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EUROPEAN MONETARY INTEGRATION IN THE 1990s

The Importance of the Legal-Tender Status of European Currencies

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Vagueness about Meaning of European Monetary Integration

THE DEBATE about European monetary integration has been complicated and at times acrimonious, but in many ways it has not been properly joined. Political leaders throughout Europe often use summits, inter-governmental conferences and the like to put together phrases about the benefits of greater monetary integration. These phrases tend to be visionary, vague and rhetorical. The sceptics' reaction is to ask 'What do you mean?'. This seems to cause resentment, partly perhaps from a feeling that nothing can be done if there is bickering about detail from the start. (The sceptics in this context include the British Government and the Bundesbank.)

Legal-Tender Status of New European Currency Is Critical

Despite the tensions about the implications of the debate, there is widespread agreement that the debate itself will be crucial in defining the UK's position in Europe throughout the 1990s. The purpose of this paper is to improve the discussion by suggesting how the general question 'What do you mean?' can be transformed into a specific choice between institutional alternatives. Enthusiasts for greater monetary integration need to be confronted with a question on the

lines 'Are you for or against X?', where X is a particular institutional arrangement. The argument here is that the key characteristic differentiating various possible arrangements is the legal-tender status of the proposed European currency. Curiously, this characteristic has not yet played much of a role in the debate. Its importance will be made clear if some basic ideas in the analysis of different monetary systems are outlined. Once this has been done, it will become possible to put forward a number of specific institutional options and to consider their implications.

The notion of a 'legal tender' tends to be taken for granted in sophisticated modern economies, but in fact it has not always been found in the past. In primitive economies, where government is weak and the rule of law is not well-established, people may refuse to accept payment in the 'money' declared to be legal tender by the state. The problem is least severe if the money is a commodity with intrinsic value. Clearly, if a monetary unit is measured as having a particular weight of gold, silver or whatever, it does not need legal-tender status for it to be of known value and therefore useful in transactions.

Legal-Tender Status Essential for Paper Money

But, as economies evolved from commodity money to paper money, legal-tender status became essential. In the 18th century the Bank of England issued notes, but these were not legal tender and only circulated widely because of the belief—justified for most of the time—that they could be converted into gold. In the early 19th century Bank of England notes were declared to be legal tender, but continued to be convertible into gold, which gave an ultimate guarantee of value. Finally, in 1931 Britain left the gold standard. The Bank's notes nevertheless remained legal tender. They have been fully acceptable in payment ever since and are rightly described as the 'monetary base' on which all credit expansion and deposit creation depend.

The key point about legal tender is that refusal to accept it in payment breaks the law. People accept bits of paper (which have almost no value in their own right) in payment for goods and services (which have obvious value) only because a powerful and effective state is able to enforce the legal-tender laws. Thus, since 1931 a one-pound note has been worth one pound not because of its form as a commodity (since the paper is practically worthless), but because the British Government is prepared to punish anyone who denies that it is worth one pound. The Government's role is decisive. If the

Government had not passed the legal-tender laws, people would not regard pound notes as an acceptable medium of exchange and they would not be 'money' in the usually understood sense.

New European Currency Will Not Be Acceptable Medium of Exchange Unless Backed by Legal-Tender Status

How is this point relevant to European monetary integration? The answer is that a European currency will not be an acceptable medium of exchange unless it is also legal tender. Further, the Governments of the EC will make no progress on monetary integration unless they decide—sooner or later—to make the chosen European 'money' legal tender in their countries. If it is ever taken, the decision to confer legal-tender status on the favoured 'money' will be the watershed in European monetary integration.

Delors Silent on Legal-Tender Implications of Its Proposals

The emphasis placed here on the legal-tender aspect of money is not found in the Delors Report. Its Stage One envisaged all community currencies joining the exchange rate mechanism of the EMS, the removal of exchange controls and a doubling of the resources of EC regional aid funds. Stage Two is seen as transitional, involving the establishment of the European System of Central Banks (ESCB). Only at the end of the Third Stage would a single European currency be instituted. Essential preliminaries to the Third Stage are listed as the irrevocable locking of exchange rates, the transfer of responsibility for monetary policy to the ESCB and the imposition of constraints on national budgets. The Report recognises that, since Stage Three would require amendment to the Treaty of Rome, it would oblige member-states to change their constitutional laws and pass new monetary legislation. But it does not highlight revision to the legal-tender laws as the critical change, as it ought to have done.

