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Is an ECU Parallel Currency the Way to Achieve European Monetary Integration?

by Peter Bofinger, Stuttgart*

A very lively debate has now developed about the future of European monetary policy. Dr. Peter Bofinger analyses the arguments for and against the promotion of the ECU as a parallel currency.

Hardly a month now passes without one expert or another demanding some programme of action or initiative for monetary integration in Europe.¹ In most cases, they call for measures that are as comprehensive and "pragmatic" as possible and quick to implement; any attempt to work out the basic principles of feasible monetary integration in Europe is, at best, a peripheral consideration. This is particularly evident with regard to the role that should be allotted to the European Currency Unit (ECU), not only in the distant future when the Community is integrated on the monetary plane but also on the long road to that goal.

The predominant view among proponents of the ECU seems to be that all steps that promote the official and private use of the ECU are automatically a valid contribution towards the optimum configuration of a European monetary union. In the final analysis, this can only be based on the hope that in its capacity as a parallel currency the ECU will eventually succeed in driving national currencies out of the market by force of competition. I propose to examine in detail the concept behind the parallel currency strategy and the expectations on which it is based, which are of key importance for the roles to be attributed to the ECU in the future.

Fixed Exchange Rates or a Common Currency?

Discussion of a European parallel currency makes no sense at all unless there is prior agreement as to the form of monetary union Europe is ultimately seeking to achieve:

- ☐ A system involving the existing national currencies, interlinked by unchangeable fixed exchange rates

without margins of fluctuation: the European Monetary System (EMS) could be developed into such a monetary union without major institutional changes if the existing margins of fluctuation around central rates were gradually reduced² and if all member countries were prepared to pursue a policy aimed at maintaining price stability, so that the need for currency realignments would disappear. A monetary union in such a form would not require any strengthening of the role of the ECU, which has been of no significance whatsoever for the functioning of the EMS. The Community could dispense with a common European currency unit, and it could equally well dispense with banknotes and coin denominated in this unit and with a European central bank. Instead of institutional arrangements of this kind, a European monetary union in the form of an area of fixed exchange rates would require above all else the co-ordination of national monetary policies, possibly in the form of a European money supply target based on national money supply targets, as proposed by Ronald

¹ See for example Helmut Schmidt: Vorschläge für eine Weiterentwicklung des Europäischen Währungssystems, in: Europa-Archiv, Vol. 40 (1985), No. 8, pp. 223-232; Robert Triffin: Vorschläge zur Stärkung des Europäischen Währungssystems, in: Ifo-Schnelldienst No. 17/18, 1985, pp. 8-14; Société Générale: L'Ecu, Naissance et développement d'une nouvelle monnaie, in: Conjoncture, February 1985, pp. 2-14; Association Belge des Banques: L'ECU et les Banques, Brussels, March 1985; Report drawn up on behalf of the Committee on Economic and Monetary Affairs, On the consolidation and completion of the European Monetary System within the framework of the proposals made by the Commission of the European Communities (Herman Report), European Parliament Working Documents (1983-84), Document 1-1251/83.

² For example, this was the intention of the decision of the Council and the representatives of the governments of member states of 22nd March 1971 on the step-by-step realisation of economic and monetary union in the Community. Reproduced in R. Hellmann, B. Molitor (eds.): Textsammlung zur Wirtschafts- und Währungsunion der EG, Baden-Baden 1973, p. 47.

³ See Ronald McKinnon: An International Standard for Monetary Stability, Washington 1984.

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McKinnon with particular reference to the major reserve currencies (the dollar, the yen and the D-Mark).³

□ An alternative form of monetary integration would be for a common European currency to replace national currencies. If it were considered politically undesirable for one of the existing national currencies to perform this role, an additional Community currency such as the ECU would be needed. A European central bank would also have to be established for a monetary union such as this.

The relative merits of the two types of integration cannot be fully discussed here. Robert Triffin considers the second option preferable, mainly on international monetary grounds, for in his opinion the ECU would then be in a position to act as a worldwide alternative to the dollar, thereby dampening the fluctuations in the dollar exchange rate.⁴ However, Triffin fails to show why the ECU/dollar rate should fluctuate less than the present-day DM/dollar rate and the dollar rates of the other EMS currencies that are stabilised vis-à-vis one another through the exchange rate mechanism. Be that as it may, one should advocate strengthening the role of the ECU only if it has already been decided in principle that European monetary integration of the "common currency" type is the better solution. Hitherto, none of the proponents of the ECU has taken the trouble to work out a reply to this fundamental question.⁵

Dominance of Market Forces?

