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Rolf H. Hasse* and Thomas Koch*

The Hard ECU – a Substitute for the D-Mark or a Trojan Horse?

The British Government's proposal to develop the ECU gradually into a "hard" European currency has begun to be viewed in a more positive light. What principles are at the heart of this proposal? Does a "hard" ECU have advantages over the existing ECU? What are its chances as a parallel currency?

The monetary, economic and social union between the two Germanies came into effect on 1st July 1990, eclipsing the start of the first stage of European Economic Union on the same date. Then the Gulf crisis overlaid the opening of the two Intergovernmental Conferences in December 1990, which had been called to draft the treaty amendments required for a European Monetary Union and a European Political Union.

As preoccupation with these two political upheavals fades, Europe's own objectives are again coming to the fore. On 8th October 1990 the United Kingdom unexpectedly joined the exchange rate mechanism of the EMS. Governments are beginning to clarify their positions on European monetary integration, with the result that the points of potential conflict are becoming more visible. In this connection, the British Government's proposal for a "hard ECU" has attracted a surprising amount of attention. When it was first presented in June 1990 by the Bank of England¹ and the UK Treasury,² it met with general scepticism and rejection.³ This second proposal for evolutionary monetary integration based on the notion of competition between currencies seemed to have met the same fate as the first British initiative of November 1989. Since January 1991, however, an increasing number of countries have spoken in favour of a hard or hardened ECU and have endorsed the British plan, either in its entirety or in part. These opinions deserve attention, for here are countries with very different fundamental conceptions of monetary policy (Spain, France, the Netherlands) that have suddenly adopted new and apparently similar positions.⁴ It is possible to gauge to some extent whether this signals a genuine change of stance or merely tactical manoeuvring on the part of these countries by examining the monetary logic of the British proposal and comparing it with the conceptions of these countries.

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The British Government and the Bank of England could rightly claim one advantage for their proposal; it was the only one to put forward concrete measures for the second stage of EMU, a point on which the Delors Report was very reticent. At its meeting in Rome on 27th and 28th October 1990 the European Council set a date for the beginning of the second stage, but its pronouncements in this regard seem designed to sow confusion, as firm deadlines and time spans were coupled with preconditions and declarations of intent. Also the confirmation by the European Council in Luxembourg (June 28, 1991) of its intention to decide upon the treaties at the meeting in Maastricht in December 1991 did not solve any issue but increased the time pressure. The British assertion that the "hard ECU" concept goes far beyond their proposals of November 1989 is also correct, but opinions are divided as to whether it constitutes an active and positive contribution on the road towards European Monetary Union.⁵ Analysis of the details of the plan gives grounds for doubting whether the British Government itself would be prepared to accept the full monetary consequences of its brainchild.

¹ See inter alia R. Leigh-Pemberton: The United Kingdom's proposal for economic and monetary union, in: Bank of England, Quarterly Bulletin, Vol. 30, No. 3, August 1990, pp. 374-377; R. Leigh-Pemberton: Beyond Stage 1 of EMU, in: Bank of England, op. cit., pp. 378 ff.; R. Leigh-Pemberton: The World Economy and Europe – 1991, reprinted in: Deutsche Bundesbank, Auszüge aus Presseartikeln, No. 7, 30th January 1991, pp. 4-8; Bank of England: The Hard ECU in Stage 2: Operational Requirements, London, 21st June 1990.

² Cf. inter alia John Major: Ein harter ECU kann in der Gemeinschaft das Rennen machen, in: Handelsblatt, 6th July 1990; John Major: Stärker als die Deutsche Mark, in: Die Zeit, No. 28, 6th July 1990.

³ Cf. inter alia the reaction of Bundesbank President Karl Otto Pöhl, expressed in an interview in The Times, 26th June 1990; P. Norman: Out of step on the ECU, in: The Financial Times, 25th June 1990.

⁴ Cf. O. Issing: Über die "Hard ECU" zur Europäischen Währungsunion?, in: Deutsche Bundesbank, Auszüge aus Presseartikeln, No. 6, 28th January 1991, pp. 7 f.

⁵ As stated by the Governor of the Bank of England in Strasbourg on 11th July 1990; see R. Leigh-Pemberton: The United Kingdom's proposal for economic and monetary union, op. cit., p. 374.

