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A. D. CROCKETT
EXECUTIVE DIRECTOR

4 July 1990

Mr Gunter Baer
Secretary General
Committee of Governors of EC Member States
Bank for International Settlements
Centralbahnplatz 2
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Basle

Dear Gunter

You may remember that at the meeting of the Governors Alternates last Friday, I was asked to circulate a written version of the remarks I made about the UK Stage 2 proposals. I attach a version of these remarks, which I would be grateful if you could arrange to circulate to colleagues. Please note that these remarks were made in a personal capacity and are circulated to Alternates in that spirit.

With best wishes

Yours sincerely

Andrew

A D Crockett

THE HARD ECU AND THE EUROPEAN MONETARY FUND

1 In these brief remarks, I would like to describe in a little more detail the basic purposes which we believe would be served by the proposals for stage 2 put forward by the Chancellor of the Exchequer. I will go on to say why we believe that these proposals address the potential risks of a parallel currency that were highlighted by the Delors Committee. I will end up by giving some indications of how the Hard ECU proposal would work in practice. At this stage, my remarks will not be comprehensive. Rather, I will aim to give an overview of the operational aspects of the proposal, so that colleagues have an opportunity to pose particular questions later.

Purposes of a Stage 2

2 I think we all recognise that the transition from a stage 1, in which there are separate national currencies fluctuating within the narrow band of the ERM, and in which the option of realignment remains a possibility, to a stage 3 in which realignments are completely ruled out and there is a single currency with a single monetary policy, is a large one. However, given the reality that monetary policy is indivisible, many observers have seen no alternative, in effect, to a jump from stage 1 to stage 3, perhaps with a brief "training period" in between. We understand the reasoning behind this conclusion. Nevertheless, we consider there are significant dangers in moving to full monetary union before the necessary convergence has been achieved, before the changes introduced by the single European Act have been properly absorbed and before adequate experience has been gained with the co-ordination of monetary policy. It therefore seems to us important, if it can be made practicable, for a smoother transition to take place, during which full convergence of policies can be achieved, the necessary integration of the real economic sectors of our economies can proceed, price stability can be entrenched and familiarity can be gained with the ECU. This is

the first reason why we believe a substantive stage 2 can serve a valuable purpose.

3 A second purpose of the UK proposals is to provide a credible, Community-based focus for the convergence of policies towards price stability that we are all seeking to promote. So far, the Deutschemark has provided an anchor for expectations, and a focal point for the monetary policies of partner countries. We all owe a debt of gratitude to the Bundesbank for the manner in which the Deutschemark has been managed, and the service it has thus provided to the other members of the Community. However, the time has come, we believe, to look forward to a situation in which a single central bank will not be expected to bear alone the task of providing a nominal anchor to the system. We believe that mechanisms can and should be put in place to ensure that Community disciplines for price stability are as strong, or even stronger, than those that exist within a DM dominated ERM.

4 Third, let me also note a political dimension to the proposals that the UK government has put forward. We recognise that many, or most, of our Community partners have accepted that a transition to a stage 3, of the kind that we are in the process of discussing, should take place at a relatively early stage. We also, however, have to face the reality that in certain member countries, including the United Kingdom, there are still significant political and constitutional reservations about the ultimate move to a single currency in Stage 3. One purpose of our proposals, therefore, is to seek a way forward that is fully consistent with an eventual move to Stage 3 - and moreover in no way retards the objective of moving to a stage 3 once the necessary conditions of convergence have been met - yet at the same time enables governments to defer the ultimate political decision on participation in the final stage of the union until greater experience with the intermediate stage has been gained.

<u>The Dangers of a Parallel Currency</u>

5 Let me now turn briefly to the objections that have often been raised to parallel currencies. There are two principal objections: the first is that a parallel currency constitutes an

additional source of credit creation that complicates the management of monetary policy throughout the Community. The second is that a thirteenth currency could create confusing signals about who was responsible for monetary policy within the Community. We think that these are legitimate concerns, and we endorse the reservations that were expressed by the Delors Committee in this connection. However, we believe that the new proposals put forward by the British Treasury and ourselves provide the appropriate safeguards.

6 How are the safeguards provided? In the first place, the creation of ECUs can only come about when national currencies are surrendered to the new institution in exchange for ECU claims. Therefore, at the point of creation of ECUs there is an equivalent extinction of national currency. We recognise, of course, that this, in itself, is not sufficient. It would still be open for a national central bank to create additional domestic money to offset the money that was extinguished - or, more generally, to conduct an insufficiently tight monetary policy. This is where the particular aspect of our proposal, that is absent from the earlier BIEC proposal, comes in. To the extent that the new institution (the EMF) receives national currencies, it will always have the right to put these currencies back to national central banks in exchange for "hard" assets. Thus, if a member central bank is running an excessively loose monetary policy, and this is resulting in the national currency concerned being exchanged for ECU denominated deposits, the national central bank will find itself either losing reserves, or having to underwrite the ECU value of the national currency holdings of the European Monetary Fund (EMF). Provided the EMF is managed in a firm anti-inflationary fashion, therefore, it will neither contribute to monetary laxity itself, nor act as a vehicle by which monetary laxity is permitted at the national central bank level. (This means, of course, that the Managing Board of the new EMF must be endowed with the same kind of independence and responsibility for price stability that we are all envisaging for the ultimate ESCB.)

