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Article — Digitized Version

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Intereconomics

Suggested Citation: Hack, Stefan Johannes; Maennig, Wolfgang (1991) : Does EMU need stage two?, Intereconomics, ISSN 0020-5346, Verlag Weltarchiv, Hamburg, Vol. 26, Iss. 1, pp. 19-24, <https://doi.org/10.1007/BF02928891>

This Version is available at:

<https://hdl.handle.net/10419/140278>

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Stefan Johannes Hack and Wolfgang Maennig*

Does EMU Need Stage Two?

The Delors Committee's three stage plan for attaining European Economic and Monetary Union has met with heavy criticism and has given rise to various counter-proposals. The following article examines the relative merits and shortcomings of the Delors Plan and the alternative concepts presented by the Deutsche Bundesbank and the British Government.

The Delors Report,¹ published in 1989, laid out a three stage plan for attaining European Economic and Monetary Union (EMU). The Community is currently in the first stage of this plan. In the criticism of stage two which is scheduled to begin on January 1, 1994 two main lines of argument can be discerned:

- On the one hand there are those who, while in favour of stage three, i.e. full monetary union, question the necessity of a transitional stage two. In this context, the possibility of a "dual-speed" union has been raised, notably by the governor of the Deutsche Bundesbank.
- On the other hand, it is sometimes reasoned that stages two and three of the Delors Plan do not offer the appropriate way towards EMU. According to this view, most clearly put by the British Government, a different approach should be followed which would allow the markets to determine if a single currency Europe comes about. The then Chancellor of the Exchequer in June 1990 outlined the "Major Plan" as an alternative to stages two and three of the Delors Plan.

The Delors Plan

The mandate given by the European Council to the Delors Committee in 1988 was only to show *how* EMU might be achieved. The committee left open whether such a union was desirable.

To attain monetary union, the committee recommended a step-by-step approach with three discrete stages.

Stage one of the process could be implemented within the existing legal framework. It began on July 1, 1990. Its main features were a strengthening of the powers of the committee of central bank governors and the full liberalization of capital flows.

No date was set for stages two and three; their inception will require a formal agreement between member states. At the end of the process, a new Community institution, a European System of Central Banks (ESCB), will be solely responsible for monetary policy. The new institution is needed "...because a single monetary policy cannot result from independent decisions and actions by different central banks."² With the ratification of the Single European Act in 1986, a clause was added to the Treaty of Rome stipulating that institutional changes in the monetary field required a change in the Treaty.³ Since Treaty changes can only be decided upon unanimously and need to be ratified by national parliaments, the founding of the ESCB may be regarded as a significant commitment to EMU by all EC member states. Neither the "construction" (i.e. the different stages before completion) nor the eventual "architecture" (i.e. the final structure, mandate, etc.) of the ESCB are as yet agreed upon. The two issues should be kept apart, as agreement on the latter may come about without a concomitant agreement on how to build it. The Delors Plan contains a fairly detailed proposal for the mandate and institutional characteristics of the ESCB. Federal and independent in nature, it would be governed by a Council made up of the twelve central bank presidents and the members of the Board appointed by the European Council. As mentioned above, the ESCB would be solely responsible for the formulation of monetary policy in the Community and committed to the objective of price stability. The System would be

¹ Committee for the Study of Economic and Monetary Union: Report on economic and monetary union in the European Community, Office for Official Publications of the European Communities, Luxembourg 1989. Hereafter quoted as "Delors Plan" with the paragraph number.

² Delors Plan, para. 32.

³ Treaties establishing the European Communities (ECSC, EEC, EAEC) – Single European Act – Other basic instruments (abridged ed.): Article 102 a, Office for Official Publications of the European Communities, Luxembourg 1987, p. 209.

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accountable through an annual report to the European Parliament and the European Council.

As regards the construction of the ESCB, the Delors Plan recommended that stage two should be a transitional or training stage, in which national central banks (NCBs) and the ESCB would exist alongside each other, with the former "...gradually tak(ing) over operational functions..." while the NCBs retained the ultimate responsibility for policy decisions. However, the Delors Committee did not "...consider it possible to propose a detailed blueprint for accomplishing this transition..."⁴

Stage three is characterised by irrevocably locked exchange rates in the beginning. The ESCB will receive full monetary authority. Decisions on exchange market interventions will be taken by the ESCB Council, according to the exchange rate policy of the Community. Finally, the ESCB will prepare the transition to a single Community currency that will be the "crowning touch" of EMU.

