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Wolfgang Filc\*

## A “Hard” or “Hardened” ECU for Europe?

Following the complete liberalization of capital movements in the core countries of the EC, the first stage of the process that should culminate in monetary union began on 1st July 1990. The entry of the pound sterling into the exchange rate mechanism of the EMS was necessary for the United Kingdom to be included in the moves towards monetary integration. The draft statute for a European central bank, modelled largely on the Bundesbank Law, met with the approval of EC Finance Ministers, if one excludes the United Kingdom's usual reservations. In addition, at the end of October 1990 the European Council decided, again without the agreement of the British Government, to begin the second stage of monetary unification at the start of 1994. The stated preconditions for this are the completion of the European internal market, further lasting progress in economic and monetary convergence and the independence of the European Central Bank that will then be established.

Concrete proposals for the second stage are a rarity. There is talk of narrower margins of fluctuation between currencies, the permanent transfer of part of national foreign exchange reserves to the European Central Bank, more binding co-ordination of national monetary policies, possibly complemented by centralising EMS exchange market intervention at the European Central Bank, and the irrevocable locking of exchange rates between EMS currencies, which have in any case fluctuated within very narrow limits in recent years.

One of the preconditions for any transfer of responsibility for monetary policy to a Community institution must be that national central banks be granted the same independence from governments and EC institutions as is foreseen for the future European Central Bank. As some member countries are unwilling to make a strict separation between government and the central bank, the second stage is likely to consist only of minor technical changes in the procedures for co-ordinating monetary policy. In that case, a second stage would be superfluous.<sup>1</sup>

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It is probably this lack of ideas as to the content of the second stage, for which the starting-date has already been set, that has generated interest in the British Government's proposal to introduce a “hard” ECU, despite the lack of a comprehensive concept so far. The upholding of the principle of subsidiarity, and hence of the responsibility of national central banks for their own monetary area while providing a further independent European currency whose value is at least as stable as that of any other EC currency, a currency that is to compete freely with national currencies and should ultimately establish itself as the sole means of payment in the EC as a result of the free choice of all Europeans—that is a proposal that promises nothing but benefits to all the citizens of Europe. Is this apparent squaring of the monetary circle the substance of the second stage? Is the “hard” ECU the shape of things to come?

Let us first look back to November 1989, when the UK Treasury presented a so-called “evolutionary” approach to the realisation of economic and monetary union,<sup>2</sup> in which the currencies of all EC countries were to compete with one another to establish which was to be the stability anchor of the European Monetary System. Flexible exchange rates were, it claimed, a prerequisite if a single EC currency were to emerge as a result of a protracted market process. This proposal was not seriously discussed as an alternative to the Delors Plan, as it was obvious that flexible exchange rates were not the way for Europe to achieve a single currency.<sup>3</sup> The British proposal now on the table is attractive, for like the Delors Plan it intends that the ECU should gradually develop into the single European currency, but it goes further than the

<sup>1</sup> See the collection of articles entitled “Eine zweite Stufe der europäischen Währungsunion?” with contributions by M. J. M. Neumann, W. Filc, R. H. Hasse and F. Reither in: *Wirtschaftsdienst*, Vol. 70 (1990), No. 7, pp. 335 ff.

<sup>2</sup> See H. M. Treasury: *An Evolutionary Approach to Economic and Monetary Union*, London 1989.

<sup>3</sup> The problems of a pure market solution leading to a single currency in an integrated area are discussed at length in P. Bofinger: *Währungswettbewerb*, Cologne 1985.

Delors plan in that it promises a "hard" ECU, which must offer advantages over the existing ECU.

The shape of this "hard" ECU has not yet been described in detail; only its outlines are discernible so far.<sup>4</sup>

□ First, the "hard" ECU would be a thirteenth EC currency, issued by a European Monetary Fund (EMF)<sup>5</sup> in exchange for EC currencies.

□ Secondly, the "hard" ECU would never be devalued against any EMS currency. It would therefore be at least as strong as the strongest Community currency.

