Bank of England
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The Governor

20 June 1990

I am sending with this letter some ideas on progress beyond Stage 1 of EMU. I should like to discuss these with you at our next meeting of the EC Governors' Commitee. The Chancellor of the Exchequer will be putting some proposals along these lines to his EC colleagues shortly, and will be publishing some of them tonight in a speech. Quite accidentally, I had to appear before a Parliamentary Committee this morning on EMU and found myself having to give some description of the proposals, although I would have preferred it that the first people to whom I said anything had been my central bank colleagues.

The attached paper deliberately concentrates on institutional arrangements that might be put in place relatively early. Their essential purpose is to bring collective counter-inflationary pressure to bear throughout the Community, while leaving the ultimate responsibility for national monetary policy decisions in national hands. This, in our view, would be the most immediately practicable way of seeking to accelerate the process of securing price stability in each member state, which is itself a necessary condition for the durable stability of intra-EC exchange rates.

Our ideas are therefore precisely directed to immediate concerns on which we are all agreed. At the same time, if the suggestions are successful in their objective, that would go a long way towards establishing the foundations necessary for monetary union.

I believe that all this represents a constructive advance in British thinking which would be compatible with progress towards Stage 3 of the Delors Report without arousing the political sensitivities of a rapid or automatic transfer of national responsibility for domestic policy to a new institution. It would give us a better chance of all moving forward together, which I think we are agreed is in itself desirable provided that adequate forward momentum is maintained. I hope you will agree that the ideas in the paper do, therefore, merit very serious consideration.

I look forward to the early opportunity of explaining these suggestions to you more fully and of discussing them with you.

Meanwhile, I am sure that I can rely upon our collective tradition of not making any public reaction until the approach has been fully examined.

BEYOND STAGE 1: PRINCIPLES FOR INSTITUTIONAL PROGRESSION

1 The current work of the Committee of Governors on the form and functions of a European System of Central Banks is founded on the shared objective of adding a monetary dimension to the process of economic integration in order to achieve downward convergence of inflation towards price stability in all Member States and to reap in full the benefits of the Single European Market. The Report of the Delors Committee showed how this could be done in three stages but left a good deal of the detail open for discussion. Agreement has already been reached among Member States on the framework for Stage 1, which begins on 1 July, and much thought is now being given to what the final stage might eventually look like but very little has been said so far about the steps which will take place after Stage 1.

2 This paper seeks to define the principles that should guide institutional development beyond Stage 1 and to illustrate how those principles might be carried through in a particular structure. The purpose of the illustration is not to offer a specific, detailed, proposal but to enable the principles to be seen in a concrete form. It might well be that the same guiding principles could be embodied in a variety of alternative institutional forms and any such ideas would be a proper subject for further debate.

<u>Progression beyond Stage 1: the nature of the problem</u>

3 In economic terms, the process of moving from separate national economies with separate currencies to the ultimate objective described in the Single European Act, Economic and Monetary Union is a continuum, whether or not there need to be institutional and constitutional discontinuities. As the tentative ideas advanced in the Delors Committee's Report imply, a self-contained Stage 2 is conceptually the most difficult section of the route-map to EMU. Rather than taking the usual starting point of an empty box defined solely by the institutional limits

of Stage 1 and Stage 3, and then looking for a suitable selection of objects to place in it, it may be more helpful to look afresh at what is involved in the difficult journey for Member States along the road from their present position, the onset of Stage 1, to further monetary and economic integration.

4 Fulfilment of Stage 1 will require the complete liberalisation of capital movements; the inclusion of all Member States' currencies within the narrow margins of the Exchange Rate Mechanism of the EMS; completion of the legal framework for a single market in goods, services, capital and labour; and closer economic and monetary policy co-ordination. But this does not simultaneously secure full economic integration and it rightly leaves policy decisions and their implementation unambiguously in the hands of national authorities. Stage 3, as defined in the Delors Committee's report, entails a single monetary policy decided at the Community level with either irrevocably fixed exchange rates (with no fluctuation margins and no realignments) or a single currency, effective national budgetary discipline and a considerable degree of economic integration. The fundamental question is therefore how to proceed from a common framework for economic integration and national policy-making to an integrated Community-wide economic and financial area; and to what event this requires organic evolution and to what extent an inorganic catalytic process.

5 Once the single market framework is fully in place, and provided that Member States are pursuing compatible policies, progressive economic integration is essentially an organic, market-driven process that should bring with it a de facto narrowing of exchange rate margins. The key consideration is therefore whether it is possible to impose on this organic process discrete institutional steps which reinforce it rather than disrupt it. In a very important sense, the transfer of ultimate responsibility from the national to the Community level can only take place in a single step. In the monetary sphere, if the transfer of responsibilities is attempted in more than one step there is a danger of confusion as to where ultimate responsibility for monetary policy lies, creating a potential source of market

instability which the narrowing of margins, especially de jure, could amplify. At the same time, it is widely agreed that until the onset of Stage 3, ultimate responsibility for domestic monetary and national exchange rate policy must continue to reside with individual Member States. The challenge, therefore, is to design institutional arrangements which are both organic, such that they keep pace with and underpin the economic and monetary development of the Community, and unambiguous in the allocation of any functions to the centre while retaining in national hands the ultimate responsibility for national currencies.