The basis of the British proposals continues to be the view that economic convergence is still insufficient for institutional agreements to be reached. They argue, in particular, that the precondition for fixed exchange rates – namely price stability – is not sufficiently well met and is inadequately anchored as a Community objective. The British monetary authorities do see monetary integration eventually leading to a single currency, but they warn that the premature discretionary introduction of such a currency would entail far greater risks than if monetary union were delayed until further progress had been made towards Political Union.

In their eyes, their proposal represents the optimum solution to the various integration objectives and strategies:

- ☐ It would combine the advantages of the three most important strategies for the phase beyond stage 1: the intensification of co-ordination and co-operation between central banks within the Committee of Central Bank Governors; the hardening of the exchange rate mechanism of the EMS and the hardening of the ECU; and the establishment of a monetary institution as an embryo of a European System of Central Banks.
- ☐ It would make an active Community contribution towards greater monetary discipline and hence to greater price stability and economic convergence.
- ☐ It would provide for the creation of a European Monetary Fund (EMF) and allow it to gain the experience and credibility that would be essential if the ECU were to replace the D-Mark as the monetary anchor of the EMS and the EMF were thus to take over the leading role hitherto played by the Deutsche Bundesbank.
- ☐ All transfers of power could take place in stages. This

would avoid the confusion that would be inevitable if the changeover were sudden.

- ☐ It would allow people to become accustomed gradually to a common currency – the ECU. Increasing market usage would solve the difficult problem of acceptance better than if the currency were suddenly decreed officially to be the only means of payment.
- ☐ The principle of subsidiarity would not be violated. The EMF would influence monetary developments, but responsibility for monetary policy would remain with national central banks during the transitional period.

The Key Concept

The idea at the heart of the proposal is to introduce the hard ECU as the thirteenth currency in the EMS and to give the EMF exclusive issuing rights. The hard ECU would be a fully-fledged currency without the connotations of a unit based on a basket of currencies, and it would be integrated into the EMS parity grid with margins of fluctuation of $\pm 2.25\%$. It would be legal tender in all participating countries. Its most important feature would be a no-devaluation guarantee. Whereas the basket-based ECU reflects the weighted average of inflation rates in the countries concerned, the hard ECU would be harnessed to the strongest currency. This guarantee would be backed by a commitment from the central banks participating in the EMF to buy back their own currency or make good exchange losses in the event of devaluations, if requested to do so by the EMF. The British Government believes that this mechanism would make the hard ECU immune to the criticism levelled at conventional parallel currencies, as rightly expressed in the Delors Report.⁶

The no-devaluation guarantee and the intended Community contribution to greater monetary discipline would be achieved with the help of the EMF. According to the latest British thinking,⁷ member central banks would undertake, at the request of the Fund, to repurchase EMF assets denominated in their currencies against hard ECUs or another hard currency. This would safeguard the value

⁶ R. Leigh-Pemberton, *ibid.*, p. 376.

⁷ See R. Leigh-Pemberton: *The World Economy and Europe – 1991*, op. cit., pp. 7 f.; UK Government: *Economic and Monetary Union – Beyond Stage 1. Possible Treaty Provisions and Statute for a European Monetary Fund*, January 1991.

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of EMF investments acquired as a result of the substitution of national currencies by hard ECUs issued by the Fund and at the same time would maintain the value of hard ECUs on the liabilities side of the EMF balance sheet.

A problem remains as to whether from the point of view of the EMF the replacement of national currencies by hard ECUs would be a passive procedure triggered solely by the inflation policies of national central banks, or one that could be speeded up by means of an active monetary and foreign exchange policy on the part of the Fund. At present the proposal contains both options. We must therefore also examine the extent to which it meets the basic assumption that

- ☐ the issue of hard ECUs will lead to no expansion of the money supply in the participating countries, and
- ☐ the actions of the EMF will at all times contribute towards improving price stability in the Community.