UK Treasury Aware of Importance of Legal Tender and Supports 'Currency Competition'

By contrast, the UK Treasury has shown an acute awareness that the question of legal tender is central to the debate. Last year it put up a proposal for 'currency competition' as an alternative to Delors at the Antibes meeting of EC finance ministers. The essence of the proposal was that all EC currencies should be legal tender in all EC states, a revolutionary change from the present position where each currency is

legal tender only in its country of issue. The idea was to initiate a process of 'may the best currency win', in the conviction that the general publics of the various European countries would select 'the' European currency by using it more frequently in transactions than the alternatives. The finance ministers from other European countries were puzzled and unimpressed by the proposal, which made no headway at all. As we shall argue below, they were right to be suspicious. However, it did have the virtue—unlike the Delors Report—of focussing on the legal-tender characteristic of money.

(It should be noted that the Treasury's concept of currency competition—that is, of trans-continental legal tender—is not the same as the abolition of exchange controls—that is, Stage One of Delors—as some newspapers have suggested. If exchange controls are removed in a particular European country, it is no longer illegal to use other EC currencies in transactions, as a unit of account and so on. But it would continue to be legal to refuse payment in such currencies. With trans-continental legal tender, it would be illegal to refuse payment in them. The difference is basic.)

A European Central Bank Would Issue Note Liabilities, Which Might or Might not Be Legal Tender; Four Alternative Proposals

In modern circumstances legal tender is in the form of either notes, when it is the liability of a central bank, or coin, when it is the liability of a mint. Since the note issue is much the larger of the two in all European countries, the discussion can proceed as if notes alone were relevant. If there is to be a European currency, it will have to be a liability of a European central bank which issues legal-tender notes. A range of options, differentiated by the extent to which this note issue and the various national note issues are accorded legal-tender status, can then be considered and related to the Delors agenda.

Four alternatives will be discussed:

1. Notes issued by the European central bank (ECB) are not legal tender in any EC member-state.

2. Notes issued by the European central bank are legal tender, but national central banks continue and their notes remain legal tender in their own countries. These national notes are legal tender only in the country of issue, not elsewhere in Europe.

3. Notes issued by the European central bank are legal tender, but

national central banks continue and their notes become legal tender in all European countries.

4. The European central bank becomes a currency monopolist, with only its notes remaining as legal tender. National notes are deprived of legal-tender status in their original country of issue.

First Proposal: ECB's notes not legal tender

The first proposal is the least interesting. As already explained, if the European currency does not acquire legal-tender status, it will not be used as a medium of exchange. It will not become a genuine 'money'. The ECB will be merely another banking institution, except that its accounts and operations will be denominated in the European currency rather than a national currency. It will be rather like the present European Investment Bank (EIB), whose accounts are expressed in terms of European Currency Units (ECUs) but which otherwise has a closer resemblance to a commercial bank than a central bank. In fact, without legal-tender status for its liabilities, the European central bank would not advance beyond its present role and would be merely a glorified EIB.

Support for this claim comes from the EC's failure to develop the ECU as a meaningful 'money' since it was introduced over 10 years ago. True enough, the ECU is widely, and increasingly, used as a unit of account in international capital markets. But nowhere in Europe is it a medium of exchange. The ECU's subordinate position in the European financial scene persists despite repeated official attempts in some countries to encourage its greater use in private transactions. The Italians have been particularly active in this area and have long allowed citizens to hold bank accounts in ECUs, but not in other foreign currencies. In contrast, the Bundesbank has always disparaged the ECU. Indeed, for many years West Germany did not allow its citizens to open bank accounts in ECU or make bank transfers in it.

Second Proposal: ECB's notes legal tender alongside only one national currency in each EC member-state

The second proposal is that the note liabilities of the ECB are made legal tender throughout the EC, alongside the existing national currencies which remain legal tender. In these circumstances the European currency would probably be used in some transactions, particularly in cross-border trade. It would therefore become, at least to

some degree, a medium of exchange. Its role in international capital markets would also expand, increasing the potential for ECU clearing business. There are, however, two serious objections to this proposal.

