LOMBARD STREET RESEARCH

Monthly Economic Review

No. 107, May 1998

Contents | Page No.

Gerrard Group PLC

Gerrard & King Limited
Cannon Bridge,
25 Dowgate Hill,
London, EC4R 2GN
Tel: 0171 337 2800
Fax: 0171 337 2801
e-mail: enquiry@gerrard.com

GNI Limited
Cannon Bridge,
25 Dowgate Hill,
London EC4R 2GN
Tel: 0171 337 3500
Tlx: 884862
Fax: 0171 337 3501
e-mail: enquiry@gni.co.uk
www.gni.co.uk

Lombard Street Research Ltd.
Cannon Bridge,
25 Dowgate Hill,
London, EC4R 2GN
Tel: 0171 337 2975
Fax: 0171 337 2999
e-mail: lsr@lombard-st.co.uk
www.lombard-st.co.uk

Greig Middleton & Co. Limited
30 Lombard Street,
London, EC3V 9EN
Tel: 0171 655 4000
Fax: 0171 655 4321

Greig Middleton, Inc.
20 Custom House Street,
Boston, MA 02110, USA
Tel: 00 1 617 292 4000
Fax: 00 1 617 292 4321

Single currency project enters its most interesting phase

Huge uncertainties - both technical and political - remain

Cancellation now would be an embarrassment, after January 1999 a catastrophe

Despite the farce over Mr. Duisenberg's appointment, the media and the markets agree that the euro will come into being in January 1999. Its introduction on time is regarded as certain even by commentators who believe that Euro-land is likely to break up later. This is strange. From a legal and practical standpoint, the cancellation of the project between now and January 1999 would matter little. (Of course, it would be a massive political embarrassment.) But the legal and practical consequences of break-up after January 1999 would be catastrophic.

No major contractual or institutional changes until now

For the next eight months the so-called "legacy currencies" (the deutschemark, franc and so on) continue in being, and so do all the associated contracts and institutional arrangements; from January next year the national currencies become - legally - nothing more than "expressions of the euro", a whole mass of contracts are altered and many new institutional arrangements come into force. A return to the *status quo ante* (i.e., the restoration of the legacy currencies as they were at December 1998, and all the old contracts and arrangements) would be hugely expensive and disruptive. So it is very important that the 11 prospective members of Euro-land realize what they are doing.

Not much has been done so far to introduce new medium of exchange

The central message of the *fracas* at the recent Ecofin summit is that the 11 governments have still not reached an understanding about how the single currency is to work. The August 1996 issue of this *Review* pointed out that EMU had a large unfinished technical agenda and said that, without political union, the whole project would be "impractical to the point of impossibility". In particular, that *Review* differentiated between introducing a new unit of account and a new medium of exchange. In effect, a new unit of account was introduced in 1979 with the creation of the ECU, but over the next 20 years this did not evolve unaided into a proper currency. (The politicians may have thought that it would.) The key turning-point comes with a new medium of exchange, which is the liability of a bank and has value in transactions. Crucially, legal-tender notes must be issued by a central bank. *It needs to be strongly emphasized that, so far, European officialdom has done very little at a practical level to establish the euro as a medium of exchange.* The current *Monthly Economic Review* argues that genuine monetary union - in other words, a monetary union with a unified central bank which has a single legal tender note issue - requires political union as a logical necessity. (So the UK would cease to be an independent nation if it participated in EMU.) But - if the nations of Euro- land try to forge monetary union without political union - they will fail. It would be better for the people of Europe if their governments recognized this before January 1999 than afterwards.

which will require political union if it is to work

Professor Tim Congdon

11th May, 1998

Summary of paper on

"The single currency project and European political union"

Purpose of the paper

The key issue raised by the decision to proceed with EMU is whether monetary union requires political union. This paper develops three arguments that monetary union will fail, unless accompanied by political union.

Main points

* **At least three arguments show that a successful European monetary union requires political union.**

* ***I. Political union, fiscal policy and inflation control.* According to an influential view, inflation is caused by excessive money supply growth as a by-product of a large budget deficit. (See pp. 3 - 4.)**

* **The consequent restrictions of nations' budget deficits, imposed by the Maastricht Treaty, reduce fiscal independence, including governments' diplomatic and military freedom. (See p. 5.)**

* ***II. Political union and seigniorage.* The issuance of money - particularly legal-tender notes by a central bank - is analogous to taxation and may transfer resources (so-called seigniorage) from the private sector to the government.**

* **The distribution of seigniorage between nations, governments and central banks is a highly political matter. Under the Maastricht Treaty seigniorage is to be distributed according to a formula, not according to central bank profitability, balance- sheet size or staff level. (See pp. 7 - 8.)**

* ***III. Political union and the "chain of security" protecting bank deposits.* Nowadays the full repayment of bank deposits (with legal tender of the same nominal value) is a central objective of public policy. Deposits are protected by banks' capital, the deposit insurance agency and the central bank's capital, but the government is the vital last line of defence. (See pp. 10 - 11.)**

* **But Europe does not have a government. The transnational banking system implied by EMU is therefore inconsistent with the national character of deposit protection. (See pp. 12 - 13.)**

This paper was written by Professor Tim Congdon. A slightly different version will be given to the Bristol Actuarial Society on 21st May, as part of the Institute of Actuaries' 150th anniversary celebrations.

