European currency and European central bank—a British view

Mr Anthony Loehnis, an Executive Director of the Bank, discusses[1] the scope for progress towards monetary union in the European Community and the difficulties that lie in its path, addressing in particular the questions of when such union might be possible, how it might be achieved and the choice of a future common currency. He argues that monetary union will be the culmination of a gradual progression towards greater convergence in economic policy and performance, in which completion of the internal market will be an important step, and that premature moves toward monetary union could jeopardise the progress being made towards the internal market. Achievement of a common currency, too, will not be feasible until much greater economic convergence has been achieved: and efforts to force the pace, by pressing for development of the ECU as the European currency and concentration on institutional changes, would be both difficult and potentially harmful in diverting attention from the essential pre-conditions. The private ECU should be allowed to develop in accordance with the needs of commercial markets.

In trying to imagine what Europe will be like when the creation of the internal market is complete, or indeed what it would be like were a genuine monetary and economic union to be achieved, I find it useful to look at the United States of America. Here, after all, is a graphic illustration to consumers and producers alike of what a federation of states without internal frontiers does look like. At the same time each state has a different set of laws, there are very great economic disparities between them, and there is in no sense a harmonised fiscal system at the state level. Those characteristics will certainly be shared by Europe. But there will remain striking differences, of which two of the most fundamental are the lack of a common language and the lack of a common currency. There can be no denying, I think, that both these deficiencies are likely to make the European internal market less effective than that in the United States.

The lack of a common language can to some extent be coped with, without seeking to move to an ECU-type basket language such as Esperanto. But the lack of a single Community currency does threaten to render the single European market less effective than it could be. Surveys of business opinion frequently indicate that the business community sees this as one of the most important obstacles to the facilitating of intra-European trade which the single market is all about. Besides the direct transactions costs of having to switch between currencies, variations in exchange rates create uncertainty which, among other things, can affect investment decisions. These difficulties should not be overstated—they discourage individuals, small businesses and firms new to cross-border trade more than larger firms or those used to buying and selling throughout Europe. And the difficulties are being reduced all the time by developments in technology (such as the increased use of credit cards and electronic funds transfer) and by developments in financial hedging instruments (such as currency options, futures and swaps). Nevertheless, it is still true that trade between member states is a degree more complicated and uncertain than trade within a state. And thus, when the conditions are right, monetary union will be an advantage to the Community.

There is, however, disagreement about how that union can best be achieved. Today, I would like to explain my view of what needs to be done. In particular, I would like to talk about the role of the ECU in this. My argument will be that it is best to treat the development of the ECU on the one hand, and progress towards monetary union on the other, as two distinct issues. Desirable though development of the ECU may be, real progress towards monetary union requires the Community's efforts to be devoted to different matters—in particular, completion of the internal market and greater convergence in economic policy and performance.

The commitment to monetary union

The idea of economic and monetary union has always been in the minds of those who have contemplated the future of the Community. The original Treaty of Rome, although not specific on the matter, refers in its recitals to the determination 'to lay the foundations of an ever closer union'. Perhaps the most significant declaration of intent followed from discussions of the Werner report in the early 1970s, which was itself the result of the Hague Conference of December 1969, where the wish was expressed to see the Community develop into an economic and monetary union. The Council Resolution of March 1971 declared that this objective appeared to be

(1) In a speech to the Intergroup 'European Currency' of the European Parliament in Strasbourg, on 15 June.

one that could be attained during the 1970s and laid down the steps to this end that were to be taken. Unfortunately, the economic disruption of the 1970s threw that plan seriously off course, and since then the Community has been more cautious about making monetary union an explicit objective with a timetable. When the EMS was being set up very little was said publicly on the matter of European union: the December 1978 European Council contented itself with the comment that the EMS would 'give fresh impetus to the process of European Union'. The reference to the consolidation within two years of the EMS into 'a final system' was correspondingly vague, notwithstanding the reference to consolidating 'the existing arrangements and institutions' in a European Monetary Fund. No attempt was made to define the functions or structure of such a fund. Since then the Single European Act has set as a Community objective 'concrete progress towards European Unity' but it too does not specify how or when. It has, of course, given the Treaty of Rome a new chapter entitled 'Co-operation in Economic and Monetary Policy (Economic and Monetary Union)' but the substance of the single article in that chapter falls very far short of anything like a commitment to monetary union.

