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To: Members of the Executive Board

From: The Secretary

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

There is attached for the information of the Executive Directors a paper on prospective change in the currency composition of the European currency unit (ECU).

Mr. Zervoudakis (ext. 8814) or Mr. Mayer (ext. 8863) is available to answer technical or factual questions relating to this paper.

Att: (1)

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Department Heads



INTERNATIONAL MONETARY FUND

Prospective 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 Manuel Guitián

July 3, 1989

The Council of Ministers of the European Communities, at its meeting of June 19, 1989, decided to revise the currency composition of the ECU and, at the request of the authorities of the respective countries, to include the Spanish peseta and the Portuguese escudo in the ECU basket as of September 21, 1989. <sup>1/</sup> The Council decision specified the new percentage weights for the (expanded) list of twelve currencies in the ECU (Table 1) and provided that the new currency composition of the ECU would be derived from these weights on the basis of the exchange rates recorded on the European markets on Wednesday, September 20, 1989 at 2:15 pm. The 3-month interval between the announcement and the adoption of the new ECU basket reflects a perceived need for an adjustment period to ensure that the private ECU market would not be disrupted.

I. Background

The Resolution of the European Council on the establishment of the EMS (dated December 5, 1978) provided for periodic re-examinations and revisions of the composition of the ECU to take account of changes in member countries' economic situations and exchange rates. All such revisions have to be mutually accepted, must not by themselves modify the value of the ECU (as expressed in any 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 establishment of the EMS in March 1979; subsequent re-examinations and revisions could occur every five years or, if the weight of any currency had changed by 25 percent, on request. The first re-examination of the ECU basket, which took place in September 1979, did not lead to any change in its composition. The next (regular) re-examination occurred in September 1984 and involved a change in the currency composition of the ECU effective as of September 17, 1984; on that occasion, the Greek

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<sup>1/</sup> Spain and Portugal became EC members on January 1, 1986.

drachma was included in the ECU basket. 1/ No advance notice was given of the exact date of implementation or of the composition of the new basket, which came into effect at the time of its announcement.

The changes in weights of currencies in the basket in the period since September 17, 1984 have reached 25 percent only in the case of the Greek drachma for which the weight in the ECU is rather small. In the event, no EC member has requested a re-examination of the currency composition of the ECU in advance of the five-year re-examination scheduled for 1989. According to the Treaty of Accession of Spain and Portugal, the regular 1989 re-examination was also to serve as the occasion for decisions, at the request of the country concerned, on the inclusion of the peseta and the escudo in the ECU. Such decisions were to take into account the "necessity of ensuring a stable development of the functions and uses of the ECU."

As the amount of each national currency in the ECU has remained unchanged since the last revision on September 17, 1984, while exchange rates have varied, the actual percentage weights of individual currencies have changed significantly over time (Table 2). In particular, the weights of the currencies of Germany, Belgium, and the Netherlands have increased, while the weights of other member currencies have decreased. In the absence of any shifts in the "economic situation" of EC countries, 2/ the periodic revisions of the currency composition of the ECU would normally aim broadly at restoring the percentage weights to their levels prevailing immediately after the last revision, i.e., at correcting for the impact of exchange rate changes in the intervening period on the percentage weight of each currency. There is also a concern that revisions should be such as to minimize abrupt changes in the characteristics of the ECU, in particular the interest rate on ECU instruments.

## II. Revision of the Currency Composition of the ECU

The implementation of the announced revision of the currency composition of the ECU will be different from that in 1984. At that time, the Council of Ministers announced the new currency composition of the ECU, which became effective immediately. By contrast, the Council decision of June 19, 1989 specified in advance the new percentage weights, which will be translated into new currency amounts on September 21, 1989 on the basis of the exchange rates prevailing on the preceding

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1/ See "Change in the Currency Composition of the ECU (European Currency Unit)" (SM/84/224, 10/12/1984).

2/ The criteria used in determining the basket of currencies comprising the ECU include the share of each corresponding country in EC gross national product, in intra-EC trade and in the quotas of the Short-term Monetary Support mechanism. However, no formal weighting scheme of these economic criteria has been established.

day. The two-stage implementation procedure was adopted "in order to ensure the continued smooth functioning of the ECU markets and to avoid unnecessary disturbances."

