

7 European Monetary Union: Is There a Halfway House?

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INTRODUCTION: THE PARALLEL CURRENCY VS. 'BIG BANG' APPROACHES TO EUROPEAN ECONOMIC AND MONETARY UNION

The pressures on the British government to accept European Economic and Monetary Union (EMU), including an eventual move to a single European currency, are intensifying. Indeed, according to many observers these pressures have built up such a momentum that they are irresistible. Since – in their view – the final destination has already been decided, the only remaining question is to choose the best route to it.

European Commissioners Delors and Christopherson were reported in *The Wall Street Journal* of 23 September 1990 to be urging that EMU be accomplished in a 'short' period. Although the precise meaning of this word was not spelt out, the general intention according to the *Journal* was that there be 'a one-year transition from so-called Stage 2, during which time the EC central bank would be set up, to the final stage 3, when national currencies would be replaced by the ECU'. Moreover, 'Stage 2 would begin in 1993 and Stage 3 in 1994'. This would be a 'Big Bang' or 'Big Leap' approach to EMU, with an abrupt replacement of the existing national monies by a single European money. (The suddenness of the change would be similar to that in London stock exchange practices in the Big Bang of October 1986.) More recently, a meeting of European leaders in Rome found a majority of EC member states in favour of setting a timetable for Stages 2 and 3. Although the timetable was less demanding than that suggested by Delors and Christopherson, with January 1994 set as the start of Stage 2 and 1997 for Stage 3, it was a clear political endorsement for imposing a single currency.

These ideas are flatly opposed to the gradual and evolutionary approach favoured by the British government, and distilled in the 'hard ECU' proposal. Despite a genuine British attempt to be conciliatory in recent months, a gulf has emerged between the British position and the so-called 'Big Bang' solution supported by other European governments. In essence, Britain favours the idea of a parallel (or common) currency which might become a single currency by an evolutionary and voluntary process possibly lasting many decades. By contrast, the rest of the EC (and, of course, the European Commission) wants a single currency to be imposed on a particular date. (The Delors Report's reference to 'stages' is perhaps rather misleading, in that it does not identify the substance of the changes being contemplated. It makes observers think in terms of the chronology of the process rather than the content.)

The purpose of this paper is not to bridge the distance between the two sides. Rather it is to clarify some key points about the nature of 'money' and 'monetary policy' which are essential if those taking part in the debate are to have a meaningful discussion. Too often in recent months meetings on EMU have broken up with participants puzzled about what the other side really meant. The gap in understanding seems to arise because certain fundamental attributes of 'money' have either been forgotten or never elucidated. One outcome of the paper will be to cast doubt on the analytical coherence of the Hard ECU proposal and so on the intellectual integrity of the British government's position. This should certainly not be taken to establish the case for the 'Big Bang'.¹ The aim is rather to tighten the logical and conceptual basis of the debate in order to highlight what is really at stake.

THE IMPORTANCE OF A CURRENCY'S STATUS AS LEGAL TENDER

Our starting point is to note, uncontroversially, that a currency is not a 'money' in the usually understood sense unless it is both a unit of account and a medium of exchange. Many things can serve duty as units of account, including a host of durable commodities and various price indices. Contracts can be expressed in terms of precious metals, a sum of money indexed to

retail prices or producer prices, and so on. But such units of account are not money. A money must also be generally acceptable in payments in a particular geographical area; it must be a valid medium of exchange.

If a currency is a valid medium of exchange, people and companies hold some of it in reserve in order to ease the process of buying and selling. In modern circumstances, when virtually all money is paper, two types of monetary asset need to be distinguished. The first are monetary assets which are claims on the private sector, nowadays almost exclusively on the banking system. The face value of such claims may not be repaid in full, if the private sector institution which issued them makes losses and goes bankrupt. Bank deposits are the dominant form of private-sector money. The other type of monetary asset is legal tender, issued almost exclusively by a central bank. The central bank may be 'independent' in a constitutional sense, but it is commonly owned by the state and has invariably been created by legislation. Legal-tender money is accepted in transactions because of its special legal status, not because of its intrinsic worth. People must take it in payment whether they like it or not. Bank notes are the main form of legal tender, although coin also needs to be mentioned for completeness.