There is, I would suggest, good reason for this caution. It does not reflect a lack of commitment to union as an eventual goal. But it does reflect awareness of the very real difficulties of getting there. To demonstrate this let me elaborate on what I see to be the key questions of when monetary union might be possible, how it might be achieved, and with what choice as Europe's future currency.

Is the time ripe?

It would be hubristic to seek to anticipate the conclusions of the European Council meeting in Hanover the week after next, but I think it reasonable to assert that few people believe that in present circumstances monetary union could be achieved tomorrow. It is useful, however, to consider how close we may be to conditions in which it would be realistic. The completion of the internal market is important in this respect. Economic theory on the subject of monetary union—the theory of optimum currency areas—concentrates on the problem of imperfect markets and in particular the problem of price rigidities in the markets for goods or factors of production. Rigidities in these markets within a region may result in a failure to achieve economic equilibrium. One way to compensate partially for these rigidities is for the region to divide itself into a number of different areas, each with a separate currency that is allowed to vary in value against the others. But the theory of optimum currency areas suggests that the greater the mobility of goods, of factors of production, and of financial services within the region the less is the need for these separate currencies. This mobility provides an alternative means of compensating for price rigidities. As 1992 approaches, goods, labour and finance are increasingly able to move throughout the Community without restriction and a single currency will therefore become increasingly plausible.

But completion of the internal market is by no means enough. Monetary union—whether in the form of a single currency or of irrevocable parities between different currencies—necessarily involves a single monetary policy. Once such union was achieved, national money supplies could not be separated one from another, and any change to interest rates in one member state would, through arbitrage, have equal effect elsewhere.

And it would not only be monetary policy that was affected, for member states' fiscal policies would also be greatly constrained. It is true that, provided national governments were not able to finance their budgets by expanding the money supply but only by market borrowing, a direct link between fiscal policy and the supply of money might be avoided; in this way, despite the common monetary policy, individual member states might have some freedom to set different fiscal policies. But this freedom would be constrained since fiscal policy would still affect interest rates. Close co-operation and co-ordination between fiscal authorities would therefore be necessary, and fiscal policy would probably need to be governed by an agreed set of rules.

Assuming the present disparities of economic growth between regions of the Community were not substantially reduced, there would also need to be an even greater transfer of resources between the regions than that which takes place at the moment. Community fiscal policy would have to allow for transfers of monies from wealthy to depressed areas in the relatively invisible way in which this currently takes place within each individual member state. I need hardly stress how emotive a political issue that is likely to be.

All this would mean that the scope for member states to pursue independent economic policies would be enormously constrained. To return to the example of the United States, there we see how, despite their federal system, economic policy is concentrated in the centre—particularly in the monetary field, where the regional Federal Reserve Banks do not have the power to set independent policies. As far as fiscal policy is concerned, recent experience in Canada provides an illustration of how the freedom of the provinces to set independent policies can cause difficulties when these policies run counter to the policy of the national government.

The current debate on the conduct of monetary policy in Europe illustrates some of the difficulties. There is broad agreement in the Community that monetary policy should enable sustainable real growth to occur within the limits imposed by the need to control inflation. But it is no secret that there exist important differences in the interpretation of this view. For example, the German authorities feel that after the changes that were agreed to in the operation of the EMS under the Basle/Nyborg Agreements of last September they have gone far enough in relaxing the constraints on inflation. On the other hand, the French and others have suggested that German caution is a brake that is inhibiting much needed growth. Hence the current debate about whether there is a need for greater symmetry in the EMS. My own view on this matter, for what it is worth, is that Europe certainly should be addressing its underperformance in growth and employment, but that it would be extremely unwise to look to one's monetary system as the main engine for growth. For this the dominant role should be played by fiscal and structural policies. The prime aims of the monetary system must be the achievement and maintenance of price stability.