Chances as a Parallel Currency

Like the basket-based ECU, the hard ECU does not have its own definition of stability, but a derived, borrowed one. It depends on the existence of other currencies. Its introduction and increasing use presuppose that monetary convergence has not been achieved, nor will be during the substitution process. The existence of marked inflation differentials as a "prerequisite of success" is so important, because the hard ECU lacks all the other factors that normally determine the demand for a currency, namely an economy with its production potential, and market acceptance that has developed over time. Is there justification for the optimism that the hard ECU will win through in the market? By its very construction it can never be better than the most stable currency in the EMS, for an absolute guarantee of value based on a purchasing power clause as proposed in the 1975 "All Saints' Manifesto for European Monetary Union" is not being contemplated.⁸ Where do demand preferences lie? Why has the D-Mark, with its free convertibility and long record of stability, not become a successful parallel currency? The D-Mark is the

monetary anchor and *n*th currency of the EMS; it is also the most important intervention currency in the EMS and the second most important investment and reserve currency internationally.⁹ Despite this, it is not a parallel currency in Europe. And yet that is what the hard ECU is supposed to become, without offering a significant advantage over the D-Mark or the other EMS currencies in terms of stability.

Upon examination, the chances of the hard ECU winning acceptance as a parallel currency are seen to be no better than those of the many variants of the basket-based ECU and the ECU as a currency in its own right that are discussed in the literature.¹⁰ If the hard ECU is to achieve widespread use as a result of market forces, it must perform all the functions of money, and be able to do so better than the majority of EMS currencies. An examination of the extent to which the hard ECU can perform the function of payment instrument and hence replace other EMS currencies as cash and non-interest-bearing sight deposits quickly reveals a host of obstacles to its acceptance. In the case of non-interest-bearing investments, one advantage of the hard ECU would be the no-devaluation guarantee, which would effectively be an open ended swap option against the most stable currency in the system. However, this would only be an advantage to persons in countries where inflation differed significantly from the average if exchange rates were adjusted according to purchasing power parities. This effect would disappear as soon as inflation differentials and temporary differences in the real value of cash were offset by mechanisms other than exchange rate adjustments.

The switch into hard ECUs would be a rational alternative for people in countries with high inflation. On the other hand, the transaction and information costs associated with the conversion into hard ECUs and with their use constitute an obstacle that is reinforced by behaviour based on past experience and convention. The monetary system is an important part of the constitutional order of a country; it has the character of social capital. Replacement of the currency would alter that order. The inertial force of established convention tends to oppose the destruction of social capital, as familiar ways are abandoned voluntarily only if the adverse effects of the existing order are very great and the information and transaction costs low. Convention may mean that an order remains stable even if it is no longer pareto-optimal.¹¹ This explains the empirical finding that demand elasticity

⁸ Reproduced in: M. Fratianni and T. Peeters: One Money for Europe, London and Basingstoke 1978, pp. 37–43.

⁹ Cf. Rolf Hasse: Konfliktpotentiale in den amerikanisch-europäischen Währungsbeziehungen, in: M. Knapp (ed.): Transatlantische Beziehungen. Die USA und Europa zwischen gemeinsamen Interessen und Konflikt, Stuttgart 1990, pp. 82 ff. and 93 ff.

¹⁰ Cf. Rolf Hasse: Die ECU – ein Währungsmedium mit Integrationswirkungen?, in: Zeitschrift für Wirtschaftspolitik, Vol. 37, No. 2/3 (1988), pp. 238 ff.; Rolf Hasse: The European Central Bank: Perspectives for a Further Development of the European Monetary System, Gütersloh 1990, pp. 101–114; see also N. Kloten and P. Bofinger: Währungsintegration über eine europäische Parallelwährung?, in: D. Duwendag (ed.): Europa-Banking. Bankpolitik im europäischen Finanzraum und währungspolitische Integration, Baden-Baden 1988, pp. 64 ff.

¹¹ Cf. Peter Bofinger: The Political Economy of the Hard-ECU Proposal, Centre for Economic Policy Research, Discussion Paper Series, No. 512, London, February 1991, pp. 6–8 and the literature cited therein.

¹² See inter alia B. Klein: Competing Monies, European Monetary Union and the Dollar, in: M. Fratianni and T. Peeters, op. cit., pp. 69–94.

for foreign currencies is low, even in times of large inflation differentials.¹²

Different currencies are not perfect substitutes, even if there are price and cost differences. Convention puts a curb on substitution, particularly as the costs of the inflation differential for the holding of cash should not be overestimated.¹³ The differences in inflation rates among the EC countries are hardly sufficient for the hard ECU to establish itself as a transaction currency; this would be essential, however, in order to reduce information and transaction costs and lend more weight to the policy of the EMF.