This distinction raises a key question. People know that they must accept legal tender in payment. But why do they also accept cheques written against bank deposits? They appreciate – or rather should not have entirely forgotten the possibility – that banks may be unable to meet their obligations in full. So why is the value of transactions completed by cheque a multiple of the value of transactions in legal tender? Why are people so relaxed about writing cheques to each other? What justifies the universal faith in the soundness of the banking system?

The explanation is that everyone believes that their bank deposits can be changed into legal-tender notes and coin at full value. Even when there is a notice period, hardly any doubt arises about the ultimate convertibility of deposits into cash. Because of this convertibility, the value of a sum of money in the bank is (practically) as certain as the value of notes and coin. Decades of safe banking have convinced people that they can treat deposits as equivalent to notes. There is even a tendency to call deposits held by companies and financial institutions their 'cash'.

It cannot be emphasised too strongly that, although almost everyone thinks they are equivalent, deposits and notes are different assets. Notes are legal tender and are always worth their face value; deposits are not legal tender and may not be worth the value stated in bank accounts. Two questions then arise: 'Why are people so confident that deposits will in fact be fully convertible into cash?' and 'Why does no one doubt that legal tender will be worth its face value?'

The answer to the first question is that banks retain a certain amount of cash in their assets and so are able to meet requests for them to convert deposits into cash. In the British context, cash is to be understood as coin, Bank of England notes and bankers' balances at the Bank of England. (A cheque drawn on the Bank of England may not be legal tender, but the point hardly matters because Bank of England balances are obviously convertible on demand into its notes.) Requests for the conversion of deposits into cash take three main forms:

1. *Deposit withdrawals over the counter.* When depositors withdraw cash, they reduce banks' liabilities (deposits) and assets (cash).
2. *Instructions to make payments (e.g. tax payments, payments for government debt issues) to the government.* The reduction in banks' cash due to tax payments is the result of certain institutional arrangements. The government's most important account is the Exchequer account at the Bank of England. When someone writes a cheque to pay taxes, he instructs his bank to make a transfer from his account to the Exchequer account at the Bank. The bank's liabilities fall because its customer's deposit is down and its assets fall because it has a lower balance at the Bank of England. The drop in the balance at the Bank is, of course, a reduction in its cash holdings.
3. *Instructions to make payments to other banks.* When someone writes a cheque to another private-sector agent, he is instructing his bank to make a transfer of cash from his account to the account of the other agent. If one bank receives a great many instructions of this kind, its cash would run out. In practice, banks receive a host of instructions both to debit and credit accounts every day. These largely cancel out for each individual bank and cancel out entirely (apart from timing discrepancies) for all banks taken together. But any shortfall by an individual bank at the clearing of the debits and credits

has to be made good by a drop in that bank's cash. The result is a fall in its Bank of England balances. (The bank with an excess of debits over credits instructs the Bank to pay the deficiency from its balance into other banks' balances.)

The various factors influencing the size of the economy's total cash holdings are listed each day in the money market report in the *Financial Times*. The various operations can seem complicated, but the report merely describes the transactions that enable the banks to have enough cash to maintain the full convertibility of their liabilities into legal tender. Very similar arrangements are found in all other industrial countries.

Our second question was 'Why does no one doubt that legal tender will be worth its face value?' The answer is very straightforward. The state is prepared to use its law-enforcement powers to make people accept that the bits of paper (i.e. bank notes) issued by the Bank of England are worth their stated face value. In the last resort legal tender has value because of the state's law-enforcement role and its monopoly of coercion (i.e. control over the army and the police) within certain geographical boundaries.

Some important consequences flow from the connection between legal-tender money and the state. Two points are obvious, although the recent debates on EMU suggest, rather surprisingly, that they need to be spelt out. First, there is a simple reason that a particular currency circulates as a medium of exchange in one country but not in neighbouring countries. This reason is not to be sought in people's currency preferences. Instead currency areas coincide with political units because national boundaries define where a state's laws cease to apply. Secondly, where legal tender is a paper asset which is costless to produce, the right to issue legal tender cannot be granted to a private sector agent. If a particular company or individual were empowered to issue legal tender, they could print enormous quantities of paper and force other people to give up real goods and services in return. This would be an extremely profitable activity! In effect, the right to issue legal tender is akin to the right to levy taxes. If someone in the private sector is given this privilege, he can rob other people almost at will. A third point follows from the second. The only logical customer for the central bank is the government, since the government is

the fitting recipient of the resources (known as 'seigniorage') made available by the issue of legal tender.

