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THE ROLE OF THE ECU IN THE PROCESS TO ECONOMIC AND MONETARY UNION.

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The President of the ECU Banking Association voiced some disappointment as he reviewed the content of the Report on economic and monetary union in the EC, signed unanimously by the 17 members of the Delors Committee in April 1989. Though some sense of disappointment may be justified by the relatively brief references in the Report to the ECU, I take a more positive view of the Report's emphasis on the institutional approach to European monetary integration relative to a so-called market approach of fostering competition between national currencies and the ECU.

In the following I propose to review first and primarily what the Report has to say about the ECU and subsequently to discuss briefly the vision of a deep monetary integration going all the way to a single currency. This vision is essential for giving perspective to the evaluation of the Report's contribution to the further development of the ECU.

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Four points on the ECU.

Having reviewed briefly in the first chapter the contrast between the limited role of the official ECU in the operating mechanisms of the EMS and the unexpectedly rapid growth – at least until 1985 – of the international banking and bond markets denominated in ECU, the Report returns in the third and final chapter on the steps towards economic and monetary union to the role that the ECU might play in this process. The Report makes four points on this subject:

(1) the ECU has the potential to be developed into a common currency;

(2) a parallel currency strategy for the ECU can not be recommended;

(3) the official ECU might be used as an instrument in the conduct of a common monetary policy; and

(4) there should be no discrimination against, and no administrative obstacles to, the private use of the ECU.

What is the main message from these admittedly short and occasionally, in appearance, conflicting points?

The essential point is (1). If one admits that a common currency would be a desirable feature at an early time after economic and monetary union, could it be anything but the ECU? Is the Report's statement more than the obvious minimum gesture? President Rambure's answer, I take it, would be no to both questions. I would, on the basis of my recollection of the views expressed in the Delors Committee, come up with a different answer.

Once exchange rates are irrevocably fixed among the participating currencies – the essential characteristic of an economic and monetary union – the area will begin to perform as if there were a single currency, and the existing national currencies will tend to become different names for the single currency. Does it matter for any essential purpose what unit is chosen – an existing national currency, the ECU or some otherwise defined unit? Could one not leave that question unresolved for that, possibly still remote, date when exchange rates have been irrevocably fixed and the introduction of a single currency is considered? Many would argue in favour of such a deferral, particularly since the issue is bound to raise politically sensitive problems relating to the symbolism of national monies, despite the, from a more technocratic viewpoint, apparent arbitrariness and even irrelevance of any particular solution adopted.

The Report might on such grounds have avoided the issue altogether. That would rightly have been seen as discouraging to the private users of the ECU market, because the longer-run fate of the unit would have become more uncertain. Mentioning the ECU (and only that unit) as the potential basis for a common currency gives market participants some assurance that the present ECU will shade over into a common currency unit with fixed exchange rates vis-a-vis the component currencies. As has been the case in the quinquennial revisions of the ECU basket in 1984 and 1989 the market value of the unit will show no discontinuity. Hence the unit can be safely used also in longer-term financial contracts, the maturity of which lies beyond the expected date of the irrevocable fixing of intra-EC exchange rates. To those, like myself, who take a positive view of the feasibility of full economic and monetary union within a decade a number of such contracts are already outstanding.

Mentioning the ECU's potential role as a future common currency also encourages practical planning for that eventuality in several areas. It becomes more likely that the unit will gain in importance for the purposes of transfer pricesystems in multinational enterprises and of accounting systems. More indirectly, the limited encouragement may be sufficient to prompt consideration of pricing to the market during a transitory period both in the producer/seller's national currency and in ECU. If one takes the feasibility of the common currency seriously, there is then a stronger incentive to familiarize oneself with calculations in ECU.

Altogether this amounts in my view to more than the "benign neglect" which some observers have used as a label for the Delors Committee's attitude to the ECU. But is not the rejection of a parallel currency role - point (2) - proof of hostility towards the unit, at least in the period until exchange rates have become fixed?