Even the ultimate objective of a common European currency does not provide conclusive grounds for adopting a parallel currency strategy. This strategy is only one of two possible courses:

□ It would be possible to conceive of a sweeping European currency reform in which all national currencies and central banks were replaced *overnight* by the ECU and a European central bank.

□ Instead of taking such a radical step, the countries of the Community could opt for a gradualistic approach whereby national currencies would be displaced *over a period of time* by the ECU acting as a parallel currency.⁶

The fundamental idea of gradual displacement in this way was aired as early as 1975 in the "All Saints' Day Manifesto for European Monetary Union", a study by nine European monetary theoreticians. The key

sentence of the manifesto reads as follows: "It is difficult to envisage a monetary union created by official edicts and legalistic structures. It must evolve on the market place."⁷ Instead of discretionary government decisions, reliance is placed on the automatic and gradual effects of market forces, which it is hoped will eventually create a situation that the politicians can no longer evade.

It is open to speculation whether this is an accurate assessment of the political decision-making process. Two points are at least questionable. First, it is surely a bold assumption that a government that is deliberately and knowingly unwilling to replace its national currency by a European currency would approve arrangements that would lead to the same result, admittedly not immediately but in the course of time. That implies the assumption that governments are not able adequately to assess the longer-term implications of arrangements they are called upon to establish. Secondly, even such an unknowing government would make its aversion to a European currency felt if its own currency was being increasingly displaced by the ECU while national currencies continued to predominate in the other EMS countries. If a government continues to be interested in having an independent national currency, it can halt the displacement process at any time by introducing restrictions on capital movements or regulations similar to Section 3 of the German Currency Law. To that extent, it is far from certain that market forces could achieve something that politicians were intent on preventing.

It would make sense to intensify this strategy debate only if it were fairly certain that the ECU could actually succeed in asserting itself in the face of competition from national currencies.

For a parallel currency strategy relying on market forces, no more than secondary importance attaches to the so-called "official" ECU, which is used only in transactions between the central banks of the EC. If non-EC central banks were interested in holding ECU exchange reserves as a means of diversifying their portfolios and thus protecting them against exchange rate fluctuations, they would probably be motivated by investment considerations similar to those of major private investors. A distinction between ECUs held as "exchange reserves" on the basis of such considerations and ECUs held by private investors does

⁴ Robert Triffin, *op. cit.*, p. 11.

⁵ Things were different in the seventies; see, for example, Hans Möller, Wolfgang Cezanne: Die Europäische Union als Währungsunion?, Vol. 5 in the series: Möglichkeiten und Grenzen einer Europäischen Union, edited by Hans von der Groeben and Hans Möller, Baden-Baden 1979, pp. 160 ff.

⁶ One can argue whether in its current form as a basket of currencies the ECU can be regarded as a true parallel currency, since the margins of fluctuation between the ECU and the national EMS currencies are limited by the intervention points. I consider this a purely semantic question.

⁷ Reproduced in M. Fratianni, T. Peeters (eds.): *One Money for Europe*, London and Basingstoke 1978, pp. 37-43.

not seem appropriate. Hence, the remainder of this article will discuss only the private use of the ECU.

At first sight, the success of the ECU in this area so far might indicate that this currency unit has tremendous development prospects. The ECU is now firmly established in the international money and capital markets, where its importance is comparable to that of the pound sterling or the Japanese yen. Nevertheless, the ECU's share of international bond issues (Euro-bonds and traditional foreign bonds) is relatively small, at around 4 % in the first half of 1985. In addition, concentration on the international markets can easily give a misleading impression, particularly if one wishes to determine whether the ECU might succeed in displacing national currencies. It is easy to overlook the national bonds issued by domestic issuers in domestic currency, which are much more significant in quantitative terms.

This emerges very clearly from a comparison between the ECU and the D-Mark. In 1984 DM Euro-bond issues totalled DM 12.3 billion, whereas ECU issues came to DM 8.4 billion.⁸ By confining the comparison to the Euro-market, it would be easy to gain the impression that the ECU was already beginning to rival the Mark. However, whereas ECU issues are made only on the Euro-market, a further DM 15.7 billion in foreign bonds was placed in the DM market in 1984, as well as DM 71 billion in new issues of domestic DM fixed-interest securities. The situation is similar with regard to the other EC currencies. In the ECU banking market, which recorded a volume of US\$ 28.0 billion at the end of 1984, non-bank ECU deposits accounted for just US\$ 2 billion, an insignificant amount in comparison with the total money stock of the EMS countries of around US\$ 1,200 billion. Hence, at present the ECU has not even begun to displace the D-Mark and the other EC currencies.