These points help in analysing various monetary proposals made in recent years. Last year the Treasury suggested at a meeting of European Community finance ministers in Antibes that the best way to proceed to EMU was currency competition, with the currencies of every EC nation given the status of legal tender in every EC nation. Our argument shows that this idea is based on a rather disturbing *naïveté* about how governments and central banks would respond. If the Italian lira were legal tender in the UK, the Banca d'Italia would be able to extract resources from the UK economy; if the pound were legal tender in Italy, the Bank of England would be able to extract resources from the Italian economy; and so on. Every central bank would have an incentive to over-issue in order to capture resources from other countries. Furthermore, over-issue of pounds and lira would affect aggregate demand in Germany and France, and, hence, increase the German and French inflation rates. Finally, currency competition is conceivable only in a regime of floating exchange rates. If exchange rates were fixed, the temptation to over-issue would not be constrained by the risks of depreciation and inflation. The urge to capture resources from other countries by printing money would become overwhelmingly attractive. At best, currency competition would therefore be incompatible with the European Monetary System as it is now constituted; at worst, it would degenerate into total instability.

The distinction between bank deposits and legal-tender notes – or, in effect, between private and state money – is crucial also to defining the meaning of 'monetary policy' in a modern context. Indeed, it is essential to understanding why central banks can conduct monetary policy in the usually recognised sense. We have seen that the complete convertibility of deposits into notes is essential to the banking system. If banks did not have legal tender as part of their assets, they could not remain in business. We have also seen that the banks and the central bank meet every day in the money market, where the various influences on the banks' (and the economy's) cash holdings intersect. The money market therefore presents the central bank with an opportunity for exerting power over the banks. By keeping the banks fairly continuously 'short' of cash and setting

the interest-rate terms on which the shortages are to be relieved, the central bank can regulate interest rates for the entire financial system. The central bank's position as the monopoly supplier of legal tender explains its ability to determine short-term interest rates and so to decide monetary policy.

The argument so far can now be summarised. The standard monetary arrangements of today – with every country having a single legal tender issued by one central bank, which is banker to the government – have not grown up haphazard. There can be only one legal tender in a particular national jurisdiction, for much the same reason that there can be only one law, one police force and one army. The one legal tender has to be issued by a public (or semi-public) authority, since private issuance of a legal tender would enable the issuer to obtain resources unjustly from the rest of the population; and, since there is room for only one legal tender, only one institution – the central bank – can issue it. Private money can nevertheless be issued in the form of bank deposits. Monetary policy, which consists essentially in the central bank exerting influence over the behaviour of private banks, can be made effective precisely because such private money is subordinate to the legal tender.

A government economist recently suggested in the official *Treasury Bulletin* that legal tender 'is often believed to have more relevance in this area than it really has.' He amplified the point by saying, 'What matters from the point of view of the monetary authority . . . is that it be regarded as the ultimate source of primary liquidity for the currency concerned. In turn, this means that its own monetary liabilities must be entirely free from risk of default. Because it would be a Community institution, backed by the Community itself, the EMF would enjoy this unquestioned status.'²

But the fact that an institution's liabilities are backed by the EC does not make them 'a source of primary liquidity'. The liabilities of the European Investment Bank are undoubtedly backed by the EC, but they are not 'primary liquidity', let alone a 'currency'. So what does this phrase, 'the ultimate source of primary liquidity for the currency concerned', mean? It evidently implies a distinction between 'primary liquidity' and the rest of 'the currency', presumably between the liabilities of 'the monetary authority' and the banking system proper. If the key

differentiating characteristic of the liabilities of the monetary authority is that they are 'entirely free from default risk' whereas those of privately-owned banks are not, the question arises 'why are they free from default risk?' If the uniqueness of the monetary authority (i.e. the central bank) rests on its backing from government and the law, 'primary liquidity' is equivalent to 'legal tender'. The Treasury's point is semantic and irrelevant, and the putative distinction between primary liquidity and legal tender collapses.