The single currency project and European political union

Could EMU be Europe's "Maoist leap forward?

EMU most daring step in European integration,

The project to introduce a single currency is the most daring step so far in European integration. Indeed, it can be correctly described as revolutionary. It is much more far-reaching than previous moves in this direction over the last 15 years, such as the harmonisation of regulations or the ending of exchange controls; it is intended not as an incremental advance, but as a complete transformation of Europe's financial arrangements.

but with little impetus "from below"

The audacity of the single currency project is the more striking, in that it is a "revolution from above" rather than a "revolution from below". The driving force has not been popular dissatisfaction with the existing currency arrangements, but the integrationist ambition of certain members of the European elite, particularly the German Chancellor, the French President and the President of the European Commission. (The integrationist ambition appears to attach to the positions *ex officio* and to be quite unaffected by the particular individuals who currently fill them.) These members of the elite emphasize the political nature of the single currency project, not the economic benefits. For example, Chancellor Kohl has said that European economic and monetary union (EMU) should prevent future wars in Europe.

Does monetary union require political union?

Despite the clarity of this emphasis on EMU's political objectives, some British politicians - such as Mr. Kenneth Clarke, the Chancellor of the Exchequer in the last Conservative Government - have asserted that monetary union does not imply political union. They have said that Britain could participate in EMU without becoming another state in a newly-created United States of Europe. This paper's theme is that such assertions are wrong. Membership of a successful monetary union is also, as a logical inevitability, membership of a political union. In such a union a central government separate from, and in most essential respects superior to, the state governments would quickly emerge. If it participated in EMU, the British Government would therefore cease to be "sovereign" in the sense now understood. Indeed, a case can be made that the very phrases "currency system" and "central bank" make logical sense only if they are attributes of a nation state.

Three arguments on link between monetary and political union

At least three strands of argument demonstrate the connection between monetary and political union. They are complementary and reinforce each other, with the key element in common being the interdependence of fiscal and monetary policy. A consequence of this interdependence is that the state is necessarily involved in monetary management, both for good and ill.

Argument I: Budget deficits are related

The first argument highlights the relationship between budget deficits and money supply growth, and the danger of excessive monetary growth for inflation. If a national government has a large budget deficit which it cannot finance outside the banking system, it may have to borrow from the banks and

to money growth and inflation

so increase the quantity of money; and, if the consequent rate of monetary expansion is too high, the result will be inflation. So - in order to prevent inflation - the budget deficit must be restricted. In short, monetary policy can be anti-inflationary only if it is supported by the appropriate fiscal policy.

This "fiscalist" theory of inflation was British in origin, but adopted in Germany

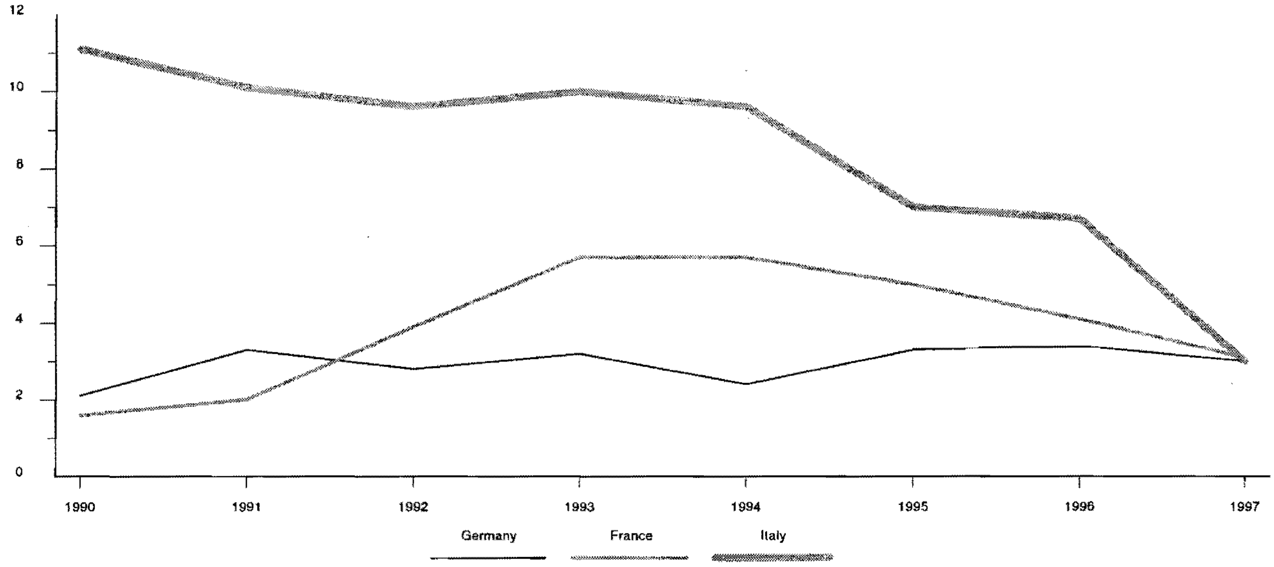
This theory of money and inflation was termed "English" by Professor Bresciani-Turroni in his famous study, *The Economics of Inflation*, about the 1923 hyperinflation in Weimar Germany. He chose this label because of the position taken by representatives of the British Treasury at international meetings in the early 1920s.(1) They pointed to the budget deficit as the cause of the hyperinflation, unlike their German counterparts who said that the central bank printed new bank notes in response to customer demand. In a magnificent historical irony this so-called "English" view of inflation was entirely erased from the institutional memory of the British Treasury over the following 30 years. By contrast, its obvious validity in the hyperinflations of both 1923 and 1946 made a deep impression on the German economics profession. The legislation which established the Bundesbank in 1957 specifically prohibited it from lending to the German government.