Equal Opportunities

Against this, it can be argued that the ECU has not been given particularly good opportunities to compete on equal terms with national currencies:

□ In Italy and France there are severe restrictions on residents purchasing ECU bonds issued by domestic and foreign issuers, holding ECU bank deposits and raising ECU bank loans for any purpose they wish. On the other hand, in certain strictly defined fields these countries accord the ECU specific competitive advantages over other national currencies and even over the domestic currency; for example, in France

export finance, foreign bank loans and ECU bonds issued by European Community institutions are exempt from restrictions on capital movements. It is difficult to assess which effect predominates.

□ In the Federal Republic of Germany residents can acquire ECU claims and hold ECU accounts in any amount, provided the debtor is a non-resident. However, Section 3 of the Currency Law forbids residents to assume liabilities denominated in ECUs.

The advocates of an ECU parallel currency strategy obviously call for all restrictions of this kind to be removed. Whether the ECU will be able to assert itself in competition with other currencies will depend crucially on whether the EMS countries feel able to let their citizens have unrestricted freedom of choice between the national currency, the ECU and all other national currencies or will permit only a limited choice between the ECU and the national currency. As the German authorities are unlikely to agree to liberalise the use of ECUs at home if existing foreign restrictions on capital movements remain in place, currency competition in Europe is conceivable only on the basis that the ECU compete as a parallel currency in each country against all the national currencies. The advocates of intensified use of the ECU, such as Helmut Schmidt and the authors of the Herman Report, also argue in favour of unrestricted freedom of capital movements in Europe.

Nonetheless, even if the European money and capital markets were to be fully liberalised, there is no guarantee that the ECU would enjoy the same opportunities as national currencies. In Germany, for example, even if a general exemption were granted under Section 3 of the Currency Law, residents would not be able

□ to quote prices to ultimate consumers in ECUs (owing to the Order Regulating Price Information),

□ to draw up their trading or tax accounts in ECUs (owing to Section 40 of the Commercial Code),

□ to elect to pay taxes and damages in ECUs.

For the ECU to enjoy complete equality of opportunity with national currencies, private individuals would have to be given complete freedom of choice in such areas as well. However, this appears to be far from realistic and even inadvisable in certain areas.⁹ To that extent an ECU parallel currency will probably always be at some competitive disadvantage in relation to national currencies.

⁸ Converted at the average DM/dollar rate for 1984.

⁹ For a fuller treatment, see Peter Bofinger: *Währungswettbewerb*, Cologne 1985, pp. 75 and 113 ff.

Let us now run through a scenario based on the following assumptions:

- ☐ There are no restrictions on the movement of money and capital in Europe.
- ☐ Residents of the Federal Republic of Germany are free not only to acquire ECU claims but also to contract debts in ECUs.
- ☐ ECU banknotes and ECU coinage are issued by an ECU central bank.¹⁰
- ☐ National regulations such as balance-sheet regulations and price labelling requirements that favour national currencies have no impact on competition.

This scenario will be played through as regards the functions of money as both a medium of exchange and a store of value.

Competition among Currencies as a Means of Exchange

What might induce an Italian, a Frenchman or a German to hold part of their transactions balances not in national currency but in ECUs? If their transaction balances were to be used solely to make payments within their own countries, such "currency substitution" would entail additional transaction costs in every case:

- ☐ The national means of exchange would have to be exchanged for ECUs at the beginning of the planning period.
- ☐ There is no assurance that the recipient of the payment would be willing to accept ECUs in place of national currency.¹¹ Further conversion costs would then arise, or another seller would have to be sought who was prepared to accept payment in ECUs. Even if the recipient were prepared to accept ECUs, information costs would always be incurred, as the day's ECU rate for the national currency in question would have to be determined, at least as long as the present margins of fluctuation within the EMS are maintained.