Stage Two: Limited Role for the ESCB

With stage one being of a preparatory nature, the Community members commit themselves to "full" monetary union at the beginning of stage two. It is hardly surprising that the Delors Committee did not propose a date on which such a move might be contemplated. Rather, it was felt that "...material progress on the economic front would be necessary for further progress on the monetary front..." and that the "...setting of explicit deadlines is therefore not advisable."⁵

Nonetheless, in the months after the publication of the Delors Report a number of such dates were suggested. Finally, eleven of the twelve heads of state (Mrs. Thatcher being the twelfth) agreed on October 27/28, 1990, at an extraordinary Council meeting in Rome, that stage two should start on January 1, 1994 and should see the

establishment of the ESCB. Three points are worth noting about the date and the process of stage two.

(1) While the Conclusions of the Presidency⁶ provide a strong impetus for a "speedy" union, within the existing legal framework of the Community no further steps can be taken if the Treaty is not amended. That task, though, is outside the scope of the heads of state, for the Treaty change requires ratification by national legislative bodies as well. The committee of central bank governors in December 1990 submitted its draft of the statutes of the ESCB to the intergovernmental conference on EMU that is preparing the Treaty change. Should it prove impossible to reach agreement on the two points mentioned above, i.e. the construction and architecture of the ESCB, progress could be halted by the "veto" of every single Community member. In these circumstances, some thought might be given to progressing outside the existing Community framework.

(2) The Conclusions do not foresee an operative role for the ESCB in stage two. Rather, its contribution would be limited to the co-ordination of the monetary policies and to the development of instruments and procedures needed for the future conduct of a single monetary policy.⁷ These are responsibilities which up to now are being carried out by the committee of central bank governors. A stage two thus defined is little more than a continuation of stage one under a different name. Nevertheless, there are some more detailed plans for this transitional phase. The governor of the Banca d'Italia and the European Commission have proposed a detailed blueprint for such a transition which enjoys a good deal of support amongst EC members.⁸ According to this proposal, the national central and commercial banks would continue to operate as before but would rely for their money creation on high-powered ECUs issued by the ESCB. Initially, the constraint

⁴ Delors Plan, paras. 55 and 57.

⁵ Delors Plan, paras. 42 and 43.

⁶ European Council: Conclusions of the Presidency issued after the European Council on 27/28 October 1990. Reprinted in: Bank for International Settlements: BIS Review, 30 October 1990. Hereafter quoted as "Conclusions of the Presidency" with the paragraph number.

⁷ Conclusions of the Presidency, para I.2.

PUBLICATIONS OF THE HWWA-INSTITUT FÜR WIRTSCHAFTSFORSCHUNG-HAMBURG

WELTKONJUNKTURDIENST

Annual subscription rate
DM 80,-
ISBN 0342-6335

This quarterly report – compiled by the Department of World Business Trends of the Hamburg Institute for Economic Research (HWWA) – analyses and forecasts the economic development of the most important Western industrial nations and of the international raw materials markets.

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created by the "forced" ECU holdings would be fairly loose – until at some point in time the ECU created by the ESCB would be declared the sole monetary base.⁹

(3) Of greater interest is the requirement that *at the latest* within three years from the start of phase two, a progress report shall be prepared by the Commission and the ESCB Council. On the basis of this progress report the European Council will take the decision on entry into stage three, "...which will occur within a reasonable time." Stage three need not, however, be reached by everyone at the same time: the Conclusions point out that the Treaty "...may lay down transitional provisions for the successive stages of economic and monetary union according to the circumstances of the different countries."¹⁰

The Conclusions of the Presidency reflect a strong trend in the Community towards visible progress in building EMU. The above has shown that by 1997 at the latest, the Council will be faced with the question of when to move to stage three. Prior to that time, the ESCB as outlined in the Council Conclusions would have only a symbolic role.

