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TRANSITION TO A SINGLE MONEY FOR EUROPE
IS THERE ROOM FOR A 'HARD ECU'?

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Paper delivered at the European Community Studies Association
Conference on THE CHALLENGE OF A NEW EUROPEAN ARCHITECTURE:
IMPLICATIONS FOR THE EUROPEAN COMMUNITY'S INTERNAL AND EXTERNAL
AGENDAS. George Mason University, Fairfax, Virginia, May 22-24
1991.

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I. INTRODUCTION -- MAJOR ISSUES

What are the major issues involved in our topic? The questions are: first, given that there is a "Europe 1992", the creation of a single European market (SEM) in the real sector, what, if any, are, or must be, the implications for the monetary sector. Second, whether and if so, at which stage of economic integration and the creation of a Single European Market (SEM) do the EC countries have to be melded into an economic and monetary union (EMU). Second, there is the related issue the most appropriate, that is, least costly or most beneficial way of "sequencing," an issue that is playing an important role in the debate over the transformation of central and eastern European countries from centrally planned to market-type economies. In our case the transition process deals with the merging of national financial markets, the creation of a well-functioning EC-wide financial sector, and how best to move from the present exchange rate arrangement of the European Monetary System (EMS) with its Exchange Rate Mechanism (ERM) to a fixed-exchange rate mechanism and, ultimately to an EMU for the Twelve (the Nineteen,¹ or whatever number there will ultimately be). Third, what are the expected major costs and benefits of EMU. And, finally, how will a single European currency affect the benefits and the costs to the

Community and/or the individual countries. I shall highlight some of the major concerns.

II. EXPECTED COSTS AND BENEFITS FROM EMU

A. Benefits

Since we observe a solid determination by the EC Commission, especially its president, but also by the European Council and other officials, to move in three stages toward and EMU, the first of which commenced last July (1990), with ultimately a single European currency, let us first see what the expected gains are from such an undertaking.

1. Macro- and microeconomic dimension

EMU has both a macroeconomic and a microeconomic dimension. While the former concentrates on stability aspects -- in the broadest sense, including policy options and policy conflicts under fixed versus more flexible exchange rate systems -- the microeconomic approach focuses on the question of efficiency gains, among them primarily the static impact of the elimination of transaction/conversion costs and the dynamic impact upon growth of added international investment stimulated by an increase in risk-adjusted rates of return. In this connection the question arises whether a single currency (for the EC) is desirable and/or necessary, or whether fixed exchange rates could accomplish the same thing.

A recent EC Commission study estimates static efficiency gains -- reduction in transaction costs -- from supplanting national currencies with a single European currency in the range of \$15-20 billion,² or slightly more than 0.5 percent of Community GDP. The dynamic effects, on the other hand, are more difficult to estimate; they relate to the elimination of realignment risks which, even under a system of fixed exchange rates can never be completely ruled out.

The ECU -- already the fifth most important currency for securities -- as single currency would become a major international medium of exchange: as major advantages are listed the reduction in transaction costs for the EC's foreign trade and investments, benefits for the EC banks which might increase their market share in international portfolio transaction, lowering the need for central banks' international reserves, and some international seignorage gains from ecu bank notes, for instance, in central and eastern Europe.³

"A common point shared by all three arguments is that the combination of a single currency and independent central bank is significantly superior in its likely net benefits than other forms of monetary union, such as fixed exchange rate regimes."⁴

2. Costs

Clearly the magnitude of costs from currency unification will be disparate in the various Community countries. The Community lists as a major cost of currency unification the loss of a major

policy instrument against economic shocks. For some the costs of losing a major policy instrument will by far exceed the benefits to reaped from a single currency.

III. ALTERNATIVES FOR REAPING EMU BENEFITS

There are basically two possibilities for a single currency to be introduced into an (optimum?) currency area: Either by the currency area's elevating an existing national currency to legal tender currency status for the entire area or through creating a new currency. In both instances, the transition could be accomplished in one leap of faith, as it were, or the transition could be gradual by first having one of the existing currencies emerge, or the new one being introduced without simultaneously discarding the existing national monies; temporarily we would settle for a parallel currency system. Each has its advantages and its shortcomings, both from the economic and the political point of view.