It is advantageous for an individual or entity to bear these transaction and information costs only if the holding of ECU payment instruments promises a higher "investment utility"¹² than the holding of payment instruments denominated in the national currency. In the case of interest-bearing ECU payment instruments, it should be assumed that they can offer no systematic advantage over interest-bearing payment instruments in national currency as far as investment utility is concerned, as efficient foreign exchange markets always ensure that expectations of changes in exchange rates are offset by corresponding interest rate

differences. Hence even if the cost of converting national payment instruments into ECUs and vice versa is relatively low, interest-bearing ECU payment instruments stand no chance against interest-bearing instruments denominated in national currency.

As far as the function as a means of exchange is concerned, the ECU can therefore compete only in terms of non-interest-bearing cash. In "weak currency countries" such as Italy it is not improbable that an ECU banknote would have a higher investment utility than a lira banknote. For that to remain true, however, Italy's inflation rate would have to remain above the Community average and realignments would have to be made within the EMS broadly in line with the inflation differential. Given the now small discrepancy between Italy's inflation rate (expected to be around 8 % in 1985) and the Community average (around 5 %), it seems highly improbable that the possible revaluation gain that an Italian can make by converting part of his transaction balance into ECUs will be sufficient to offset the transaction cost disadvantages of ECU banknotes and coin; if the average cash holding in ECUs were, say, the equivalent of DM 300, an annual 3 % revaluation of the ECU against the lira would produce an annual investment utility advantage of just DM 9. Even if one assumes that this advantage would lead to a significant displacement of lira cash by ECUs, it would still be within the power of Italian economic policy to halt this process by adopting stabilisation measures. The parallel currency strategy would thus have run its course if it induced a country to seek greater convergence of economic policies. In any case, non-interest-bearing cash accounts for a relatively small proportion of the total money supply in countries with a high inflation rate; in Italy it is around 15 %.

Not Particularly Attractive

The strategy presents a further problem: the competition described here would not be confined to the ECU and the national currency. The currencies of Community countries oriented towards stability, such as the D-Mark, should also be considered as competitors. If the cost of converting lire into ECUs is exactly the

¹⁰ ECUs could be issued in other ways, for example by national central banks. However, this question is of little significance for the analysis that follows.

¹¹ This would also be the case if the ECU were made legal tender. The debtor's freedom of choice would not be curtailed by such a measure provided he settled on a currency other than the ECU when concluding the contract. For a fuller treatment, see Peter Bofinger, *op. cit.*, pp. 62 ff.

¹² The investment utility of a security comprises the interest on the security plus the change in the value of the security expected over the investment period.

same as that of converting lire into Mark, it is self-evident that the Mark is greatly preferable to both the lira and the ECU, particularly as the Mark is already legal tender in a large monetary area, the Federal Republic of Germany. Hence, if currency competition develops at all in Europe, which must be open to doubt given the comparatively high transaction costs and only small investment utility advantages, the most it might do is to establish the monetary supremacy of the D-Mark. A currency of middling quality, such as the ECU, would therefore stand no chance of gaining acceptance even in weak currency countries, not to speak of the EMS countries with currencies of above-average stability.

In the light of these considerations, it is also perfectly logical that the authors of the All Saints' Day Manifesto of 1975 did not campaign for a European currency of the ECU type but for a parallel currency that would show no loss of purchasing power when measured against an average European basket of goods. If the purchasing power parity theory applies, such an index-based currency would also show an investment utility advantage over the D-Mark, so that in theory at least, and assuming very low transaction costs, it could also make ground against the D-Mark in the cash field.

The low attractiveness of the ECU in relation to the D-Mark changes very little if currency competition is concentrated on cross-frontier transactions. For a German exporter and an Italian importer it is attractive to

invoice in ECUs at present owing to Italian restrictions on capital movements. However, if money and capital movements were completely free, they would no longer have any incentive to use the ECU instead of one of the two national currencies. Indeed, invoicing and settlement in ECUs would entail higher overall transaction costs than the use of one of the national currencies. Nor would it be any benefit for travellers spending their holiday in an EMS country if they had to exchange their money from, say, D-Mark into ECUs instead of lire. In this area the Eurocheque system already provides a very efficient and widespread communications network for intra-European settlements in which the currency in which the account of the payer and that of the payee are denominated is of purely secondary importance. The same applies to credit card networks, such as Eurocard; the decisive factor in saving transaction costs in such exchange intermediation systems is no longer the convertibility of currencies but the compatibility of payment systems. In these areas the market (or more precisely the banking system) has succeeded in creating a meaningful form of monetary integration in Europe, years ahead of the Eurocrats.

