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10 August 1990

Prime Minister

Rather a good paper.

CDP 10/8

Charles Powell Esq
Private Secretary to the
Prime Minister
10 Downing Street
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Dear Charles.

FURTHER UK PAPER ON THE HARD ECU

At the July meeting of the ECOFIN Council it was agreed that the UK proposals for a hard ecu should be examined at a meeting of the Monetary Committee on 4 September. The outcome of that meeting would then be reported to the informal ECOFIN Council on 7-8 September. It was also agreed that the UK should prepare a more detailed paper for the Monetary Committee on the proposals, spelling out the material in the Chancellor's speech to the German Industry Forum on 20 June. In conversation with Delors the Chancellor said he would consider whether that paper could be made available a week or so in advance of the Commission meeting on 21 August.

Treasury officials, in consultation with Bank of England and other departments, have now prepared the attached paper, which the Chancellor thought that the Prime Minister might wish to see. It is being sent to the Monetary Committee, with personal copies also being made available to the Delors, Brittan and Christophersen Cabinets.

The paper is not being made publicly available at this stage, although the Chancellor will be considering after the Monetary Committee and informal ECOFIN Council discussions whether a similar document should be made available to the Parliamentary Select Committees and other UK audiences. But once the paper is available in Community circles, the possibility of it being made public cannot be ruled out. If this does happen the Chancellor sees no difficulty about confirming the existence of the paper and making clear that it spells out in greater detail the proposals he launched in his 20 June speech.

I am sending copies of this letter to Richard Gozney (Foreign Office), Martin Stanley (DTI), Paul Tucker (Bank of England) and Sonia Phippard (Cabinet Office).

Tancred Tarkowski

T TARKOWSKI
Private Secretary

UK PROPOSALS FOR A EUROPEAN MONETARY FUND AND A HARD ECU

Background

In his speech to the German Industry Forum on 20 June 1990 the Chancellor of the Exchequer outlined his further proposals for the development of economic and monetary union beyond Stage 1. These included some key new features, in particular:

- the creation of a common currency, the hard ecu, with firm anti-inflationary properties;

- and a new Community institution to manage both the currency and other monetary activities.

2. The purpose of this paper is to provide further details of the proposals so as to assist the Monetary Committee in their examination of the Chancellor's ideas. The paper deliberately does not provide a precise blueprint. Indeed views would be welcomed on the various options available for carrying forward beyond Stage 1 the framework described below.

3. The paper focuses on the key role of the new central monetary institution, namely the management of the hard ecu as a common currency in the Community. But it would also be possible for the institution, which might be called the European Monetary Fund (EMF), to assume responsibility for a number of existing Community functions. These could include the management of the ERM, the coordination of exchange rate intervention against the currencies of non-Community countries, the management of medium term balance of payments lending, and the provision of a secretariat for the coordination work of Community central bank Governors. These possibilities, which would have to be consistent with the monetary role of the institution, are not explored in this paper, but would merit further consideration.

4. The rest of this paper discusses the hard ecu proposal under the following main headings:

- The key requirements (paragraphs 5-6)
- The Chancellor's approach in outline (paragraphs 7-11)
- The relationship between the basket ecu and hard ecu (paragraphs 12-13)
- The development of the hard ecu (paragraphs 14-26)
- Counter-inflationary discipline: operation of the EMF (paragraphs 27-38)
- Realignments and the EMF's balance sheet (paragraphs 39-43)
- Conclusion (paragraphs 44-45)

The key requirements

5. Any approach for moving onwards from Stage 1 to the further development of EMU should reflect a number of basic principles. These are:

- The process should be evolutionary, because in that way any costs and shocks to member states' economies are likely to be reduced.
- It should ensure, to the maximum degree possible, anti-inflationary pressure and movement toward stable prices and exchange rates, in order to reinforce economic convergence.

- It should work with the grain of the market and individual choice. In this way economic efficiency will be maximised and political acceptability increased.

- It should maintain the clarity of responsibility between Community and National institutions, while respecting the principle of subsidiarity.

- It should provide a framework within which all member states can proceed together along the path of financial and economic integration towards the Community's agreed objective of economic and monetary union.