and implicit in Maastricht Treaty

This same view of inflation - that it originates in budget deficit and the consequent "printing of money" (or, in jargon, the "monetization of deficits") - explains the Maastricht Treaty's insistence that countries can participate in EMU only if they have curbed their budget deficits to a low ratio of national product. The Treaty refers to deficits in the period before the single currency. Subsequently agreement has been reached on a Stability and Growth Pact, which maintains a similar discipline over the size of budget deficits once the new currency has been brought into being. If the deficit limits are breached after EMU has been established, nations are to be fined. The result is plainly a huge erosion of national government's financial independence.

Control over budget deficits in the 1990s

Chart shows ratio of general government deficit to GDP. Figure for 1997 is OECD estimate.



Does control of deficit lead to control of spending?

It is sometimes remarked - particularly by enthusiasts for European integration - that the Stability Pact relates to *the size of deficits*, not to *the levels of government spending and taxation*. It is claimed that, because governments can determine how much they spend, they remain very much in control.(2) However, in the real world decisions to spend and decisions to borrow cannot be entirely distinct. A fundamental shift in power is in prospect.

Answer must be a partial "yes", given inevitable effect of exogenous shocks on fiscal deficits,

The scale of this shift is readily demonstrated by considering how a government might respond to a sudden change in its financial circumstances after the Stability Pact had become effective. Suppose that the sudden change leads to a large and unexpected imbalance between revenue and expenditure. A deep recession (which hits tax revenues), a commodity-price shock (like a fall in the oil price in the UK) or a systemic crisis in the financial system (which may require an infusion of public money to recapitalize loss-making institutions) are examples. But by far the most drastic case is war. In that event any government would want to increase defence spending and, almost inevitably, to raise the budget deficit. Under the Stability Pact the government concerned would have to seek the approval of other European governments before it could react to foreign aggression.

especially if the shock is war

Chancellor Kohl might say that this discussion shows, exactly, the importance of monetary union to the avoidance of intra-European war. But military threats to the nations of Europe do not nowadays come from each other. Instead they come from delinquent nations in other parts of the world, such as Argentina in its invasion of the Falklands in 1982 or Iraq by its annexation of Kuwait in 1990. Under EMU Britain would have had to seek the agreement of other European governments for the stand it took in these two conflicts, because of the implications of more defence spending on its budget deficit and so for the Stability Pact.

Chancellor Kohl might claim that the European Union would always support one of its members in such circumstances, but this is far from certain. (Italian public opinion was unsympathetic to Britain during the Falklands conflict.) Perhaps he might also reflect on the difficult situation in which Germany itself would be placed by ethnic turmoil in the Balkans or a renewal of Russian territorial expansionism, with a revanchist military government in Moscow invading the Baltic states. It is quite conceivable that the European Union would be split on the appropriate response, but every nation - including Germany - would have to seek the approval of the ECOFIN-Council for any rise in defence spending which led to an excessive deficit.(3)

EU's Council of Ministers could control individual nations' diplomatic and military destiny

Evidently, the centralization of the power to issue money has led, via the necessary consequent restrictions on individual governments' ability to run budget deficits, to a situation where these governments are no longer in control of their own diplomatic and military destiny. The term "sovereignty" is ambiguous and complex, and lends itself to verbal conjuring tricks. But, surely, on any reasonable definition of the term, once a government has to seek other governments' consent to raise finance for a war it is no longer "sovereign".