- A. Elevate an existing currency to international legal tender status

From monetary history we know that legal tender status is neither necessary nor sufficient to bestow on an object general acceptability -- the usual definition of money as medium of exchange. What is important is that the circulating medium has instilled confidence through purchasing power maintenance and

familiarity, which, through economies of scale, reduces information costs.

B. Create new currency

Britain's "hard ecu" proposal for Stage Two of the Delors Report's three stages toward EMU chooses the second route: it is designed to accomplish two things: acquaint the public with the new medium of exchange; and second, market forces rather than a government decree from the bureaucratic center at Brussels would determine its acceptance since the hard ecu, initially as a parallel currency, would have to prove itself.

C. "Hard ecu" -- proposal, debate and reality

1. Salient features

Britain's John Major, as Chancellor of the Exchequer, submitted his "Hard-ECU"-cum European Monetary Fund proposal June 20, 1990, barely a fortnight before the EC entered Stage One as outlined in the famed Delors Report's road to EMU, the Report which to this day serves as the basis for the envisioned EMU.⁵ Based on an earlier (1989) British counterproposal "An Evolutionary Approach to Economic and Monetary Union," was to reduce peoples' (Britain's?) reluctance to renounce their sovereignty in monetary matters; they would still have it symbolically through their own currencies; yet, they would understand that ultimately EMU would entail a single currency for the Community. The outline of a "hard ecu" deals with Stage 2 exclusively.

The Delors Report was fairly clear on Stages 1 and 3 but rather vague about what was to be accomplished and how it was to be accomplished in Stage Two, the transition stage, which prompted some Community members to suggest its omission. In Stage 2 the ESCB should be created or emerge. But it was not clear what exactly would be the competency and authority of the central banks in this stage. Monetary policy coordination was to be further strengthened from what it was in Stage One, exchange rate changes were still permitted but should be kept to a minimum -- but this has already been implemented even before the start of Stage One, as exchange rates in the ERM have not been realigned since January 1987, a minor realignment of the Italian Lira upon its entry into the narrow margin being the exception.

A new bank, to be created in Stage 2, the European Monetary Fund (EMF), subscribed to by the Member banks -- an EMF had already been planned by the founders of the EMS -- would issue ECU bank notes as legal tender, upon demand in exchange for Community currencies. To prevent inflationary oversupply of Ecus, Ecus would have to be fully backed by the EMF's holding of member currencies that make up the Ecu. The Fund would not set interest rates; rather Ecu deposits would carry an interest rate, as is now the case, determined by the weighted average of interest rates of the constituent currencies. Ecu bank notes would provide a convenient vehicle "for tourists and business travelers" and

greater popularity of the notes might eventually lead to "large scale markets in Ecu deposits."

But Major's proposal of a "hard Ecu" would go beyond the existing ecu: it would elevate the hard ecu from a basket of currencies to a genuine, 13th Community currency, with its own exchange rate vis-à-vis other currencies. The EMF would manage the hard Ecu to ensure it stayed within the ERM margins; the EMF would set interest rates on hard Ecu. To assure its acceptance and desirability, the hard ecu would never be devalued against other Community currencies but move with the strongest.

D. Some issues with the Hard-Ecu Proposal

With respect to this last point, and taking a cue from the working of the EMS, the DM could have fulfilled the functions of the hard ecu. It has never been devalued against any other member currency. Is the "hard ECU" thus no more than an exercise in semantics? Not quite; getting back to the issue of sovereignty and seignorage, not every EC country would willingly accept the DM as the EC currency -- remember the purpose of the EMS to do away with a dominant (key, reserve, intervention, and reserve) currency issued by the économie dominante. But given the quality of the DM and freedom of financial flows in the EC the DM could have become a parallel currency if desirable. The quasi-monopoly of national currencies in the EC is reconcilable with the "hard ECU" concept. Parallel currencies succeed best when the monetary scene is in disarray, as the "best" (ie., the most stable or

least inflationary) currency would tend to displace the others -- pace Mr. Gresham.⁶ But by now, the major EMS/ERM currencies "have approached the quality of the DM and what risk of depreciation remains is adequately compensated for by interest-bearing monetary assets."⁷