The first is that there is a tendency for transactors in any market to standardise on one unit of account. This tendency was first described by the Austrian economist, Carl Menger, in a famous article, written in the 1890s, on the origins of money. The common sense behind it is obvious. Comparisons of value are complicated if prices are expressed in terms of two monies rather than one. The price mechanism is supposed to bring supply and demand into balance, but if every object has two prices the costs of using the price mechanism are increased. It follows that, when people are already happy with prices expressed in terms of their national currencies, they will be reluctant to set prices in terms of the European currency. The spread of the European currency as a medium of exchange will be impeded.

Secondly, there will be a new task of managing the European currency. Many advocates of a European currency seem to believe that it will easily supplant national currencies, particularly if national central banks continue to pursue inflationary policies. But that depends on what the new European currency is and how it is controlled. If the new currency is a legal-tender ECU, its inflationary performance will be no better than that of the average of the national EC currencies. In the low-inflation countries of the EC the ECU will have no attractions compared with the national currencies; even in the high-inflation countries its merits as a store of value will depend on how far the depreciation of national currencies is outweighed by the interest differential between deposits in ECUs and such currencies. There is nothing inevitable about Europe's citizens wanting to hold vast quantities of ECUs, even if it is legal tender. If the European currency is not to be the ECU but some entirely new instrument, the discussion becomes even more hypothetical. It must be emphasised that the people of Europe will be suspicious of a currency which has no track record.

In practice, there would be a finite demand to hold the European currency, whatever form it took. As with any money, if the supply came to exceed the demand, there would tend to be a loss of value which would be symptomised in a depreciation of the European currency on the foreign exchanges. This would, of course, be catastrophic for its continued viability as a medium of exchange in competition with national currencies. The ECB would therefore have

to be prepared to intervene on the foreign exchanges to keep the European currency stable against the various national currencies.

Over-supply of ECB's Note Liabilities Would Lead to Depreciation

This point is immensely important. It explains why Stage Three of the Delors Report envisages irrevocable locking of EC exchange rates and pooling of reserves. It also explains why these proposals are potentially so contentious. Suppose that the ECB expands its balance sheet aggressively in the first few years after its liabilities are granted legal-tender status. Its assets might consist principally of so-called 'structural loans' to poor regions of the EC, extra finance for various EC development funds, the Common Agricultural Policy and the like. Sooner or later the European currency threatens to collapse because it has been over-supplied, with people selling it in order to hold not only more dollars and yen, but also more deutschemarks, pounds, francs and so on.

How would the European central bank react? If it were unable to contract its loans and balance-sheet size, it would have to sell the reserves that the various European countries had left with it. In other words, the reserves would be spent to support a number of European causes with which some governments, including the British Government, have little sympathy. There would be a genuine, and possibly large, transfer of resources between countries, depending on whether they borrowed more from the ECB than they lent to it. (Of course, the point would be most serious if the pooling of reserves involved permanent loss of ownership and/or control of reserves by individual countries, rather than simply lending them to the ECB.)

National Central Banks Might Have to Lend to ECB, with Inflationary Consequences

What would happen if the European Central Bank ran out of deutschemarks, pounds, francs and so on, as it sold these currencies in order to sustain the value of its note liabilities? The answer is that it would go to the various national central banks and ask them for further supplies of their respective currencies. The national central banks could meet these requests by expanding their balance sheets, with potentially inflationary consequences. More generally, unless co-operation between the ECB and the national central banks were

remarkably smooth, there would be constant bickering between the various parties concerned about how much the bank could borrow and lend, whom it could lend to and so on. Heavy emphasis needs to be placed on the point that, in a democratic context, such squabbling would be on public view and would undermine the credibility of the European currency. *The demand to hold the currency would be correspondingly limited.*

It should be clear from our discussion that the apparently technical issue of how to operate the European Central Bank is really a political question about which country gets what. This difficulty recurs with the next two proposals and is, in fact, inescapable with any pan-European monetary arrangement.