Now these differences already cause problems within the relatively flexible constraints imposed by the Exchange Rate Mechanism; to go further and establish a common currency is not feasible until they are ironed out. It is worth stressing that the problem is not just a political one to do with the loss of member states' independence, important though that problem is. There are genuinely held differences of opinion, partly almost philosophical, partly about how economies work, which are particularly difficult to resolve given the existing disparities in economic performance. Nor is it at all clear that, even if a single monetary policy were agreed on and tight guidelines on the operations of fiscal policy established, the freedom of manoeuvre in economic management remaining to member states would be sufficient to give them any real independence in economic policy or enable them to fulfil their obligations to their electorates.

Achieving monetary union will be difficult. I have tried to suggest that there will be a need for much greater convergence in economic policy and performance than now exists. There will be a need, moreover, for *balanced* progress on a number of fronts. The Community is in the middle of a complex juggling act, trying to make progress in a number of areas. First, it is trying to remove the barriers to trade—in goods, services and labour. Second, an important step forward was taken on Monday when the ECOFIN Council approved the Directive on Liberalisation of Capital Movements, which provides for the complete removal of the remaining exchange controls in a majority of member states within two years and a timetable for their removal in the remainder. Third, the central banks of the Community are always alert to the possibility of further changes to the mechanisms of the EMS to increase its effectiveness. If all this is to succeed, and end in monetary union, it must keep in step with progress towards economic convergence. That is the really important task for the Community that has perhaps so far not been fully faced up to.

In my judgement monetary union will be the culmination of an asymptotic progression towards greater convergence of economic performance and more closely co-ordinated economic policies, on which path the perfection of the single market is an extremely important aim or milestone. It will not be easy to achieve the single market by 1992, because as each of the draft directives comes closer to the moment of decision, so the real political obstacles in many instances will surface. To risk jeopardising this process by superimposing a premature and simultaneous effort to establish monetary union would seem to me most unwise. The political sensitivities concerning loss of sovereignty in monetary matters are only likely to be overcome when there is an invisible demand from *below*—that is from the industrial, commercial and financial constituencies—for a common currency. It is dangerously unpractical to suggest that it will be possible to impose monetary union from above, even supposing the political sensitivities prove more tractable than I believe them likely to be. Those constituencies will be greatly strengthened as a result of the moves towards completing the internal market by 1992, and as experience of working in a frontier-free environment grows. That is why priority must be given to the 1992 process, and its achievement not be put in jeopardy by premature moves towards monetary union.

The choice of currency

So much for when monetary union might be achievable. The second question I would like to address is that of which currency should be chosen to be the single currency of the Community. Some would say that there is no real choice, that it would naturally be the ECU. After all, the Bremen Council in 1978 asserted that the ECU 'will be at the centre of the system'. The ECU has indeed become a symbol of European monetary identity, but I would suggest that it is not necessarily the most appropriate choice for Europe's future currency. We need to distinguish between, on the one hand, the importance of the ECU as a composite market currency unit in an unstable multi-currency system and, on the other hand, the creation of a single European currency. It is possible to envisage the latter happening in one of two ways.

The first way would concentrate on the gradual convergence of economic policy and performance that I have discussed earlier. As this happened, the main source of disturbance to ERM parities would progressively disappear. It is hard to say how long this process of convergence might take, and the sceptical financial markets are likely to require somewhat longer to be convinced, during which time the threat of disruptive capital movements would remain. That threat would not be removed even by declarations that established parities had become unchangeable. The condition necessary to remove it—and the logical outcome of the process of convergence—is the disappearance of separate national currencies and their replacement by a single Community currency. And the moment for that step change will be when economic timeliness is matched with a willingness to merge sovereignty at the political level and the formation of a European identity at the social level.