7 The second objection to a parallel currency is one often made by President Pöhl, that monetary policy must be indivisible and

there must be no mixing of responsibility. We believe our proposal meets this criterion. Each national central bank is responsible for its own monetary policy; and the Board of Management of the EMF is responsible for the maintenance of value of the Hard ECU. There is no ambiguity about the responsibility of the managing authority (the EMF). It is to maintain the value of the ECU in terms of the strongest currency, and to ensure that continuous downward pressure on inflation is maintained. Similarly, there is no ambiguity about the responsibilities of individual national central banks. Their participation in the narrow band of the exchange rate mechanism means that they will manage their currency (with regard to other currencies and the ECU) in exactly the same way as they currently manage their currency. In other words, they will attempt to maintain the value of their currency in terms of the agreed standard (the ECU), although in extremis they will have the opportunity to realign in the same way as they can now. National authorities will, of course, in managing national policies, have to take account of the market influence exerted by the collective management of the ECU, and it is through that influence that the EMF can give a counterinflationary emphasis to policy through the Community, contributing to the stability necessary for a successful move to MU.

8 Perhaps I might note at this stage that I have not referred to the possible role of the Hard ECU as a circulating medium of exchange. This feature was referred to by the Chancellor of the Exchequer, and is indeed a possible line of development. However, we in the Bank of England would prefer to focus on the function of the ECU as a focus for policy convergence and price stability. We would certainly not rule out the use of the Hard ECU by private individuals and entities - as a medium of exchange. We believe that the new Hard ECU might have a significantly greater attraction for wholesale purposes than the present basket ECU because of its greater strength. The evolution of a retail ECU, however, is an additional development which is not, in our view, the key policy element of the proposal.

Operational Aspects of the Hard ECU

9 Most of the relevant operational aspects of the UK proposal are described in the memorandum which I circulated to members of this Committee last week. In brief, we envisage that a new institution would be established, capitalised from contributions from member central banks and charged with the responsibility of managing the development of the Hard ECU in such a way as to preserve its value in terms of the strongest Community currency. Once the new institution was established, ECUs would come in to existence through economic agents making deposits at the Hard ECU bank in national currency. They would receive in return claims denominated in ECU. The new institution would initially have a balance sheet with claims denominated in national currencies and liabilities denominated in ECU. (The speed with which its balance sheet increased would, of course, depend upon the level of interest rates offered for deposit at the new institution.) Its operation - which would need to be conducted with the primary objective of maintaining the value of the ECU - could consist of the following:-

(i) it could return its holdings of EC national currencies to the issuing central banks and require to receive ECUs (or non-EC hard currencies) in exchange.

(ii) it could buy or sell ECUs in the foreign exchange market in exchange for non-EC currencies.

(iii) it could borrow non-EC currencies (by taking deposits or issuing securities) in the open market and invest its holdings of non-EC currencies.

(iv) it could borrow ECUs (by taking deposits) in the open market and buy ECU denominated assets.

The combination of (i) and (iv) should provide the EMF with the capacity to create market shortages of ECU and to manage EC interest rates, in the same way as national central banks manage the interest rates in their own national currencies. These operations would unavoidably involve risk of loss, and the EMF would need capital and/or guarantees sufficient to cover the risks.

10 We have come to call the feature of the proposal by which the Hard ECU bank is permitted to put back to national central banks holdings it acquires of national currencies the "closing of the loop". This feature means that the Hard ECU bank has considerable power to ensure that appropriately tight monetary conditions are maintained throughout the Community.

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Although I could not spend too much time with this, here are some ideas on the UK proposal.

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José Viñals.

3 July 1990

COMMENTS ON THE MOST RECENT UK PROPOSAL

1. The UK proposal for the process of European Monetary Integration beyond stage 1 presented by the Chanceller of the Exchequer on 20 June 1990 constitutes a welcome change in the British attitude towards this process. Indead, if one carefully compares this late proposal to the earlier British proposal it is clear that the British authorities now accept the possibility and desirability of going beyond Stage 1 to a true monetary union with a common currency -and even a single currency- and a supranational monetary authority. Thus there is now complete agreement among all Community member states about the final goal of EMU, as stated in the Delors Report.

2. Nevertheless, the new British proposal still argues in favour of a different transitional period in going from Stage 1 to Stage 3 from that outlined in the Delors Report. Namely, this alternative transition should be: (a) based on market mechanisms; (b) gradual and evolutionary; and (c) consistent with the subsidiarity principle. In essence, the British proposal is to establish a "hard ECU-standard" (alike the Gold Standard) managed by a European Monetary Fund to insure a succesful process of gradual crowding out of the different national currencies by the parallel hard ecu currency in a non-inflationary Community environment.

3. While I can find some political advantages in the new proposal, I still fail to see clearly why it should be considered superior -or as good as- the plan outlined in the Delors Report, and even to other more recent proposals like those of Tygesen-Gros and Giovannini. In short, my comments in the rest of the note suggest that the proposal:

a- Does not facilitate but rather adds complexity to the monetary coordination process.

b- May jeopardize Community-wide price-stability and the reduction of intra-Community inflation differentials.

c- May induce foreign exchange market tensions thus delaying and even damaging the prospects for further exchange rate stability.

d- May produce a crowding-out of the hard ecu by the national currencies of countries following fiscally undisciplined policies.

In sum, because of the above reasons I believe that the British Proposal will not help smoothing the transition from Stage 1 to Stage 3 and, in fact, may even delay the whole monetary integration process pushing backward the begining of Stage 3.

4. The logic of the proposal is that by creating a hard ecu and by guaranteing its value vis-à-vis the strongest Community currency there will be a gradual crowding out of national currencies by the hard ecu thus leading to a true common -parallel- European currency and, eventually, to a single currency if the private sector and governments so wish.

However, it is not clear why there should be a stable demand for the hard ecu in the EC. While it is likely that agents may want to invest in the hard ecu habilities issued by the EMF if the ecu interest rate is 1) atractive enough, it is not clear who would want to borrow in hard ecus. Moreover, while it is certain that the hard ecu will not be used as a means of payments as long as it does not have the same legal status as national moneys, it is not evident either that it would be significantly used as a means of payments for domestic transactions even if granted 2) this status since local habits only disappear very slowly.