<u>Guiding principles for institutional progression</u>

6 The overriding objective in developing the Community's monetary framework is convergence on stable prices. Success in achieving that will create the conditions for stability in exchange rates, and then for locking of parities, between the national currencies. Accordingly, the first, self-evident, principle is that <u>the operation of new institutional arrangements should not produce any net addition to monetary expansion within the Community</u>. The second principle is that the new arrangements should be able progressively <u>to exert pressure on National Central Banks ("NCBs") to curtail their monetary expansion</u> - particularly on those that are over-expanding. The third principle, reflecting the wider principle of subsidiarity, is that <u>the choice of the means by which to respond to these pressures should remain, within Stage 2, fully with the NCBs</u>. The fourth principle is that <u>choices made by the public and the markets should play a central part in the evolution of the new mechanism</u>, through their interaction with those managing the new arrangements in transmitting pressure to NCBs.

7 In what follows, a particular institutional form is outlined as an illustration of how those guiding principles might be applied in practice. The

institutional arrangements which are put forward build on the existing framework of the EMS. Alternative institutional forms could be envisaged. Other complementary elements of Stage 1 could also be carried through to Stage 2 and incorporated into the new arrangements. The ultimate test of any institutional proposal for Stage 2, however, must be its conformity with the above guiding principles.

Application of the principles

8 One possible step which would meet these requirements would be to convert the ecu from its present form, as a composite currency unit which reflects only the average performance of its constituent national currencies, into a currency which, by definition, could not have its parity devalued in terms of any Community currency. This "hard ecu" would accordingly match the Community currency which had best non-inflationary performance, and hence the best-maintained purchasing power, at any point in time. Its exchange value in terms of national currencies would be guaranteed by the national central banks as the owners and managers of a new institution, or Hard Ecu Bank (HEB), which would have sole responsibility for issuing the hard ecu. The HEB would provide hard ecus against the surrender of holdings of national currencies at an exchange rate set at an intervention margin against parity. It would thereby acquire assets in the form of deposits denominated in EC national currencies and it would issue interest-bearing liabilities in hard ecus.

9 A key element in ensuring the non-inflationary character of the scheme would be that each participating central bank would accept an obligation to maintain the ecu value of the HEB's holdings of its own currency, which the HEB could require it to fulfil by repurchasing some or all of those holdings against hard ecus or some other currency. Thus any national central bank that allowed excess supply of its own currency to develop, relative to the hardest national currency at the time and hence relative to hard ecu, would be obliged to redeem the excess against hard currency. This would help to ensure that the HEB, which issued ecus only against the national currencies of Member States or

third-country hard currencies that it took in, did not validate at the Community level any excessive liquidity creation by an individual national central bank. Other instruments could be devised to ensure the non-inflationary character of the Bank if these were thought necessary.

10 The new institution could, in time, develop a capacity to exert somewhat greater downward pressure on liquidity creation within the Community. This would be accomplished by managing the interest rates on ecu liabilities so as to attract conversion from national currencies, thereby impelling national central banks to accompany their own responsive liquidity contraction by corresponding interest rate management. The effectiveness of the mechanism would depend on two factors: the extent to which the public and the financial markets developed a demand for the hard ecu, and the extent to which the HEB was prepared to stimulate such demand by offering attractive interest rates on its liabilities. The latter would involve the HEB in exposure to some financial risk, so that, initially at least, its managers would be subject to tight constraints as to the interest rates that could be paid on its hard ecu liabilities and the quantities of national currencies that it could hold in its own asset portfolio rather than laying them back on national central banks against hard currency assets. In due course, as experience of operating the new system grew and the hard ecu's reputation were consolidated, there might be more freedom to promote its circulation in place of existing currencies. In time, it could develop into a dominant common currency and ultimately into the single currency if that were the Community's chosen outcome. That would, however, not be a pre-ordained result. The point of the scheme is that, as the circulation of the hard ecu rose in relation to, and in <ins>substitution</ins> for, national currencies, it would provide a powerful leverage for the extension of a collectively-agreed, <ins>non-inflationary</ins> monetary policy among Member States, who would still retain responsibility for their own <ins>national monetary policies</ins>. But the pace of the ecu's development would be determined by the interaction between judicious supply of hard ecus by the authorities and <ins>market demand</ins> for a strong common currency, in contrast with other schemes that foresee the

transition to a single currency being determined purely by administrative fiat. It would thus satisfy each of the four principles outlined in paragraph 6.

11 This paper has not addressed the other functions that might be attributed to a new institution created in Stage 2. It could, however, prove useful to give it some of the functions that would need to be performed by a ESCB/CMI in Stage 3, and that would not infringe on the need to leave monetary sovereignty in Stage 2 with national authorities. Such functions might include management of the operation of the ERM and EMCF, certain prescribed responsibilities for intervention against third currencies, and responsibility for promoting closer co-ordination of monetary policies etc.

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