The argument so far may seem drastic enough, but much more can be said in the same vein. If a government exceeds the deficit ceiling laid down in the Stability Pact, the so-called "Excessive Deficit Procedure" starts to operate. After receiving a report from the Commission, it is the task of the ECOFIN-Council - taking a decision by qualified majority voting - to confirm or deny that the deficit is indeed excessive. If ECOFIN decides that the deficit is excessive, it makes recommendations about fiscal policy in the country at fault and "requires that effective actions have to be taken within four months".(4) If the country fails to take such actions, ECOFIN imposes a fine. The fine takes an unusual form, with the offending government having to lodge a non-interest-bearing deposit at a European banking institution, presumably the ECB. It forfeits the interest until its finances again comply with the Stability Pact.

Huge erosion of sovereignty also implied by "Excessive Deficit Procedure",

This sounds tough, but is it credible? It lacks plausibility, for at least two reasons. First and most obviously, the fine would widen the deficit and so aggravate the problem. But, more fundamentally, how would ECOFIN react to fiscal transgressions by a number of European countries, where the countries stubbornly refuse to take "effective actions"? Would it expel them from the monetary union? Perhaps this is the unstated threat, but the Treaty says nothing about the mechanics of expulsion. And what happens if the number of European countries with excessive deficits becomes so large that they can block a hostile vote in ECOFIN? In the extreme, high-deficit countries might outnumber low-deficit countries, so that the financial delinquents controlled ECOFIN. In that event the incentive for every European government is straightforward: it is to cheat on their public finances and maximize the deficit.

although this procedure is hardly credible

The natural answer - almost certainly the only effective long-run answer - to problems of this kind would be to have a single federal European government, with a centralized treasury and the undoubted ability to enforce financial sanctions ("rate-capping" and the like) on formerly sovereign national governments. Monetary union would have led to political union.

unless a single federal government exists

The proliferation of new bodies involved in European monetary policy - bodies which might be fashionably described as stakeholders in EMU - multiplies the scope for debate and disagreement. There is great uncertainty about the relative powers and responsibilities of ECOFIN and the newly-created Euro-X committee, about the operation of the chain of command from the European

Proliferation of EMU bodies, with competing and overlapping responsibilities,

Chancellor Kohl on EMU and political union

EMU is but the beginning, says Helmut Kohl, the Germany chancellor... The euro, he said in a speech last week, would give a "mighty push" to political union, though he said this would be decentralised, and not a European superstate.

Quote from *The Sunday Times*, 26th April 1998

will emphasize need for single over-arching authority

Central Bank to the national central banks, about the extent of the ECB's accountability to the European Parliament, about the political status of the technical input from Eurostat and the EU's "economic and financial committee", and, indeed, about how each and every one of these bodies is to relate to all the others.(5) There is a clear need for a single over-arching organization, a democratically-elected central government of Europe, to set agenda and arbitrate disputes.

Argument II: "Seigniorage" accrues to national central banks and governments,

The second strand of argument pivots on the similarity of the power of national governments to raise taxes and to issue legal- tender currency. Obviously, tax-raising extracts resources from the private sector and makes them available to the government. But the issue of legal-tender bank notes has much the same effect. If the government borrows from the central bank and the central bank issues new notes, the goods and services purchased with the notes also become available to the government. This power to extract resources comes under the general heading of "seigniorage". The *Concise Oxford Dictionary* defines "seigniorage" as "profit made by issue of coins rated above intrinsic value" and notes that, historically, it was "something claimed by sovereign or feudal superior as prerogative".(6)

The definition invokes these awkward words "sovereign" and "prerogative". Despite the many semantic games that can be played in this area, it is clear that the right to extract resources from a particular nation by the issue of money is a right which, over extended historical periods, has belonged only to the sovereign power within that nation. Further, a strong justification can be found for the state's monopolization of this right. Suppose that the right to seigniorage were spread among dozens of private companies. Since each of them could extract resources by printing money, and since each individually maximizes its revenue by printing as much as possible, a widely-dispersed seigniorage right would lead to over-issue and inflation. This danger is avoided when the government restricts the right to issue legal- tender money to itself. In most countries the history of monetary legislation has been largely the history of the elimination of private note issues and the concentration of the right of issuance in the government's own bank. Indeed, it was very much for this reason that the government's bank became the central bank. (7)

and is difficult to distribute internationally

In the context of EMU, this argument creates a serious problem. The European Central Bank is to be the banker not just to one government, but to a number of governments. The question immediately arises, "how much seigniorage is to be appropriated by each nation?". The Maastricht Treaty does in fact have a formula which determines the answer. The formula - in which seigniorage is based on population and gross domestic product - looks fine in principle. So it might also be in practice, if all the governments and central banks of Europe had understood what they were doing. Unfortunately, that does not seem to be the case. Relative to the current situation, the formula implies a large shift in seigniorage from Germany and Spain to France. It seems that - when the German Government signed up for the Maastricht deal - neither it nor the Bundesbank recognised the scale of the loss. Some estimates are that the