Finally, as parity realignments become more of a remote possibility it is even conceivable that the hard ecu will be driven out of the market by the national currencies of fiscally undisciplined countries. For example, if a country runs a very expansionary fiscal policy and finances it by borrowing this will put an incipient upward pressure on domestic interest rates bringing in capital flows. Private agents will then go from ecu and other currencies to the fiscally undisciplined country's currency. To avoid an appreciation of this last currency there will then be foreign exchange market intervention consisting on sales of this currency and purchases of ecu and other currencies. Thus there will be an increase in the "bad" currency supply relative to the supply of ecu and other "good" currencies. "Bad" money drives out "good".

5. While I think that there will not be a gradual increase in a stable demand for ecu liabilities, there may be nevertheless traumatic sudden bursts of ecu demand whenever the market suspects that there may be a realignment. One could argue that the threat of speculative attacks on the verge of a realigment will happen under full capital mobility either in the Delors or in the alternative British plan. Nevertheless, the prospect of having a well-specified currency which will always appreciate relative to the (N-1) remaining national currencies may in fact trigger larger speculative attacks. Indeed, it is conceivable that the hard ecu will not only follow the Nth hardest Community currency in a realigmment but that it may even initiate a realigmment if there is a flight for ecus assymmetrically divided among EC currencies. Obviously, this would complicate the already very difficult task of preserving exchange-rate stability by giving the markets a new and superior possibility of speculation to add to the 12 already existing.

Furthermore, this will only increase the demand for ecu temporarily -on the verge of realigments- while ecu holders will switch back to national currencies after realignments(to use as means of payments in domestic markets) once they have made large capital gains.

6. Even if the above problems were absent and there was a gradual and relative symmetric substitution of ecu for other Community

currencies, it is still not clear that the British proposal guarantees or contributes to a <u>non-inflationary</u> environment. While it is true in principle that there will not be net money creation in a EC-wide sense derived from the transformation of national currencies into ecu liabilities of the EMF, this in no way prevents a 13th source of money creation coming from EMF [redacted] foreign exchange intervention operations vis-à-vis third currencies. Moreover, it is not clear either that there will not be net EC-money creation as a result of the operation of the EMF even if the repurchase obligation described in the proposal is introduced, as long as national central banks can sterilize repurchases to maintain monetary targets. In this case there will still be a net addition to EC liquidity.

7. The proposal suggests that the EMF can influence the liquidity conditions in Europe by moving the <u>ecu interest rate,</u> and therefore provoking a similar movement of the 12 national interest rates. However, this means that at best there will be 13 rather than 12 players in the monetary coordination process, making it therefore more complex. On the other hand, it is not clear that there will be such a complete freedom of manouver by the EMF since its interest rate level will not only be affected by intra-EC considerations (ie. EC-wide price stability) but also by extra-EC considerations (as long as the Community wishes to stabilize its ecu exchange rate vis-à-vis third currencies).

But, most important of all, the ecu interest rate will most likely be a follower of other national interest rates in the Community rather than a leader (as pressumed in the British proposal) as long as there is not a large and stable ecu demand. The reasoning in section 4 above indicates that the likelihood of a weak ecu demand in the foreseable future will not permit the EMF to exert any significant and lasting influence on the level of national Community interest rates. Rather the ecu interest rate will largely depend on the national interest rate in the strongest economy (for instance, nobody believes that interest rates in Germany are affected by interest rates in Greece but the other way around).

8. To conclude, while the British proposal is not without merit it <u>does not seem to improve the prospects for a smooth transition from Stage 1 to Stage 3, and might even make it more difficult to reach this last Stage</u>. It is therefore globally inferior to the Delors Report proposal, although this last proposal also needs further elaboration to avoid the risks during the transition associated with the increasing currency substitution in the face of imperfect monetary policy and non-existing fiscal policy coordination.

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N L Wicks CVO CBE
Second Permanent Secretary

Members of the Monetary Committee

21 June 1990

Dear Colleague

You may like to see the speech which the Chancellor of the Exchequer made last night to the German Industry Forum here in London. A copy is attached.

Yours sincerely

Nigel Wicks

N L WICKS

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CHANCELLOR'S SPEECH TO GERMAN INDUSTRY FORUM: 20 JUNE 1990

ECONOMIC AND MONETARY UNION: BEYOND STAGE 1

Tonight, I want to deal with one of the most important issues on the current political agenda: the future of economic and monetary union in Europe. It is a hugely controversial subject, but I know of no other that is of such importance to the future direction and influence of the Community.

2. The Delors Report on EMU, with its 3 stage model, is at the centre of that debate but it does not present a universally acceptable prescription for the future and certainly cannot be the final word. But although we have substantial objections to the Delors prescription, that does not mean that we cannot make progress. I believe we can, and will - and I don't just mean on Stage 1.

3. Of course Stage 1 is vitally important. It starts in ten days' time, and will entail the construction of a Single Financial Area in the Community, with a single market in all financial services, and wholly free movement of capital. That is a massive task - by any yardstick - which will mean an enormous amount of hard work for many people. But it is a task to which we in the UK are wholly committed. And our commitment is not merely expressed in words, but also - and more importantly - in deeds. A Commission report at the end of March found that the UK and Germany lead the rest of the Community in this respect, the UK having enacted all but 9 of the single market measures due for implementation by then, and Germany all but 11. Some other member states have as many as 30 or even 50 measures outstanding. I need hardly make the obvious point that we need faster progress than that.

4. Stage 1 also involves the completion of the exchange rate mechanism. The UK is firmly committed to taking

sterling into the exchange rate mechanism of the EMS. This we shall do, as I have made plain on innumerable occasions, when our well-known conditions are met. I restate that commitment yet again.

5. But the starting point for my remarks tonight is a world where Stage 1 is in place. For the debate about what comes then is moving rapidly forward. In a few months' time the economic and monetary inter-governmental conference will begin. That is a perilously short time when the Community is so far from reaching agreement on the practical steps needed to develop the Community's institutions. We need to debate these matters fully and constructively and reach conclusions that take all of Europe's nations forward together. Tonight I would like to indicate some fresh developments in our thinking.

