Note from the Spanish Ministry of Economic Affairs on EMU (Madrid, 24 January 1991)

Caption: On 24 January 1991, the Spanish Ministry of Economic Affairs forwards a note to Jacques Delors, President of the European Commission, regarding Spain’s position on the establishment of Economic and Monetary Union (EMU).

Source: Ministerio de Economía y Hacienda, Madrid. http://www.meh.es/Portal.

URL:

http://www.cvce.eu/obj/note_from_the_spanish_ministry_of_economic_affairs_on_emu_madrid_24_january_1991-en-22dcb078-a30b-43eb-bd5b-30c6ac217cb4.html

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The ECU and the ESCB during Stage two (24 January 1991)

I. Introduction.

In its previous contribution to the Intergovernmental Conference (IGC) ("Staying the course", September 1990) Spain advocated the creation of the new monetary institution right at the beginning of Stage two, and the further development of the ECU, suggesting that the UK proposal for a "hard-ECU" contained useful ideas which could be made to fit into Stage two of the EMU.

A few weeks later, the conclusions of the European Council held in Rome in October called for the strengthening and development of the ECU during Stage two of the EMU, to start on January 1st 1994 with the establishment of the new EC monetary institution. How to achieve that strengthening of the ECU, as well as what should be the precise role of the new institution during Stage two, were questions raised by a number of Ministers both at the informal meeting of Milan and in the first working session of the IGC in Rome.

Earlier this month, the UK submitted to the IGC a new document, which puts its original proposal into Treaty language. The UK has, furthermore, specifically invited other countries to expand or build on its proposal.

Spain remains of the opinion that there would be merit in the UK proposal to the extent that:

– The "hard-ECU" proposal is included in the new Treaty as a transitional. Stage two provision, before the ECU, by dint of the political decision by the European Council to enter Stage three, becomes automatically the EC single currency.

Consequently, there would be no need for the Monetary Union to be achieved through a process of crowding-out of existing national currencies by the hard-ECU. Furthermore, although the term "hard-ECU" is a handy, colloquial way to refer to the UK proposal, the new Treaty would refer just to the "ECU", with no discontinuity between the current, the Stage two and the Stage three ECU.

– The new monetary institution is made independent from national Governments and other EC institutions, is designed so as to be transformed easily and automatically into the final "European Central Bank" upon the expiration of Stage two, and is vested with the specific role of coordinating and supervising national monetary policies and preparing Stage three.

Spain recognizes, though, that the concept of creating since the beginning of Stage two an "abstract" ECU to be included in the Exchange Rate Mechanism (ERM) as an independent, 13th currency, has elicited serious misgivings, which mirror those expressed in paragraph 47 of the Delors Report. Thus, while the British idea of strengthening the ECU has been generally welcomed, it has been observed by some that it could be achieved not by the creation of an "abstract" ECU, but rather by changing in the new Treaty the current definition of the ECU and hardening the ECU'S definition so that the ECU cannot be devalued against any Community currency. More specifically, this could be achieved by transforming the current "basket ECU" into a "hard-basket ECU" (in which individual currency amounts would be adjusted after every realignment, so as to preserve a fixed central exchange rate between the ECU and those currencies not experiencing devaluation).

The "hard-basket ECU" has in turn created concerns among those who feel that the new definition could put at risk the huge private ECU market already in existence, specially because the new "adjustable basket" would preclude commercial banks from creating "synthetic" hard-ECU assets and liabilities.

This note presents a scheme which draws indeed on the British plan and on Member States' reactions to it, as well as on the Draft Treaty presented by the Commission in December. It attempts, first, to endow the new EC monetary institution with a clear, operational role that will not interfere with the conduct of monetary policy by national Central Banks, but will be instrumental in helping the new institution undertake its key advisory and coordinating role; it intends, also, to address fears about a prematurely "abstract" ECU which could, furthermore, bring about an artificial process of interest rate competition in the Community; to create an institutional framework which, while building on existing practices in the private ECU market, will foster its development, by establishing a direct link between the official and the private ECU (as suggested by France as far back as 1985); to avoid discretionary "maintenance of value" and "buy-back" clauses, while allowing for a "graduated response" which may enhance the credibility of the monetary discipline imposed by the new institution on diverging national policies; and, finally, to allow for the immediate issuance of fully-backed ECU notes (a subject already discussed in the Monetary Committee as early as 1982), which might produce immediate savings in transaction costs and pave the way for the final Stage of EMU.

The Annex to the note includes a preliminary version of the changes necessary in article 109 of the Draft Treaty made public by the Commission on December 10, which Spain regards as a most helpful starting point.

II. Main features of the scheme.

1. The key role of the new monetary institution.

The key role of the European Central Bank (ECB) during Stage two will be to coordinate national monetary policies primarily through a process of ex-ante consultation and ex-post surveillance, and not through an artificial process of interest rate and currency competition between a new, 13th currency and the 12 EC national currencies. Besides, the ECB should be empowered to make, when necessary, general economic policy recommendations going beyond the realm of monetary policy (e.g. opinions on the appropriateness of a certain "policy-mix").