1. Control over Money Supply

Since countries could be tempted to convert their own currencies -- which they can freely supply -- into ecus at the EMF, the EMF would have no control over Community money supply, countries would be obliged -- in case of "excessive ecu conversion" to repurchase their own currencies from the EMF in exchange for their own ecus or hard currencies. But who would determine whether or when a country's ecu creation is "excessive"? The British proposal for the creation of a hard ecu would compromise the indivisibility of monetary policy without solving the sovereignty issue.

Interesting to observe: not only can one bring many arguments against the introduction of a thirteenth currency, the Delors report -- signed by all central bank governors, including the British -- rejected the idea of creating a parallel system.

And yet, markets behave often differently from the rules and anticipations; this is what happened with the working of the EMS, which was supposed to introduce symmetry into the European monetary arrangements and dethrone the DM. It hardly succeeded. Similarly, a -- call it -- "hard private ecu" has emerged recently as a

parallel currency with its own discount or premium vis-à-vis the basket ecu -- depending on demand and supply conditions -- and with its own interest rate which may be at a premium or below the weighted average of the ecu basket.⁸

2. The Bundesbank's position

The Deutsche Bundesbank, on the other hand, opposed the "hard ecu" proposal, favoring a gradual strengthening of the existing ecu until it could -- in Stage Three -- take on the role of single European currency. Such a strengthening of the ecu could occur by guaranteeing the value of the ecu through adjustment of the basket composition of the revaluing currencies. The creation of a Bank of Issue -- the EMF -- and its timing were problematical. To create a central bank already at the beginning of Stage Two, or introducing an EMF with the authority of creating ecu parallel currency would blur central bank responsibilities and might lead to inflationary increase in the money supply. This would serve neither price stability in the Community nor the reputation of a future European System of central banks (ESCB).⁹

E. Central bank and the autonomy debate

The verdict of central bank responsibility has undergone a dramatic change during the last decade: the goals to be pursued were reduced from four macroeconomic goals -- price stability, satisfactory and sustainable growth rate, full employment, and external equilibrium (the order in which they are listed does not

necessarily reflect ranking of importance) -- to one, for which central banks have a comparative advantage: price stability.

1. How independent are central banks?

Central bank independence has four aspects: a domestic and an international one; an institutional and a market aspect.

a. Domestic aspects

There has been general agreement, corroborated by empirical data that central bank policy independence and the achievement of medium- and long-term price stability are positively correlated.

British and German concerns centered around the future of central bank independence. How independent of the government and the political maelstrom should and can central banks be.

Institutional arrangements, on the one hand, and consideration of market forces, on the other. When one discusses the former type of central bank independence, one generally refers to independence of political interference -- and that includes independence of the influence of the treasury. On that account there currently are only four major central banks that qualify for the attribute "independent" -- the Federal Reserve, the Deutsche Bundesbank, and the central banks of the Netherlands and Switzerland.

(1) The German Sideshow

Last week, May 17, 1991, after a week of intense rumors, Deutsche Bundesbank president Karl Otto Pöhl officially announced his resignation. Rumors of major conflicts with the Kohl government of the handling of economic policy and the German economic.

monetary, and social unification (GEMSU) had circulated for some time, and Pöhl's critical statements of a monetary union -- both that of Germany and the planned but possibly premature EC economic and monetary union -- have encouraged speculation about his departure halfway through his second term as Bundesbank president. The suspicion of political interference increased as eastern Germany demanded an expansion of the Bundesbank board of governors to include representatives of the recreated five eastern German Länder, which would render the Bundesbank board unwieldy and the would add to the Board "political hacks"¹⁰ with no commitment to the -- so far -- overriding goal of prices stability. Is, thus, the independence of the Deutsche Bundesbank threatened from the inside and the outside?