6. Our approach builds on the paper I published last November that set out principles which should guide the future development of economic and monetary integration in the Community. We believe that any change:

- should be gradual and evolutionary;

- should work with the grain of markets;

- should respect the principle of subsidiarity - namely that functions should not be carried out at Community level when they can satisfactorily be carried out at national level;

- and we believe that any change should strengthen the forces making for stable prices.

7. We do not believe the ideas currently being worked on meet these criteria and we continue to have fundamental reservations about them. The core of our concern is that a

Central Community Bank - a Eurofed - would not be accountable to elected Governments even though the electorate would look to these Governments to ensure their economic wellbeing. The British House of Commons recently made it quite clear that the lack of accountability in what is proposed is unacceptable. Moreover we do not believe that the single monetary policy and the single monetary authority that are envisaged would deliver the economic performance and inflation performance that the Community will need in the future.

8. These are significant disadvantages that cannot lightly be brushed aside. But this does not mean that some form of EMU is not desirable - it clearly is - or that there are not other - better - ways of achieving convergence and low inflation, throughout Europe. And this could well involve institutional and currency development. That is the theme of the ideas I shall be putting forward tonight.

9. In particular they address the very practical question of where the Community should be looking to go once Stage 1 has been completed. It is generally recognised that this is one of the weaker points in the current debate. But it is a no less crucial question for that. For this reason, I have to say I view with concern recent suggestions from some quarters that the Community could do without Stage 2 altogether. I do not think that is practical.

10. It may well be that this latest outbreak of Big-Bangism has been triggered by events in Germany, where a very rapid transition to monetary union is envisaged. We all, of course, welcome the momentous changes in Germany. But we must beware of drawing false parallels with events on the broader European canvas. What is happening in German monetary union is that a large and healthy economy, and a strong currency, is absorbing the declining economy and weak currency of the GDR. It is - to all intents and purposes - a

takeover, willed by both sides, and with economic consequences primarily affecting Germany. EMU is a much bigger, and wholly different, proposition.

11. One of our main concerns about the idea of an EMU "big bang" is that it presumes a far greater degree of convergence of economic performance than is yet available, or in prospect. I might add that it is far from self-evident to me that such convergence is to be achieved by means of a single common monetary policy. On the contrary, the significant differences in inflation between the economies of the Community probably require that for our inflation performances to converge, our interest rates must diverge - as indeed they do at present. That does not suggest a swift move to a single European monetary authority; indeed it argues strongly against it.

12. All those who are most anxious to set in place successful movement towards economic and monetary union should hold fast to this: without greatly increased convergence, monetary union simply would not work. A premature attempt to implement it would be unsustainable, and hence a huge setback, damaging both economically and politically, and would lead not to unity, but to disunity. Indeed there are already signs of that happening.

13. What we decide about economic and monetary union should be determined by our view about the kind of Europe we want to see. Our vision is of an open Europe: open to trade and investment; open too to new members from Europe, East and West. We welcomed to Community membership some of the newly democratic countries in Southern Europe. Now several of the countries in Eastern and central Europe see very clearly the benefits of membership of the Community. In due course we should welcome this prospect, when their political and economic systems are ready. We should develop a form of EMU

that permits them to join us and does not put up barriers against it.

14. To my mind that argues even more powerfully for a gradualist and evolutionary approach, and against any attempt to move to a rigid and closed structure. It suggests that we should look for arrangements that promote convergence - and particularly convergence on low inflation - while retaining flexibility and choice.

15. We believe that we can now see a way forward which does precisely this. We believe that whatever the outcome of the debates about the longer-term, in the short and medium-term there are steps the Community could - and should - be taking which are valuable and useful in their own right and which would take the process of economic and monetary convergence further.

16. The issue need not be so divisive. The key is to build on Stage 1 further steps to promote convergence of economic performance, low inflation and stable exchange rates. And to do so by building up our infant common currency - the ecu.

17. A first practical step towards this might be to encourage the use of the existing ecu by issuing ecu bank notes for general circulation in the Community. This would require a new institution which I shall call the European Monetary Fund. The Fund, acting as a currency board, would provide ecus on demand in exchange for Community currencies. This can be done in such a way as to avoid increasing the Community's total supply of money. To ensure this, we would insist that the Fund could only issue ecu notes that were fully backed by its own holdings of the various currencies which make up the ecu. So there would be no new money creation, and no threat to inflation. Interest rates on ecu deposits and loans would be determined, as now, by the weighted average of interest rates on the ecu's constituent

currencies and so the Fund would play no role in setting interest rates.

18. Ecu bank notes could provide a natural currency for tourists and business travellers. The idea could catch the popular imagination; and as notes came to be used more frequently it could help the development of largescale markets in ecu deposits.

19. But these are modest steps, and I think we could and should go further. In my view, the best approach is the creation of a new "hard ecu". Under this approach the ecu would no longer be defined as a basket of currencies but would become a genuine currency in its own right - a new and international currency - which would never devalue against other Community currencies. A version of this approach has been canvassed in a recent paper by the British Invisible Exports Council under their Chairman, Sir Michael Butler. Our proposals are rather different, but I readily acknowledge the debt they owe to his.

20. Under our approach, the European Monetary Fund which I have suggested would manage the hard ecu to ensure that, in the ERM, it stayed within its margins, and that at realignments it was never devalued. The EMF would issue ecu deposits or notes in exchange for national currencies. It would set interest rates on hard ecu. Initially, it would do this by setting rates on the interest bearing deposits it took, probably largely from commercial banks. Later on, as the private hard ecu market developed and commercial banks built up hard ecu deposits taken from the public, the EMF could move to setting interest rates by the normal central banking techniques, namely through the creation of money market shortages which would then be relieved at the chosen interest rate.