The operational functions of the ECB, while primarily geared towards facilitating the development of the private ECU market, should, however, allow Central Banks:

– To monitor and control jointly the gradual development of a Community-wide ECU market and the process of currency substitution.

– To achieve some degree of explicit monetary coordination.

– To exert effective pressure on loose national monetary policies.

Justification:

– Respecting the principle of national monetary sovereignty during Stage two while creating a non-political, independent "watchdog" of national economic and monetary policies, which, besides coordinating national monetary policies, helps the ECOFIN and the Commission in conducting during Stage two their "multilateral surveillance" role, a key aspect to enhanced convergence.

2. The definition of the ECU as standard of value.

2.1. During Stage two the ECU's official value will remain determined on the basis of a basket of EC currencies, so that the ECU will not become a new abstract currency existing independently from the 12 EC national currencies

2.2. Although "freezing" the current definition of the ECU's official value would not be incompatible with the rest of this note, there is a strong case for redefining the ECU in the Treaty as a "hard-basket" ECU (in which specific currency amounts in the ECU formula would be revised after every ERM realignment, so as to preserve for the ECU a fixed central exchange rate vis-à-vis all those currencies not experiencing any depreciation).

Consequences:

– The ECU would have neither an "independent" or "abstract" value, nor an independent market interest rate: the latter would probably be some weighted average of national interest rates (minus some allowance for the option element embedded in its definition, plus or minus some margin bearing on the hard-ECU's usability as a means of payment and market recognition).

– The ECU would not be a new 13th currency to be included in the ERM, and the ECB would not be able to conduct an active monetary policy. No arbitrage possibilities would exist between any "artificial" ECUs and the ECB's liabilities.

– The ECU would keep a fixed central rate vis-à-vis the strongest EC currencies, i.e. the ECU'S performance would always match (although never outperform) that of the best performing EC currencies.

– Its basket, non-abstract definition would not hamper in the least the use of the ECU as a Community-wide means of payment, as the external gold convertibility of sterling until 1931 and of the dollar from 1934 to 1971 did not hamper (but rather helped!) their use as international vehicle currencies.

– The basket "definition" of the ECU should be just understood as a mathematical formula to fix the ECU'S official value. Therefore, the issuance of ECU denominated liabilities does not imply per se any issuance of the individual currencies used in the ECU's formula.

Justification:

Of 2.1. ("basket-ECU")

– More consistency with the Delors Report, in which paragraph 47 criticizes strongly the parallel currency strategy.

– Having just one ECU, avoiding the potential problems of coexistence of a "hard, abstract ECU" with the traditional "basket-ECU".

– Building on existing institutions and market practices.

– Avoiding the potential risk of an artificial "interest rate competition" among the new monetary institution and national Central Banks.

Of 2.2. ("hard-basket")

– Consistency with the recent European Council's call for a strengthening of the ECU.

– Additional strength and prestige for the European currency, something economically desirable and especially important for those countries with a national currency traditionally stronger than the current ECU, which remain understandably reluctant to endorse the concept of an EC currency of lesser quality than its national one.

– Facilitating the removal of indirect restrictions of capital movements resulting from exchange-risk “prudential” regulations on insurance companies and pension funds, thereby expanding the demand for ECU assets.

3. The transitional nature of the scheme.

The present scheme is legally framed as a Stage two, transitional provision of the Treaty, which should formally declare the ECU as the future EC single currency with no discontinuity between the current, the Stage two and the Stage three, abstract ECU.

<u>Consequence:</u>

– Treaty language should refer only to the “ECU”, with expressions like “hard-basket ECU or “hard-ECU” remaining colloquial terms not to be enshrined in the Treaty.

<u>Justification:</u>

– Consistency with the Delors Report and the concept of EMU (see Spain’s “EMU: staying the course”, September, 1990).

– No disruption of the private ECU market.

4. Issuance of ECU liabilities.

The ECB will issue <u>ECU notes and coins</u> and will accept <u>ECU deposits</u>, against surrender of EC national currencies. The ECB would have the <u>monopoly</u> of issuance of ECU notes and coins, but these would <u>not</u> have <u>legal tender</u> status except in those countries which so decided (i.e. the ECU could be considered a “foreign” and not a “domestic” currency for national monetary purposes). The ECB would sell (issue) and buy (redeem) ECU notes, coins and deposits in unlimited amounts against EC national currencies, at the (basket-determined) market exchange rates.

The ECB would keep with national Central Banks the EC national currencies received in exchange for ECUs (see however point 6 below).

<u>Consequences</u>:

– The ECB would not create net liquidity, but just act as a <u>“Currency Board”</u> or <u>“Substitution Account”</u>, which would facilitate and monitor the process of currency substitution.

Its issuance of ECU notes and coins would not represent monetary “sovereignty”: the ECB would be as sovereign as some Scottish banks are today, because it would be subject to a <u>100% reserve requirement</u> with national Central Banks.