□ Thirdly, every citizen would have the option of exchanging national currencies for more stable "hard" ECUs.

□ Fourthly, the EMF would be given the right to sell national currencies for "hard" ECUs in order to exert pressure for a monetary policy consistent with stability.

<sup>4</sup> See Bank of England: The hard ECU in stage 2: operational requirements, 21st June 1990; The United Kingdom's proposal for economic and monetary union, in: Bank of England, Quarterly Bulletin, Vol. 30, No. 3, August 1990, pp. 374 ff.; H. M. Treasury: Economic and Monetary Union – Beyond Stage I: Possible Treaty Provisions and Statute for a European Monetary Fund, Proposals by the UK Government, January 1991.

<sup>5</sup> The Bank of England working paper "The hard ECU in stage 2", op. cit., still talks of a "Hard ECU Bank (HEB)".

<sup>6</sup> "The HEB's ability to issue interest-bearing hard-ecu paper in unlimited amounts (subject to its intervention obligation), and at interest rates of its own choosing, would give it the power to manage ecu interest rates." (The hard ECU in stage 2, op. cit., p. 7.)

<sup>7</sup> See The United Kingdom's proposal for economic and monetary union, op. cit.

□ Fifthly, the principle of subsidiarity would be upheld in the monetary domain, and with it the undivided responsibility of national central banks for their respective monetary areas.

□ Sixthly, the EMF would be able to pursue an independent interest rate policy for the "hard" ECU.<sup>6</sup>

The stated aim of the UK Treasury and the Bank of England is to replace the imposed institutional change postulated in the Delors Report by an evolutionary development that would, after a fairly long transitional period, eventually lead to a single European currency, namely the "hard" ECU.<sup>7</sup> However, even the few characteristics of the "hard" ECU that are known raise serious doubts whether this is a feasible route to a single European currency.

It is unclear whether the ECU would continue to be based on a basket of currencies. The present structure of the ECU, consisting of fixed amounts of each currency in the basket, means that it cannot appreciate against all the constituent currencies. On the other hand, it would not be inconsistent with being a basket of currencies that the ECU should never depreciate against the strongest EMS currency. For that purpose, the proportion of each currency in the basket would have to be adjusted if other EMS currencies were devalued against the ECU and the strongest EMS currency. If the "hard" ECU is to have qualitative advantages over all EC currencies, the link with them would have to be cut, and hence it would have to cease to be basket-based. If that were to happen, however, it is unclear how the value of the ECU would be determined.

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Christine Borrmann  
Jochen Michaelis

**LEBENSMITTEL IM EUROPÄISCHEN  
BINNENMARKT**

Zwischen Verbraucherschutz und Wettbewerb

The admission of foreign foodstuffs which do not comply to the strict German legislation does not lead to the feared reduction of the quality standard to the lowest common denominator in the European internal foodstuffs market. On the contrary, there is a growing diversity of products and high quality is increasingly demanded. The main beneficiary of this trend will thus be the consumer. This is one of the surprising conclusions of this study, which was conducted by the HWWA-Institute for the Federal Ministry of Economics. (Only available in German).

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### **No Economic Area**

So far, we do not know how the value of any good, financial asset or currency can emerge in the absence of fundamental determinants. The relative value of national currencies is determined by the present and prospective economic performance of the relevant country and hence from expected rates of return on financial and physical assets. A "hard" ECU issued by the EMF in exchange for national currencies has no economic area to support it. Consequently, no exchange rate for the "hard" ECU against EC currencies can emerge that is in any way an expression of relative economic performance.

On the other hand, it would be conceivable to boost the attraction of this thirteenth currency by offering particularly attractive interest rates on financial assets denominated in that currency. But how would this be done? Only the EMF would be allowed to issue hard ECUs and the volume in circulation would be restricted by the volume of EC currencies withdrawn. Interest rates on "hard" ECUs could not be set independently, given the EMF's passive role in the issue of this thirteenth currency.