The prospects are no better if one examines whether the hard ECU could serve as a non-interest-bearing payment instrument for external transactions. Here too, the domestic currency has predominated hitherto over all alternatives worldwide.¹⁴ The theoretical savings in transaction costs if everyone held only one internationally traded currency are not achieved in practice. Even in countries where exchange controls prohibited forward transactions (such as France and Italy) few transactions were invoiced in the possible alternative, the basket ECU.¹⁵

The prospects for the hard ECU as an interest-bearing investment are no better if one relies solely on market forces, as the British proposal emphasizes one should. It is true that such deposits can be assumed to have a greater rationality and demand elasticity with respect to inflation than non-interest-bearing cash, but it must be noted that an inflation differential is an essential, although not necessarily sufficient condition for the substitution of one currency for another. Currency substitution only occurs if

☐ the inflation differential is not offset by an interest rate differential, and

☐ changes in the value of money are not anticipated by movements in exchange rates.

Efficient foreign exchange markets ensure that exchange rate expectations are offset by corresponding interest rate differentials. The incentive for currency substitution is therefore nullified. The level of the inflation differential is thus not critical; more important is the accuracy of the inflation forecast, which depends less on the level of inflation than on the variance in the rate. In the case of interest-bearing investments, interest rates on

hard ECU claims would therefore probably always be lower than those in countries with higher inflation. The interest rate on hard ECUs would be close to that on investments in the most stable EMS currency. Initially, hard ECU investments would have an additional handicap, as low market volume would make transaction costs higher than those in the market for D-Mark investments, for example. Without an interest rate subsidy or a pronounced willingness on the part of EC institutions to borrow in hard ECUs, the growth in this market would be modest, at best. An "infant currency" policy would clearly run counter to the ideological creed of the British plan, namely that the hard ECU should establish itself in the market, because preferences can be ascertained more reliably in the market than through governmental decrees.

In conclusion, it can be seen that the proposed shape of the hard ECU, with convertibility between EMS currencies and backed by a no-devaluation guarantee, in no way justifies high hopes that currency substitution will occur. The proposition that the hard ECU could become a worthy successor to the D-Mark as the anchor currency of the EMS is explained not as the result of market forces but as a political decision lying outside the fundamental ideological considerations: "But if the Community is going to move towards monetary union, then the deutschmark is going to cease being the anchor currency; it could only continue in that role if the deutschmark itself became the single currency, and that would not be politically feasible."¹⁶ However, this presupposes that the hard ECU's contribution to monetary discipline has been large enough for the convergence of economic performances and policies to have been achieved.

The Passive Role of the EMF

The real advance inherent in the British plan is the institutional expansion it entails. The British Government recognizes that even a parallel currency cannot operate without institutions. On the one hand the proposed EMF is important to establish the hard ECU in the market. It could act as lender of last resort and also serve as a clearing house; the absence of a body to perform these two functions has always been regarded as a great drawback of the private basket-based ECU.¹⁷ On the other hand, monetary and political problems will arise if the EMF is to be more than an agency for converting national currencies into hard ECUs, as indicated by the highly disparate tasks it is supposed to assume.

¹³ See the explanations in R. Hasse: *The European Central Bank*, op. cit., pp. 108 f.

¹⁴ Cf. Peter B. Kenen: *The Role of the Dollar as an International Currency*, Group of Thirty, Occasional Papers, No. 13, New York 1983.

¹⁵ See the empirical evidence in R. Hasse: *Die ECU – ein Währungsmedium mit Integrationswirkungen*, op. cit., pp. 243 f.

¹⁶ R. Leigh-Pemberton: *The World Economy and Europe – 1991*, op. cit., p. 7.

¹⁷ Cf. Rainer S. Masera: *An Increasing Role for the ECU: a Character in Search of a Script*, in: D. E. Fair and C. de Boissieu (eds.): *International Monetary and Financial Integration – The European Dimension*, Dordrecht 1988, pp. 129–150.

