Prof. Issing gives his views on the hard ecu as a possible route to European Monetary Union Translation of an extract from an address held by Prof. Issing, a member of the Board of the Deutsche Bundesbank, at the Management FORUM in Madrid on 25/1/91.

The signals for EMU have long since been set and the train moving towards complete monetary integration is speeding up. With the exception of the United Kingdom, all EC partners seem to be in agreement on the goal and how to get there, with the only question still outstanding being the speed and timing of the individual steps.

But signs of deeper differences of opinion can be discerned behind the smooth facade of unanimous pronouncements. The problem of how to integrate fiscal policy in the monetary integration process is still unresolved, both in theory and with respect to when such integration should occur in the process of co-ordinating and finally unifying monetary policy. For some, the sanctions imposed by the market will be enough to nip any signs of destabilising budget policies on the part of member states in a uniform currency zone in the bud. There are others who do not share this faith in the efficacy of financial market sanctions, if only because countries forming a monetary union would in the final analysis prove to be a "Community based on solidarity". Thus the assumption that a member would be bailed out would arguably influence market opinion so strongly that a long period of budgetary laxity on the part of individual member states could not be ruled out. In such a situation, monetary policy would be confronted with the difficult task of breaking the inflationary expectations that would be bound to arise in a process which would probably cost the economy dear. The outcome of these considerations is inevitably the call to limit the scope for fiscal policy in a monetary union in such a way that fiscal laxity on the part of individual member countries cannot give rise to any serious macro-economic instability which, in turn, cannot spread through the European Community as a whole.

It is, of course, easier to make such demands than to implement them. The painful experience suffered by many countries show how difficult it is to set sensible limits to deficit spending policies, to express these limits as operational directives and, finally, to ensure they are observed.

What is equally controversial is the question as to what extent progress has to be made in consolidating public sector budgets as a prerequisite for further steps on the road to EMU. In its Statement of September 1990 on the establishment of EMU in Europe, the Bundesbank wrote with regard to the convergence of anti-inflation policies in member states that before the commencement of the final stage, budget deficits in all participating countries will have to be reduced to a level which is tolerable over the longer term and unproblematic in terms of anti-inflation policy. This prerequisite is to be seen as having been met only when the durability of the convergence achieved is reflected in the markets' verdict, i.e. in a virtual harmonisation of capital market rates. There is still a long way to go before this prerequisite for monetary union is met. The fact that the size of Germany's budget deficit and the level of its interest rates have attained levels similar to those in other countries does not make the route any the shorter; in fact, the opposite is the case. This is because, firstly, convergence towards an "average" level of performance as regards fiscal policy or the inflation rate which disregards stability is undesirable and, secondly, the exceptional situation currently prevailing in Germany must not be forgotten when establishing the extent of convergence in these fields.

Finally, there is one vital matter which is entirely hidden behind vague assumptions, namely the extent to which member states are prepared to transfer national sovereignty to the supranational level of the Community. One can only warn against going beyond the point of no return on the path to EMU without having subjected this willingness to a serious test outside the realm of monetary policy. Here again it is those responsible for fiscal policy who should be the focus of attention.

Recently, however, differing concepts of how to attain monetary integration have also been regaining ground.

Leaving aside the possibility of a "quantum jump" into EMU - the occasional analogy with German monetary union that is put forward is almost grotesque in its failure to recognise the different starting points and also deliberately overlooks the problem of immense financial transfers - only two paths to monetary union are open to us in principle. At all events, this is true provided that the choice of using one national currency as the uniform currency can be excluded - as it can be for obvious reasons - from the range of logical possibilities.

The Delors Report is in favour of the approach whereby monetary union is to be attained via a three-stage process of increasingly closer co-ordination of monetary policy that goes hand in hand with parallel progress towards economic union. The Committee of EC central bank Governors has, as is well known, submitted draft statutes for a European System of Central Banks, for which the Heads of State or Government gave their basic approval at their Rome summit. Thus, we may already now be seeing something more than the outlines of an institution which one day will bear responsibility for a uniform monetary policy.