In a monetary area, interest rates are determined against the background of the macro-economic development of the corresponding economic area. They are also manipulated by central banks, and monetary measures are often the predominant influence. The "hard" ECU has no economic area, and there are no macro-economic conditions that could be reflected in interest rates.

Consequently, interest rates for the "hard" ECU could be independent and different from those in national economies only if the EMF issued interest-bearing assets and set their rate of return, thus determining the interest rates for the private use of "hard" ECUs. Such issues of securities would have a counterpart in the provision of additional "hard" ECUs over and above money creation by EC central banks. The independent determination of interest rates for the "hard" ECU would therefore inevitably debase the standard of stability in the common European monetary area.

### **Inconsistencies in the Proposal**

The upholding of the principle of subsidiarity in monetary matters, which the British Government is otherwise quick to defend, is therefore incompatible with the issue of the ECU as an additional, independent currency. The British proposal is also inconsistent in that the guarantee of an ever stronger "hard" ECU, in other words a currency that tends to appreciation against all EC national currencies, is incompatible with higher interest rates, for that would create a double incentive to hold this

new European currency—first as a result of expectations of appreciation and secondly because of the interest rate advantage. This "evolutionary" approach can therefore not be reconciled with any equilibrium between a market for ECU financial assets and national financial markets or with an equilibrium exchange rate for the ECU against EC currencies. Arbitrage between financial markets requires that if it is guaranteed that the "hard" ECU will show an upward trend against all EMS currencies the interest rates for this additional currency should be lower than those in all EMS countries. In that case, however, interest rate trends in Europe would be unequivocally determined by the EMF; all the EC central banks would have to ensure that interest rate differentials between the financial markets in their economic areas and the ECU market were consistent with the expected rate of appreciation of the ECU. Consequently, the EMF would have to pursue a more "expansionary" monetary policy than every central bank in the Community. This would have inflationary implications.

It is the right and duty of state institutions—central banks and banking supervisors—to set the institutional and legal framework for the monetary system in their currency areas and to manage interest rates in national money markets, all with a view to achieving the objective of monetary stability in order to create appropriate conditions of scarcity between monetary assets, real assets and production potential. An ECU that is independent of national currencies can make no contribution in this regard. A thirteenth independent currency for twelve economic and monetary areas in the EC is inconsistent. It would increase the potential for money creation and have an inflationary effect.

### **Chances of Success in the Market**

An inflation of the "hard" ECU would not be directly obvious as the currency does not represent an economic area, but it would be evident indirectly in national economic areas. Even if possible inflationary dangers and inconsistencies are disregarded, it is extremely questionable whether such a currency could ever succeed in competition with national currencies and would have the potential to be accepted as the single European currency. Why should a "hard" ECU enjoy a market success that the existing basket-based ECU does not, despite being undeniably "harder", in other words more stable in value, than all EMS currencies except the D-Mark and the Dutch guilder?

The main reason for the basket-based ECU's lack of success as a transaction instrument is that it is not legal tender anywhere. One constituent feature of the monetary system is the co-existence of money created by

commercial banks and central bank money, the issue of banknotes by central banks as legal tender. It is this function that enables central banks to exercise monetary policy and in this way to influence interest rates and macro-economic activity in a currency area. The "hard" ECU could therefore supersede national EC currencies only if it became legal tender in all the countries of the Community.

A currency area also requires a uniform legal framework, however. National legal tender alongside "hard" ECUs as an additional legal payment instrument would necessitate competing monetary legislation in each country of the Community – on the one hand national laws and on the other the writ of the EMF. That is an absurd idea; it conflicts with the subsidiarity in monetary matters that the British Government demands as a general principle and in connection with the "hard" ECU. This principle would have to be abandoned.

It would not be possible to demarcate clearly between national monetary policy and the monetary policy of the EMF in the way necessary for interest rates on "hard" ECUs to be determined independently. The British plan for a parallel currency therefore jeopardises a stability-oriented monetary policy in Europe. Far from fostering monetary integration in Europe, it would be certain to rule out the possibility of a single European currency if serious consideration were given to implementing it.