Competition among Currencies as a Store of Value

Although one gives the ECU extremely slim chances of surviving in the market as far as its function as a means of exchange is concerned, the displacement

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Michael Frenkel

MAKROÖKONOMIK DES PROTEKTIONISMUS BEI FESTEN UND FLEXIBLEN WECHSELKURSEN

(THE MACROECONOMICS OF PROTECTIONISM UNDER FIXED AND FLEXIBLE EXCHANGE RATES)

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process might possibly come about as a result of its gaining acceptance as a store of value (and as a unit of account). This is considered a realistic proposition by Roland Vaubel, for example, one of the advocates of an indexed parallel Community currency.¹³ If one concentrates on the function of money as a store of value, it is obvious that there will be little demand for non-interest-bearing ECU notes and coin for that purpose as long as interest-bearing securities in national currency are available. What has already been said with regard to interest-bearing payment instruments also applies to competition between interest-bearing ECU investments and interest-bearing investments in national currency: if interest rates for the national currencies and hence also for the ECU basket currency reflect the expectations of changes in exchange rates for these currencies and the ECU, the ECU in itself is no more attractive as a store of value than national currencies. The argument that the ECU is a particularly safe currency since it is a basket currency also carries very little weight; for an investor who plans to make the bulk of his future expenditure in national currency, only the national currency itself constitutes a "safe" investment. Every investment in foreign currency is less secure by comparison. The ECU possibly stands out as the least insecure investment for those who hitherto had no foreign currency position, since

- ☐ the national currency always makes up a certain proportion of the ECU currency basket;
- ☐ fluctuations in the exchange rate of an EMS currency contained in the exchange rate mechanism must be smaller vis-à-vis the ECU than vis-à-vis a currency such as the dollar or yen, and
- ☐ being a basket of currencies, the ECU offers the advantage of diversification.

These advantages of the ECU may induce investors from EMS countries to substitute ECUs for the part of their portfolio previously denominated in a foreign currency. However, it continues to be much safer to invest the store of value in securities denominated in national currency. For companies operating in international markets, it may be safer to place their resources not in ECUs but in, say, pounds or yen if they export their goods to the United Kingdom or Japan. Hence, a possible process of displacement cannot be deduced in respect of this function of money either. In this area the ECU proves at best to be a valuable addition to the range of investment possibilities.

Hence Helmut Schmidt's dogmatic statement that "there will naturally be a tendency for the weaker currencies to be displaced"¹⁴ does not hold good.

Neither as a means of exchange nor as a store of value do securities denominated in ECUs appear to be a superior alternative to national currencies, even those of "weak currency countries". In the case of the function of money as a means of exchange, the hurdle of transaction cost disadvantages that the ECU must overcome in relation to established currencies is higher than the possible investment utility advantages. If the cost of converting currencies should ever decline in importance, then it is not the ECU but the D-Mark that will gain supremacy in Europe. In the case of its function as a store of value, the spread of the ECU is impeded by the fact that it is far less "safe" than domestic currencies and that companies operating internationally are safer if they aim for an investment portfolio tailored to their foreign exchange position than one in the "artificial" ECU.

An Alternative

The lesson for European monetary policy is clear: it is not worth setting store by a parallel currency strategy centred on a currency of only middling quality. Hence there is also no sense in taking measures to strengthen the official and private roles of the ECU that can be justified only on the basis of such a strategy. It would surely not be difficult to abandon a rather unpromising path to monetary integration that is in any case beset by uncertainties and speculation, since the foundations for even closer monetary co-operation have already been laid in the form of the European Monetary System and its exchange rate mechanism. Given adequate economic stability and convergence in all member states, the exchange rate mechanism based on bilateral intervention points, in which the ECU plays only a supporting role as a divergence indicator, can lead to a high degree of monetary integration in Europe

- ☐ through the abolition of the wider margin of fluctuation for the lira,
- ☐ through the entry of the United Kingdom,
- ☐ through narrower margins of fluctuation for all member currencies,
- ☐ through the removal of all controls on capital movements, and
- ☐ possibly through the setting of a common European money supply target,

without the need for new monetary institutions entailing scarcely quantifiable risks.

¹³ Roland Vaubel: *Strategies for Currency Unification*, Tübingen 1978, pp. 181 ff.

¹⁴ Helmut Schmidt, *op. cit.*, p. 227.