Problem illustrated by German loss of seigniorage under EMU

cumulative loss to Germany over five years could be over $10b. A full capitalization of the loss would be yet higher. Not surprisingly Germany and Spain want the relevant part of the Maastricht Treaty to be reconsidered and perhaps even renegotiated. According to the journal *Central Banking*, "Behind the scenes feverish negotiations have been going on to try and reduce these transfers." (8)

Further point of distribution of seigniorage between governments and central banks

But the problems do not stop there. One question is the distribution of seigniorage between nations; another is the distribution of seigniorage between the government and the central bank in each of the nations; and a further related matter is the extent to which the seigniorage is supposed to cover a particular central bank's own costs. Most European countries have specific legislation to deal with these matters. As EMU approaches they are all having to change the legislation, sometimes with curious results. In France the government has found considerable resistance in parliament to its proposals. The *Financial Times* of 7th April reported that the cabinet-approved draft law had "been altered in commission, making it difficult for the Bank of France to reduce any of its almost 17,000-strong staff." In other words, the French parliament and government seem to believe that, under EMU, they will have a veto on any decision by the ECB which might affect the Bank of France's staff numbers. The relationship of seigniorage revenue to staff costs, or indeed of any revenue to any costs, is apparently not deemed to be relevant.

Share out of the European Central Bank profits

	Monetary base, $b., mid-1996	% share of European monetary base	% share holding of 12-member ECB	Estimated annual loss/gain from Maastricht seigniorage formula, $b.
United Kingdom	41.01	8.48	19.08	1.59
France	56.72	11.73	21.13	1.41
Portugal	8.04	1.66	2.3	0.1
Belgium	15.27	3.16	3.48	0.05
Finland	8.67	1.79	2.05	0.04
Luxembourg	0.18	0.04	0.19	0.02
Ireland	4.79	0.99	0.99	0
Sweden	22.38	4.63	3.61	-0.15
Netherlands	31.7	6.55	5.28	-0.19
Austria	21.8	4.51	2.66	-0.25
Spain	70.21	14.51	11	-0.53
Germany	202.94	41.95	28.03	-2.09
	483.72	100	100	

Source: *Central Banking*, spring 1997, p.9.

Estimate assumes a 12-member Euro-land, i.e., that the UK participates in EMU. For details, see source.

National pride and self-respect at stake

Are these details so petty that they do not deserve to be mentioned? Supporters of EMU might insist that the Bundesbank's loss of seigniorage and the Bank of France's staff costs are trifling considerations, particularly when compared with the vast geopolitical benefits of a single European currency. But there is a pressing need - in this whole subject - for the discussion to be brought down from the geopolitical sublime to the logistical nitty-gritty. The size of central bank losses and profits, and the division of such losses and profits between the nations of Euro-land, are highly contentious subjects. National pride and self-respect are at stake. The tensions would be most simply overcome if the national governments were subordinate to a single European government, presumably based in Brussels. Again, EMU ineluctably creates pressures for political unification.

No previous example of multiple central banks in a single currency area

All over the modern world, the world of paper money, a particular set of monetary institutions is found. In each nation state there is one government, one central bank and one legal-tender currency. The central bank is the sole issuer of the legal-tender currency, and it is also the banker to the government and the commercial banking system. Usually, although not invariably, the central bank is owned by the government. *There are no examples of the same legal-tender currency being shared by several significant nation states.* Each central bank is the central bank in the nation concerned; it does not share its note-issuing power, or its functions as banker to the government and the commercial banking system, with another central bank; indeed, it could not be *the* central bank if these powers and functions were shared among a number of institutions. The European System of Central Banks proposed under EMU will be a unique institution, where money-issuing powers and the related functions are to be shared - within a single monetary area - by 11 distinct national organizations. Doubts have to be expressed about whether this can work.

Political union would create a more normal chain of command

The attempt to distribute seigniorage between nations by an international treaty is - logically and intrinsically - inconsistent with the way that seigniorage is earned, as a by-product of a central bank's monopoly of the note issue within a single nation state. However, the inconsistency is overcome if the separate governments of Europe form a single government. In that case the normal set of monetary institutions in the modern world is restored and, of course, monetary union is accompanied by political union.

Argument III: Political union and the protection of bank deposits

The third strand of argument originates in the modern conception of bank deposits. When a bank takes deposits of notes from the general public, there is a risk that the bank may not be able to repay them in full. In the 19th century bank failures were accepted as part of business life. However, in the 20th century - and particularly since the traumatic effect of bank failures in the 1930s on economic activity - public policy has taken a close interest in the security of bank deposits.