### **An Alternative**

In place of the "hard" ECU as a thirteenth currency in Europe, it would be possible to "harden" the existing basket-based ECU by guaranteeing that it would never depreciate against the strongest EMS currency. The value of the ECU in a national currency is derived from the sum of fixed amounts of currencies at their respective exchange rates on the foreign exchange market of the country in question. If these currency components remain unchanged, the depreciation of any one basket currency in the EMS causes the appreciation of at least one other currency. Depreciation of the ECU in the EMS could be avoided if the composition of the ECU were revised accordingly at every realignment of central rates. There are three possibilities for this.<sup>8</sup>

First the amounts of revaluing currencies could be increased. This would demonstrate that the quality of the ECU was gradually to be raised to that of the strongest EMS currency, since the percentage of this currency in the ECU would increase and those of weaker currencies would decrease accordingly. Secondly, the guarantee that the

ECU would not depreciate is also compatible with increasing the amounts of currencies that are devalued and reducing those of currencies that are revalued at the time of realignments. Finally, a combination of these two approaches is also conceivable, with the amounts of both devaluing and strong EMS currencies being increased. All three possibilities are compatible with the guarantee that the "hardened" ECU will not depreciate against any currency in the basket.

### **Lack of Willingness**

The amounts of the currencies making up the ECU have been adjusted twice since the EMS came into force. The first revision in September 1984 also saw the inclusion of the drachma in the basket; at the second adjustment of the basket the peseta and escudo were included. In addition, twelve realignments of EMS central rates have been carried out since March 1979. The combination of central rate realignments and changes in currency amounts shows that no attempt was being made to harden the ECU, in other words to bring it up to the quality of the strongest EMS currency. On the contrary, the aim has been to weaken it.

Table 1 shows the ECU central rates of the original component currencies at the inception of the system and since the entry of the pound sterling to the exchange rate mechanism of the EMS. The percentage changes in ECU central rates show rates of appreciation or depreciation of the ECU against the basket currencies. Since the launch of the EMS, the ECU has therefore lost ground only against the Dutch guilder and the D-Mark but appreciated against all other EMS currencies, in some cases substantially.

A "hardened" ECU would have required the original ECU central rate of the D-Mark still to be applied today. A

**Table 1**  
**ECU Central Rates of EMS Currencies**

Currencies	ECU central rates		Percentage change
	13. 3. 79	8. 10. 90	
Bfr/Lfr	39.4582	42.4032	+ 7.5
DKr	7.08592	7.84195	+ 10.7
DM	2.51064	2.05586	- 18.1
Ffr	5.79831	6.89509	+ 18.9
£ <sup>1</sup>	0.663247	0.696904	+ 5.1
Ir£	0.662638	0.767417	+ 15.8
Lit	1148.15	1538.24	+ 33.9
Fl	2.72077	2.31643	- 14.9

<sup>8</sup> I am grateful to Peter Rühmann of the University of Göttingen for useful comments on this question.

<sup>1</sup> Notional central rates applied until the entry of the pound sterling into the exchange rate mechanism of the EMS.

hardening of the ECU so that it could gradually take over the functions of the D-Mark as a key currency and anchor in the EMS could have been achieved by increasing the DM content of the ECU whenever an EMS currency was devalued against the ECU and hence also against the Mark. As a consequence, the relative weight of the Mark in the ECU would have increased at each realignment and that of depreciating EMS currencies would have declined accordingly. In this way, the ECU would gradually have been topped up with stable Marks, so that the D-Mark

would have squeezed weak EMS currencies out of the ECU.