21. A traditional criticism that has been made of certain parallel currency proposals is that they could raise inflationary dangers. I share that concern. But a crucial element of the scheme I propose - indeed, my very reason for advocating it, is that effective safeguards could be built in to prevent this. So a key feature of the proposal is that there would be an obligation placed on all member states' central Banks to repurchase their own currencies from the EMF for hard currencies. This repurchase obligation would ensure that the combined effect of the Fund's own money creation - through the issue of hard ecu liabilities and the influence it exerted on money creation by national central banks - was not inflationary.

22. It will be noted that both these ideas for developing the ecu envisage the development of a new institution. Let me explain why I have no qualms about such an institutional development. We are not opposed to new institutions where there are new jobs that genuinely need to be done. And that is certainly the case here. For not only would we be looking at the job of managing the ecu; there are other important roles such an institution might usefully take on. These might include the tasks involved in managing the ERM, and its financing facilities, including the functions of the central Bank Governors Committee and the existing European Monetary Cooperation Fund (EMCF) in this area. An additional function could be medium-term balance of payments lending: to the extent that the Community is involved in this, the new institution could help in managing it.

23. It might also take on the essential task of coordinating member states' intervention against external currencies: in particular, the dollar and yen. By the end of Stage 1, all Community currencies will be members of the ERM and will share a common interest in the value of their currencies against the dollar and the yen. This coordination would not involve member states giving up part of their foreign

currency reserves. Instead, intervention would be coordinated through the EMF, which would draw and repay tranches of dollars, yen and national currencies, as necessary, from member states. Market operations, as now, would be carried out by individual national central banks.

24. All these are key functions that will be vitally necessary in the world beyond Stage 1. It makes practical sense to have a new institution - an EMF - to carry them out.

25. There is much discussion about the final stages of EMU. And more than one version of it. In those discussions, the UK will play a full and constructive part. But whatever the outcome of that debate may be, the evolutionary process advocated by the UK, the further ideas I have sketched out this evening - for promoting greater economic and monetary integration beyond Stage 1 - must be fully considered. They offer a way forward around which all Europe should be able to unite.

26. They will, I know, be controversial to some. But they are practical. They are progressive. They offer choice not prescription. But they evolve naturally from stage 1 and have the potential to evolve further. In time the ecu would be more widely used: it would become a common currency for Europe. In the very long term, if peoples and governments so choose, it could develop into a single currency. But that is a decision we should not take now, for we cannot yet foresee what the size and circumstances of the new Europe will be. In addition the development of a hard ecu should promote lower inflation and thereby greater exchange rate stability. And most importantly of all, the steps we propose have the advantage of retaining choice, diversity and flexibility. I believe they represent a practical and sustainable way forward for Europe.

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A.D. CROCKETT
EXECUTIVE DIRECTOR

21 June 1990

cc M Bascoul
M Scheller
M Stahlae
+
Dr Baer

Andrew Giles Esq
Secretariat du Comite des Gouverneurs
Bank for International Settlements
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21/6/90

Dear Andrew

Following the Governor's letter yesterday, I am enclosing a brief technical paper on the operational requirements of a scheme along the lines set out there. I hope this will be useful in providing additional background about the kind of institutional developments we have in mind. I am, of course, available to you for any additional information you may require and I look forward to discussing these proposals in more detail when we next meet.

Yours sincerely

M.L. Vermocke

pp A D Crockett

21. 6.90

THE HARD ECU IN STAGE 2: OPERATIONAL REQUIREMENTS

1 This note suggests how a new banking institution on the lines of the BIEC scheme might operate in practice during Stage 2 and what safeguards would be needed to ensure that it would not be a potential source of inflation.

The new currency

2 The first step would be to redefine the ecu as a new hard currency whose parity would never be devalued against any ERM currency. The definition would provide that its central rate, which could be changed only as part of a more general realignment, would at realignment always move up in step with whichever happened to be the strongest currency. The hard ecu would be subject to the same (narrow) margins of variation as the other ERM currencies, whose central rates during Stage 2 would become increasingly fixed, but not irrevocably. The credibility of this definition would depend on the constitution and management of the issuing bank ensuring that it remained at all times solvent, and so able to meet its liabilities in full.

The issuing bank

3 A new institution (termed here, for illustration, the"Hard Ecu Bank" or HEB) would be set up to issue and manage the new currency. It would be owned and controlled jointly by participating national central banks as shareholders. The new institution could stand on its own, or be part of a larger institution with multiple functions, like the new EMF suggested in the Chancellor's speech to the German Industry Forum on 20 June. Participating central banks would subscribe capital (or commit themselves to do so on request) in agreed proportions reflecting relative economic size as measured, for example, by GNP. The capital or guarantees would be needed because the HEB would necessarily undertake financial risks, as well as to determine voting power on the HEB's governing board, and perhaps to provide income. In the latter case, some capital would need to be paid up and invested in

interest-bearing assets, in amounts sufficient to meet the HEB's initial operating expenses. The bulk of capital could however be uncalled, but it would commit the shareholders to meet whatever losses the HEB might suffer, subject perhaps to certain pre-agreed limits. However denominated, there would have to be some mechanism for adjusting the shares of individual banks to reflect changing economic strength.

4 If absolute credibility were to attach to the commitment to maintain the value of the hard ecu, this commitment would need to be unlimited. It would, however, be the task of management to limit the extent of possible loss, balancing that risk against the requirements of creating a competitive and durable new currency. The interaction between these two objectives is discussed in paragraphs 7-9 below.

5 The HEB would essentially be a deposit-taking and currency-switching institution. Its business would consist of receiving deposits in national currencies from the general public (probably, but not necessarily, channelled through commercial banks) which would become its initial asset; in return it would issue deposits denominated in hard ecu and these (apart from capital) would comprise its main liabilities. The HEB would be free to accept and convert national currencies on demand at the market rate, subject to an obligation to purchase at an intervention point set at the lower margin of variation against the currency's ecu central rate. It would also undertake to supply national currencies against ecu at the upper end of the range. The HEB would not be confined to issuing deposits. It would also be empowered to issue hard-ecu currency notes.