Firstly, with its plan entitled "An Evolutionary Approach to Economic and Monetary Union" which the Treasury submitted in November 1989 the United Kingdom, by contrast, opted for the second conceivable strategy, namely that of competition between individual currencies. The initial idea was to allow existing national currencies to compete with each other. This would have led to monetary union (in the wider sense, i.e. one which would not necessarily have meant reducing the number of currencies to only one). The UK Government meanwhile favours the "hard ecu", which, as an independent thirteenth currency is to be given a "devaluation guarantee" against existing national currencies. The UK authorities give the hard ecu good chances of holding its own in competition with other currencies.

Of late, the proposal put forward by the United Kingdom has, surprisingly enough, been meeting with acclaim from other EC states. However, in agreement with prevailing opinion in other key countries leading spokesmen for the Bundesbank have left no doubt from the outset that this is not the right path to take. Incidentally, the Delors Report examined the parallel currency concept and said that it was not to be recommended for two reasons. First, a further (thirteenth) currency could be a source of additional money creation that would be difficult to control and thus inflationary. Second, monetary policy in the individual member states - and especially its co-ordination - would be made extremely difficult.

It is difficult to counter the argument that creating another currency would hamper the co-ordination of monetary policy. But it has little weight in principle as an objection to the parallel currency strategy, in which there is no attempt to approach monetary union via the successively closer co-ordination of monetary policy anyway. But the argument that there is the risk of inflationary money creation if another currency is issued is much more difficult to counter, if indeed it can be countered at all. The UK proposal points out the strict rule that ecu would only be issued against national currency and that the aggregate money supply would therefore not be affected. While this argument is accurate in a purely "technical" sense, it is difficult to discern a basis for the confidence that is needed to rely on the issuing of ecu being controlled in fact and being kept parallel with the creation of national currency.

In the hard ecu plan this specific shortcoming goes hand in hand with the basic problem of any parallel currency strategy. As experience shows, currency substitution, i.e. the crowding out of one national currency by other means of payment, occurs only in situations of extreme monetary instability. It is, however, to be hoped that nobody in the European Community is expecting national inflation rates to be so high that the opportunity cost of using domestic currency makes the utilisation of other currencies, e.g. the ecu, economically worthwhile. In our world of free capital markets in which investors can choose between an almost limitless range of options, there is no need in any case to introduce an artificial variant by fiat. This is all the more the case seeing that market participants are also able to provide "basket solutions" to a great extent.

Given these circumstances, it is not difficult to forecast that the hard ecu would not win the day. There would then, however, be the inevitable fear that the proponents of a policy favouring this strategy would not give up without a fight, or to put it differently: sooner or later, everything would be done to ensure the success of a candidate which had no chance at all on the free market by "assisting" it.

This, however, would be tantamount to standing the idea of competition between currencies on its head. If one takes the notion of such competition seriously, one should first of all acknowledge the basic principle behind it, which rules out political, or official decisions as to whether a uniform currency is actually the best solution for the European Community as a whole or for a more or less large-sized "subset" of it. Currency competition can be seen as a method of ascertaining what the optimum currency area actually looks like. Thus, it would be incompatible with the concept of the parallel currency strategy if already at the start of the process its culmination with the existence of a single currency were to be publicly announced.

To this extent, the UK proposal is and remains an alternative strategy which cannot be linked to the one which most countries have hitherto been pursuing. Introducing an additional thirteenth currency, issued by a Community institution, would inevitably create the problem of having a "proxy monetary authority" during the transitional period, which according to the logic of the parallel currency strategy could last for ever. But quite apart from this, the main weakness is that under the UK plan, the new ecu derives its "hardness" from the guarantee that it will not have its bilateral central rate against other currencies reduced. The ecu thus borrows its stability, as it were, from other currencies. Now assuming for the sake of argument that the hard ecu had won the day and crowded out all the other currencies, then it would lose this anchor at the very same moment! It would lose its quality of hardness, which would always have merely been a relative, derived quality. As soon as the ground under its stability had vanished, the "hard ecu" could very rapidly become a "soft ecu".