The EC central banks and governments responsible for monetary and exchange rate policy were clearly unwilling to do this, however. They were aiming not for a "hardened" ECU, but for a "weakened" one. Table 2 shows that in the revisions of the ECU basket the DM component was reduced by more than the percentage depreciation of the ECU against the Mark. The percentage share of the D-Mark and the Dutch guilder in the ECU, the two strongest EMS currencies, is now lower than when the EMS came into being. This reduction in the weight of strong currencies was accompanied by an increase in the weights of weak currencies. For example, the ECU has been revalued by 34% against the lira, but the share of the lira in the ECU basket has risen by 39%. In March 1979 the combined share of the D-Mark and the Dutch guilder was 43.5%; since September 1989 it has been reduced to 39.8%. As a result the ECU became lighter, not heavier.

**Table 2**

**Composition of the ECU Basket**

Currencies	From 13. 3. 79		From 21. 9. 89	
	Component	Percentage share	Component	Percentage share <sup>1</sup>
Bfr	3.66	9.28	3.301	7.78
Lfr	0.14	0.35	0.13	0.31
DKr	0.217	3.06	0.1976	2.52
DM	0.828	32.98	0.6242	30.36
Ffr	1.15	19.83	1.332	19.31
£ <sup>2</sup>	0.0885	13.34	0.08784	12.60
Ir£	0.00759	1.15	0.008552	1.11
Lit	109.00	9.49	151.8	9.86
Fl	0.236	10.51	0.2198	9.48
Pta	—	—	6.885	5.15
Dr <sup>2</sup>	—	—	1.440	0.70
Esc <sup>2</sup>	—	—	1.393	0.78

<sup>1</sup> On 8th October 1990 (entry of the pound sterling into the exchange rate mechanism of the EMS).

<sup>2</sup> Notional central rates for currencies not participating in the exchange rate mechanism of the EMS.

**Interests of Member Countries**

This weakening of the ECU clearly suited the interests of governments and central banks not only in weak currency countries but also in Germany. An increase in the share of strong currencies would have necessitated reducing those of weaker currencies. However, the smaller a currency's weight in the ECU, the wider the possible exchange rate fluctuations of the ECU against that currency and the greater the risk of changes in the value of residents' assets denominated in ECUs. In addition, if the weight of strong currencies in the ECU were higher, interest rates on assets denominated in ECU would be lower. This would not be in the interests of countries with weak currencies, especially Italy, where for good reason the ECU has had the greatest market success. A weakening of the ECU was not inconvenient to the Deutsche Bundesbank either, as it consolidated the role of the D-Mark as key currency and anchor within the EMS. It should be remembered that for many years the Bundesbank cited the ban on indexation contained in the Currency Law to justify its refusal to allow commercial banks in Germany to take ECU deposits or make loans in ECUs.

**Table 3**

**Components of a "Hardened" ECU**

(1) Currency	(2) Currency amount	(3) Exchange rate (DM per currency unit)	(4) Absolute share of value (2) x (3)	(5) Relative share of value (4) : Σ (4)
Bfr/Lfr	3.80	0.0484837	0.18423	7.34
DKr	0.217	0.262162	0.05689	2.27
DM	1.1366	1.00	1.1366	45.27
Ffr	1.15	0.298164	0.34289	13.66
£	0.0885	2.95	0.26108	10.39
Ir£	0.00759	2.67894	0.02033	0.09
Lit	109.00	0.00133651	0.145679	5.80
Fl	0.391	0.922767	0.36288	14.46

The currency components and relative weights of EMS currencies in the ECU can be calculated as if from the outset the ECU had been guaranteed against depreciating against any EMS currency.<sup>9</sup> For the sake of simplicity let us make two assumptions. First, let us assume that the central rates set at the inauguration of the EMS for the D-Mark and the Dutch guilder (the only EMS currencies

<sup>9</sup> Only the situation in which the ECU would be replenished with amounts of appreciating currencies is described here.

that have appreciated against the ECU) have remained unchanged against the ECU and hence against one another. Secondly, let us ignore the fact that the inclusion of the escudo, drachma and peseta in the currency basket made it necessary to reduce the amounts of the original nine ECU currencies.