6. The Chancellor's proposals incorporate all these features.

<u>The Chancellor's approach in outline</u>

7. The main role of the EMF would be the management of the hard ecu. This would serve as a common currency in the Community, and at the same time strengthen the pressures towards anti-inflationary convergence throughout the Community. The present basket ecu offers no guarantee of that anti-inflationary outcome; its performance is linked to the <u>average</u> inflationary performance of the existing national currencies from which it is formed. The need is for a common currency which meets the standard of the <u>best</u>, not of the average.

8. The hard ecu would meet that requirement. It would no longer be defined as a basket of other European currencies. It would be a new currency in its own right, operating alongside the existing Community currencies - all of which, following Stage 1, it is assumed would be fully participating in the ERM on equal terms.

9. The hard ecu's key feature would be that at realignments it could never be devalued against any national Community currency (though, like other ERM currencies, it would be free to move within its band). It would provide a means for putting the ecu at the centre of the system, managed by a new Community institution, immediately after Stage 1 rather than at a later point in the progressive realisation of EMU.

10. The hard ecu represents a fundamentally different approach from the parallel currency proposal rejected by the Delors Committee. That approach, as the Committee pointed out, would have weakened anti-inflationary pressures in the Community. The hard ecu, on the contrary, has been designed specifically to strengthen the pressures for anti-inflationary convergence in the Community.

11. This would be achieved by reinforcing the central provision that the hard ecu could not be devalued against other Community currencies with provisions for:

- the EMF to issue hard ecu deposits in the Community only in return for national currencies.

- a requirement for national central banks to repurchase excess quantities of their national currencies held by the EMF.

- the EMF to operate interest rate policy in a way which affected monetary conditions throughout the Community.

- a possible requirement that each national monetary authority should guarantee the value in hard ecus of the EMF's holdings of their currencies.

The relationship between the basket ecu and the hard ecu

12. In recent years there has been substantial and encouraging growth in the use of the basket ecu. A continuing role for the basket ecu is not inconsistent with the introduction and progressive development of the hard ecu. But the normal pattern might be for outstanding arrangements in basket ecu simply to run to maturity, and then be steadily replaced by hard ecu alternatives. Over time, individuals, businesses and market operators are likely to be increasingly attracted to the hard ecu, given its stronger anti-inflationary properties and greater suitability as a common currency in the post-Stage 1 development of EMU. Therefore, from its inception the hard ecu would probably be the main vehicle for new ecu contracts. (In due course the new common currency might simply be termed the "ecu", although in order to distinguish it from the present basket currency this paper uses the term "hard ecu").

13. Meantime, of course, existing basket ecu contracts would continue to be serviced. And it would be open to market operators to continue to use the basket ecu, for example as a hedging instrument. As use of the hard ecu grew, instruments and options for converting assets and obligations from basket into hard ecus could be developed by the market.

The development of the hard ecu

14. The hard ecu would from the outset be a currency operating within the ERM, subject to the normal margins of fluctuation. Its initial definition, enshrined in the statutes of the EMF (if not in the Treaty itself), would prescribe a central rate against each member currency which could only be changed as part of a realignment within the ERM. It would be subject to the constraint that the hard ecu could never be devalued at realignments against any other Community currency. Thus the hard ecu could be realigned upwards with whichever happened to be the strongest Community currencies, or revalued over time against all other Community currencies.

15. The hard ecu would be issued and managed by the EMF. The Fund would set interest rates at which it was prepared to receive hard ecu deposits. Those rates would be set at levels which ensured the hard ecu was held within its ERM margins. In this way the EMF would receive funds in national currencies from the general public - probably for the most part channelled through commercial banks - and these national currencies would provide its initial asset base. In return it would issue obligations denominated in hard ecu which would comprise the main part of its liabilities. The Fund would be able to accept and convert national currencies on demand at the market rate, with an obligation to purchase national currencies at the lower margin against the hard ecu central rate and to supply national currencies at the upper margin.