It would not greatly matter which currency became the common currency. There would, of course, be the question of seignorage which individual countries would be reluctant to sacrifice. This might point pragmatically to the adoption of the ECU as the single currency. But that in turn raises the question of who issues the ECU, and points to the creation of a European central bank. Theoretically, however, the single currency could equally be one of the existing national currencies, or even a new currency. All would share the same characteristics apart from size. The only real difference would be the purchasing power of each unit of the single currency; for example, one lira would buy less than one ECU. Beyond that it would only be a question of name. Again, national susceptibilities would no doubt dictate a change of name to something more neutral, such as EUROPA or CHARLEMAGNE or even, had the name not been pre-empted by something else, ECU.

This first method I have described accepts the fact that the complete achievement of a common currency is not feasible until much greater economic convergence has been established, and concludes that because of this the question of which currency becomes the single currency is not an important one except at the point of change, when the question of seignorage and which institution is to issue the single currency would assume great importance. But in principle a common currency could also be achieved by a second route, which would involve developing the use of the ECU, beyond its role as numeraire, as a currency in its own right in parallel with the existing currencies. This would mean encouraging the use of the ECU and enhancing its official status until it reached a position where it could displace national currencies. This idea of developing a parallel Community basket currency has been popular since the mid-1970s and has a powerful grip on the minds of many who are anxious to achieve monetary union. It is a superficially attractive approach. It involves concrete and visible action now, not later; and, of symbolic importance, it makes use of a currency that is itself a union of other currencies. But I believe the apparent attractiveness of this approach arises from a confusion. The ECU is seen as a source of stability in an unstable multi-currency world—and even in the ERM there has, of course, been significant exchange rate volatility. It therefore appears already to be starting to do the job for which supporters of this approach intend it—that is, acting as Europe's single currency. But to have a healthy ECU playing its part in a system of fluctuating currencies is one matter. To say that because of this the ECU is the best way of replacing those currencies is quite different. Let me try to explain why.

There are three important points. The first is that it is not *necessary* to develop the ECU in parallel. Even if we were successful in doing so, the step from that to displacing national currencies to any significant degree still could not take place until a common monetary policy had been agreed and the rules on fiscal policy set. In other words, it could not take place until there was sufficient convergence of economic policies and performance. In that sense it would, at best, have no advantage over the first route I suggested.

The second point is that it would anyway be *difficult* to develop the ECU as a *currency* in parallel with national currencies. The ECU has undoubtedly proved its worth over the past nine years. But the ECU has disadvantages as well as advantages. It is difficult to strike the right balance with basket currencies—the balance between the need for diversification so that the currency is a genuine alternative and the weight within the basket of the major currencies for which it is intended to be the alternative. Sophisticated users can create their own basket currencies either for themselves or by using a facility offered by some banks. An additional disadvantage is the inherent confusion between the official ECU and the commercial ECU. The official ECU is strictly limited as to its use and who can hold it. It is specifically not fungible with commercial ECUs, although a number of ingenious mechanisms have been put forward to make them interchangeable, all of which founder ultimately on the fact that there is a cost or a risk that has to be borne by someone which renders them unusable. What we are talking about in the context of the ECU as a parallel currency is the *commercial* ECU. So there are limits to the degree that the natural commercial advantages of the ECU will be enough to encourage its further use.

To become a genuine reserve currency in its own right, the ECU will need to have large and well-functioning money and capital markets; as yet these are in a fairly embryonic stage, and it will be difficult to force the pace of development. Moreover, there will be technical and legal problems about the use of the ECU as legal tender while the ECU and other currencies exist in parallel. There have been suggestions, for example, that there should be dual pricing—with prices (and perhaps taxes and other payments too) quoted both in ECUs and in the national currency, leaving consumers free to choose how they paid. But the complexities of dual pricing would place a considerable administrative burden and cost on firms and governments. And it would be likely to become an exercise in cost minimisation and tax avoidance as accountants and planners tried to predict ECU/national currency exchange rates to decide which would be most favourable.