If one reads carefully the text (para. 47), a more qualified view emerges. What is being rejected is the effort to accelerate the process towards economic and monetary union through the issue, during the stages prior to the locking of exchange rates, of a new fully-fledged currency called the ECU, but in reality rather different from the unit we know to-day. It would no longer be a basket of the 12 EC-currencies, but an abstract unit to which the participating currencies would be pegged.It would be issued by an emerging European Central Banking System (ESCB) and it would compete in the various monetary functions with the national currencies.

The rejection in the Delors Report of this version of the parallel currency strategy is ostensibly based on two arguments: An additional source of money creation without linkage to economic activity could jeopardize price stability; and the addition of a new currency might complicate the already difficult effort of coordinating policy for the existing 12 currencies.

While not without foundation, these arguments are in themselves less than fully convincing. The issue of a parallel-currency ECU would be less in addition to than in replacement of national currencies. There is already some indication of currency substitution between the latter in the present system and there is a risk that the major national currency, the DM, could become a <u>de facto</u> parallel currency throughout much of the EMS area without this being the intention of either the German or other national authorities. Member states might find it easier rather than more difficult to influence the process of currency substitution through a conscious strategy for the ECU as a parallel currency than without it. But it does seem correct to say that it is in priciple possible to achieve the benefits of monetary integration prior to the locking of exchange rates via a gradual tightening of coordination of monetary policies for the participating currencies in stage one, and via some upgrading of decision-making on their relative positions and their aggregate supply in stage two, as proposed in the Report, while retaining the ECU largely as a private financial instrument - and not as an officially issued currency during these two stages.

There is also in my view a message in this apparently negative verdict which contains encouragement to the ECU Banking Association and others who have invested significant efforts over nearly a decade to build up a market of more than ECU 100 billion. The message is that no further experimentation with the basket construction is required. It is not advisable to think in terms of constructing an abstract unit to which national currencies are pegged rather than the present unit which reflects the average of the latter; nor is it recommended to narrow the present basket to a small number of its major component currencies. Both of these changes could prove upsetting to the market which has developed, particularly in the former case where market participants would have to form an opinion of the policies for managing the abstract ECU before full economic and monetary union is established. Once the decisive step of locking exchange rates has been taken, these various options will, indeed, merge into one and the responsibility for managing the system will be clearly vested in a central institution. By rejecting intermediate solutions for a new parallel currency prior to that stage the Report has also given a mark of approval to the unit around which large markets have been built up. This positive aspect of the message should not be discarded by participants in those markets.

When the EMS was launched there were expectations that the official ECU would come to play a central role as a reserve asset and a means of settlement among the central banks. In practice the system has developed differently, and the facilities have been much less used than was expected. The Report mentions – point (3) – that the potential of the official ECU as an instrument of joint monetary control has also remained unexplored. Some members of the Committee made suggestions for developing the official ECU, defined as the present basket, into a common reserve base money through which domestic money creation in the participating countries could be controlled. It is unfortunate that these suggestions were in the end relegated to a volume of personally contributed annexes, to be published in August 1989, some months after the completion of the Report. These ideas will form part of the basis for the elaboration of stages two and three in the EC Monetary Committee and the Committee of Central

Bank Governors.

The basic idea on the use of the official ECU can be simply stated. The ESCB which is to begin operation when Treaty changes attributing some monetary competence to it have been ratified at the end of stage one, could be empowered to impose modest reserve requirements on national central banks in proportion to their domestic money creation, and to issue to them, through allocations or by open market purchases in the respective national markets, a volume of reserves judged adequate to sustain the rate of domestic money creation agreed upon within the system. The ESCB would retain tight control over the volume of such reserves, to be denominated in ECU. In stage two the ESCB would only be in contact with the national central banks and no merging of the markets for private and official ECU would be foreseen. In stage three one might consider bringing the ESCB into direct contact with private banks by extending the reserve requirement system to apply directly to the latter. This would create the foundations of a system – wide market for reserve money in which the terms on which the ESCB were to accommodate marginal needs for credit would become the focal point of monetary policy, as is the case in national systems to–day. The interest rate of the reserve ECU would then become divorced from an average of rates on the component currencies.