The modern view is that public policy should - as far as possible - ensure that bank deposits are always worth their nominal value. (In other words, banks

Nowadays a strong public policy interest in 100% repayment of bank deposits,

must be able to repay their deposits with notes of the equivalent value.) Various institutional arrangements have therefore developed to protect depositors. The textbooks of money and banking often highlight the role of the central bank as lender of last resort. If one bank (or a small group of banks) is unable to maintain payments, and if this isolated failure casts doubts on other banks and causes depositors to withdraw their cash *en masse*, the central bank must lend to all banks or purchase assets from them. The effect is to replenish their balances at the central bank. These balances can be converted at will into notes and so be used to repay depositors. If depositors are persuaded that there is no point in further withdrawals, the panic is over.

which requires injection of capital to maintain bank solvency, as well as lender-of-last resort help for liquidity

The lender-of-last-resort role is important. Indeed, a serious defect of the Maastricht Treaty is that it says almost nothing about how lender-of-last-resort operations are to be conducted under EMU.(9) One interpretation of the apparent oversight is that nowadays central banks are not, in fact, the only or even the main organizations responsible for deposit protection. Arguably, lender-of-last-resort assistance is the provision of liquidity to the banking system, but this is merely a temporary palliative. At root major financial crises in the last 20 or 30 years have been about the insolvency of one or a number of banks; they have been due *to a lack of capital, not to a shortage of cash.* The lack of capital has typically been a result of imprudent lending and heavy bad debts. If the bad debts are so large as to have exceeded a bank's capital, the depositors risk losing their money.

Central bank capital in Europe, end-1996

Central bank capital is small compared with the capital of the commercial banking system and would be inadequate in a serious crisis

all figs. in b. of ECU	Capital of central bank: Narrow definition	Capital of central bank: Broad definition	"Capital accounts" of deposit money banks
Germany	11.7	26.0	322.1**
France	2.4	30.8	160.6
Italy	2.1	45.9*	130.7
Spain	9.7	11.7	68.7
Netherlands	1.4	10.4	42.4**
Belgium	1.3	6.6	32.5

Notes: The narrow definition of central bank capital includes capital, reserves and undistributed profit; the broad definition includes the narrow definition, the revaluation surplus on the foreign exchange reserves and gold, provisions and other items of a capital nature. Figures for central bank capital are taken from accounts of the central banks; figures for deposit banks' "capital accounts" come from International Monetary Fund's *International Financial Statistics*.

* Banca d'Italia's wider capital includes 38.5b. ECU of "sundry provisions".

** These figures described as "other items (net)" in *International Financial Statistics*. In the German case this figures is much above commercial banks' combined *equity* capital.

A "chain of security" protects depositors

How are depositors protected in these circumstances? The arrangements vary between countries, but in general terms a "chain of security" can be described.(10) If one link in the chain is broken, another link comes into play. Once the capital of the bank in question has been exhausted, four links come into play. First, the capital of other banks may be available, either because the central bank coerces them into supporting the failed bank (as in "the lifeboat" in Britain in the mid-1970s) or because they see genuine commercial opportunity in absorbing the failed bank's infrastructure. Obviously, this first link is reliable only if most of the banking system is healthy and profitable. If not, the first link in the chain is severed.

i. Capital of other banks,

ii. Resources of deposit insurance agency,

The second link is the resources of the deposit insurance agency, if there is one. (Note that some countries do not have a deposit insurance system. The UK did not have one until 1979.) Deposit insurance involves the payment of premiums into a central fund by all banks and a promise by that fund to make good depositors' losses up to a certain figure. Deposit insurance is usually for the benefit of small retail depositors. The fund rarely covers losses incurred by corporate depositors or, indeed, losses on loans between banks. In any case the resources of the deposit insurance agency are in most countries rather small compared with the banking system's capital. In a big crisis - say, of the kind that hit the American savings and loans industry in the early 1990s, or being experienced in Japan today - the deposit insurance agency may itself be threatened with bankruptcy. If so, this second link in the chain of security is also broken.

iii. Capital of the central bank,

What, then, about the third link, the capital of the central bank? Plainly, this is a question of the relative size of the capital of the central bank and the commercial banking system, and of the central bank's willingness to shoulder losses. In most developed countries, and certainly in the European Union, the capital of the central bank is a fraction of all commercial banks' capital in combination, while central bankers are reluctant to take on substantial business risks. The Bank of England has sometimes stepped in to support an ailing institution, but its implied investment has been criticized in parliament as "a waste of taxpayers' money", or something of the sort.(11) In short, the central banks's capital can be used to protect depositors only in very exceptional circumstances and, even then, only to a limited extent.

and, finally, iv. the government

So - if a banking crisis is systemic and deep-seated, and if the resources of the commercial banks, the deposit insurance agency and the central bank have been swept away by a tidal wave of loan losses - who remains to ensure that depositors are paid in full? The answer, of course, is the government. It has tax-raising and note-issuing powers so that its support for the banking system is theoretically almost limitless. Whatever the formal position, and despite the existence of deposit insurance and central banking, the underlying reality of deposit protection in a modern industrial state is simple. In the final analysis, it is the government that makes sure bank deposits are repaid in full. But this liability is not unlimited. Crucially, the government of a particular nation is most comfortable when it protect deposits made by the citizens of that nation.