16. The EMF's hard ecu liabilities would take various forms. The Fund could offer interest bearing liabilities with a range of maturities and notice periods, including in marketable certificate of deposit form. The Fund could issue hard ecu currency notes as soon as demand for transactions in hard ecu developed. As commercial demand grew, a central clearing and settlement system would be developed for banks participating in hard ecu denominated business, which would be matched by the start of demand for non-interest bearing operational hard ecu deposits at the Fund.

17. The speed at which private and commercial demand for the hard ecu developed would depend on the forces of supply and demand. Thus the speed of its development is inevitably uncertain - just as it has been for the basket ecu. But some likely factors can be identified; and are described in the paragraphs that follow.

<u>Hard Ecus in the Financial Markets</u>

18. In the initial stages of development the main source of growth for the hard ecu would be as an instrument in financial markets. It would offer attractions both as an asset and a liability.

19. As an asset its appeal would develop strongly once its anti-inflationary features became clear in financial markets. Both savers and lenders would find a strong common currency that was not a national currency a highly attractive medium, and they would also have the benefit of a full currency guarantee within the Community.

20. But the fact that it was attractive to lenders would not mean it was lacking in appeal to borrowers. Those personal sector borrowers whose income or assets were still largely denominated in national currency might be initially reluctant to expose themselves to currency risk by borrowing in hard ecu. But, for as long as there was a significant risk of member state currencies being devalued against the hard ecu, interest rates on hard ecu, relative to the Community average, would tend to be low. For sophisticated corporate borrowers and financial market operators this would provide a marked incentive to demand the new common currency.

21. To some degree the attraction of hard ecu to borrowers is the obverse of the attraction to lenders. But the reduction in uncertainty and greater stability provided by the development of hard ecu instruments would provide a substantial net increase in the currency's overall attraction as a financial mechanism. And financial institutions would be an important catalyst for the development of lending and borrowing transactions. They would be keen to increase the use of - and their market share in - what they would perceive as the key European currency of the future.

<u>Transactions in Hard Ecus</u>

22. For transactions purposes growth in the use of hard ecu is likely to come initially from businesses engaged in intra-Community trade, which will form a growing proportion of the member states' total trade as the benefits of the single market are secured. Community businesses would derive substantial convenience benefits and cost savings from the use of a common

currency which was free from risk of devaluation. Once a central clearing and settlement system was in place, firms would find attractions in holding hard ecu balances, and in urging both suppliers and customers to settle accounts in this form.

23. The benefits of using the hard ecu would also be apparent to private individuals travelling - either on holiday or business - from one member state to another. With growing travel between Community countries an increasing proportion of the population might also consider using the hard ecu for domestic transactions - particularly as it became clear that it was the most secure currency.

24. The attitude of Governments to the use of hard ecu for transactions in which they are involved - for example payments for contracts and of the salaries of employees, together with receipts of tax payments - would influence the potential demand for the new currency. Governments might wish to consider removing impediments to the use of hard ecu for these purposes. But as in other areas of demand it would be right to let the speed of development reflect market demand rather than for Governments to insist on the use of hard ecu before people were ready for it.

Legal Tender

25. Legal tender is a concept which applies throughout the Community and is recognised in Community law. Once demand for the hard ecu for transaction purposes had developed action could be taken in member states to make the currency legal tender. It would be a step which could be taken to help the process of monetary integration with relatively little difficulty. But the significance of this action should not be overstated. Indeed, the concept itself is often misunderstood.

26. First, since legal tender is relevant only to transactions to be settled in notes and coin, it has no practical impact on the vast bulk of commercial transactions settled in other ways. Second, it is relevant only when the means of settlement has not been agreed in advance (in which case the debtor can settle in

legal tender in the knowledge that that will constitute full and fair settlement of his debt). In the vast majority of cases, both parties to the transaction will have agreed the means of settlement in advance and legal tender rules will have no application. So, overall, the absence of legal tender status is not usually an obstacle to the use of a particular currency for transactions. What matters is the acceptability to both parties.

Counter-Inflationary Discipline: Operation of the EMF

27. The precise way in which the Fund would operate in managing the hard ecu would evolve over time. But it would be of the essence that its operations could only subtract from inflationary pressure and never add to it. This would reflect the key features summarised in paragraph 11 above.