6 Currency notes apart, the HEB would need to offer interest on its ecu liabilities, in order to stimulate demand for them. They could span a range of maturities or notice periods, with corresponding interest rate terms, and could take the marketable form of CDs. Only at a mature stage in the hard-ecu's development, and probably only when it had been complemented by the provision of a central clearing and settlement system for commercial banks participating in ecu-denominated business, would any significant

demand be likely to emerge for non-interest-bearing, operational deposits. In time, numbers of commercial banks might hold operational balances in hard ecu at the HEB and if so these would be a means whereby the new institution could exert increasing influence on monetary conditions throughout the system. The implications of that development are considered further below, in paragraph 14.

The repurchase obligation on central banks

7 It is the management of the HEB's assets which poses the more difficult questions. One objective would be to contain the risk of loss arising from a mismatch - by currency, maturity term or interest rate - with the liabilities described above. A second objective would be to assert appropriate pressure for policy action on the issuing central bank(s) of the currency(ies) which were offered for conversion to the HEB. This means not simply that the issuing central bank(s) would be impelled to correct any policy weaknesses that had caused their currencies to be on offer - as in the HMT "competing currency" proposal. It also requires that the combined effect of the HEB's own money creation - through the generation of hard-ecu monetary liabilities - and the influence it exerted on the money creation of the national banking systems would be beneficial to the anti-inflationary ambitions of the Community as a whole. There is potential conflict between these objectives.

8 The conflict would be lessened if the HEB had prearranged protection from the currency mismatch created by the initial conversion operation described in paragraph 5 above, by being empowered to require issuing central banks to repurchase, against hard currency, balances in their currency which the HEB acquired, and/or to provide a maintenance of ecu-value guarantee of them. In effect, central banks would be required to support their respective currencies at close to their ERM central rates by spending hard currency reserves. This would both safeguard the HEB against loss, and provide leverage on the policies of the issuing central bank. The HEB's ability to "close the loop" would be an essential building block in making it an effective institution.

9 There remains, however, a range of options over how this power might be exercised. At one extreme, full discretion might be left to the HEB's management regarding the amounts of national currency that the institution might hold (and therefore the amounts that needed to be presented to national banks for repurchase); and the currencies that would be acceptable to it in the event of repurchase. Alternatively, or in addition, maintenance of value guarantees might in some cases be deemed sufficient protection for its national currency holdings up to a certain point, perhaps in association with monetary policy undertakings by the relevant national bank. However, in other cases mere guarantees on their own might leave problems of creditworthiness or ineffective response. If stronger protection were deemed necessary, limits might be imposed in advance on the quantities of individual national currencies that the HEB might hold (either as absolute amounts or proportions of its balance sheet, or both), and excess holdings required to be presented for conversion by national banks either in hard ecu at the exchange rate implied by the lower ERM margin against the currency's hard-ecu central rate; or in an external (to country of issue) currency, at the rate implied by combination of the previous rate and the market rate between the external currency (if a non-ERM currency) and the hard ecu. In the latter case, the HEB would have a currency mismatch of a different sort, which could also involve risk of loss.

10 The obligation on central banks to repurchase their currencies would exert monetary discipline through the familiar mechanism of reserve loss. National authorities would be obliged to spend their own reserves or to purchase reserves with their own currencies (in both cases extinguishing an equivalent amount of domestic monetary base), or borrow reserves in the market. Whichever action were followed, downward pressure on their currencies would ensue, which would need to be countered by raising their interest rates, and this would tend to depress national currency creation until the cause of the problem confronting the HEB had been removed.

11 If deemed necessary, automaticity could be made virtually complete, by permitting the HEB to hold only minimal working balances of national currencies, its

other acquisitions being immediately presented for repurchase by central banks. In the most extreme version, central banks would be required to supply only hard-ecu to the HEB, which might inhibit the permanent substitution of hard-ecu for national currencies, though national banks might issue their own hard-ecu liabilities. Alternatively, central banks could be required to repurchase with only the strongest ERM currency. This would limit the issue of hard-ecu base money by the HEB to the amount by which the strongest-currency central bank permitted additional external holdings of its currency.

12 The harder the monetary discipline to be exerted on individual country(ies) of issue, the greater the need to insist on immediate and full redemption in external assets. This would replicate the mechanisms of "competing currency" and ERM/VSTF arrangements if the HEB were to manage the hard ecu in a passive way, ie, by simply matching interest rates on the hardest ERM currency. A more proactive monetary role for the HEB would require more active promotion of the ecu, by outbidding equivalent interest rates (see below, paragraphs 15-17). However, this would involve it in greater exposure to risk of loss. The trade-off between monetary leverage and exposure to loss would depend on the degree of maturity of development and acceptability of the ecu.

13 In order to provide reassurance against fears that the new currency would be potentially inflationary, the HEB would probably need to develop by stages in an evolutionary process, the extent and pace of which would be carefully controlled. It might, for example, start operations purely as a currency board, perhaps issuing notes and deposits denominated only in existing ecu, with full backing in corresponding national currencies. Any scope for management of the ecu parity and interest rate would then await ecu redefinition, as would scope to hold a currency mismatch. After redefinition there would be an unavoidable trade-off between the key objectives of enlarging the HEB's monetary role and leverage, and minimising exposure to loss. Initially a high degree of discipline could be ensured by requiring full and immediate repurchase of national currencies by central banks for designated hard currency (say,

DM). If the DM were the designated currency, there would be no significant difference from a hard-EMS system dominated by the DM, except that in effect restrictions on the issue and use of the DM would be removed throughout the Community. If rigorous limitations of this kind were maintained, the new currency might remain for many years, perhaps indefinitely, a transitional device, never developing into a rival for existing currencies. However a decision could be taken at some stage, when the HEB had built up operating expertise and a good non-inflationary reputation, to allow it greater discretion to hold weaker currencies, using the room for manoeuvre thereby gained to promote hard ecu substitution on a larger scale.