If this second approach were to be followed, some sort of institutional structure would need to be put in place. The supply of ECUs would need to be controlled, and the markets in the currency managed. This could perhaps be done by the existing central banks working in co-operation and according to an agreed set of rules; or a new European monetary institution might be established for the purpose. This is presumably the idea behind the European Monetary Fund conceived at Bremen in 1978. Either way there would be important questions to be settled about the balance of powers. Who would control ECU monetary policy? How would the relationship between the supply of ECU and that of national currencies be determined?

While the ECU continued as a secondary currency, a Eurobasket as it were of national currencies, playing a relatively modest role compared to that of national currencies, none of these problems would be, in the final analysis, of major importance. But if the ECU were to become a real alternative currency on any significant scale, they would become critical. In particular, there really would be fundamental problems about managing the supply of ECU in parallel with that of national currencies and ECU monetary policy would somehow have to be compatible with each of the national monetary policies—a complex, probably impossible, task.

But developing the ECU to such an extent in parallel with other currencies would not just be unnecessary and difficult. My third point is that it could also put at risk the economic and financial development of Europe which is already in train. It is not clear that the sort of laws and institutions which would be needed to establish the ECU as a fully-fledged currency at this stage are the sort that will be needed once a common currency is genuinely possible. Even if the road taken were the right one, a great deal of effort might be spent sorting out difficult and controversial questions, when the time could be more usefully spent in completing the internal market and increasing economic convergence. There is, of course, an argument that by putting the institutions in place now, impetus will be given to the process of monetary union and the conditions necessary to achieve it. Once monetary union is close to being a reality there may be some force in this. But for the immediate future I cannot see that the non-existence of an institutional structure will in any way hinder progress. Rather, if we were to attempt to set up such institutions prematurely and fail, serious damage might be done, delaying the achievement of monetary union. It could be damaging in another way. To the extent that the ECU found favour as a parallel currency it would be likely to do so at the expense of its own weaker component currencies. Gresham's law might work in reverse in those Member States whose economies were not soundly based. This might, in due course, force the governments of those countries to adopt more appropriate policies but in the meantime the undermining of their currencies could have a destabilising effect on the ECU itself.

The role of the ECU

What I have said so far may not have sounded very complimentary to the ECU. If so, it was not intended so, but I did want to distinguish clearly the two separate issues of, on the one hand, how best to achieve monetary union and, on the other, the future of the ECU. As far as union is concerned it seems to me that development of the ECU as a currency is a distraction. But that is not to deny the importance of the ECU as it stands and the need to consider the role it should play and how that role might be enhanced.

I earlier referred to the usefulness of the commercial ECU in a relatively unstable multi-currency system. The ECU is still young as currencies go, but it has already proved itself to be a currency of significance, and its use in the commercial banking and bond markets is now well established. Over the past year there have been a number of important and welcome events. In particular I am thinking of the change in German law to permit Germans to hold liabilities denominated in ECU (although I still have some reservations about its treatment for the purpose of reserve requirements); and the development by the ECU Banking Association and the BIS of a clearing system for ECU payments. These events illustrate two important types of development. The first illustrates changes in domestic regulations made to ensure that the ECU's progress is not hindered by restrictions that unnecessarily place it at a disadvantage. The second illustrates changes made by the market to meet market needs. Both sorts of development are welcome. But a third type of development is also possible—namely changes in laws or government practices with a view to actively promoting or discriminating in favour of the ECU. Many are also in favour of this type, and if the ECU were essential to the success of monetary union, this might be justifiable. But since, as I have argued, it is not essential and may indeed be a distraction, what is the purpose of such active discrimination?