The hard ecu plan thus - and quite inappropriately - pushes the central issue into the background, namely how to safeguard the stability of a uniform currency. It is no accident that other proposals envisage a stable anchor for the parallel currency, for example in the form of a purchasing power guarantee, which would not lose its basis if other currencies were to be crowded out.

The logic behind the parallel currency strategy is that there is obviously no reason to introduce an additional currency which would lose its advantage in terms of stability precisely at the point in time at which other currencies had been crowded out. On that day, if it arrived via this route at all, the European Community would be standing where it is already standing under the alternative strategy at the start of the other path, namely establishing the conditions which have to be met for the common currency to be a stable currency as well.

In its latest proposal of January this year, the UK Treasury takes such objections into consideration to the extent that the draft statutes for a European Monetary Fund, which is intended to be responsible for issuing and managing the hard ecu, contain corresponding provisions relating to the goal of price stability and independence. However, these provisions are in turn considerably watered down by an "alternative proposal", which does not allow for such independence. But quite apart from this objection, the attempt to render the hard ecu proposal compatible with the intentions of other EC countries will always raise the problem of co-ordinating the Fund's policy on the ecu with the monetary policies of national central banks. As the Fund grew in influence, so too would the danger that supporting measures would be adopted to make the new European currency a success.

Nobody, of course, would wish to imply that the United Kingdom has the intention of bringing this sort of development about. It will nevertheless be difficult to prevent efforts from being made in this direction, if the Fund and the new currency were to be introduced. Thus, the most recent proposal submitted by the United Kingdom does not alter the substance of the arguments I have already put forward above.

<u>Draft for the second phase of European Economic and Monetary Union submitted by the Government of Spain</u> EUROPE DOCUMENTS, 1/2/91.

At the ministerial meeting on 28 January, the Spanish government submitted to the governments of the Member States participating in the intergovernmental conference on EMU a draft that focuses particularly on the development of the ecu during the second stage. This draft is in addition to the European Commission draft and the British proposal on the hard ecu.

<u>The ECU and the ESCB during Stage two.</u>

I. <u>Introduction</u>.

In its previous contribution to the Intergovernmental Conference (IGC) ("Staying the course", September 1990) Spain advocated the creation of the new monetary institution right at the beginning of Stage two, and the further development of the ECU, suggesting that the UK proposal for a "hard-ECU" contained useful ideas which could be made to fit into Stage two of the EMU.

A few weeks later, the conclusions of the European Council held in Rome in October called for the strengthening and development of the ECU during Stage two of the EMU, to start on January 1st 1994 with the establishment of the new EC monetary institution. How to achieve that <u>strengthening of the ECU</u>, as well as what should be <u>the precise role of the new institution during Stage two</u>, were questions raised by a number of Ministers both at the informal meeting of Milan and in the first working session of the IGC in Rome.

Earlier this month, the UK submitted to the IGC a new document, which puts its original proposal into Treaty language. The UK has, furthermore, specifically invited other countries to expand or build on its proposal.

Spain remains of the opinion that there would be merit in the UK proposal to the extent that:

- The "hard-ECU" proposal is included in the new Treaty as a transitional, Stage two provision, before the <u>ECU</u>, by dint of the <u>political</u> decision by the European Council to enter Stage three, becomes automatically the EC single currency.

Consequently, there would be no need for the Monetary Union to be achieved through a process of crowding-out of existing national currencies by the hard-ECU. Furthermore, although the term "hard-ECU" is a handy, colloquial way to refer to the UK proposal, the new Treaty would refer just to the "ECU", with no discontinuity between the current, the Stage two and the Stage three ECU.

- The new monetary institution is made independent from national Governments and other EC institutions, is designed so as to be transformed easily and automatically into the final "European Central Bank" upon the expiration of Stage two, and is vested with the specific role of coordinating and supervising national monetary policies and preparing Stage three.