Table 3 shows the resulting currency amounts and relative proportions of EMS currencies in the ECU on the basis of the central rates applying since 8th October 1990. The Dutch guilder and D-Mark together would have accounted for 59% of the ECU. In fact, since the last revision of the basket they have had a share of 40%. Put another way, if the ECU had been "hardened" from the outset, the weaker EMS currencies would have had a weight of around 40%, instead of the 60% they now have. A "hardened" ECU would therefore be a closer substitute for the D-Mark as key currency in the EMS than is actually the case. A hardening of the ECU could also have reinforced the stabilisation efforts of some EC countries earlier and thus helped them to avoid the devaluation of their currencies and a reduction in their weight in the ECU.

#### **Expectations of Realignments**

The interest rates on financial instruments denominated in ECUs are a weighted average of the interest rates prevailing on the national financial markets, in keeping with the composite nature of the instruments. The weighting corresponds to the relative shares of each currency. As a result, ECU interest rates are higher than in countries that have a stable currency and low interest rates by EMS standards, and lower than in countries whose currencies are regarded as weak. In the past, interest rate differentials between the national financial markets of EMS countries and the ECU offered fair compensation for the chances and risks of exchange rate realignments; they largely reflected the expectations of changes in central rates. In opting for an investment in ECUs, investors from countries with currencies regarded as strong would be seeking an interest rate advantage as a premium for the risk of a future depreciation of the ECU, while those from countries with weaker currencies would be compensated for the interest rate disadvantage by the expectation of an appreciation of the ECU.

Interest rates on a "hardened" ECU would have to be determined differently. If a credible guarantee were given that the ECU would never depreciate against the D-Mark as the most stable EMS currency and if the risk that this assurance might be broken as well as fluctuations in the exchange rate between the ECU and the Mark are disregarded, interest rates on financial assets denominated in ECUs would have to be the same as for comparable financial assets in Germany. If expectations

of a devaluation of an EMS currency against the D-Mark and the ECU strengthened, interest rates in the country with the suspect currency would rise. On the German forward foreign exchange market the currency would trade at a discount equivalent to the interest rate differential. By contrast, the forward and spot rates for the ECU on the German foreign exchange market would always have to be identical, because it would be known for certain that no change would be made in the central rate of the D-Mark against the ECU. Consequently, interest rates for comparable financial instruments would have to be the same, whether the instruments were denominated in ECUs or D-Mark, for expectations that the central rates of EMS currencies will change by the same amount against both a "hardened" ECU and the Mark would imply a future increase in the DM component in the basket. For investors and borrowers this is not relevant, however, as long as a constant exchange ratio between the Mark and the ECU is guaranteed.

A departure from the present basket construction of the ECU, with fixed amounts of the twelve EC currencies even after exchange rate realignments, and the exclusion of a possible appreciation of the D-Mark against the ECU would increase Germany's dominance over interest rates in the EC still further. Interest rates on a "hardened" ECU would be equivalent to those on comparable securities denominated in D-Mark. Interest rates on ECUs would decline, and with them the incentive for the private use of the ECU in weak currency EMS countries. If this policy had been adopted at the outset in order to strengthen the ECU, it would undoubtedly have had less market success among private users. The ECU would be a perfect substitute for the Mark; to put it another way, it would simply be the Mark by another name and the Mark's role as key currency would be more obvious.

#### **Conclusions**

It is time to end the discussion about a parallel currency for Europe, a "hard" or "hardened" ECU. The basket configuration of the ECU has served the European unification process well. It has helped resolve conflicts and find consensus and has prevented unilateral changes in EMS central rates. If the consensus that has developed on stabilisation policy is to be maintained, realignments will probably be only minor between now and the start of the final stage of monetary integration in Europe. For that reason it makes no practical sense to think up a different formula for the ECU. Let us leave things as they are: the D-Mark is the key and anchor currency in the EMS, while "ECU" is a monetary term that links together the currencies of the EC and the striving of all Europeans for a single currency.