Besides taking into account the inclusion of the Spanish peseta and the Portuguese escudo, the new percentage weights also incorporate some reapportionment of the weights of the other ten currencies (Table 1). In particular, the prospective inclusion of the two new currencies in the ECU--with a combined weight of 6.1 percent--was not accompanied by a uniform proportional reduction in the weights of the remaining ten currencies compared with their levels on September 17, 1984. The weight of the French franc was left unchanged and that of the Italian lira was reduced only slightly, while the weight of the pound sterling was decreased by 13.3 percent; on the other hand, the reductions in the weights of the other major currencies were more or less in line with the 6.1 percent norm. In comparison with the percentage weights based on market exchange rates prevailing on June 19, 1989, the new weights of the German mark, the Dutch guilder, the Belgian franc and the Danish krone have been significantly lowered (by 9-15 percent), while the weight of the Italian lira has been raised by 9 percent; the weights of the remaining currencies included in the present basket show little change. 1/

### III. Effects of the Revision

While the revision of the ECU basket will change the amount of each currency in the basket, by statute, it will leave the value of the ECU (i.e., the value of the ECU expressed in any one currency) unaffected at the time of transition. The revision will not cause any change in the ECU central rates of EMS currencies and, hence, the grid of bilateral central rates and bilateral intervention limits. 2/ It will also leave unchanged the "representative rate" of the ECU in terms of SDR as calculated by the Fund. On the other hand, the inclusion in the ECU of a new currency (escudo) that is not part of the exchange rate mechanism and another (peseta) that is subject to wide margins will further reduce

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1/ The Greek drachma is the exception. Its new weight, while 38.5 percent below the September 1984 level, is one third above the level on June 19, 1989.

2/ Spain's full participation in the EMS as of June 19, 1989 has added a new set of central rates and intervention limits (see EBD/89/207, 7/5/89).

the precision of the divergence indicator. 1/ However, in light of the relatively limited reliance on the divergence indicator for the operation of the EMS in practice, it is unlikely that these particular changes will have any significant effect on exchange rate developments in the future.

The revision of the composition of the ECU will, of course, also influence the evolution of its market value in the future, thereby affecting the attractiveness of financial assets denominated in ECU relative to those denominated in other currencies including the individual component currencies of the ECU. However, insofar as the inclusion of the peseta and the escudo has been anticipated for some years, this influence will be small. According to EC Commission estimates, the revision of the composition of the ECU basket will raise ECU interest rates by about 30 basis points.

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1/ It will thus exacerbate the distorting effect that the inclusion in the ECU of the pound sterling, Italian lira and, to a lesser extent, the Greek drachma have had on the divergence indicator. This effect occurs despite corrections being made for deviations of these currencies from their (notional) central rates by more than 2.25 percent.

Table 1. Composition of the ECU

	National Currency Units		Percentage weights		Change in percent
	September 17, 1984	September 21, 1989 <sup>1/</sup>	September 17, 1984	September 21, 1989	
Deutsche mark	0.719	...	32.0	30.10	-5.9
French franc	1.31	...	19.0	19.00	--
Pound sterling	0.0878	...	15.0	13.00	-13.3
Italian lira	140	...	10.2	10.15	-0.5
Dutch guilder	0.256	...	10.1	9.40	-6.9
Belgian franc	3.71	...	8.2	7.60	-7.3
Luxembourg franc	3.71	...	0.3	0.30	--
Danish krone	0.219	...	2.7	2.45	-9.3
Irish pound	0.00871	...	1.2	1.10	-8.3
Greek drachma	1.15	...	1.3	0.80	-38.5
Spanish peseta	--	...	--	5.30	...
Portuguese escudo	--	...	--	0.80	...

Source: EC documents.

<sup>1/</sup> To be derived from the already specified percentage weights (shown in the fourth column) on the basis of the exchange rates recorded on the European markets on Wednesday, September 20, 1989 at 2:15 pm.

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

	Sept. 17, 1984	1985	1986	1987	1988	1989	June 19, 1989	Sept. 21, 1989
		Average during the first quarter of each year						
Deutsche mark	32.0	32.3	33.2	34.8	34.8	34.5	34.7	30.10
French franc	19.0	19.2	19.7	19.0	18.7	18.5	18.6	19.00
Pound sterling	15.0	14.3	13.7	12.0	12.8	13.6	13.0	13.00
Italian lira	10.2	10.1	9.5	9.5	9.2	9.2	9.3	10.15
Dutch guilder	10.1	10.2	10.5	11.0	11.0	10.9	11.0	9.40
Belgian franc	8.2	8.3	8.4	8.7	8.6	8.5	8.6	7.60
Luxembourg franc	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.30
Danish krone	2.7	2.8	2.7	2.8	2.8	2.7	2.7	2.45
Irish pound	1.2	1.2	1.2	1.1	1.1	1.1	1.1	1.10
Greek drachma	1.3	1.3	0.9	0.8	0.7	0.7	0.6	0.80
Spanish peseta	--	--	--	--	--	--	--	5.30
Portuguese escudo	--	--	--	--	--	--	--	0.80

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

1/ Calculations of percentage weights are based on New York quotations. The weights may not add up to 100 due to rounding.