The Bundesbank View

Although the Bundesbank has always subscribed to the idea of European monetary union, it has also time and again made clear that it belongs to the "economist" school of thought. This is reflected in the "coronation" or "hardening" strategies put forward by the Bundesbank and a number of German economists. In their view, EMU may most safely be achieved by allowing the present arrangements (i.e. the EMS and the ERM) to continue until economic convergence amongst EC members has hardened to the point where it may be crowned by a common monetary policy.¹¹ The "monetarist" alternative of first establishing a joint monetary policy in the hope that economic convergence will follow would lead, in the words of the Bundesbank, to "grave risks for stability" in Germany.¹² Accordingly, the Bundesbank feels that the

decision to enter stage three of the Delors Plan should be made dependent not on any predetermined dates but on the degree of economic convergence reached.

A second point concerns the question of transitional periods on the road to EMU. Mr. Pöhl has repeatedly stated that "monetary policy is indivisible"¹³ and responsibility for it must rest *either* with a Community body *or* with the competent national authorities. A gradual transfer of national sovereignty as envisaged for stage two in the Delors Plan is not a satisfactory solution. Should the Bundesbank find itself unable to participate in any such scheme, a different dual speed strategy – with Germany in the rearguard – might be the result.

Both the Bundesbank and its governor recognise however the strong political drive towards EMU which has manifested itself in the Council Conclusions and which has been increased by German reunification and the accompanying calls for a stronger incorporation of Germany into Europe.

Thus if EMU is indeed to come sooner rather than later, it might as well come without the three-year waiting period during which the ESCB is little but an "empty shell".¹⁴ Rather, it would seem sensible to call a "full-scale" ESCB into life as soon as possible after 1994 with full membership open to all those countries who had reached a sufficient degree of convergence. It will be recalled that such a course is entirely possible under the Conclusions of the Presidency which speak of "three years at the latest" before the progress report is drawn up and of "transitional provisions" for some countries.

Dual Speed Strategy

The high speed of monetary integration might well be overly demanding for some member countries. In July 1990, the governor of the Deutsche Bundesbank, Karl-Otto Pöhl, suggested a dual speed union in which a "core" group of countries would "...start with a European System of Central Banks and others who have not reached the same degree of convergence are invited for later."¹⁵ The governor's remarks met with little support from the "late-comers" and the idea was never taken up officially. Yet when the decisions reached at the October summit are combined with the German position on EMU, a dual speed strategy seems worth discussing.

⁹ Carlo A. Ciampi: An operational framework for an integrated monetary policy in Europe, in: European Communities (ed.): Collection of papers submitted to the Committee for the Study of Economic and Monetary Union, Office for Official Publications of the European Communities, Luxembourg 1989, pp. 225-232; Commission of the European Communities: Design of the Economic and Monetary Union (part IV of the paper "Economic and Monetary Union, The Economic Rationale and Design of the System", reprinted in: ECU, Issue 12, Brussels 1990/III, pp. 20-23.

¹⁰ For a detailed discussion of this proposal see Manfred Willms: Der Delors-Plan und die Anforderungen an eine gemeinsame Europäische Geldpolitik, in: Kredit und Kapital, Vol. 23, No. 1, 1990, pp. 30-59.

¹¹ Conclusions of the Presidency, para I.2.

¹² See, for example, Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung: Weichenstellungen für die Neunziger Jahre – Jahresgutachten 1989/90, Stuttgart 1989.

¹³ Deutsche Bundesbank: Stellungnahme zur Errichtung einer Wirtschafts- und Währungsunion in Europa, in: Deutsche Bundesbank – Auszüge aus Presseartikeln, No. 73, 25. 09. 1990, pp. 1-3.

¹⁴ See, for instance, Karl-Otto Pöhl: Prospects of the European Monetary Union, Address by the President of the Deutsche Bundesbank at the conference "Britain and the EMS", London, November 9, 1990, reprinted in: Deutsche Bundesbank – Auszüge aus Presseartikeln, No. 87, 12.10.1990, p. 3.

¹⁵ Karl-Otto Pöhl: Prospects of the European Monetary Union, op. cit., p. 4.

