has an important role, being used as a numeraire for expressing central rates, as a unit of account for operations in the intervention and credit mechanisms, and as a reference unit for the operation of the divergence indicator. The ECU is also a reserve asset and serves as a means of settlement between the monetary authorities of the EC. 2/

The EC currencies participating in the exchange rate mechanism of the EMS (which excludes, for the time being, the pound sterling and the Greek drachma) have central rates expressed in ECU. Bilateral central rates (the so-called parity grid) are expressed in participating currencies. From these, market rates may deviate up to the bilateral intervention limits by 2.25 percent (6 percent for the Italian lire). At these limits participating central banks are obliged to intervene on their own markets in the currencies concerned in whatever amounts

1/ A revision requires a unanimous decision by the EC Council of Ministers, acting on a proposal from the EC Commission, after consultation with the Monetary Committee and the Board of Governors of the European Monetary Cooperation Fund.

2/ For more details on the operation of the EMS and the role of the ECU see "The European Monetary System - Main Operational Features", SM/79/55, 2/16/79 and "The European Monetary System - The Experience, 1979-82", SM/83/16, 1/24/83.

necessary; in practice, intervention within the margins has also been common.

The divergence indicator for an EMS currency measures the divergence in its market rate from its central rate, both expressed in ECU, corrected by a factor reflecting the weight of the currency in the ECU basket and, hence, the influence of this currency on the value of the ECU. When the market rate of a given currency reaches 75 percent of its maximum allowed deviation from the central rate, that currency has reached its divergence threshold. In such a case, there is the presumption that the concerned member state will take corrective action.

The ECU is also used as a unit of account for the credit facilities of EC. Of these, the Very Short-Term Financing Facility is limited to financing obligatory intervention in the EMS, the Short-Term Monetary Support is for financing temporary balance of payments deficits within certain limits, and the Medium-Term Financial Assistance is for mutual, conditional financial assistance in case of balance of payments difficulties. Another credit facility, denominated in ECU, is the Community loan mechanism, established in 1975 in connection with the first round of oil price increases.

Furthermore, the ECU serves as a reserve asset and a means of settlement under the EMS agreement. The EMS central banks have deposited 20 percent each of their gold holdings and gross dollar reserves with the European Monetary Cooperation Fund in return for a corresponding amount of ECUs. These transactions take the form of three-month revolving swaps. ECUs thus created are to be used as a means of settling debts arising from intervention in participating currencies in the framework of the EMS.

In addition to fulfilling its functions in the European Monetary System, the ECU is employed as a unit of account for other official operations of the EC. It is used for the EC budget, in the accounts and transactions of the European Investment Bank, the European Development Fund and the financial operations of the European Coal and Steel Community. Moreover, the ECU plays a role in the Common Agricultural Policy (CAP) of the EC, in particular for denominating common agricultural prices.

4. Private use of the ECU

Private transactions in ECU take place through bank deposits, bank credits and bond issues. To a limited extent the ECU is also used for trade invoicing and for the denomination of credit cards and travellers' cheques. In recent years, the private ECU market has expanded rapidly to an estimated total of ECU 15-18 billion in early 1984. At present, some 200 banks are involved in the interbank ECU market. The growing number of banks participating in the market has led to efforts to set up an interbank clearing system for ECU transactions.

There are several reasons for the rapid growth of the private ECU market. Its growth has been actively supported by EC institutions, which act both as borrowers and depositors of ECU. Also, the ECU offers corporations engaged in EC-wide operations a vehicle for diversification of exchange and interest rate risks. Furthermore, the operation of the EMS ensures that the value of the ECU remains relatively stable in terms of most participating currencies, at least over relatively short time periods, thus reducing the risk premium of investors.

5. Percentage weights of currencies in the ECU basket since 1979

Because the amount of each national currency in the ECU has remained unchanged until the recent revision ^{1/} while exchange rates have varied, the actual percentage weights of individual currencies in the ECU basket have changed significantly over time (Table 2). Compared with the situation in March 1979, the weights of the currencies of Germany, the Netherlands, and the United Kingdom have increased, while the weights of other member currencies have decreased. These changes are due chiefly to exchange rate realignments in the EMS and do not necessarily correspond to changes in the economic importance of EC countries as exemplified, for instance, by the share in total EC production and intra-EC trade of the countries concerned (Table 3).