14 The degree of freedom allowable to the HEB might depend on the extent to which a derivative ecu commercial banking system developed in conjunction with the new institution. In the early stages of the new currency, the HEB's liabilities, being highly liquid, would constitute a form of broad money. Nevertheless their issue would not add to the total of broad money in circulation because they would substitute for national currency deposits, and the convertibility obligations discussed in preceding paragraphs could be used, with some flexibility, to ensure that national central banks did not permit replacement of those deposits, and thus not create potentially inflationary monetary conditions. This would be something to be taken into account in managing ecu interest rates. At the "base money" level, market sales of a national currency to the HEB in exchange for ecu (and the subsequent presentation of the national currency to its issuing central bank in exchange for ecu by the HEB), would create a market shortage of the relevant national currency and an equivalent market surplus of ecu. Both of these would normally be fully offset under present arrangements for money market management in EC countries - the shortage of national currency by purchases of national currency assets by the issuing central bank, and the surplus of ecu by sales of ecu assets (or issuance of liabilities) by the same central bank, which would of course need to raise ecu in order to repurchase its own currencies from the HEB.

Managing the ecu interest rate

15 The HEB's ability to issue interest-bearing hard-ecu paper in unlimited amounts (subject to its intervention obligation), and at interest rates of its own choosing, would give it the power to manage ecu interest rates. Such operations would, if conducted with the deliberate purpose of influencing interest rates, constitute a form of open market intervention resembling the methods by which central banks normally seek to manage interest rates in their money markets. The leverage which the HEB could exert over interest rates would depend, within certain limits, on the extent to which it was prepared, through using 3-month or 6-month bills or CDs, to cause cash shortages in the ecu market, which it would then relieve on its chosen terms, being the only net source of ecu cash to the market at a whole; or on the interest rates which it was prepared to offer on overnight deposits. Such operations, even if designed to lower ecu interest rates, would not in themselves involve a permanent net injection of ecu cash into the market; they would merely affect the terms on which it was available.

16 The immediate purpose of managing hard-ecu interest rates would be to influence the exchange rate of the ecu against other currencies. A range of possibilities would be available to the HEB. At one extreme it could pursue an entirely passive or non-managed approach, in which it would set hard-ecu interest rates close to those on corresponding maturities of the strongest of other ERM currencies. In that case the rate of growth of the hard ecu would depend purely on the market's view of (i) the HEB's commitment to maintaining its exchange value, as reflected in the credibility of the guarantees provided by its shareholders; (ii) the usefulness of the new currency as a payments medium, which would depend on the rate at which associated chequing facilities and a clearing and settlement system developed; and (iii) the value of the option which the new currency would in effect provide for its holders to convert to any preferred ERM currency at close to the existing central rate in the event of a realignment. If its reputation were at least on a par with that of the central bank with the strongest currency, the HEB might, by virtue of the option afforded by the hard ecu, find that it could set the ecu deposit rate below those on the strongest national currency,

and still see some substitution of hard-ecu for other deposits. The greater any expectation of a forthcoming devaluation of the hitherto strongest currency, the larger would be the margin by which hard-ecu interest rates could diverge below those on that currency.

17 In a more managed approach, it would be open to the HEB to raise the interest rate on hard ecu relative to the rates on national currencies in the ERM, either by raising the rate it offered on ecu deposits or by raising the rate at which it lent ecu to relieve market shortages of ecu created by its sales either of ecu assets or of its own ecu term liabilities. In the early stages, a higher interest rate on ecu would be the only available means of provoking additional demand for ecu assets, other things being equal, and the HEB, which would be called upon to satisfy the additional demand, might well face the choice between, on the one hand, selling increasing amounts of its own ecu liabilities, to maintain its desired level of rates, and on the other hand allowing market interest rates on ecu assets to fall away from the desired level. Of course the stronger the HEB's resolve to keep the ecu interest rate up, the greater would be its ability to sell ecu assets or issue ecu liabilities, and the greater would be the pressure on national central banks to move their interest rates up in parallel. The strength of this pressure would also depend on how widely the ecu was used in commercial transactions. Admittedly an operation of this sort could prove costly to the HEB in profit terms and this would in practice imply some limitation on its willingness to act for long in this kind of way. In the longer run, the key means of enhancing the new currency's role would be to secure its reputation as a currency subject to low inflation expectations, backed up by an efficient clearing and settlement system. This should enable a negative risk premium to be established against even the strongest currency, and that in turn would permit low ecu lending rates which would enhance its appeal for borrowers.

Conclusions

18 The essential safeguard needed to prevent the hard ecu from becoming a source of potential inflation would be the repurchase obligation on participating central banks

to maintain their respective currencies in terms of the hard ecu. The new institution would thereby be able to insist on an extinction of base money in national currency, equivalent to any permanent increase in its own monetary liabilities. But it should be free to exercise discretion over how fully it used its power to require redemption.

19 There is a potential price for the development of monetary leverage by the HEB, in that it must accept some mismatch exposure in order to build up the usage of the hard-ecu. Considerable treasury management skills would be called for, in managing the trade-off between financial prudence and the pursuit of monetary objectives; the scope for the latter would be bound to be slow to develop, and dependent on decisions taken by the money-holding public.

Bank of England

21 June 1990

M E M O R A N D U M

TO : M. Bascoul
M. Scheller
M. Stubbe

CC : Dr. Baer

DATE : 21st June 1990

The attached have been sent to me unofficially. I have no qualms about circulating them amongst the Secretariat at this juncture, but the point might be raised in due course as to why the Secretariat was not notified of this missive beforehand, and why we found out about its existence third-hand. In future, we must ensure that all such communications are sent to the Secretariat, otherwise we will always remain one step behind.*

Andrew Giles

Andrew Giles

Encs

* I have raised this matter with the BofE and they are aware of the importance of keeping us informed.