Spain recognizes, though, that the concept of creating since the beginning of Stage two an "abstract" ECU to be included in the Exchange Rate Mechanism (ERM) as an independent, 13th currency, has elicited serious misgivings, which mirror those expressed in paragraph 47 of the Delors Report. Thus, while the British idea of strengthening the ECU has been generally welcomed, it has been observed by some that it could be achieved not by the creation of an "abstract" ECU, but rather by changing in the new Treaty the current definition of the ECU and hardening the ECU's definition so that the ECU cannot be devalued against any Community currency. More specifically, this could be achieved by transforming the current "basket ECU" into a "hard-basket ECU" (in which individual currency amounts would be adjusted after every realignment, so as to preserve a fixed central exchange rate between the ECU and those currencies not experiencing devaluation).

The "hard-basket ECU" has in turn created concerns among those who feel that the new definition could put at risk the huge private ECU market already in existence, specially because the new "adjustable basket" would preclude commercial banks from creating "synthetic" hard-ECU assets and liabilities.

This note presents an scheme which draws indeed on the British plan and on Member States' reactions to it, as well as on the Draft Treaty presented by the Commission in December. It attempts, first, to endow the new EC monetary institution with a clear, operational role that will not interfere with the conduct of monetary policy by national Central Banks, but will be instrumental in helping the new institution undertake its key advisory and coordinating role; it intends, also, to address fears about a prematurely "abstract" ECU which could, furthermore, bring about an artificial process of interest rate competition in the Community; to create an institutional framework which, while building on existing practices in the private ECU market, will foster its development, by stablishing a direct link between the official and the private ECU (as suggested by France as far back as 1985); to avoid discretionary "maintenance of value" and "buy-back" clauses, while allowing for a "graduated response" which may enhance the credibility of the monetary discipline imposed by the new institution on diverging national policies; and, finally, to allow for the inmediate issuance of fully-backed ECU notes (a subject already discussed in the Monetary Committee as early as 1982), which might produce inmediate savings in transaction costs and pave the way for the final Stage of EMU.

The Annex to the note includes a preliminary version of the changes necessary in article 109 of the Draft Treaty made public by the Commission on December 10, which Spain regards as a most helpful starting point.

II. Main features of the scheme.

1. The key role of the new monetary institution.

The key role of the European Central Bank (ECB) during

Stage two will be to coordinate national monetary policies primarily through a process of ex-ante consultation and ex-post surveillance, and not through an artificial process of interest rate and currency competition between a new, 13th currency and the 12 EC national currencies. Besides, the ECB should be empowered to make, when necessary, general economic policy recommendations going beyond the realm of monetary policy (e.g. opinions on the appropiateness of a certain "policy-mix").

The operational functions of the ECB, while primarily geared towards facilitating the development of the private ECU market, should, however, allow Central Banks:

- To monitor and control jointly the gradual development of a Community-wide ECU market and the process of currency substitution.
- To achieve some degree of explicit monetary coordination.
- To exert effective pressure on loose national monetary policies.

Justification:

- Respecting the principle of national monetary sovereignty during Stage two while creating a non-political, independent "watchdog" of national economic and monetary policies, which, besides coordinating national monetary policies, helps the ECOFIN and the Commission in conducting during Stage two their "multilateral surveillance" role, a key aspect to enhanced convergence.

2. The definition of the ECU as standard of value.

2.1. During Stage two the ECU's official value will remain determined on the basis of a basket of EC currencies, so that the ECU will not become a new abstract currency existing independently from the 12 EC national currencies.

2.2. Although "freezing" the current definition of the ECU's official value would not be incompatible with the rest of this note, there is a strong case for redefining the ECU in the Treaty as a "hard-basket" ECU (in which specific currency amounts in the ECU formula would be revised after every ERM realignment, so as to preserve for the ECU a fixed central exchange rate vis-à-vis all those currencies not experiencing any depreciation).

Consequences:

- The ECU would have neither an "independent" or "abstract" value, nor an independent market interest rate: the latter would probably be some weighted average of national interest rates (minus some allowance for the option element embedded in its definition, plus or minus some margin bearing on the hard-ECU's usability as a means of payment and market recognition).
- The ECU would not be a new 13th currency to be included in the ERM, and the ECB would not be able to conduct an active monetary policy. No arbitrage possibilities would exist between any "artificial" ECUs and the ECB's liabilities.
- The ECU would keep a fixed central rate vis-à-vis the strongest EC currencies, i.e. the ECU's performance would always match (although never outperform) that of the best performing EC currencies.