- ☐ First, it is to contribute to monetary discipline.
- ☐ Secondly, it is to exert influence on monetary developments without depriving national governments of autonomy in monetary policy.
- ☐ Finally, it could be the precursor of a European System of Central Banks (ESCB); to support this objective, the British Government has set out its ideas for a statute for the EMF.

One aspect needs to be mentioned straight away, as it is not considered in the official papers, namely the relationship between the private basket-based ECU, which has its own market, and the hard ECU. As the private ECU was conceived as an open basket, it could be argued that all claims and liabilities denominated in ECUs should simply be converted into hard ECUs on a given day. However, this would fundamentally alter the original considerations on which the investments had been made. The attraction of the private basket-based ECU lies in its mix of currencies and interest rates, which makes possible particular arbitrage and hedging transactions. The hard ECU, by contrast, would gravitate towards the interest rates and value of the most stable EMS currencies. Whether the simple conversion from one to the other would give creditors a one-sided advantage in the form of continued high interest rates at reduced risk still has to be examined with regard to all assets with a non-variable interest rate. It is conceivable that this type of financial innovation could and should continue as an independent instrument.

The monetary policy implications of the EMF are more important. As a matter of principle the EMF would issue hard ECUs only against financial assets in national EMS currencies. In so doing it would be assuming a commercial risk (the risk of a fall in value due to devaluation), protection against which is coupled with the guarantee for the value of the hard ECU. The EMS central banks belonging to the EMF would undertake to guarantee the value of the Fund's assets. This is crucial in the event of devaluations. The loss would be compensated by central banks repurchasing their national currencies with hard ECUs or "some other strong currency".

These transactions have a number of primary effects. As a general rule it is assumed that the issue of hard ECUs would not create additional liquidity. However, this is true only if the EMF deposits the assets it acquires in national currencies with the corresponding central banks. In that case, the expansion in the hard ECU money supply is offset by a contraction in the money supply in national currency, so that central bank money would remain constant at Community level. It would have to be decided whether central banks should pay interest on EMF

deposits. If the EMF chose instead to invest its assets in the national financial market, the problem of remuneration would be solved but there would be a net liquidity effect: the money supply in hard ECUs would increase and central bank money in national currency would remain unchanged. Since the British plan presupposes that there would be no net liquidity effect, deposit with national central banks would have to be compulsory. As demonstrated below, this clashes with another part of the proposal.

The goal of avoiding a net liquidity effect when issuing the hard ECU is even more complicated if the EMF acquires commercial bills or public bonds. In both cases a direct net liquidity effect will occur even if the EMF passes these assets on to the national central bank. The assumption that issuing hard ECU will not lead to an expansion of the money supply in the participating countries presupposes close cooperation between the EMF and the national central bank. Either they coordinate their rates of monetary expansion or the national central banks must be willing to reduce ad hoc their money base when hard ECU are issued. How valid is the hypothesis that the actions of the EMF will not constitute an interference in the national autonomy in monetary affairs?

Aspects of the Repurchase Commitments

Certain aspects of the repurchase commitments are also interesting. Repurchase with hard ECUs would reduce the volume of money in circulation in hard ECUs. This effect may not be desirable from the point of view of the EMF, as it would slow down the substitution process and the development of the hard ECU financial market. For that reason, the repurchase arrangements might quickly be confined to the unspecified area of "some other strong currency".¹⁸ EMS currencies or third currencies could be used. A strict interpretation of the wording would rule out Special Drawing Rights. The D-Mark would be the primary candidate among EMS currencies, and probably the US dollar among non-member currencies.

Two aspects need to be considered here. Transfers of D-Mark would solve the value guarantee problem if it can be assumed that the D-Mark remains the most stable currency in the EMS. That can hardly be assumed in the case of the US dollar. The EMF and the hard ECU would continue to run a value risk. Hence it can be concluded that repurchase against "some other strong currency" would always entail some residual risk with regard to value, which

¹⁸ This is reminiscent of the suspension of gold transfers under the settlement arrangements in the European currency snake in 1972. In April 1972 this rule was written into the Basle Agreement, only to be suspended the first time it was to be used in a case involving Italy in December of the same year.

would necessitate additional arrangements for adjusting the balance sheet of the EMF. The second problem is how the national central bank in question would finance the transfer. If adjustment were made in US dollars, it can be assumed that the central bank would have reserves in that currency. This would not necessarily be the case with transfers of D-Mark, given existing agreements within the EMS. The problem of financing therefore remains to be solved (purchases in the market with attendant exchange rate reactions, borrowing in the financial markets, central bank credit). The simple-sounding formulae therefore conceal numerous problems.