Third Proposal: ECB's notes legal tender and national currencies become legal tender across Europe

The third proposal is more ambitious and resembles the Treasury's Antibes scheme. It is that legal-tender status be accorded within each EC member-state not only to the note liabilities of the European Central Bank and its own national central bank, but to the note liabilities of all other EC national central banks. In other words, the deutschemark, French franc, lira and so on become legal tender in the UK in addition to the European currency and the pound sterling. The thinking here is that, in a Darwinian competitive contest between currencies, the fittest currency will survive. The proposal has an attractively democratic flavour. Instead of Brussels taking all the decisions, the people of Europe will choose the best currency.

Unhappily, this proposal suffers even more from the two objections raised to the previous suggestion. The argument that transactors standardise on one unit of account is awkward enough if only two currencies, the national and the European, are in competition. But there would be even more trouble if half-a-dozen or more currencies were involved. Indeed, competition between such a large number of currencies would be extraordinarily inconvenient and transactors in each country would surely very quickly narrow down the choice to one or two currencies. (This is not to deny that they might hold deposits denominated in several foreign currencies. But—in EC countries without exchange controls—they can do this at present. To repeat, a currency is not a proper 'money' if it is used only as a store of value. It must also act as a medium of exchange.)

Central Banks Could Export Inflation to Other Countries, Where Their Currencies Are Also Legal Tender

The problem over the relative size of the various central bank balance sheets would also be more serious. With all the currencies jostling against each other, the demand for a particular currency could fluctuate sharply. Unless the central banks were prepared to lend to each other on a massive scale, the fixed exchange rates between their currencies could probably not be maintained. Indeed, there is one argument which seems to be a crushing refutation of this proposal. If the lira is legal tender in West Germany, the Banca d'Italia has an incentive to issue enormous amounts of lira and hope that they will be spent in West Germany. If they are spent in West Germany, they will increase the demand for German goods and services, not Italian, and the inflationary effects will not be confined to Italy. More generally, in a continent whose countries have several legal tenders, the concept of a 'national inflation rate' breaks down.

Concept of 'National Inflation Rate' Breaks Down

But the breakdown of the concept of a 'national inflation rate' is fatal to the idea of currency competition. The purpose of currency competition is to see which central bank is best at keeping inflation down. If comparisons of national inflation rates are no longer possible, currency competition is not viable.

Our analysis of the last two proposals shows how complicated it is to imagine a situation where several currencies are legal tender within the same political unit. The difficulties suggest that there are two valid options, the present one where each currency is legal tender in its nation of issue but nowhere else, and a radical alternative where all the national currencies have disappeared, only one European currency remains and this currency is legal tender across Europe. In both cases there is only one legal tender and, presumably, only one 'money', which agrees with Menger's theory that transactors standardise on one unit. The final proposal is therefore that the European Central Bank becomes Europe's currency monopolist and that its note liabilities alone are legal tender. This could be regarded as the ultimate objective of the Delors Report.

Fourth Proposal: ECB's notes as only legal tender in Europe and ECB becomes Europe's currency monopolist

The discussion of the two versions of currency competition has served a useful purpose by warning that the transition from the present

situation to the ultimate Delors goal will be difficult to plan and even, in some respects, difficult to conceptualise. Our argument has been, first, that a currency cannot become a meaningful 'money' unless it has been given the status of legal tender and, second, that competition between several legal tenders in one political unit is liable to be chaotic. It follows that any transition process which envisages a number of co-existing legal tenders—during, say, Delors Stage Two or the early part of Delors Stage Three—should be regarded with considerable scepticism. Indeed, the problem of specifying the transition is so serious that the only way forward appears to be a leap from the present situation to the final situation with the ECB as Europe's monopoly central bank. In this leap the existing national currencies would suffer a sudden death. Is this desirable? Is there any way it could be made to work?

It should be said straightaway that there can be no doubts about the feasibility of a single European currency if there is already a single European government in being. If the leaders of the 12 EC member-states were to agree that at some future date they would surrender sovereignty, and in particular the power to tax, to one European government, an agreement on the unification of monetary systems ought to emerge quickly *after* that one European government had been created. But that is not the issue. Instead the Delors thinking is that a single European currency is to develop *before* a single European government is established. Two kinds of problem must be highlighted, the first connected with the sudden death of existing national currencies and the second with the need to decide which countries lend to the European central bank and which borrow from it.