- Its basket, non-abstract definition would not hamper in the least the use of the ECU as a Community-wide means of payment, as the external gold convertibility of sterling until 1931 and of the dollar from 1934 to 1971 did not hamper (but rather helped!) their use as international vehicle currencies.
- The basket "definition" of the ECU should be just understood as a mathematical formula to fix the ECU's official value. Therefore, the issuance of ECU denominated liabilities does not imply per se any issuance of the individual currencies used in the ECU's formula.

Justification:

Of 2.1. ("basket-ECU")

- More consistency with the Delors Report, in which paragraph 47 criticizes strongly the parallel currency strategy.
- Having just one ECU, avoiding the potential problems of coexistence of a "hard, abstract ECU" with the traditional "basket-ECU".
- Building on existing institutions and market practices.
- Avoiding the potential risk of an artificial "interest rate competition" among the new monetary institution and national Central Banks.

Of 2.2. ("hard-basket")

- Consistency with the recent European Council's call for a strengthening of the ECU.
- Additional strength and prestige for the european currency, something economically desirable and specially important for those countries with a national currency traditionally stronger than the current ECU, which remain understandably reluctant to endorse the concept of an EC currency of lesser quality than its national one.
- Facilitating the removal of indirect restrictions of capital movements resulting from exchange-risk "prudential" regulations on insurance companies and pension funds, thereby expanding the demand for ECU assets.

3. The transitional nature of the scheme.

The present scheme is legally framed as a Stage two, transitional provision of the Treaty, which should formally declare the ECU as the future EC single currency with no discontinuity between the current, the Stage two and the Stage three, abstract ECU.

Consequence:

- Treaty language should refer only to the "ECU", with expressions like "hard-basket ECU or "hard-ECU" remaining colloquial terms not to be enshrined in the Treaty.

Justification:

- Consistency with the Delors Report and the concept of EMU (see Spain's "EMU: staying the course", September, 1990).
- No disruption of the private ECU market.

4. Issuance of ECU liabilities.

The ECB will issue ECU notes and coins and will accept ECU deposits, against surrender of EC national currencies. The ECB would have the monopoly of issuance of ECU notes and coins, but these would not have legal tender status except in those countries which so decided (i.e. the ECU could be considered a "foreign" and not a "domestic" currency for national monetary purposes). The ECB would sell (issue) and buy (redeem) ECU notes, coins and deposits in unlimited amounts against EC national currencies, at the (basket-determined) market exchange rates.

The ECB would keep with national Central Banks the EC national currencies received in exchange for ECUs (see however point 6 below).

Consequences:

- The ECB would not create net liquidity, but just act as a "Currency Board" or "Substitution Account", which would facilitate and monitor the process of currency substitution. Its issuance of ECU notes and coins would not represent monetary "sovereignty": the ECB would be as sovereign as some Scottish banks are today, because it would be subject to a 100% reserve requirement with national Central Banks.
- If that were the wish of Member States, the "official convertibility provision" (i.e. the exchange by the ECB of ECUs into EC currencies and viceversa), through the use by the ECB of specific ECU exchange rates consistent with the ERM parity grid, could be potentially designed so as to make redundant most ERM interventions by national Central Banks.
- The ECU exchange rate of each national currency would become the most visible one, as envisaged by the European Council in 1978 when the EMS was created, thereby facilitating the future replacement of national currencies by the ECU.

Justification:

- Allowing EC citizens and companies to enjoy the savings in transaction costs from using a common currency (e.g. ECU notes and coins) since the beginning of Stage two, thereby enhancing the popular visibility of the EMU project.
- Establishing a clear link between the "private" ECU (i.e. commercial banks' ECU liabilities) and the "official" ECU (i.e. ECB's liabilities).
- Relieving EC commercial banks from the need to create "synthetic" ECU assets if a market imbalance between ECU assets and liabilities were to exist during Stage two.