CONSUMER RESISTANCE TO PARALLEL CURRENCIES

The argument of the last section is hardly very abstruse. Indeed, it merely recapitulates certain long-familiar features of our own and every other modern monetary system. But its message for the parallel-currency approach to EMU is very damaging. The parallel-currency approach proposes that a new currency should, in some sense, be introduced in order to coexist with a national currency. In other words, two (or perhaps even more) currencies would circulate at the same time. This raises several difficulties in the logical design of the new monetary order.

The first is simply why anyone should want to switch from the existing national currency into the new currency. It is all very well to say a parallel currency is to be established on a particular date in a particular year. But what does that mean in practical terms? Currencies are issued by banks. Which banks are to issue them? Are they to be issued in response to demand or irrespective of demand? And, crucially, are they to be legal tender or not?

In fact, Europe has had a parallel currency of sorts for over a decade. The ECU was born in 1979 at the same time as the EMS, with its value based on a weighted basket of the various national currencies. It was a development of the 'European unit of account' which had been used for EC public accounting since 1975. The ECU has subsequently developed into a popular currency of denomination in the international bond market, apparently from a wish to diversify and reduce currency risk. But it is striking that the ECU has not been widely adopted as a unit of account within European countries and nowhere is it a recognised medium of exchange. The ECU may be a 'parallel

currency'; it is certainly not a currency. Advocates of another parallel currency need to be asked: 'Why has the ECU failed to become a currency?' and 'Why should your alternative do any better?'

The ECU's failure is due partly, no doubt, to the deadweight of tradition, the tendency for people to adhere to the currency with which they are familiar because all prices have previously been expressed in terms of it. But, surely, the dominant reason is that its legal position is unclear and inferior. Without legal-tender status it cannot compete against existing national currencies. That is the gravamen of our argument about the connection between money, law and the power of the state. (It should be emphasised that some countries, notably West Germany, have in the past officially discouraged the private use of the ECU.)

So supporters of a parallel currency have to add some spice to the idea if they are to be persuasive. This is the function of the word 'hard' in the 'hard ECU' proposal. One of the reasons the Germans dislike the ECU is that its inflation performance is the average of all European countries', not the best, which is Germany's itself. Suggestions that the ECU become the single European currency are therefore likely to be rejected by the Bundesbank. But the word 'hard' means that the hard ECU cannot be devalued against the deutschmark or any other European currency. According to Mr Paul Richards of Samuel Montagu & Co., writing in the *Financial Times*, 'The hard ECU would not be the same as the deutschmark; the deutschmark's central parity in terms of the hard ECU could never be revalued, although it could be devalued.'

Here is the key innovation in the hard ECU plan. It is the added ingredient which, apparently, is judged to make the idea so worthwhile. To quote from one of Mr Richards' papers, 'If there was a realignment in the ECU central parities of national Community currencies, the central parity of the strongest national Community currency in terms of the ECU would not change as a result of the realignment. In other words, the hard ECU would be as strong as the ECU central parity of the strongest national Community currency.' Let us consider whether the hard ECU, thus defined, could ever become a 'currency' or 'money' in the usually understood senses of these terms.

First, would it be accepted as a medium of exchange? This seems to be the official intention. In his speech 'Beyond Stage One' on 20 June 1990 Mr John Major, the Chancellor of the Exchequer, urged two steps – first, an initial issue of ECU bank notes against deposits of national notes and, secondly, once the idea had been agreed, an issue of hard ECU bank notes also against deposits of national notes. (According to Mr Major, people and companies would go to a new institution, a European Monetary Fund, to convert national notes into ECU or hard ECU equivalents. The EMF's note liabilities would thus be fully backed by national notes.)