The market, I would suggest, will develop the ECU where it is needed; and this development cannot effectively be forced. Certainly, national authorities for their part need to consider where their laws may need changing so as to permit the wider use of the ECU. One such change might be to allow companies to publish their accounts in ECU rather than national currencies, an option that might be increasingly welcome as the approach of 1992 encourages pan-European companies. Governments themselves might increasingly find it useful to raise money by issuing ECU paper over the full range of maturities; or central banks may find it convenient to hold ECU for intervention purposes. This would add to the impetus to the market already provided by borrowers such as the European Communities, who currently have in syndication the largest ECU bond issue ever. In addition, European institutions such as the Commission or the European Parliament might give a benign push to the use of the ECU by using it not only as a unit of account but also as a means of payment. When considering these sorts of changes, however, the costs and benefits need to be carefully weighed—purely symbolic gestures are not needed. This approach to the ECU has so far been successful and enabled the ECU to take its place as a significant international currency. The key to the ECU's future growth will be how well the currency meets future market needs, in particular by offering an attractive combination of profit and risk.

A European central bank

In speaking of the future of the ECU, I have suggested that we need first to agree on what needs to be done and only then to consider how best to do it. In my view this argument is equally valid as a response to the current scramble to find something for a European central bank to do to justify its creation. I do not doubt that when monetary union is achieved, or about to be achieved, it will be necessary to have a European central bank. There must be a central institution responsible for issuing the common currency and for determining and executing the common monetary policy, both internal and external. This would involve providing lender of last resort liquidity to the system where necessary. These are the minimum functions. There could well be others, but I see little advantage in seeking too precise a blueprint too far in advance of the time when it may be realistic actually to found such an institution. Thought will have to be given to how such an institution would relate to existing central banks, to the Ministries of Finance of member countries, to other Community institutions, such as the Commission, the Council and the Parliament. Powerful voices have already asserted that it would have to be wholly independent of all such institutions and dedicated to the task of bringing price stability. Both are aims which I, as a central banker, can wholeheartedly endorse. But my instincts tell me that while it might theoretically be possible for such an institution to be wholly independent of national governments, since the Rubicon of giving up national sovereignty over monetary policy would have been crossed by the time a common currency had been established, it might well be much harder for it to be wholly independent of any Community institution. Who, at the end of the day, will be responsible for appointing its Governor and directors?

I would certainly think it likely that we will be looking at some sort of analogue to the US Federal Reserve System or the Bundesbank. Clearly with a single Community currency and unified monetary policy, many of the traditional functions of the national central banker will fall away. But there will still be important functions relative to note issuance (or will all money be pen and ink or plastic by then?), perhaps to the clearing systems, to banking supervision and so on where the relationship between the European central bank and the residual national central banks will need to be thought about and established.

All of these questions will have to be submitted to intensive study, and I cannot pretend that we in the Bank of England have yet begun to do much more than scratch the surface. As I have indicated, I do not believe the conditions for the establishment of a European central bank are likely to exist for some considerable time, but there may be some merit in setting in train a careful examination of the principal issues involved and the broad principles in accordance with which such a bank in due course might be established. Such studies will take a long time. They should be undertaken by those with the necessary experience and technical expertise, who are likely to be found mainly in central banks and Finance Ministries.

It follows from this, I think, that I do not see scope at this stage for adapting any existing institution, such as the FECOM, to make it an embryo European central bank. First, we must know where we are heading. Meanwhile, the practical business of co-ordinating monetary policy more closely is taking place within the Monetary Committee and the Committee of Governors. Progress over the past eighteen months—anyway since the last realignment in January 1987—has been most heartening. Without it, it is hard to think that the parities established at that time could have survived the shock of Black Monday and two French elections. And it has required no institutional change.

Conclusion

In conclusion, I would like to stress my belief that monetary union is an important final goal, and that the ECU is already playing a useful role which could evolve further still. My argument has been that if these two issues are confused we may travel down the wrong road, or at best down the right road too slowly. I can understand the desire for visible progress, but I firmly believe that concentration on institutional change at this time, and on the development of the ECU not just as a useful commercial tool but as *the* Community currency, is premature, difficult and potentially harmful. It is likely to distract the Community from the important efforts needed to accomplish the bulk of the 1992 agenda and to achieve economic convergence. That progress will be less glamorous, less visible and it will not be easy. But it is the vital underpinning without which our efforts to achieve monetary and economic union will prove to be built upon sand.