The possibility of a dual speed union raises a number of questions within the Community. The most difficult task would lie in reaching agreement on the *concept* of a dual speed union. The rationale behind progressing at different speeds is an "economist" one – it postulates that simply setting up an ESCB and handing over national sovereignty in monetary matters will not of itself solve the economic problems of the Community. In this view, the ESCB is not a panacea, i.e. a substitute for necessary and often costly adjustment processes. The same applies, of course, to the exchange rate mechanism (ERM), which is sometimes cited as a model for progress at different speeds. Yet the "asymmetry" in the ERM which puts the burden of adjustment on the inflationary country has become widely recognised and accepted. The same does not seem to apply to the ESCB; rather, the perception seems to be that one will have only to declare the willingness to participate in it for the benefits to come automatically. As long as this "monetarist" viewpoint persists, it will be very difficult indeed to come to an agreement whereby some Community members progress more quickly than others. Finding such an agreement is further complicated by the highly visible nature of a "brick and mortar" ESCB as compared to the somewhat abstract ERM. This is doubly true if the often heralded ECU notes and coins should eventually be issued by the ESCB as a means of payment.

Assuming, for the moment, that accord on the concept of a dual speed union is possible, further agreement would then be needed on the question of conditions for participation. Here again, the ERM does not provide a satisfactory example. For if the assumption of asymmetry holds, then the burden of *future* adjustment falls most heavily on the prospective member, which is therefore free to choose unilaterally when and under what conditions to join. The same would not apply to the ESCB, where *past* economic solidity should be a prerequisite for entry. Agreement would thus be necessary on the criteria that were applied to measure economic convergence. It is open to debate whether these criteria should be decided upon only by the founding members of the ESCB or by all Community nations.

Clearly, agreeing on a dual speed union within the present Community framework would not be an easy task. The dual speed union might be agreed upon outside the Treaty of Rome. This would assuredly put a great strain on the political idea of a European *Community*. In time, however, the current political drive towards the

"grand gesture" may be tempered by a clearer view of the economic consequences of proceeding too hastily. At that point, a dual speed strategy, although probably not by that name, could be deemed a promising step in the right direction.

British Misgivings

A penchant for "grand gestures" can certainly not be imputed to Great Britain, whose government has repeatedly warned against an "activist" strategy in the pursuit of EMU. The British arguments, which have led to the alternative proposal for stages two and three discussed below, fall roughly into two categories:

□ On the economic side, the British are unconvinced that EMU is a desirable goal for Europe. All other EC members seem to have accepted that Europe is indeed an optimum currency area – at least the question has not been much debated since the publication of the Delors Report. An optimum currency area presupposes a region with high labour mobility, because nominal exchange rate changes which could otherwise dampen economic shocks are no longer possible under a fixed rate regime. It is not unreasonable to suppose that even when all customs barriers fall in 1992, there will still be language and "patriotic" barriers to a free flow of labour. If EMU is "installed" when these barriers are still high, it might make very large fiscal transfers necessary to regions with low labour mobility and low productivity. The governor of the Bank of England has recognised this possibility and called for "... preserving the realignment option but only as a last resort for easing the costs of economic adjustment."¹⁵

□ On the political side, the British are uncomfortable with the loss of sovereignty implied by EMU and the ESCB. While they share the view that the ESCB should be committed to the goal of price stability, they think that a central bank should remain accountable to Parliament. Other EC members, notably the Germans, have called for the ESCB to be quite independent of any legislative body in the execution of its tasks. They aver that accountability is served enough if the governing committee of the ESCB is *appointed* by some democratically elected body and subsequently left alone. It must be noted that both the British and the Germans are arguing from the position they have inhabited for a long time and to which they have grown accustomed. Certainly, the Bundesbank can look back on an excellent record on inflation. Whether this is due, though, only to its guaranteed independence or may also be attributed in part to the aversion the "average"

¹⁵ Quoted in: Lucy Kellaway and Stefan Fidler: Pöhl suggests dual-speed union, in: Financial Times, 12.07.1990, p. 1. The "core group" was to include France, Belgium, Luxembourg, the Netherlands and Germany.

¹⁶ Robin Leigh-Pemberton: Speech given on 16 January 1990 to the West-German Savings Bank and Giro Association, reprinted in: Bank for International Settlements, BIS Review, January 1990, p. 10.

German feels for any vaguely inflationary policies is an open question.