This question had been raised previously, when GEMSU was promised: German economic, monetary and social unification together with the permanently fixing of what economists and the Deutsche Bundesbank had warned was a wrong exchange rate of 1:1. Helmut Kohl, had put the Deutsche Bundesbank before a fait accomplis, when he declared, early in 1990, the creation of GEMSU and an unrealistically favorable (for eastern Germany) exchange rate¹¹ - - even while Karl Otto Pöhl and his East German counterpart, Kaminsky, were negotiating about a more logical and economically defensible exchange rate somewhere between 3:1 and 2.5:1. The average exchange rate turned out to be about 1.8:1 -- a still too favorable exchange rate for eastern Germany. The opponents to a

premature economic union and the accompanying unrealistic exchange rate -- the Deutsche Bundesbank (Pöhl) and most economic advisers inside and outside the government -- had warned of dire consequences for east Germany in terms of loss of competitiveness, massive unemployment, and no definitive stop to the large-scale emigration of eastern Germans to the West.

The permanency of the exchange rate was assured because the Ostmark was to be absorbed by the DM and ceased to exist effective July 1, 1990. Thus, German monetary union preceded political unification. Interestingly, German economic unification coincided with the start of Stage 1 on the road to the EC's EMU and the abolishment of exchange restrictions and control to capital movements in the EMS/ERM (for most but the weakest countries).

b. International economic aspects of central bank independence

International transmission of economic shocks and business cycles in both the real and the monetary sector, and under different exchange rate systems -- fixed (pegged) and flexible exchange rates -- has been widely discussed in the economic literature. Experience has amply demonstrated that countries were not too successful in shielding themselves from foreign real shocks through floating exchange rates and even monetary shocks were absorbed less than had been expected.

With the introduction of the EMS the transmission process has been enhanced, although initially there were -- partly successful

-- attempts at reducing the transmission mechanism within the ERM by changing the severity of capital controls. But since July 1, 1990, the major ERM countries have managed without these wedges between capital markets of the member countries.

If nations are already closely interdependent through money flows, then exchange rate changes may have lost some of their effectiveness and thus, appeal, which, in turn, lowered the resistance to the introduction of the EMS. Devaluations alone have not been able to enhance international competitiveness as the exchange rate illusion vanished (money illusion anteceded it); ie., exchange rate changes are not the efficient instrument it was believed to be or might have been -- if not supported by tight domestic policies after exchange rate devaluations. Furthermore, the elimination of exchange rate manipulation as a policy tool has become less significant as Community trade has moved more toward intra-industry trade, "which means that sector-specific economic shocks are increasingly less country-specific in nature."¹² Econometric tests show that a significant source of economic shocks within the Community comes from imperfectly coordinated monetary policies -- time inconsistencies -- which EMU is expected to eliminate. The Community as a whole still retains some exchange rate flexibility in relation to the rest of the world. And finally, real changes in labor costs and competitiveness between states remain possible in monetary unions, as the examples of existing federations shows.¹³

2. Whither central bank independence?

Considering these external constraints, how realistic is the issue of central bank independence in today's environment? My comments were not meant to denigrate the importance and influence of central bank monetary policy or to claim that central banks may be absolved of their responsibility for the outcome of their policies or that their policies do not matter. Rather, in isolation they -- especially the central banks of the smaller countries -- have lost some power, which requires better and closer international policy coordination and cooperation, as has already been in effect for a number of years.⁷

3. The EMF and Independence

Some labeled the draft treaty of the European Monetary Fund (EMF), put forward on January 8, 1991, "a tease." It contained two conflicting options: according to one the EMF "shall be completely independent and shall neither seek nor take instructions from any community institution, national government or any other body or person." However, another article states that "the provisions of this treaty are without prejudice to the existing relationships between national central banks and the governments of the member states."