– If that were the wish of Member States, the "official convertibility provision" (i.e. the exchange by the ECB of ECUs into EC currencies and vice versa), through the use by the ECB of specific ECU exchange rates consistent with the ERM parity grid, could be potentially designed so as to make redundant most ERM interventions by national Central Banks.

– The ECU exchange rate of each national currency would become the most visible one, as envisaged by the European Council in 1978 when the EMS was created, thereby facilitating the future replacement of national currencies by the ECU.

Justification:

– Allowing EC citizens and companies to enjoy the savings in transaction costs from using a common currency (e.g. ECU notes and coins) since the beginning of Stage two, thereby enhancing the popular visibility of the EMU project.

– Establishing a clear link between the "private" ECU (i.e. commercial bands' ECU liabilities) and the "official" ECU (i.e. ECB' s liabilities).

– Relieving EC commercial banks from the need to create "synthetic" ECU assets if a market imbalance between ECU assets and liabilities were to exist during Stage two.

5. ECU clearing and payment system.

The ECB would be Central Agent for the private ECU clearing system, as well as ECU fiscal agent for EC institutions and willing EC governments.

Consequences:

– All banks belonging to the "ECU banking association" (ABE) and EC institutions would open accounts with the ECB.

– The ECB would replace the Bank for International Settlements as agent of the private ECU clearing system.

Justification:

– Facilitating the supervision by the ECB of the ECU interbank market.

– Building on existing private ECU clearing arrangements.

– Starting during Stage two some future operations to be centralized in the European Central Bank during Stage three.

6. ECU swaps of the ECB's national currency holdings.

The ECB would conduct automatically with national Central Banks short-term callable swaps into ECUs of all EC currencies held by the ECB. These swaps would be real, so that the ECB would enjoy a full ECU exchange-rate cover on the entire amount of its national currency holdings.

Consequences:

– The swaps would differ from those carried out at present between the FECOM and Central Banks in some technical aspects:

• The swaps would be real ones, and not just an accounting device.

• The ECB would be the party getting an ECU asset, in exchange for an EC national currency (rather than gold or dollars). For national Central Banks the situation would, however, resemble their current position when borrowing under the Very Short Term Financing Facility of the ERM, in which debts are recorded in ECUs.

– The ECB could call the swaps at any time in case of need, in order to redeem (buy) its own ECU liabilities into EC currencies.

Justification:

– To preserve the ECB's financial balance while, at the same time, avoiding that the ECB gets "double compensation" from its holdings of "soft", high-yield EC currencies (i.e. the yield differential plus "maintenance of value" payments).

7. Limits of ECB's holdings of individual national currencies.

Once the ECB holdings of any specific EC currency attained specific thresholds, the ECB would, first, impose penalty rates on the terms of any additional swaps; later, require the Central Bank to buyback immediately its own currency ("asset settlement of excess holdings"); and, finally, refuse to issue (sell) ECU liabilities against that specific currency ("suspension of official convertibility").

The thresholds would be established by the ECB in a non-discretionary way, according to some objective rule. The rule would have to be, however, flexible enough to allow for a "natural", non-pathological process of currency substitution.

Justification:

– To establish non-discretionary, objective limits to the "credit" given by the ECB to individual Central Banks when holding their currencies.

– To increase the credibility of potential ECB "sanctions" on individual Central Banks by allowing for an automatically "graduated response".

– To set up a procedure which would require the ECB Council to monitor monetary growth in individual EC countries.

8. Third currencies.

The ECB would be authorized to hold and manage non-EC currency holdings as Trustee for national Central Banks.

Justification:

– The ECB may play a useful role in the coordination of foreign exchange national policies. But, beyond a strengthening of consultation procedures, some voluntary "pooling" of foreign exchange reserves could be envisaged during Stage two. This should reinforce the impact on the market of any intervention, as well as pave the way for the full centralization of reserves to take place in Stage three.

9. ECB lending.

During the course of Stage two – but not necessarily since its beginning – the ECB could be allowed to lend short term to EC commercial banks (e.g. by accepting short term overdrafts) up to a limit ("lending authority") not exceeding, for instance, the ECB's capital.

Justification:

– To allow the ECB to help balance the private ECU market in case the traditional excess of the supply of ECU liabilities over demand for ECU assets were to persist into Stage two, thereby relieving EC commercial banks from the need to create "artificial" ECU liabilities.

10. Reserve requirement (*).

The ECB (and not national Central Banks), by a unanimous decision of its Council, would be empowered (but not required) to impose a reserve requirement on ECU liabilities of EC banks. If it were imposed, subject to potential transitional arrangements for individual Member States, it would be expected to be a uniform one and to be covered with deposits in the ECB.

Justification:

– In light of differences in national money multipliers, to allow the ECB to control any indirect money creation resulting from the substitution of the ECU for EC national currencies.

– To set in train a process of coordination and harmonization of national reserve requirements.

(*) This point might prove to be a controversial aspect of the scheme, which is not essential at this stage, and warrants more in-depth analysis. Consequently, it appears in bracketed form in article 109 e. 5 iv) in the Annex.