

COMMITTEE OF GOVERNORS OF THE CENTRAL BANKS  
OF THE MEMBER STATES  
OF THE EUROPEAN ECONOMIC COMMUNITY

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SECRETARIAT

Basle, 6th July 1990

Please find attached the written version of the remarks Andrew Crockett made at the last meeting of the Alternates about the UK Stage 2 proposals. Please note that Mr. Crockett's remarks were made in a personal capacity and are circulated to Alternates in that spirit.

Kind regards,



Gunter D. Baer

2130B

## THE HARD ECU AND THE EUROPEAN MONETARY FUND

1 In these brief remarks, I would like to describe in a little more detail the basic purposes which we believe would be served by the proposals for stage 2 put forward by the Chancellor of the Exchequer. I will go on to say why we believe that these proposals address the potential risks of a parallel currency that were highlighted by the Delors Committee. I will end up by giving some indications of how the Hard ECU proposal would work in practice. At this stage, my remarks will not be comprehensive. Rather, I will aim to give an overview of the operational aspects of the proposal, so that colleagues have an opportunity to pose particular questions later.

### Purposes of a Stage 2

2 I think we all recognise that the transition from a stage 1, in which there are separate national currencies fluctuating within the narrow band of the ERM, and in which the option of realignment remains a possibility, to a stage 3 in which realignments are completely ruled out and there is a single currency with a single monetary policy, is a large one. However, given the reality that monetary policy is indivisible, many observers have seen no alternative, in effect, to a jump from stage 1 to stage 3, perhaps with a brief "training period" in between. We understand the reasoning behind this conclusion. Nevertheless, we consider there are significant dangers in moving to full monetary union before the necessary convergence has been achieved, before the changes introduced by the single European Act have been properly absorbed and before adequate experience has been gained with the co-ordination of monetary policy. It therefore seems to us important, if it can be made practicable, for a smoother transition to take place, during which full convergence of policies can be achieved, the necessary integration of the real economic sectors of our economies can proceed, price stability can be entrenched and familiarity can be gained with the ECU. This is

the first reason why we believe a substantive stage 2 can serve a valuable purpose.

3 A second purpose of the UK proposals is to provide a credible, Community-based focus for the convergence of policies towards price stability that we are all seeking to promote. So far, the Deutschemark has provided an anchor for expectations, and a focal point for the monetary policies of partner countries. We all owe a debt of gratitude to the Bundesbank for the manner in which the Deutschemark has been managed, and the service it has thus provided to the other members of the Community. However, the time has come, we believe, to look forward to a situation in which a single central bank will not be expected to bear alone the task of providing a nominal anchor to the system. We believe that mechanisms can and should be put in place to ensure that Community disciplines for price stability are as strong, or even stronger, than those that exist within a DM dominated ERM.

4 Third, let me also note a political dimension to the proposals that the UK government has put forward. We recognise that many, or most, of our Community partners have accepted that a transition to a stage 3, of the kind that we are in the process of discussing, should take place at a relatively early stage. We also, however, have to face the reality that in certain member countries, including the United Kingdom, there are still significant political and constitutional reservations about the ultimate move to a single currency in Stage 3. One purpose of our proposals, therefore, is to seek a way forward that is fully consistent with an eventual move to Stage 3 - and moreover in no way retards the objective of moving to a stage 3 once the necessary conditions of convergence have been met - yet at the same time enables governments to defer the ultimate political decision on participation in the final stage of the union until greater experience with the intermediate stage has been gained.

#### The Dangers of a Parallel Currency

5 Let me now turn briefly to the objections that have often been raised to parallel currencies. There are two principal objections: the first is that a parallel currency constitutes an

additional source of credit creation that complicates the management of monetary policy throughout the Community. The second is that a thirteenth currency could create confusing signals about who was responsible for monetary policy within the Community. We think that these are legitimate concerns, and we endorse the reservations that were expressed by the Delors Committee in this connection. However, we believe that the new proposals put forward by the British Treasury and ourselves provide the appropriate safeguards.