The EMF would only issue hard ecu deposits in return for national currencies within the Community

28. The EMF by its nature would act as the "central bank" for the hard ecu and its deposit liabilities would comprise the hard ecu monetary base. It is clearly important in avoiding inflation that increases in the EMF's liabilities should not have the direct effect of adding to the aggregate Community money supply. The safeguard that it would issue its deposit liabilities only in exchange for Community currencies would prevent that undesirable outcome. On the one hand, it would preclude the EMF from financing its own expenditure by creating money. But, more importantly, it would prevent sales of non-Community currencies to the EMF, dollars or yen for example, from expanding the Community's money supply via an increased issue of hard ecus, unmatched by a reduction in Community national currencies.

The hard ecu would never be devalued against any other Community currency

29. The EMF's ability to issue hard ecu deposits only in return for Community national currencies is a necessary safeguard. But it is not of itself sufficient to produce the appropriate monetary discipline. As the hard ecu developed, as with other currencies, it would be most unlikely that it would consist solely of its central bank's liabilities. A large part of the hard ecu money supply, perhaps the predominant part, would consist of liabilities of the commercial banks. In a fully liberalised financial system, such as some members of the Community already enjoy, and which will characterise all of the Community by the end of Stage 1, it will be possible to control wider monetary growth only by means of influencing its price. In practice that means keeping interest rates - the price of money and credit - sufficiently high to maintain a tight counter-inflationary policy.

30. It is in this context that the no devaluation requirement would be vital. Because it could never devalue the hard ecu against any other Community currency the EMF would be constrained to follow as least at tight a monetary policy as that of the firmest national monetary policy in the Community. Should the EMF begin to pursue a policy less firm than would be consistent with this stringent standard, it would find the hard ecu under pressure in the financial markets and in increasing danger of devaluation. The EMF would then have no choice but to defend the hard ecu by raising its interest rates and thus tightening its monetary policy.

The repayment requirement provisions

31. By setting its interest rates to maintain the hard ecu as the strongest currency in the Community, the EMF would be setting a stiff standard that other national monetary authorities would be under pressure to emulate. They would have either to pursue policies themselves which would be equally tough on inflation or

to face the prospect of having to devalue within the ERM to which they would all belong. But to prevent the discipline being undermined, it is necessary to close a potential loophole stemming from the EMF itself.

32. If a national monetary authority persisted in pursuing a loose policy, there would be a tendency for people to move out of that currency into, amongst other currencies, the hard ecu. People would sell the weak currency to the EMF in return for hard ecu deposits. But if the EMF was prepared to go on absorbing the weak currency without limit, there would be no pressure on the national monetary authority concerned to correct its lax policy stance. It could persist with its loose stance safe in the knowledge that the EMF would continue to hold its excess monetary creation as the Fund's own assets - in effect, providing unlimited support. Apart from the attenuation of monetary discipline, these operations would place the financial viability of the EMF in question. It would have increasing exposure from its growing holding of weak currency assets compared with increasing volumes of strong hard ecu liabilities.

33. The repayment requirements envisaged in the scheme would be mandatory on all participating monetary authorities. On demand from the EMF, an individual member state would have to repurchase its own national currency from the Fund in exchange for hard ecu or some other strong Community currency which the Fund might nominate. The detailed workings of the repayment requirements need to be discussed further. But in order to maintain counter-inflationary discipline, as well as to protect the EMF's financial standing, there would need to be, at the centre of the arrangements, pre-set limits on the amounts of individual national currencies the EMF could hold. These might be prescribed either in absolute terms or in relation to the proportion of total EMF assets in any one currency. Once reached, such limits would automatically trigger the repurchase requirement. They would need to be tightly drawn.

34. It would also, however, probably be desirable, as the system developed, to allow for some graduation of response without detracting from the rigour of the system. One possibility would be to have, within the pre-set limits, "grey zones" for each currency - where the proportion for a particularly national currency had built up to a certain level but not yet reached the pre-set limit. Within this range, the EMF board might have the discretion but not the obligation to insist on repayment. It might also be empowered to instigate monitoring or surveillance. But the national monetary authority would know that if it failed to take the necessary corrective action, the repurchase requirement would shortly be operated against it automatically.