IV. PRECONDITIONS FOR SUCCESSFUL COMPLETION OF EMU

Pöhl recently warned that the EC should not, on a large scale, repeat the mistake which Germany made on a smaller scale with its

premature GEMSU combined with the fixing of a faulty exchange rate -- a political decision, as we have seen, which he later called "a disaster."¹⁴ The European Council in October 1990 -- preceding the first intergovernmental conference on the creation of a European Central Bank -- had already attached important conditions, which had to be fulfilled, to the timetable for the further economic and monetary integration. Especially, the overriding goal of each country's economic, fiscal and monetary policy had to be the pursuit of stability of prices and costs in order to forestall inflationary relapses. This would facilitate a permanent fixing of exchange rates and the eventual replacement of national currencies with a single European currency. Correct economic policies of the ERM countries within the framework of the EMS/ERM can heighten the credibility of their policies.¹⁵

As the Bundesbank points out in its Annual Report for 1990, some EMS member countries were successful in the 1980s to create stability, forming a nucleus of stability ("Stabilitätskern") -- recognizable, among others, by the small interest rate differentials between those countries and the Federal Republic of Germany.¹⁶ But tensions within the system cannot be ruled out in the future, as cyclical divergences between countries manifest themselves as happened toward the end of 1990 and the beginning of 1991. Eg., in 1990 the inflationary divergence (on CPI basis) rose to 18 percentage points (from 13 percentage points in the previous year), with the countries which do not belong to the

"Stabilitätskern" having substantially higher inflation (and interest) rates.¹⁷

V. CONCLUSION

In conclusion, there are some observations of an economic but also of a political nature, and it is not easy to pull all the strings together. We have barely started to scratch the surface.

As one would expect, the situation is extremely fluid: many political as well as economic issues are involved, and as economists we ought not to underestimate the significance of the former. I would like to remind you, that the EMS was created when France's Giscard d'Estaing and Germany's Helmut Schmidt made the leap of faith agreeing on the establishment of that system -- with little regard for the "monetarist" - "economist" debate nor, for that matter to the Deutsche Bundesbank's strenuous reservations and objections. Additionally, Kohl "snared the Bundesbank into taking part in the newly created Franco-German finance council where Pöhl is outnumbered by politicians and a politically dominated body, the Bank of France." And more recently, as we have discussed previously, Kohl decided GEMSU as well as the conversion rate of the Ostmark into the Deutsche mark -- against the counsel of even his own economic advisors.

When comparing costs and benefits, both economic and political costs and benefits are compared -- not only on the same plateau but there is criss-crossing between political and economic costs

and benefits. The time horizons of politicians and economists is rather different. Politicians tend, if not to ignore, then at least to underestimate the economic costs when calculating SHORT-RUN political benefits -- which may eventually haunt them, as happened not long ago, when Kohl's party, the CDU, suffered a stunning defeat even in Kohl's own home state (the Rhineland-Palatinate).

Before closing two additional major observations are in place: the Werner Report, which we can consider a forerunner of the Delors Report, assumed an EC within the monetary world of the pegged-rate Bretton Woods system; the Delors Report was written also was written with the EC in a completely world from which Europe finds itself now: it predates the fall of the Wall and all that it entails for Germany, the EC, and the rest of Europe.

Second, two non-EC, or not-yet-EC Western European countries, Norway earlier in 1991 and Sweden on May 17, 1991, and one former eastern European country, Poland, decided to abandon their previous international monetary arrangements. Norway and Sweden formally tied their currencies to the EMS's ECU standard.¹⁸ Poland, at the time of devaluing the zloty by 17 percent against the dollar, will calculate the value of its currency against a basket of currencies more closely reflecting its external trade, since the dollar appreciation had hurt its exports vis-à-vis western Europe.¹⁹ John Major's was a "vision ... of an open Europe: open to trade and investment; open too to new members from Europe, East

and West ... [to] develop a form of EMU that permits them to join us and does not put up barriers against it."²⁰

