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The ECU as a parallel currency

Any discussion on promoting the ECU as a parallel currency requires answers to two obvious questions: what do we mean by it and what does one expect to achieve with it? There are various possible definitions of the ECU as a parallel currency but they all have one characteristic feature in common: the development of the ECU as a parallel currency would imply its increased use in international transactions, both within and outside the European Communities, while national currencies would - at least for the foreseeable future - retain their functions and their central rates could continue to be adjusted. A parallel currency therefore implies the absence of a Monetary Union which can be defined as an area with either a single currency or with national currencies with margins eliminated, full convertibility and central rates irreversibly locked.

Some technical features

At present two separate ECUs exist:

- the official ECU, created according to fixed rules by converting international reserves and held exclusively by central banks;
- the private ECU, assets denominated in ECUs and held primarily by the market.

The development of the ECU as a parallel currency widely used in international transactions refers, of course, to ECUs held by the private sector. At first the use of the ECU by the private sector has shown a remarkable development, but recently the increase in its use has not continued in its initial pace. However, if the market would feel the need, a resumption of its initial growth rate could occur without changing either the separation of the two ECUs or the basket definition of the ECU.

Proponents of the further development of the private ECU are reluctant to await market developments and they feel the need for a more active stance on the part of the authorities. They see two major distinct avenues along which official measures can be taken to promote its use, which I shall call the market oriented approach and the institutional approach.

In the market oriented approach the techniques of the ECU are left unchanged, but the private ECU market is stimulated by actions like those taken by the UK authorities. These actions are taken with a view to facilitate the functioning of the private ECU market and to contribute to its depth and its overall liquidity. A greater use of the private ECU by governments, especially in the sphere of the Community budget, could also be seen as a possible element in this market oriented approach.

If such an approach indeed would lead to an increase in the use of the ECU by the private sector, this could possibly have implications for monetary policies in the member states. This would e.g. be the case if the share of the private ECU in official reserves of EC central banks were to rise substantially. To this end it has already been agreed that the Dalgaard Group will closely monitor the development of the private ECU, and will call for consultations if problems of a monetary character were to arise. A further step could be taken by the inclusion by member states of liquid assets denominated in ECUs held by residents in their domestic monetary aggregates. In that case of course also liquid assets denominated in all Community currencies should be included in this extended M aggregate.

In general, it would seem that the market oriented approach would ensure that a further increase in the use of the ECU would indicate market appetite for the ECU. Therefore, this avenue would seem to be less problematic than the situation in which the authorities would provide the market with private ECUs which at times may not be absorbed by the market without consequences for the exchange rates, and, by implication, the monetary policies of the member states.

The second avenue, the institutional approach, is advocated by those who feel that the use of the private ECU can only be stimulated by giving that task to a European institution. More precisely, official involvement in the private ECU would be increased by charging the European Monetary Co-operation Fund with responsibility for the ECU. Thus the suggestion has been made to give the Fund a responsibility for the exchange rate relationship between the ECU and third currencies. Another suggestion is to abolish, in addition, the basket definition, introducing an 'abstract' ECU.

Charging the Fund with responsibility for the exchange rate vis-à-vis third currencies would mean that for instance the decision at what level and for what amounts to support a weak dollar, at present taken by the central bank of the strongest EMS currency, would be transferred to the Fund. The Fund would of course have to be permanently provided with both third currencies and with either Community currencies or the possibility to sell newly created ECUs to be able to discharge its interventions.

The effect on member countries would depend on the ECU's definition. Among the many possibilities for such a definition three major variants can be distinguished.

- If the basket definition were maintained any intervention would affect exchange and monetary policies of all member countries, strong and weak.
- If the basket definition were abolished and an 'abstract' ECU be

introduced, the maintenance of stable exchange rates between member currencies and the ECU would require the introduction of ECU intervention obligations for each member currency.[1] In that case dollar purchases by the Fund against ECUs would lead to ECU purchases against national currency by the strongest members. The difference compared to the present situation, where the stronger members buy dollars directly, would be that the decision to intervene is taken by the Fund and no longer by the countries concerned. This implies that exchange and domestic monetary policies of mainly the strongest member countries would be affected by actions beyond their control. The size of the dollar purchases by the Fund and thus of the monetary consequences for the latter countries would increase if the EMCF would be enabled to create ECUs by granting credit.