As a consequence of the revision of the currency amounts, the percentage weights of the ECU currencies are again close to what they were in March 1979 but still significantly different from what they were initially in 1975, when the basket was established (see Tables 1 and 2). Compared with March 1979, the weights of the pound sterling, the Italian lire and the Irish pound have been allowed to increase. Furthermore, the Greek drachma has been included in the ECU for an amount equivalent to 1.3 percent. In comparison with the percentage weights based on market exchange rates prior to the revision, on September 14, 1984 (see Table 2), the weights of especially the deutsche mark and the Dutch guilder have been lowered while those of the French franc and the Italian lire have been raised.

6. Effects of the revision

While the recent revision of the ECU changed the amount of each national currency in the basket, it left the external value of the ECU (i.e. the value of the ECU expressed in any one currency) unaffected at the time of transition. The revision did not cause any change in the ECU central rates of EMS currencies and, hence, the grid of bilateral central rates and bilateral intervention limits. It also left unchanged

^{1/} The currency basket used for the ECU actually remained unchanged since 1975 when it was established in connection with the introduction of the EUA.

the "representative rate" of the ECU in terms of SDR as calculated by the Fund. 1/

The revision of the composition of the ECU will affect its future value compared to what it otherwise would have been, as market rates of EC member currencies vary relative to each other. The new currency composition of the ECU might affect the attractiveness for private investors of the ECU relative to individual currencies, causing a shift in funds and thus affecting exchange rates. The effect is likely to be minor, however, because the main thrust of the revisions has been anticipated for some time, giving the markets time to discount at least partly the impact of the revision. The revision will also have an effect on ECU interest rates both for official and private use.

The revision of the composition of the ECU basket will marginally affect the thresholds of the divergence indicator for the EMS currencies. It is unlikely, however, that these changes will have any noticeable effect on exchange rate developments in the future.

1/ See EBD/82/8, 1/12/82 and Decision No. 7041-(82/8) G/S, 1/13/1983. The representative rate is obtained using the reciprocal of the U.S. dollar equivalent as calculated and published by the European Commission and the SDR equivalent of one U.S. dollar as calculated and published by the Fund for the same day. If both of these rates are not available for the same day, the rate for the next preceding day on which both rates are available is used.

Table 2. Percentage Weights of Member Currencies in the ECU 1/

	April 21, 1975 <u>2/</u>	1979	1980	1981	1982	1983	1984	Sept. 14, 1984
	<u>Average during the second quarter of each year</u>							
Belgian franc	8.0	9.1	9.1	8.8	8.1	8.1	8.0	8.1
Danish krone	3.0	3.0	2.8	2.7	2.7	2.7	2.6	2.7
French franc	21.7	19.7	19.7	19.1	18.3	16.9	16.7	16.7
German mark	26.9	32.8	32.9	32.7	34.7	36.5	37.0	36.9
Irish pound	1.4	1.1	1.1	1.1	1.1	1.1	1.0	1.0
Italian lire	13.3	9.7	9.2	8.6	8.2	8.1	7.9	7.9
Luxembourg franc	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Dutch guilder	9.1	10.4	10.3	10.2	10.8	11.2	11.4	11.3
Pound sterling	<u>16.2</u>	<u>13.8</u>	<u>14.5</u>	<u>16.5</u>	<u>15.7</u>	<u>15.1</u>	<u>14.8</u>	<u>15.1</u>
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
<u>Memorandum item:</u>								
<u>Value of 1 ECU</u>								
in terms of								
Belgian franc	45.53	40.34	40.36	41.43	45.10	45.23	45.61	45.40
Danish krone	7.16	7.15	7.83	7.97	8.13	8.08	8.21	8.14
French franc	5.29	5.83	5.85	6.03	6.29	6.81	6.87	6.89
German mark	3.08	2.52	2.51	2.54	2.38	2.27	2.24	2.25
Irish pound	0.55	0.66	0.67	0.69	0.69	0.72	0.73	0.72
Italian lire	819.43	1128.65	1182.76	1263.36	1321.97	1346.57	1382.75	1381.14
Luxembourg franc	45.53	40.34	40.36	41.43	45.10	45.23	45.61	45.40
Dutch guilder	3.14	2.75	2.76	2.81	2.64	2.55	2.52	2.53
Pound sterling	0.55	0.64	0.61	0.54	0.56	0.59	0.59	0.58
U.S. dollar	1.29	1.33	1.39	1.12	1.00	0.91	0.83	0.74
Japanese yen	292.40	290.06	322.39	245.41	244.66	216.65	189.48	181.88
Swiss franc	2.57	2.28	2.34	2.27	2.00	1.89	1.85	1.85

Sources: IMF, International Financial Statistics; Data fund; and staff calculations.