This is obviously only a long–run possibility, but it may be sufficient to indicate that the so–called institutionalist approach to monetary integration, when elaborated in more detail, has considerable potential for making use of the ECU in a way that can hardly fail to give momentum also to the private use of the unit. The transformation of the official ECU from a shadowy concept of accounting and settlement between central banks towards an instrument of monetary control will increasingly focus attention on the value and the remuneration of the unit and prepare for the day, after the locking of exchange rates when truly system–wide markets in ECU, ranging all the way from reserve money assets ("Federal Funds" in the US analogy) to long–term securities, emerge.

There is little to say on point (4), the ambition to remove all discrimination against and administrative obstacles to pri–

vate use of the ECU. On this point it must be admitted that the Report is not only brief, but also insufficient to give any basis for the efforts of interpretation that are made above with respect to points (1)-(3). Briefly stated, the prevailing views of national authorities appear to be that, having put the ECU in nearly all respects on the same footing as a foreign currency, there is little more to be done; the rest should be up to the choice of private market participants and the public institutions which use the ECU. No need was perceived by most members of the Delors Committee to address specific recommendations to these users. Now was there any suggestion to modify the discrimination in favour of national currencies which exists through legal tender provisions. That would have brought back outright advocacy of a conscious parallel currency strategy for the ECU, rejected by the Committee for the stages prior to full economic and monetary union.

The task of pointing out how a more specific content could be given to the general encouragement of a resumption of growing private use of the ECU through liberalization therefore rests with market participants and with the ECU Banking Association in particular. As one can see in the recent report by your Association's Macro-Financial Study Group (EBA Newsletter, April 1989) there is no shortage of ideas, and I shall leave it to the chairman of that study group, Professor Alfred Steinherr, to comment on them.

<u>Wider implications for the ECU of the Delors Report</u>.

The survey of the preceeding section of the four specific points regarding the ECU, mentioned in the final chapter of the Delors Report, is far from exhausting the implications for the ECU contained in the Report.

On the whole the Report has in my view to be seen as a bold document where one considers that the bulk of the membership of the Committee was made-up of the governors of the twelve EC central banks who could be expected to be more cautious in their approach to monetary integration than their governments and more conscious of the risks inherent in the process. Though the Report contains a blunt analysis of the non-monetary prerequisites for irrevocably fixed exchange rates, including the authority for the Council of Ministers to fix binding rules for budget deficits. it clearly considers full monetary integration a viable option for the Community. The Report is remarkably specific on the mandate, functions, structure and status of a joint monetary authority and it emphasises that the monetary policy to be conducted by that authority would be committed to the objective of price stability. By underlining the classical central banking function of contributing to a high degree of predictability and stability of the future price level, the Report has taken seriously the concerns of the most stability-oriented members of the present EMS. The challenge outlined is that of extending into a future of joint monetary management the best practice of the present EMS. Since it has for some time been clear that there will only be an ultimately single currency, if that currency is supplied - and seen to be supplied - in a way broadly consistent with stable prices, the Report brings the achievement of that objective nearer.

The Report also makes an effort at linking the pragmatic steps towards strengthening the EMS which are feasible within the present Treaty to the longer-run, though not very distant, future in which the ESCB is to begin to operate and build up experience in preparation of the irrevocable locking of exchange rates. By giving a first outline of how procedures of coordination may be tightened and gradually upgraded to an EC forum, the Report has, hopefully, begun to bridge the gap between pragmatism and radicalism.

By endorsing that preparations for the second and third stage should begin immediately to form the basis for an intergovernmental conference to be convened "once the first stage has begun" in July 1990, the European Council in Madrid on June 26-27, 1989 in its conclusions maintained the linkage of the three stages proposed in the Delors Report and the momentum intended for the whole process. While the outcome of these preparations and, even more so, of the intergovernmental conference remains uncertain, the Delors Report as a whole and the process it has helped to maintain should offer far more encouragement to those engaged as active participants in the ECU market than meticulous textual interpretation of what is actually said about the ECU in the Report.