The activities of the EMF will not be confined to this primary function, however. Under the British plan, the EMF would also play a more active role in Community monetary policy. It is conceded that the Fund would regulate the supply of hard ECUs by means of interest rate and money supply policies, like any other central bank. Furthermore, it would pursue an active monetary policy; "if the Board of the EMF believed that monetary conditions in the Community as a whole needed to be tighter, it could increase hard-ECU interest rates".¹⁹ However, it is also envisaged that the EMF would actively influence the money supply in individual currencies by requiring central banks to repurchase their national currency.

In putting forward these ideas, the British are touching upon sensitive political issues and at the same time putting the credibility of their ideological approach to the test. The British advocates of the hard ECU never tire of stressing that the right of the EMF to sell any purchased national currency to the issuing central bank and to pursue an independent price and money supply policy by means of and for the benefit of their hard ECU would exert pressure on the central banks concerned and on their monetary policy. At the same time, however, they are unanimous in expressing the view that this would influence but not dictate national monetary policy. In stage 2 of EMU responsibility for monetary policy would therefore continue to rest with national central banks, so that the principle of subsidiarity would remain intact. Moreover, it is stressed that "there would thus be no muddying of responsibility or violation of the principle of the indivisibility of monetary policy".²⁰

If these pronouncements are put together, only two possible conclusions can be drawn: either the theoretical concept is unclear and the proponents of the plan are trying to justify the market as the driving force of change while at the same time giving the EMF far-reaching

discretionary powers over monetary policy, or they have no clear idea what policy the EMF should pursue (the passive conversion of currencies coupled with transactions to safeguard the value of the ECU, or active interest rate and money supply policies via the hard ECU) in which stage of the development of EMU. In either case (immediate, full powers to pursue both policies, or a gradual extension of powers during stage 2), the question must be raised whether the establishment of the EMF falls under Article 102a of the EEC Treaty, so that an agreement requiring ratification under Article 236 is necessary. The interference in monetary policy autonomy and, for example, in the independence of the Deutsche Bundesbank appear to be too far-reaching for a procedure under Article 235 (agreement not requiring ratification). Otherwise, the EMF could operate or be used as a lever against the Deutsche Bundesbank and the D-Mark. The reason for the sudden French interest in the British proposal probably lies somewhere in this area.

Scope for an Independent Monetary Policy

This broad range of problems can only be outlined here. It is necessary to ascertain how much scope the EMF would have for pursuing an independent monetary policy and whether less stability-oriented behaviour would also be probable. The EMF would have the right to set interest rates at a level at which they would exert restraint on excessively expansionary monetary policy in the Community via conversion into hard ECUs. Essentially, this requires that national central banks be prepared to abstain from any compensatory monetary policy.

Given the design of the hard ECU, interest rates can normally be expected to fluctuate around the level of rates of the most stable currencies. A reduction in interest rates by the EMF would be no way of enhancing the attractiveness and spread of the hard ECU; the willingness to switch would decline, the hard ECU would tend to weaken in the EMS parity grid and might have to be supported by the purchase of hard ECUs. The financing of intervention would constitute an additional problem.²¹ An increase in interest rates would improve the attractiveness and spread of the hard ECU as well as having a disciplining effect on the Community money supply. Conversion would become more worthwhile. Moreover, the hard ECU would strengthen within the parity grid and would be used in

¹⁹ R. Leigh-Pemberton: *The World Economy and Europe* – 1991, op. cit., p. 8.

²⁰ Ibid.