6 How are the safeguards provided? In the first place, the creation of ECUs can only come about when national currencies are surrendered to the new institution in exchange for ECU claims. Therefore, at the point of creation of ECUs there is an equivalent extinction of national currency. We recognise, of course, that this, in itself, is not sufficient. It would still be open for a national central bank to create additional domestic money to offset the money that was extinguished - or, more generally, to conduct an insufficiently tight monetary policy. This is where the particular aspect of our proposal, that is absent from the earlier BIEC proposal, comes in. To the extent that the new institution (the EMF) receives national currencies, it will always have the right to put these currencies back to national central banks in exchange for "hard" assets. Thus, if a member central bank is running an excessively loose monetary policy, and this is resulting in the national currency concerned being exchanged for ECU denominated deposits, the national central bank will find itself either losing reserves, or having to underwrite the ECU value of the national currency holdings of the European Monetary Fund (EMF). Provided the EMF is managed in a firm anti-inflationary fashion, therefore, it will neither contribute to monetary laxity itself, nor act as a vehicle by which monetary laxity is permitted at the national central bank level. (This means, of course, that the Managing Board of the new EMF must be endowed with the same kind of independence and responsibility for price stability that we are all envisaging for the ultimate ESCB.)

7 The second objection to a parallel currency is one often made by President Pöhl, that monetary policy must be indivisible and

there must be no mixing of responsibility. We believe our proposal meets this criterion. Each national central bank is responsible for its own monetary policy; and the Board of Management of the EMF is responsible for the maintenance of value of the Hard ECU. There is no ambiguity about the responsibility of the managing authority (the EMF). It is to maintain the value of the ECU in terms of the strongest currency, and to ensure that continuous downward pressure on inflation is maintained. Similarly, there is no ambiguity about the responsibilities of individual national central banks. Their participation in the narrow band of the exchange rate mechanism means that they will manage their currency (with regard to other currencies and the ECU) in exactly the same way as they currently manage their currency. In other words, they will attempt to maintain the value of their currency in terms of the agreed standard (the ECU), although in extremis they will have the opportunity to realign in the same way as they can now. National authorities will, of course, in managing national policies, have to take account of the market influence exerted by the collective management of the ECU, and it is through that influence that the EMF can give a counterinflationary emphasis to policy through the Community, contributing to the stability necessary for a successful move to MU.

8 Perhaps I might note at this stage that I have not referred to the possible role of the Hard ECU as a circulating medium of exchange. This feature was referred to by the Chancellor of the Exchequer, and is indeed a possible line of development. However, we in the Bank of England would prefer to focus on the function of the ECU as a focus for policy convergence and price stability. We would certainly not rule out the use of the Hard ECU by private individuals and entities - as a medium of exchange. We believe that the new Hard ECU might have a significantly greater attraction for wholesale purposes than the present basket ECU because of its greater strength. The evolution of a retail ECU, however, is an additional development which is not, in our view, the key policy element of the proposal.

## Operational Aspects of the Hard ECU

9 Most of the relevant operational aspects of the UK proposal are described in the memorandum which I circulated to members of this Committee last week. In brief, we envisage that a new institution would be established, capitalised from contributions from member central banks and charged with the responsibility of managing the development of the Hard ECU in such a way as to preserve its value in terms of the strongest Community currency. Once the new institution was established, ECUs would come in to existence through economic agents making deposits at the Hard ECU bank in national currency. They would receive in return claims denominated in ECU. The new institution would initially have a balance sheet with claims denominated in national currencies and liabilities denominated in ECU. (The speed with which its balance sheet increased would, of course, depend upon the level of interest rates offered for deposit at the new institution.) Its operation - which would need to be conducted with the primary objective of maintaining the value of the ECU - could consist of the following:-

- (i) it could return its holdings of EC national currencies to the issuing central banks and require to receive ECUs (or non-EC hard currencies) in exchange.
- (ii) it could buy or sell ECUs in the foreign exchange market in exchange for non-EC currencies.
- (iii) it could borrow non-EC currencies (by taking deposits or issuing securities) in the open market and invest its holdings of non-EC currencies.
- (iv) it could borrow ECUs (by taking deposits) in the open market and buy ECU denominated assets.

The combination of (i) and (iv) should provide the EMF with the capacity to create market shortages of ECU and to manage EC interest rates, in the same way as national central banks manage the interest rates in their own national currencies. These

operations would unavoidably involve risk of loss, and the EMF would need capital and/or guarantees sufficient to cover the risks.

10 We have come to call the feature of the proposal by which the Hard ECU bank is permitted to put back to national central banks holdings it acquires of national currencies the "closing of the loop". This feature means that the Hard ECU bank has considerable power to ensure that appropriately tight monetary conditions are maintained throughout the Community.

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