Government is long stop, especially for domestic retail deposits

(The citizens are also voters.) It does not like giving similar protection to deposits from foreigners.

Governments give *national* protection to deposits, but - under EMU - banking is to become *transnational*

If the single currency proceeds, Europe must over time also have an increasingly integrated banking system. The clear expectation, and indeed the official intention, is that banks are to take euro-denominated deposits and make euro-denominated loans in many countries, and to have shareholders across Europe. They are to become - in effect - "transnational". However, under EMU deposit protection is to remain a national responsibility, with the concept of "nationality" determined by the centre in which a bank is registered. In principle all banks could register in Luxembourg, but conduct their business (including deposit-taking) in every country of Europe.

Tension between national deposit protection and transnational banking system,

This is a recipe for chaos. Consider the pattern of incentives on banks, borrowers and depositors. Banks' managements will find it advantageous to register in the nation with the lightest regulation and supervision; depositors will transfer funds to capture the protection of the most generous deposit insurance scheme; borrowers will take out loans in the country with the narrowest bank margins (and, probably, the least adequate deposit insurance, and the sloppiest and cheapest banking supervision); and so on. This statement is an exaggeration, but it is a fair summary of the direction of the likely pressures.

which could lead to uncertainty in severe banking crisis

What would happen in the event of a big crisis, in which bad debts had obliterated the capital of several large banks? *It was argued earlier that nowadays the last link in the chain of deposit protection is the government of the country in question. But there is no European government, only the governments of the various European nations.* No definite prediction can be made about the outcome under EMU, but the tendencies are clear. None of the national governments would quickly and willingly inject capital to overcome a banking crisis; every government would blame bank managements and economic conditions elsewhere in Europe for the bank failures, and try to force other governments to meet the cost. As far as possible, national governments would refuse to bail out "European banks". Parliamentary debates would give ample scope for banker-bashing tinged with nationalism and selfishness. The disturbing conclusion has to be that, from a supervisory standpoint, the safety of bank deposits under EMU would be less than at present.

The disturbing example of BCCI

These comments are admittedly rather lurid. Central bankers could object that the trend towards the internationalization of the banking system is already well-advanced and EMU will only give it extra impetus. But international banking today is mostly about wholesale banking, where depositors are corporate and grown-up, and know they are at risk. The integration envisaged by EMU is different, in that it concerns the retail side of banks' operations. The reference to Luxembourg was deliberate, because it was the country where the notorious Bank of Credit and Commerce International was registered. When BCCI was shut down in 1991, thousands of small depositors in the UK and elsewhere lost large amounts of money. (At the time of BCCI's worst transgressions Luxembourg had 15 bank examiners.)(12)

At worst, the inconsistency between national responsibility for deposit protection and the increasingly transnational character of European banking could lead to the formation of a number of banks like BCCI. This would be a nightmare for banking supervisors and the national central banks. The obvious way to end the inconsistency, and to restore the traditional chain of security in deposit protection, would be the formation of a European central government. Ideally, both a truly unified central banking system and a single banking supervisor would be answerable to the one central government. As in the conventional modern relationship between government and central bank, this central government would have tax-raising and note-issuing powers. These powers would absorb those which had traditionally been held and exercised by Europe's independent national governments. Monetary union would have culminated in political union.

Problems would be overcome by full unification of banking supervision under one government

Conclusion: monetary union can work with political union

Chancellor Kohl is right: the logical accompaniment of EMU is European political union. However, it is important to understand precisely what is being said. The three strands of argument developed in this paper show that monetary union without a central government cannot work. Monetary union requires a central government to decide fiscal policy, to receive seigniorage and determine its distribution between regional governments and central banks, and to protect depositors in the event of a systemic banking crisis. If monetary union is attempted before such a central government exists, the momentum of events will demonstrate the practical necessity of early political union. Political leaders will soon see that they must form a central government which reduces their still nominally "national governments" to the status of regional governments in a federal union.

And, without political union, monetary union will fail

But the analysis has another implication. Without a central government of the kind described here, monetary union will fail. The heart of the problem is that a single authority is essential to set the agenda of fiscal and monetary policy, to carry it out and to be accountable for mistakes. Each of the three lines of argument has the same message. If there are a multiplicity of monetary authorities, areas of responsibility are not demarcated clearly. Where these areas overlap, it is inevitable that muddle and confusion will lead to tension, indecision and disputes on such a scale that the system cannot survive.