²¹ It would have to be clarified which national currency was to be sold and whether it was to come from a country's reserves or financed via EMS intervention credit. Since only a strong currency is eligible, frequent use of the D-Mark would have to be expected, for interventions both at and within the margins. However, since the EMF would have only small holdings of D-Mark, it would have to receive intervention credit. This would affect the money supply in Germany. The British proposal does not state whether or not the EMF would be part of the system of very short-term financing.

interventions to purchase weaker currencies. An absolute prerequisite for the destruction of liquidity in national currencies is that the assets acquired by the EMF be deposited with the central banks in question, which at the same time would refrain from restoring liquidity to its former level. Either compensatory monetary measures are prohibited, or the EMF is given the right to revalue the hard ECU and hence trigger a forced conversion in order to impose monetary discipline.

It must also be borne in mind that the success of this policy will depend on the demand for hard ECUs. Why should borrowers find it more attractive to opt for hard ECUs if interest rates rise? Where does the interest of creditors lie? An increase in interest rates could lead to a split in the market, with creditors moving into hard ECUs but borrowers not. At the same time, creditors must be offered attractive investments. In our view, the EMF must therefore issue paper at market interest rates. The right conditions would have to be created first. The situation is further complicated by an operational problem: who would pay the interest? This question again highlights the problems stemming from the clash between the desire to exert monetary discipline (deposit of the Fund's holdings of national currencies with the central banks) and the objective of earning interest income on investments in national financial markets (without reducing central-bank money).

The refinancing policy of the EMF may give rise to another effect if a sufficiently large hard ECU market were to develop. In its function as lender of last resort, the EMF could gradually become the thirteenth central bank and multiple credit creation could occur in hard ECUs. The Fund's policy would then be anything but neutral from the point of view of liquidity.

Apolitical Reasoning

The effects of a further aspect of the British proposal deserve to be examined. Here too it is striking that the plan adopts a purely technical, almost apolitical line of reasoning. The EMF would be given the right to strengthen monetary discipline by requiring "autonomous" national central banks to repurchase their currencies. This proposal is a prime example of the fact that the theoretical monetary dimension of the plan has not been thought through sufficiently well. If a direct absorption of liquidity is intended, it must be borne in mind that this will occur only if the EMF's assets in national currencies have previously been invested in the financial markets. This prerequisite contrasts starkly with the conditions that must be met if the original conversion of national currencies into hard ECUs is to be neutral from the point of view of liquidity. The liquidity effects sought from the repurchase of currencies,

and the forms of investment this would entail, mean that the initial issue of hard ECUs would have an expansionary net liquidity effect; far from being neutral, the concept would induce monetary expansion. The exchange rate effects of a call for repurchases must also be considered. By demanding that a national central bank repurchase its currency, the EMF would be signalling that it was pursuing an inflationary policy and would trigger speculation of devaluation. This would lead to intervention, which would in fact reduce the national money supply but also expand the supply of hard ECUs. The British proposal does not, however, state whether the EMF would be part of the EMS system of very short-term financing.

Against this background it is almost academic to enquire whether national central banks would finance repurchases by drawing on their reserves of hard currencies or – as has long been possible and practised – on funds raised in the international financial markets.²² The intended budget restraint exercised via the foreign exchange reserves would then not bite as quickly. However, it would be interesting to know whether a repayment in hard ECUs, and hence a reduction in the money supply in that currency, would be in the interests of the EMF.

This leads on to another unclear part of the British plan. The operation of the concept is viewed only from the standpoint of the EMF and its objective of Community-wide stability. The assumed positive effects cannot be verified, as the plan has a series of theoretical flaws. A further problem might stem from the interests pursued by the EMF. Let us assume that the hard ECU establishes itself in the market but that the D-Mark remains the more important monetary anchor of the EMS. Is it not likely that the EMF would make the same complaints against the Deutsche Bundesbank as national central banks and governments have, namely that the Bundesbank is overdoing its policy in pursuit of stability?²³ Since the central banks of EMS countries are represented in the EMF, they could exert pressure at Community level to ensure that the Bundesbank refrained from or eased back on restrictive measures that were necessary domestically and which at the same time would safeguard the Community's standard of stability. One argument might be that it would be problematic if, for example, an increase in German interest rates put downward pressure on the hard ECU, which could be countered only by reducing the volume in circulation by means of interest rate changes or

²² Cf. Rolf Hasse: *Multiple Währungsreserven. Probleme eines Währungsstandards mit multiplen Devisenreserven*, Stuttgart, New York 1984, pp. 149 ff.