Practical Difficulties with Sudden Death of National Currencies

The sudden death of existing national currencies would lead to serious inconvenience and confusion, and this inconvenience and confusion would be distributed so arbitrarily between people, companies and nations that the whole idea has to be regarded as impracticable. In the extreme case all the existing currencies lose their legal-tender status overnight. Institutional upheaval on a massive scale would then become necessary. Millions of contracts—insurance policies, bank loans, the terms of bond issues, wills, agreements between customers and suppliers—would have to be revised in short order. These revisions would not be matters merely of form (as with decimalisation), since virtually all contracts have some interest rate content and the adoption

of a new currency would mean a change in the effective interest rate. There would be the awkward question of what should be done with public debts, since these differ substantially (as a share of GDP) between European countries. The nature of the relationship between the new European central bank and the banking systems of the individual EC countries (e.g., in terms of reserve ratios, liquidity ratios, access to lender-of-last-resort facilities) would have to be resolved.

Finally, but certainly not least, no one could predict in advance just how large the ECB's balance sheet should be. There would be a danger of rapid inflation if it were too large and deflation if it were too small. In short, the sudden replacement of existing national currencies by one European currency is not practical politics.

Which Governments Are Entitled to Borrow from the ECB?

The question of which countries deposit with the European central bank and which borrow from it, and of the terms and conditions on the various deposits and loans, is also highly problematic. It is related to the question already discussed under the heading of the second proposal, of how the new bank should conduct its business. At present the governments of Italy, Spain and Greece borrow heavily from their central banks and banking systems. With the disappearance of their national central banks, they would presumably seek similar levels of financing from the European central bank. But why should these governments be entitled to borrow more from the European central bank than the governments of the UK and West Germany?

Summary of the Argument: Delors Report Unworkable

The argument can now be summed up. No proposed European currency will be a genuine 'money' unless its acceptability as a medium of exchange is backed up by legal-tender status. We can think of various possibilities. If the liabilities of the new European central bank are not legal tender, it would be nothing more than a glorified European Investment Bank. If they are legal tender and compete with either one currency in each nation (the second proposal) or all national currencies across Europe (the third proposal), the situation would become unstable for a variety of reasons, not least people's preference for a single unit of account. These instabilities warn that a process of gradual transition to a single European currency will be

difficult, perhaps unacceptably so. *But the final option, with the sudden death of existing national currencies in order to bring in the new European currency overnight, would be so traumatic as to be politically impossible.*

In short, our attempts to specify how the Delors programme might work in practice fail. Legal-tender status is essential to the acceptance of paper money as money. But, as soon as we ask how legal-tender status is to be introduced in a European context while there are still several independent governments, we encounter insuperable difficulties. The European leaders who support the Delors Report may mean what they say; the trouble is that they do not seem to know what they mean. The right way to demonstrate the vagueness of their thinking is to ask them, 'When do you want the single European currency to become legal tender?', and 'Do you want it to be the only legal tender in Europe or a legal tender in competition with existing national currencies?'. These are the serious questions that need to be answered at the inter-governmental conference on European monetary integration which is due to be held in December 1990.

West Germany Will Reject the Delors Report

In fact, it is already known that they will not be answered. Despite Chancellor Kohl's enthusiasm for the Delors Report for most of last year, the reality is that the Germans are suspicious of European monetary union. According to the *New Europe* newsletter of 21 December 1989, German representatives at the Strasbourg summit were 'dragging their feet' because they were 'worried that the implications of a European banking system have not been sufficiently thought through'. The Bundesbank's probable hostility in future to conferring legal-tender status on a European money is revealed by its active discouragement in the past of the private use of the ECU.

1990s Will Not See European Monetary Union

Mrs Thatcher has taken no risks in rejecting Stages Two and Three of the Delors Report. She has been criticised for keeping the UK out of the European Monetary System and 'missing the boat' to European monetary union. But the EMS and EMU need to be sharply distinguished. Despite continuing currency realignments, the EMS is undoubtedly afloat. But the boat of EMU has never, in a meaningful

sense, been launched. Unless and until the proposed European currency is to be accorded legal-tender status and made into a genuine money, all the visionary rhetoric about EMU is just so much waffle. The 1990s will not be a decade of European monetary integration. At the beginning of the 21st century there will still be deutschemarks, pounds, francs, lira, pesetas and so on. Deep down, every European knows this.