The British Government has twice proposed alternatives to the Delors Plan. Both of these were intended to show a way towards monetary union that would take account of the British reservations. Specifically, the alternatives were designed: firstly to leave the decision on whether or not Europe is an optimum currency area to the markets and secondly to obviate the need for a centralised new Community institution.

The "Evolutionary Approach" to EMU¹⁷ published by HM Treasury in 1989 was based on a competing currency approach. It recommended that the Delors Plan be discontinued after stage one and entirely denied the need for a new monetary institution. The Evolutionary Approach did not enjoy a long life, however – it was superseded in June 1990 by the so-called Major Plan,¹⁸ which is based on a parallel currency approach.¹⁹

The Major Plan

At the core of the Major Plan is a new, 13th Community currency which participates in the ERM but enjoys the advantage of a value guarantee – the Hard ECU. Unlike the Evolutionary Approach, the Major Plan foresees a new Community institution, a European Monetary Fund (EMF) that would issue the Hard ECU and use it to exert a restrictive influence on the national central bank's (NCB) money creation.

According to Mr. Major, the Hard ECU and the EMF are supposed to work in the following way:

The EMF issues Hard ECU in a straight one for one exchange for Community currencies. This leaves the money base in the Community unchanged, thus eliminating the primary inflation potential for which parallel currency approaches are usually criticised. The Hard ECU are attractive to investors because they cannot be devalued at realignments. No matter which currency the investor has bought Hard ECU with, after realignments he can always demand repayment in the currency which has appreciated most. During the time between realignments, the Hard ECU is a currency just like any other in the ERM – it can move around its band or even be continuously at the bottom of it.

Besides the primary inflation risk connected with the introduction of Hard ECU, there is a further potential for inflation if NCBs should attempt to replace the amount of their currency exchanged into Hard ECU by sterilisation policies. To counter this risk, the EMF would be empowered to exercise a "repurchase obligation", forcing NCBs to buy back their currencies from the fund with Hard ECU or some other strong currency.

To stimulate demand for Hard ECU initially the EMF could set attractive interest rates on them. As use of the Hard ECU grew more widespread, its interest rate policy coupled with the repurchase obligation would give the EMF a powerful weapon for combating monetary situations it regarded as too "lax". The Fund would increase Hard ECU interest rates to stimulate flows into them. When it had accumulated a sufficiently large amount of national currencies in return, the Fund would ask the NCBs to repurchase these. The NCBs' limited supply of Hard ECU or other reserves would force them to raise interest rates "at home", leading to the desired tightening in monetary conditions.²⁰

Unenthusiastic Reception

The reception of the Major Plan by other governments has not been overly enthusiastic – the main criticism being that it is a detour and not an alternative to the Delors Plan. There are a number of problematic points about Mr. Major's suggestions, which have not been examined very closely.

The first difficulty concerns the chances of the Hard ECU of crowding out national currencies. An analysis of the three money functions shows that as a means of payment the Hard ECU suffers from the problems inherent to all parallel currencies: i.e. it is little known and there is no memory of prices in it. Moreover, its value relative to other currencies is not constant but subject to the "usual" fluctuations of the ERM band. This handicap would in all likelihood also hinder its use as a unit of account. It is only as a store of value that the Hard ECU could pose a threat to established currencies. But even this would be the case only under rather special circumstances. To wit, a currency which at "realignments is always revalued in line with the strongest currency" is more attractive than any other single Community currency only if: a) realignments are fairly frequent and b)

¹⁷ HM Treasury: An Evolutionary Approach to Economic and Monetary Union, London, December 1989.

¹⁸ John Major: Economic and Monetary Union beyond stage 1: The UK Approach. Speech given by the Chancellor of the Exchequer to the German Industry Forum in London on 20 July 1990, reprinted in: ECU, Issue 11, Brussels, 1990/II, pp 13-16.

¹⁹ While a competing currency approach relies only on the existing national currencies, in the parallel approach an additional currency is introduced that is common to the Community. It circulates in parallel with national currencies and competes with them.