²³ For more detail, see Rolf Hasse: *The European Central Bank*, op. cit., pp. 143 ff.

interventions. Since it would hardly be possible to use the hard ECU to influence German monetary policy directly, this indirect path might be chosen.

That such fears are not unfounded can be seen from the proposals that the British Government submitted at the beginning of 1991 for the statute and objectives of the EMF. They deliberately avoided adopting a clear position by offering two alternatives.²⁴ In option 2 the EMF should not foreshadow the configuration of the ESCB; members of national governments as well as national central banks would sit in its governing bodies. In option 1 the EMF "shall be completely independent". But option 1 puts up a smokescreen, for the board of this variant of the EMF would also be composed of the representatives of national central banks, who are largely required to follow instructions, particularly as the proposal makes no mention of altering the statutes of these central banks.

The UK Government partly unveils its own camouflage in Article V, Section 2. It adds a sort of fair-play plea to assure its definition of complete independence: "Member States and the institutions of the Community shall respect the independence of the members of the Governing Board and Executive Board of the Fund and not seek to influence them in the performance of their duties."

Conclusions

Contrary to the British Government's claims, the hard ECU and the EMF are by no means the instruments that could easily improve monetary discipline and ensure the convergence of economic performance and policy. Nor do they solve the difficulties attached to the concept of a parallel currency.

A more serious drawback of the British proposal is that it does not adhere to its own ideological creed that the hard ECU should stand or fall as a result of market forces. The further it moves away from that concept, the more the stability-oriented objective is relativised. In addition, there are conscious or unconscious flaws in the monetary reasoning.

The hard ECU has a hidden virtue, in that its value is oriented more strongly towards stability than that of the basket-based ECU. Nevertheless, this is not sufficient for market forces to set it in place of a still stable D-Mark as the monetary anchor. At best, the hard ECU is a "D-Mark in disguise".²⁵ For many, the replacement of the D-Mark in this role is an important objective, either in the short or the long term.

The problem with the parallel currency concept is that it works only if economic convergence is not achieved. It is not certain that the hard ECU and the EMF will make the

contribution to convergence that is being expected of them; indeed, many aspects and shortcomings tend to suggest the opposite. Close attention should be paid to the technical details and design of the EMF.

The EMF is not a neutral institution; its proposed monetary policy activities bring it close to being the thirteenth central bank. In the configuration foreseen so far, it would have to be established in accordance with Articles 102a and 236 of the EEC Treaty. The institutional problems raised by the EMF can be seen in the two statute options, which would both lead to an EMF bound by the directions of governments.

From the German viewpoint, the hard ECU and the EMF can be seen as a means of exerting greater indirect influence on German monetary policy. It is the function of the D-Mark as the monetary anchor and the independence of the Deutsche Bundesbank that are being targeted, but the alternatives do not offer a comparable level of stability.

It may be in France's interest to see the creation of the EMF if it means the early establishment of an institution that bypasses Article 102a. This would open the door to a system in which stability was less stringently policed. On the other hand, it is hardly likely that France would be ready to accept the right of the EMF to demand the repurchases of national currencies, as formulated in the British proposal. Contrary to the political premise of the plan, this would be such a massive interference in national monetary policy that the United Kingdom would also have to reject the consequences of its own proposals. However, even the argument that this would run counter to the principle of subsidiarity misses the point. In this form the EMF would be the thirteenth central bank, and a European central bank to boot, so that the principle of the indivisibility of monetary policy would be seriously violated.

As part of a cautious strategy aimed at achieving greater economic convergence, a sensible German position would be above all to continue to pursue the national stability policy and to offer staunch resistance to any undermining of that policy and its institutions. One means of doing so could be to call for a hardening of the basket-based ECU to reverse the creeping erosion as a result of the growing weighting of the countries with more rapid inflation. At all events, any institutional proposals should be examined critically in accordance with Article 102a of the EEC Treaty.

²⁴ See R. Leigh-Pemberton: *The World Economy and Europe – 1991*, op. cit., p. 8.

²⁵ Cf. M. Russo: *Cooperation and Coordination in the EMS: The System at a Crossroads*, in: C. Dräger and L. Späth (eds.): *Internationales Währungssystem und weltwirtschaftliche Entwicklung*, Baden-Baden 1988.