5. ECU clearing and payment system.

The ECB would be Central Agent for the private ECU clearing system, as well as ECU fiscal agent for EC institutions and willing EC governments.

Consequences:

- All banks belonging to the "ECU banking association" (ABE) and EC institutions would open accounts with the ECB.
- The ECB would replace the Bank for International Settlements as agent of the private ECU clearing system.

Justification:

- Facilitating the supervision by the ECB of the ECU interbank market.
- Building on existing private ECU clearing arrangements.

- Starting during Stage two some future operations to be centralized in the European Central Bank during Stage three.

6. ECU swaps of the ECB's national currency holdings.

The ECB would conduct automatically with national Central Banks short-term callable swaps into ECUs of all EC currencies held by the ECB. These swaps would be real, so that the ECB would enjoy a full ECU exchange-rate cover on the entire amount of its national currency holdings.

Consequences:

- The swaps would differ from those carried out at present between the FECOM and Central Banks in some technical aspects:
  . The swaps would be real ones, and not just an accounting device.
  . The ECB would be the party getting an ECU asset, in exchange for an EC national currency (rather than gold or dollars). For national Central Banks the situation would, however, resemble their current position when borrowing under the Very Short Term Financing Facility of the ERM, in which debts are recorded in ECUs.
- The ECB could call the swaps at any time in case of need, in order to redeem (buy) its own ECU liabilities into EC currencies.

Justification:

- To preserve the ECB's financial balance while, at the same time, avoiding that the ECB gets "double compensation" from its holdings of "soft", high-yield EC currencies (i.e. the yield differential plus "maintenance of value" payments).

7. Limits of ECB's holdings of individual national currencies.

Once the ECB holdings of any specific EC currency attained specific thresholds, the ECB would, first, impose penalty rates on the terms of any additional swaps; later, require the Central Bank to buyback immediately its own currency ("asset settlement of excess holdings"); and, finally, refuse to issue (sell) ECU liabilities against that specific currency ("suspension of official convertibility").

The thresholds would be established by the ECB in a non-discretionary way, according to some objective rule. The rule would have to be, however, flexible enough to allow for a "natural", non pathological process of currency substitution.

Justification:

- To establish non-discretionary, objective limits to the "credit" given by the ECB to individual Central Banks when holding their currencies.
- To increase the credibility of potential ECB "sanctions" on individual Central Banks by allowing for an automatically "graduated response".
- To set up a procedure which would require the ECB Council to monitor monetary growth in individual EC countries.

8. Third currencies.

The ECB would be authorized to hold and manage non-EC currency holdings as Trustee for national Central Banks.

Justification:

- The ECB may play a useful role in the coordination of foreign exchange national policies. But, beyond a strengthening of consultation procedures, some voluntary "pooling" of foreign exchange reserves could be envisaged during Stage two. This should reinforce the impact on the market of any intervention, as well as pave the way for the full centralization of reserves to take place in Stage three.

9. ECB lending.

During the course of Stage two -but not necessarily since its beginning- the ECB could be allowed to lend short term to EC commercial banks (e.g. by accepting short term overdrafts) up to a limit ("lending authority") not exceeding, for instance, the ECB's capital.

Justification:

- To allow the ECB to help balance the private ECU market in case the traditional excess of the supply of ECU liabilities over demand for ECU assets were to persist into Stage two, thereby relieving EC commercial banks from the need to create "artificial" ECU liabilities.

10. Reserve requirement(*).

The ECB (and not national Central Banks), by a unanimous decision of its Council, would be empowered (but not required) to impose a reserve requirement on ECU liabilities of EC banks. If it were imposed, subject to potential transitional arrangements for individual Member States, it would be expected to be a uniform one and to be covered with deposits in the ECB.

Justification:

- In light of differences in national money multipliers, to allow the ECB to control any indirect money creation resulting from the substitution of the ECU for EC national currencies.
- To set in train a process of coordination and harmonization of national reserve requirements.

(*) This point might prove to be a controversial aspect of the scheme, which is not essential at this stage, and warrants more in-depth analysis. Consequently, it appers in bracketed form in article 109 e. 5 iv) in the Annex.