1/ Calculations of percentage weights are based on New York noon quotations. The weights may not add up due to rounding.

2/ Weights are those of the European Unit of Account (EUA) which was introduced in certain areas of Community activities as of April 21, 1975. The EUA is defined as a basket of all EC currencies; this basket was also used for defining the ECU in 1979.

Table 3. Distribution of EC Real GNP and
Intra-EC Trade in 1974-78 and 1979-83 1/

(In percent)

	Share of EC Real GNP/GDP <u>2/</u>		Share of Intra- EC Trade <u>3/</u>	
	1974-78	1979-83	1974-78	1979-83
Belgium	4.0	4.1	14.1 <u>4/</u>	12.8 <u>4/</u>
Denmark	2.7	2.4	2.8	2.6
France	24.2	22.7	17.6	16.9
Germany	25.4	30.4	26.4	26.2
Ireland	0.7	0.7	1.8	2.1
Italy	17.6	13.5	11.0	11.4
Luxembourg	0.2	0.2
Netherlands	5.5	6.2	14.9	13.9
United Kingdom	<u>19.8</u>	<u>19.7</u>	<u>11.4</u>	<u>14.0</u>
Total	100.0	100.0	100.0	100.0

Sources: IMF, International Financial Statistics; Direction of Trade Statistics; and staff calculations and estimates.

1/ Excluding Greece; shares may not add up due to rounding.

2/ Calculated at 1980 prices and actual exchange rates.

3/ The sum of merchandise exports and imports in nominal terms.

4/ Data refer to the Belgium-Luxembourg Economic Union (BLEU).

COUNCIL OF THE
EUROPEAN COMMUNITIES

Bromoland Castle, 15 September 1984

D E C L A R A T I O N

In accordance with the provisions adopted in the Resolution of the European Council of 5 December 1978 on the establishment of the European Monetary System and in particular Article 2.3 thereof, which provides for a periodic re-examination of the composition of the ECU, the Council, after having reviewed the evolution of the weights of the currencies that make it up, has decided, upon a proposal from the Commission and after consulting the Monetary Committee and the Board of Governors of the European Monetary Cooperation Fund, to revise the composition of the ECU.

This revision has been carried out taking into account the underlying economic criteria, as well as the need to ensure the smooth functioning of the markets.

The Greek government has taken this opportunity to request the inclusion of the drachma in the ECU, in application of the provisions of the Treaty of Accession of the Hellenic Republic. The Council has agreed to this request. The Council notes that the Greek authorities will continue to pursue policies for stabilization of the economy and that they have taken appropriate technical measures in the area of money and exchange markets for the smooth functioning of the markets following the inclusion of the drachma in the ECU. The Council also warmly welcomes the decision of the Greek authorities; it stresses that, for Greece, the inclusion of the drachma in the ECU fits into the framework of a medium-term policy aimed at an increased convergence of the economic evolution of this country towards that of the other countries of the Community.

The amounts of the national currencies of the Member States in the ECU have been fixed using the following weighting coefficients:

DM	32.0
FF	19.0
UKL	15.0
LIT	10.2
HFL	10.1
FB	8.2
DKR	2.7
DR	1.3
IRL	1.2
LFR	<u>0.3</u>

100.0

As a consequence, from 17 September 1984, the ECU is defined as the sum of the following amounts of the currencies of the Member States:

DM	0.719	FB	3.71
FF	1.31	DKR	0.219
UKL	0.0878	DR	1.15
LIT	140	IRL	0.00871
HFL	0.256	LFR	0.14

The Council stresses that this decision conforms to the provisions of the Resolution of 5 December 1978 and notably the rule that it establishes for maintaining the value of the ECU. Moreover, this revision does not affect the ECU central rates of the different currencies participating in the exchange rate mechanism, or, of course, the bilateral parities within the EMS. Similarly, this decision does not have any agri-monetary effect.