- If an 'abstract' ECU through its definition were to become a near-perfect substitute for the strongest ERM currency, its creation by the EMCF would have monetary consequences for all Community countries. The need for the monitoring of an extended M aggregate, referred to earlier, would increase.

In all three variants official policy aiming at increasing the ECU's private role, promoting its development into a parallel currency, would imply an increase in the European Monetary Co-operation Fund's functions. These functions would be external, but they would by implication not only comprise interventions but also the creation of central bank money. Therefore they would tend to decrease the scope for national central banks' internal policy. It is therefore necessary to consider what its purpose would be and whether all would agree with it.

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[1] *To be able to comply with their intervention obligations in ECU the central banks would require ECU reserves that can be used directly for intervention. One way of providing them with such reserves would be through abolition of the separation between official and private ECU.*

Arguments for a parallel currency

Various motives, explicit or implicit, can be identified on the part of proponents of the ECU as a parallel currency. These motives can also lead to different forms of the ECU as a parallel currency.

i) It is believed that the increased use of the ECU in international transactions will enable it to compete with the dollar to an extent that would be impossible for any national currency in Europe and that this in time would help Europe to reduce its sensitivity for dollar fluctuations.

ii) The ECU as a parallel currency is expected to contribute to the development of a decision-making procedure in the EMS which would be considered more 'European' than the present one.

iii) Some hope that if the ECU is widely used for international transactions it may in time develop into a common currency in a way that is less painful than the process foreseen in the Council Resolution of 1971, which requires a high degree of economic convergence and surrender of sovereignty.

iv) It is suggested, inter alia from the industry side, that a wider use of the private ECU would diminish transaction costs for intra-Community trade on the assumption that also the exchange risk would diminish.

ad i) Reducing Europe's dependence on a strongly fluctuating dollar would probably be welcomed by most of us. The obvious way to achieve it would be genuine European economic and financial integration. Further convergence would enable European currencies to form a solid bloc, diminishing the adverse effects of dollar fluctuations on any single member country. However, the development of the ECU as a parallel currency would by itself not diminish the exchange rate risks, neither outside nor inside the EMS. There is no inherent disciplinary capacity of the private ECU which would bring about price and exchange stability. This can be brought about only by firm national policies directed towards domestic price stability. If these policies succeed in wiping out expectations of EMS realignments, then a true independence of the dollar will be achieved, the more if they would be accompanied by the complete liberalization of capital movements.

ad ii) Increasing the European Fund's role in managing the ECU and notably charging it with interventions would transfer decisions from national central banks to the Fund, limiting national central banks' domestic monetary control. It is precisely for that reason that this could never take place in isolation but only in the context of wider economic and monetary integration, while tasks and autonomy of the European Fund would have to be agreed upon and guaranteed in the Treaty.

ad iii) In how far could a parallel currency provide a road towards a common currency less painful than the one agreed in 1971 requiring convergence and loss of sovereignty? In fact it would not. At best it would imply an unnecessary detour towards a common currency. But it could equally turn out to become a permanent feature not facilitating further integration in any way. In so far as it would weaken discipline in member countries experiencing more inflation than others and balance of payments deficits, it might be rather the reverse.

ad iv) It is a valid point that a decrease in the transaction costs for European industry would be desirable. Presently there are in most countries no major obstacles for European industry to use the ECU as the transaction currency or the currency of denomination. It is up to industry to judge whether there is a need to use this possibility. However, it is not the greater use of the ECU wich will determine the exchange risk, but the level of convergence, as discussed under (i). A measurable decrease in transaction costs can only be achieved by the near-elimination of realignments.

Conclusions

Three conclusions can be drawn from the foregoing.

First. Economic and monetary union requires economic convergence and the acceptance of the loss of sovereignty implicit in the abolition of the exchange rate as an adjustment instrument. The development of the ECU into an international currency used in parallel to national currencies cannot enable us to avoid this requirement nor can it facilitate its realization.

Second. While we can agree that no obstacle should be put to the increased market use of the ECU, the future developments should be closely monitored and the implications of an increased use for internal monetary policies should be signalled at an early stage.

Third. New responsibilities for the European Fund for Monetary Co-operation involving market intervention in ECUs imply a shift in decision making and restrict national central banks' scope for control of domestic money supply. Such new responsibilities therefore would not be consistent with the present institutional framework but would constitute an institutional change in the Single European Act.