²⁰ This mechanism is more or less identical to that employed in the ERM, save for the "arbitrariness" of the Fund's interest rate policy.

it is not always the same currency which is revalued most. Neither condition has been met in the past. For the most part (though admittedly not always) the DM has emerged from realignments as the strongest currency, and since 1987 there have not been any realignments at all. If this situation is expected to continue in the future then the only other way to make the Hard ECU attractive would be to set interest rates on it very low, making it interesting for borrowers, or very high, which would lead to its proliferation as an investment instrument.

Assuming for the moment that the difficulties of introducing the Hard ECU can be overcome, for instance by the method described of offering high interest rates on it, then another set of questions in connection with the EMF presents itself. These begin with that institution's opening balance sheet. Mr. Major has stated that the EMF could finance itself by the Hard ECU notes it issued. This would seem to imply that the Fund can profitably invest its assets, i.e. the national currencies it receives whenever it hands out Hard ECU. Yet if the Fund invests its assets, they are not withdrawn from circulation and base money in the Community is increased after all. A promising alternative to this conundrum could lie in NCBs' subscribing to the capital of the Fund from their own assets. This would only cover the EMF's running costs, though, and leave open the way in which the Fund reaps the profits from its money creation. The only way that the Fund could "make money" without adding to inflationary pressures would seem to lie in NCBs' agreeing a priori to a reduction of their own money creation in favour of the Fund.

In addition to this, NCBs might also be forced from time to time to cover the losses incurred by the EMF. After every realignment, all assets of the Fund (except for those in the respective strongest currency) would be devalued relative to its liabilities. Though the repurchase obligation ensures that the holdings of weak currencies would not be too large, it cannot be ruled out entirely that the EMF might come out of a realignment in a severely weakened position. The risk of this happening would be greatest if the EMF had offered exceptionally high interest rates to stimulate interest in Hard ECU.

The interest rate policy that the Fund would pursue is another complex matter. Mr. Major's remarks and their elucidation by the governor of the Bank of England²¹ both point to the Fund's taking an active and discretionary stance in determining the Hard ECU interest rates. It is not clear that there would be a link between these rates and

any real variable in the Community. There would seem to be a danger of the Fund using its rates policy as a kind of "marketing instrument" both in initially boosting the Hard ECU and subsequently when attempting to correct situations of undue monetary expansion.

Detour or Blind Alley

This leads to the final question, which has been left unanswered up to now by the British government but which is the most important in assessing the merits of the Major Plan relative to the Delors Plan. The question is what the institutional structure and mandate of the EMF should look like. Assume firstly that the foremost objective of the EMF would be to further the use of the Hard ECU and to employ it to exert a dampening effect on NCBs. Then assume that the governing body of the ESCB is made up mainly from the twelve governors of the national central banks. From these two assumptions follows a rather curious situation: in their capacity as members of the EMF, the governors' main job is to make sure that national currencies are crowded out by the Hard ECU. In the execution of this task they have to agree on which countries' monetary policy may be regarded as too lax and take appropriate action by increasing Hard ECU rates. Once they return home to their own banks, they then have to ward off the threat to their currencies by the Hard ECU, while simultaneously worrying about the high Hard ECU rates which will force them to subsidise the EMF if a realignment occurs.

This somewhat pointed description may nonetheless serve to illustrate one of the two remarks which can be made on the Major Plan: the Hard ECU, if taken seriously, requires as much thought being spent on institutional aspects as the Delors Plan. The amount of sovereignty that would have to be signed away to a common institution is no smaller with the EMF than with the ESCB.

The second point is that the idea of leaving the decision on EMU to the markets can only be applauded from a theoretical point of view. Yet in practice the Hard ECU, even if equipped with a value guarantee, would in "normal" times not be on an equal footing with national currencies but would have to be subsidised by the EMF and indirectly by the member states.

No matter how the EMF was constructed, it could only be successful if member states were willing to watch their own currencies being crowded out and to subsidise this process. If that willingness is actually to be found amongst Community members, then the Major Plan would truly be a detour. If it is not to be found, then the Major Plan and all other plans for EMU will be a blind alley.

²¹ Robin Leigh-Pemberton: Speech given to the European Inter-Currency Group and the European Parliamentarians and Industrialists Council (EPIC) in Strasbourg on 11 July 1990, reprinted in: Bank For International Settlements, BIS Review, 07. 1990, pp 1-6.