35. Tight application of the repurchase requirement would establish beyond doubt the counter inflationary credentials of the EMF by demonstrating that it would not allow excessive money creation by an individual central bank to be validated at Community level. An increasingly strong discipline would be exercised by the repurchase obligation as the hard ecu became more widely used. (This discipline could be given added force by imposing a <u>guarantee obligation on each national monetary authority</u> - see paragraphs 42-43.)

<u>Interest rate management</u>

36. Whilst it would be necessary from the outset for the EMF to set interest rates at the levels needed to keep the hard ecu strong, the means that it employed to set interest rates could well evolve over time. In the initial stages of its operation, whilst the hard ecu circulation was building up, the EMF would be likely to rely on its own deposit rates as its main means of influencing interest rates. But as an increasing range of institutions come to deal in hard ecus, and the hard ecu financial structure itself developed, the EMF would be able to employ the techniques which established national central banks use to set rates.

37. In particular, it would be able to conduct open market operations in hard ecu paper to generate cash shortages in the hard ecu money market. It would then be able to relieve those shortages on its own chosen terms, thus influencing hard ecu interest rates, the hard ecu's exchange rate against other currencies and affecting monetary conditions throughout the Community.

Institutional arrangements

38. The organisation necessary to ensure this gradual exercise of the EMF's wider role would need to be considered in formulating the precise constitution, initial financing and accountability arrangements. This paper does not seek to address these issues, for which there would be a range of options. But a key feature of the EMF's constitution would have to be that all its actions were governed by the fundamental objective of price stability in the Community.

Realignments and the EMF's balance sheet

39. The precise composition of the EMF's balance sheet cannot be forecast with any certainty, because the development of the hard ecu would largely depend on market demand. But its general outline is clear. Initially, the Fund would probably have relatively few non-interest bearing liabilities; these would develop as demand for the hard ecu for transactions purposes built up. The currency mix of its asset base is also uncertain, although rigorous rules would be likely to apply at the outset. But it is clear that, in the early stages, the bulk of the EMF's liabilities would be in hard ecu and most of its assets in other currencies.

40. This currency mismatch could have important consequences for the EMF's balance sheet if there were realignments within the ERM. Although the hard ecu would from the beginning have a helpful influence on the convergence of inflation rates within the Community, realignments remain a possibility.

41. Because the hard ecu would be at least as strong as any other currency when parities changed, realignment would expose the EMF to exchange losses. It is impossible to say whether such capital losses would exceed the EMF's regular net earnings arising from having higher interest rates on its national currency assets than on hard ecu liabilities. But in fact, over the period since the inception of the EMS, the total return to the weaker currencies has tended to exceed that on stronger ones - perhaps to compensate for their perceived poorer stability in value. If that pattern continued the EMF might well be able to operate at a profit over time. But of course the possibility of losses in some periods cannot be ruled out.

42. These potential losses would need to be covered in some way. One approach would be to place on each national monetary authority an obligation to guarantee the value in hard ecu terms of the EMF's holding of their currencies. In that case if there was a realignment each country would face an obligation to reimburse the EMF to cover the extent to which their rate was devalued against the hard ecu.

43. Apart from safeguarding the EMF against the risk of losses such an arrangement could also provide an extra discipline on individual member states who were pursuing relatively lax monetary policies. This too would add to the stimulus for convergence under the new system.

Conclusion

44. This paper has indicated possible ways in which the hard ecu and EMF could develop. It is an evolutionary system and the pace of development would largely be driven by individual choice and the operation of market forces. That is perceived as a crucial strength in the system.

45. Moreover the system provides a powerful mechanism for promoting anti-inflationary convergence in the Community. At the same time the system could provide a currency - the strongest currency in the system - which most Community citizens could come to prefer. In short the Chancellor's approach provides a highly attractive and practical way for moving onwards from Stage 1, with the potential to evolve further into a single currency if peoples and governments so chose.

HM Treasury
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