The problem here is that the new (ECU) and old (national) notes would be exactly stable in value – and therefore virtually equivalent for practical purposes – only if exchange rates between currencies were locked irrevocably. If exchange rates still varied a little, ECU notes would fluctuate in value against those of any individual currency. Businessmen would know this and would be reluctant to incur the extra costs involved in transacting in both kinds of notes. Hard ECU notes would be particularly awkward, because the hard ECU plan has meaning only if exchange rate variation is explicitly envisaged.

This kind of difficulty would be particularly serious at the cheque clearing in any of the EC member states. Advocates of the hard ECU plan presumably want to end the differentiation between clearing in domestic currencies and the inter-bank settlement of intra-European foreign exchange transactions. They may hope that, in short order, banks would treat debits and credits in ECU or hard ECU in exactly the same way as debits and credits in national currencies, and that the two types of debits and credits would become indistinguishable. But that would clearly not be possible. Since the hard ECU would be revalued from time to time, the banks could suffer arbitrary losses or profits at the clearing after such revaluations, depending on the balance of their customer business between national currencies and hard ECUs. They would have to separate payments in hard ECUs and national currencies, as they do now.

The very notion of a parallel currency is a contradiction in terms. People use a currency because – in the well-defined political unit of the modern nation-state – it is the only currency. The usefulness of a currency rests on this uniqueness. People and companies want to standardise on one currency because it

reduces transaction costs and provides a common standard of value, and they standardise on that unit which has legal recognition and government backing. The familiar monetary and political arrangements of the modern age – with each nation having one law, one government, one central bank and one currency – have not evolved accidentally. Except in cases of severe monetary dislocation (such as Latin American hyperinflations), no significant counter-examples to this pattern exist.

WOULD A HARD-ECU 'MONETARY POLICY' BE POSSIBLE?

The hazy legal status of the hard ECU would give rise to further problems, notably the difficulty of operating – and, indeed, even of defining – a meaningful 'monetary policy'.

We have already seen that the money market – the market where banks settle imbalances in their cash receipts and payments – is the arena in which central banks enforce monetary policy decisions. If the hard ECU plan were adopted, the prospect of occasional revaluation would require that there still be several national money markets and, hence, a need to retain the existing national central banks. The European Monetary Fund would not have primacy over these banks. On the contrary, if ECU (or hard ECU) notes were not legal tender but the national notes were, the banking systems of the various EC countries could ignore the EMF. In deciding where to set interest rates, they could continue to take the lead from the national central banks.

In his speech on 20 June Mr Major nevertheless suggested the EMF 'would set interest rates on hard ECU'. Initially this would be confined to large interest-bearing deposits from commercial banks. Later, 'the EMF could move to setting interest rates by the normal central banking techniques, namely through the creation of money-market shortages which would then be relieved at the chosen interest rate.'

One is reminded of the general who, when asked how he would move his troops, replied 'by land, by sea and by air'. Again, it is essential to delve into the practicalities. As we have explained, the 'normal central banking techniques' are successful only because the note liabilities of central banks are

legal tender. It is this which gives central banks their cutting-edge against the commercial banks in setting interest rates. Nowhere in this speech (or others) does Mr Major spell out what legal-tender status he foresees for the hard ECU. The whole notion of 'money market shortages' is meaningless unless there is a legal-tender 'money' which can be in short supply.

Of course, if the hard ECU notes were legal tender and the EMF had the right to lend to governments, the hard ECU proposal would be in deep water. It would involve as massive a transfer of sovereignty to a European monetary authority as anything implied by the Delors Report. To grant the right to issue legal tender to the EMF would be a clear encroachment on the British Parliament's fiscal prerogatives. But let us make the discussion as favourable to the hard-ECU scheme as possible. Assume that Britain does plunge in at the deep end, and that the government overcomes its reservations about monetary sovereignty and allows Hard-ECU notes to become legal tender. Would the EMF then be able to conduct 'normal central banking techniques' to influence interest rates, as Mr Major claims?