Europe's leaders have regarded the change in the unit of account as the essence of monetary union,

None of this might matter, if the governments of Europe had understood the consequences of their decisions. But Europe's leaders have not understood what they have done. Many of them believe that the essence of monetary union is the change from one unit of account to another. They correctly think that the switch from one unit of account to another is a straightforward matter, like decimalisation or metrication, and does not necessitate a radical institutional upheaval. They have not seen that for an object to be "money" *it must serve as both a unit of account and a medium of exchange*, and that it can serve as a medium of exchange only if it has value. The conferral of value on a monetary medium of exchange - by legislation on legal tender, central banking and deposit protection - is a highly political act and must involve the power of the state. To introduce a new medium of exchange therefore necessitates institutional upheaval on a huge scale.

but this is a serious misunderstanding

The key conceptual mistake of Europe's elite - the belief that the essence of monetary union is a change in the unit of account - is evident in the Maastricht Treaty itself and in the sequence of new bodies created since the signing of the treaty. The treaty includes a long period from January 1999 to July 2002 (phase B of stage three) in which the legal unit of account has changed, because the euro is said to exist "in its own right", and yet in which notes and coin, the actual media of exchange, continue to be the old national-currency notes. It is already clear that this period will at best be awkward and inconvenient, and at worst could create serious contractual uncertainties.(13) Meanwhile the passage of the Stability and Growth Pact, the formation of the Euro-X committee and the refurbishment of the EU "monetary committee" - all of which post-date the Maastricht Treaty - show that EMU was not well-conceived at the start. Instead of being planned well in advance, vital institutions are being cobbled together almost at random.

Key institutions are being hurriedly improvised

In this year's Jubilee Lecture Lord Hurd described the EU's approach to the single currency project as a "Maoist leap forward". He was worried by our neighbours' embrace of radical change for its own sake, regardless of the exact consequences. EMU could indeed prove to be a catastrophe for the integrationist project. It can work if it leads quickly to a comprehensive scheme of European political union. But, without European political union, it will prove impractical to the point of impossibility. If so, its failure will be the greatest setback to the cause of European integration since the formation of the European Economic Community in 1957.

A "Maoist leap forward"?

Notes

(1) Constantio Bresciani-Turroni *The Economics of Inflation* (London: George Allen & Unwin, 1937), pp.46.)

(2) Christopher Johnson *In with the Euro, Out with the Pound* (London: Penguin Books, 1996), pp.106-27.

(3) The ECOFIN-Council is the Council of Ministers, when it is attended by finance ministers. The Council of Ministers decides on whether legislative proposals emanating from the European Commission should be submitted to national parliaments. The Council of Ministers consists of foreign ministers when foreign policy is under consideration, of transport ministers when the subject is transport policy and so on.

Note that Germany is opposed to Russian membership of the European Union. But how can any settlement in Europe guarantee peace is Russia is an outsider? Kohl avoids this difficult subject, although it is fundamental to the security of Germany and Europe.

(4) The quotation is from K. Regling "The Stability and Growth Pact", paper given at the Royal Institute of International Affairs' conference on *European Economic and Monetary Union: the politics and practicalities* in London on 23rd October 1997.

(5) The Euro-X committee supplements ECOFIN; it consists of finance ministers from the 11 countries destined to participate in Euro-land from the start. The "economic and financial committee" is the successor to the EU monetary committee which prepared ECOFIN meetings. See supplement on "The birth of the Euro" in the *Financial Times*, 30th April 1998.

(6) *Concise Oxford Dictionary* (Oxford: Oxford University Press, 1982), p. 953.

(7) The claims made in this paragraph are contentious, being opposed by the neo-Austrian school which favours the denationalization of money. For further discussion, see T. G. Congdon "Is the provision of a sound currency a necessary function of the state?" *National Westminster Bank Review* 1981.

(8) The subject was discussed in two articles in successive issues of *Central Banking*, 'ESC profits: a Bundesbank miscalculation', pp.19 - 24, in the winter 1996 issue and 'Dispute over ESCB profits', pp. 7 - 10 in the spring 1997 issue. The quotation is from p. 23 of the winter 1996 issue.)

(9) The subject has also been reflected in the European Monetary Institute's *Annual Reports*.

(10) The following discussion of the chain of security to protect bank deposits was prompted by an exchange with Lord Simon and Mr. Howard Davies, then Deputy Governor of the Bank of England, at a televised debate held on the

Bloomberg television channel in 1997. A short correspondence with Mr. Davies followed. I am grateful to Mr. Davies for his interest, although we hold different views.

(11) Stephen Fay *Portrait of an Old Lady: turmoil at the Bank of England* (Penguin Books: London, 1988), pp. 141 - 72.

(12) James Ring Adams and Douglas Frantz *A Full Service Bank: How BCCI stole billions* (London, Sydney and New York: Simon & Schuster, 1992), p.29.

(13) Walter Eltis *The Creation and Destruction of the Euro* (London: Centre for Policy Studies, 1997).