As it stands now (end-May, 1991), England has been granted a reprieve: it would drop the "hard ecu" demand, would agree to the January 1, 1994 date for the beginning of the second stage toward EMU, but could choose the date for participation in it. The EC still intends to combine the establishment of the single European market with monetary union as its monetary extension, through "the phased introduction of a single currency issued by a single central bank.... It also involves closer coordination of member states' economic policies, through a few simple rules reflecting the principle of subsidiarity. All the studies show that economic and monetary union will substantially increase the benefits of the single market. And it will enable the Community to make a real contribution to international monetary stability."²¹ As German EC Commissioner Martin Bangemann recently observed: "Please don't be misled by the debate on monetary union and the central bank. There is no longer a debate on the events as such. It is a debate on conditions and timetables. There is a consensus about it"²² [ie., EMU] even, we might add, if it means a "Europe at many different speeds."

Endnotes

1. The EC plus the six Efta countries and Liechtenstein. Switzerland and Liechtenstein have a monetary union.
2. Commission of the European Communities, European Economy -- One Market, one money. 44(October 1990).
3. Michael Emerson, "The Economics of EMU." Institute for International Economics, International Economic Insights 1(November/December 1990):35.
4. Michael Emerson, "The Economics of EMU." Institute for International Economics, International Economic Insights 1(November/December 1990):35.
5. Report on economic and monetary union in the European Community, 1989.
6. John Major's "hard ECU" proposal was designed with this hypothesis in mind and can thus be considered as an alternative constitutional approach; it was different from the earlier Nigel Lawson currency competition proposal where exchange rate would have, preferably, remained flexible. "Major schlägt harte Ecu vor." VWD Finanz- und Wirtschaftsspiegel, June 25, 1990; Deutsche Bundesbank, Auszüge aus Presseartikeln (June 28, 1990):2.
7. "Major schlägt harte Ecu vor." VWD Finanz- und Wirtschaftsspiegel, June 25, 1990; Deutsche Bundesbank, Auszüge aus Presseartikeln (June 28, 1990):2?
8. "Wachsende Bedeutung the Ecu als Parallelwährung." Neue Zürcher Zeitung, April 16, 1991; Deutsche Bundesbank, Auszüge aus Presseartikeln (April 24, 1991):5.
9. Geschäftsbericht der Deutschen Bundesbank für das Jahr 1990, p. 11.
10. Leonard Silk, "Bonn's Contrasts with Washington." New York Times, May 17, 1991, D2.
11. It is interesting to note that Hans Tietmeyer, now one of the seven-member directorate of the Deutsche Bundesbank and slated to become Bundesbank president after Helmut Schlesinger's retirement, had been state secretary in the finance ministry and close adviser to Helmut Kohl at that juncture.

12. Michael Emerson, "The Economics of EMU." Institute for International Economics, International Economic Insights 1(November/December 1990):35.
13. Michael Emerson, "The Economics of EMU." Institute for International Economics, International Economic Insights 1(November/December 1990):35.
14. Referred to again in the New York Times, May 19, 1991, p. 3.
15. Geschäftsbericht der Deutschen Bundesbank für das Jahr 1990, p. 6. Emphasis added.
16. Geschäftsbericht der Deutschen Bundesbank für das Jahr 1990, p. 6.
17. Geschäftsbericht der Deutschen Bundesbank für das Jahr 1990, p. 8.
18. The Swedish krona had been coupled to a basket of currencies, in which the dollar, with 21.9 percent, carried the greatest weight.
19. Wall Street Journal, May 21, 1991.
20. Extracts from the Chancellor of the Exchequer's speech in London, June 20, 1990. Financial Times (London) June 21, 1990; Deutsche Bundesbank, Auszüge aus Presseartikeln (June 22, 1990):12.
21. Jacques Delors, "Europe after 1992: Signposts to Where?" Address to the Council of Foreign Relations, April 24, 1991. Mimeographed.
22. Eurecom, Monthly Bulletin of the European Community Economic and Financial News 3(April 1991):3.