In national money markets as now constituted central banks relieve shortages by purchasing interest-bearing instruments (Treasury or commercial bills, mostly) from the banking system. Of course, the central banks take them onto their balance sheets. But – according to Mr Major's 20 June speech – the EMF is supposed to be 'a currency board', with its ECU notes backed only by its own holdings of the various currencies which make up the ECU. The EMF is meant to abstain from 'new money creation'. It follows that the EMF's assets would consist only of national notes and balances with national central banks. By definition, they could not include interest-bearing instruments. As a matter of logic, the EMF could not determine hard ECU interest rates, because its operations would be confined to currency transactions between the ECU and national monies. The EMF could determine hard ECU interest rates only by purchases and sales of hard ECU interest-bearing instruments. But, if it did purchase such instruments, it would be straight into the business of money creation.

In short, the Treasury's description of the EMF's balance sheet and its account of hard ECU monetary policy are logically incompatible. If the EMF denies itself the ability to create money, it cannot determine European monetary policy; if it is

to determine European monetary policy, it has to have the ability to create money. It cannot be both a blameless and inactive observer of national central banks' propensity to print money and an all-powerful umpire superintending their monetary policies.

CONCLUSION: THE IDEA OF A PARALLEL CURRENCY IS NOT VIABLE

To summarise, our argument is that the hard ECU plan cannot be reconciled with certain necessary and essential characteristics of any 'money' and any known structure of 'monetary policy'. The difficulties are not unusual with parallel-currency proposals, which in the past have tended to have rather murky intellectual pedigrees.

The Bundesbank – which pro-EMU British politicians usually profess to admire – is very clear that it dislikes this route. In a clear attempt to distance itself from the British position, it has insisted in recent months on the indivisibility of monetary policy. Dr Pohl, president of the Bundesbank, was particularly emphatic about this in a speech he gave to a conference at the London School of Economics on 9 November. Noting that the hard ECU would be issued by a newly-established European Monetary Fund coexisting with central banks, he charged that the parallel-currency approach has 'the disadvantage that an indeterminate area of monetary policy responsibilities might emerge'. It followed that 'we are unable to support the proposal to create a new monetary institution because this could lead to a grey area in monetary policy.' The Bundesbank's preferred approach to EMU would be to set a European central bank with powers similar to its own and to mimic the process of German monetary unification completed in recent months. In its June *Monthly Report* the Bundesbank published the regulations and ordinances required to implement the Treaty on German monetary union. The first article reads as follows:

With effect from 1st July 1990 the deutschemark shall become the currency of the GDR. As from 1st July 1990 the banknotes denominated in deutschemark issued by the Deutsche Bundesbank and the Federal coins denominated in deut-

schemark or pfennig issued by the Federal Republic of Germany shall be the sole legal tender.

Note that the phrase, 'sole legal tender', is used at the very outset of the document. The strategic importance of legal-tender status is clearly well-understood by the Bundesbank. The transfer of the legal-tender role from the ostmark to the deutschmark was vital to the change in monetary regime. Indeed, it virtually defined GMU. The Bundesbank was not so silly in early 1990 as to set out proposals for GMU which were inconsistent with basic defining features of any viable monetary system. Unless the British Treasury pays more attention to such features in the coming debate on EMU, it will be overwhelmed intellectually by the Germans at the December IGC.

This does not mean that other European countries have all the answers. They certainly have not worked out in detail all the ramifications of the Big Bang route to EMU. Some of them, particularly the smaller countries, are likely to have a shock when they realise the scale of the hijack of national sovereignty implied. But other European governments are probably right that the Big Bang route is the only one that would 'work', in the sense of actually introducing a single European currency. The Big Bang introduction of this new currency would be a very definite, once-for-all event. Either a country joins or it does not join. No intermediate position can be imagined. Equivocation and trimming would be no different from a flat refusal to participate.

If Britain does not want to participate in EMU, it will have to stop dithering. The answer has to be 'yes' or 'no', not 'perhaps', 'sometimes' or 'later'. Attempts to evade a clear-cut response – like the competing currencies idea and the hard ECU plan – cannot be sustained. They are little better than elaborate word games and merely forfeit intellectual respect for Britain in other European capitals. The British government must decide whether it is for or against EMU, and say so.

NOTES

1. The author has criticised the Big Bang approach in a recent pamphlet *EMU now? The leap to European money assessed*, published by the Centre for Policy Studies, November 1990.
2. 'The UK Proposals for a European Monetary Fund and a "Hard Ecu"', *Treasury Bulletin*, Autumn 1990.