Herald Tribune

Thursday, June 21, 1990

Major Proposes 'Hard' ECU as 13th Currency

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By Leigh Bruce
International Herald Tribune

LONDON — The British chancellor of the Exchequer declared Wednesday that some form of EC economic and monetary union was desirable, and he proposed a "hard" European currency unit that would circulate alongside the existing national monies as one of a series of measures to move in that direction.

John Major's proposals, said analysts, seemed a serious step forward from early British ideas for competing currencies, but they do not set a final objective. This would distress Britain's partners in the European Community.

Mr. Major said the idea of an EC central bank and a single currency for the Community "does not present a universally acceptable prescription for the future and certainly cannot be the final word." This plan was contained in a 1989 report by a panel chaired by Jacques Delors, president of the EC Commission.

Although Mr. Major asserted that "we can and will" make progress on economic and monetary union, he rejected a recent plan by Karl Otto Pöhl, the Bundesbank president, under which West Germany, France, Belgium, the Netherlands and Luxembourg would quickly move to such a system, while the other EC nations would join later.

Speaking in London to the German Industry Forum, a German business association, Mr. Major advocated replacing the EC's existing basket currency — the European Currency Unit — with a new, hard ECU, which would circulate freely alongside existing national units as a 13th, parallel currency. It would not be allowed to be devalued against any EC currency.

The new ECU would be managed by a European Monetary Fund, which would issue it only in exchange for national currencies. This would be to prevent inflationary monetary creation.

The chancellor did not rule out that the ECU might become a single currency some day, but insisted "that is a decision we should not take now."

Chancellor Helmut Kohl of West Germany and Mr. Pöhl have stated strongly that the Community could not embark on courses with no defined objective.

Analysts and officials also pointed out that West Germany has consistently opposed any suggestion of a parallel currency, which might weaken monetary control.

Initial reaction in London was cool. David Kern, chief economist of National Westminster Bank, said the plan had "attractions intellectually." But he warned managing a parallel currency would be "very, very cumbersome, which is something the Germans will not like."

According to Mark Cliffe of Nomura Research Institute, "It does not answer the question of accountability. Who is setting the policy?"

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THE TIMES Thursday, June 21, 1990

MR MAJOR'S SMALL COUP

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John Major's extraordinary sally into the realm of European monetary reform last night must have left his European counterparts puzzled. What is so remarkable, they must have asked, about a British finance minister parroting his boss's well-known view that Delors "two and three" — the notorious way-stations on the route to European economic and political union — are unacceptable to Britain? They knew that already.

They know that Britain is an ardent supporter of the free market and 1992. They know that Britain believes that the rest of the Community pays only lip service to markets, and is deeply suspicious of the deference it perceives in Brussels to corporatist interests. They know that M Delors' more advanced proposals for a single monetary authority, a single bank and a single currency leave most Britons baffled, even those who understand them. The idea of a central community bank — a Eurofed — repels London because it would not be accountable to elected governments, to whom, as John Major said last night, the electorate looks to ensure its economic wellbeing. They know that collective determination of British fiscal policy, British mortgage rates and the British Budget judgement is too much for most Britons to stomach.

Yet Mr Major teased his listeners with promises that "some form of European Monetary Union is desirable", which in time could indeed "involve institutional and currency development". He wanted no Big Bangs. He wanted — rightly — a Europe which does not put up barriers against trade with the East. He wanted merely "convergence of economic performance, low inflation and stable exchange rates". But, turning from these motherhood statements, he said that convergence would require, given the significant differences in inflation within the Community, divergent interest rates. And that alone, he said, "argues strongly against" a single European monetory authority.

Mr Major's most constructive contribution was for a "hard" ecu, a parallel Euro-currency to stand shoulder to shoulder (though he did not say this) with the mighty mark. This would be controlled by a new European Monetary Fund, a body of utterly Thatcherite rigour, to ensure that the ecu is not inflationary. Few Europeans are likely to take this ecu too seriously, but then they are not meant to. This is a designer currency, cunning crafted to pass muster with Margaret Thatcher, a currency that manages to be anti-inflationary, European yet not German, an astonishing creation.

In practice the British ecu would be merely a sort of traveller's cheque. It would end up tied, presumably, to the one currency it was supposed not to be, the mark. In other words, the new ecu must either be inflationary, in which case the Germans will not want to know about it, or non-inflationary, in which case why not go for the mark?

The whole business is an exercise in Europolitics, and none the worse for that. Mr Major and the foreign secretary, Douglas Hurd, have clearly decided to play directly to the current anti-British hysteria in European circles. They have, significantly, presumed British membership of the European exchange rate mechanism (Delors "one"), and they hardly even bother to mention it. Britain is likely to join before the year is out. But they have given not an inch to the more complex institutional structures that M Delors would like to see in place before he returns to national politics in France.

Mr Major's speech was thus a classic case of jaw-jaw being better than war-war. He hopes to keep Brussels talking at least through the next British election, and through the next German one as well. He knows that Europe is passing through a delicate period, one in which the precise future of its neighbourhood superpower, Germany, remains uncertain. Mr Major is to be congratulated on a very modest coup. Who knows what may turn up? Who knows who may have moved on before anybody takes these ideas seriously? When it comes to Europe, Britain is right to travel under its patron saint, Mr Micawber.

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Thursday 21 June 1990 THE INDEPENDENT

Major's real alternative to Delors

The Nigel Lawson plan for competing European currencies, the one which would allow you to pay the gas bill in pesetas, was the result of an increasingly desperate search for a practical alternative to the headlong rush towards a single European currency. It was dismissed out of hand by most of the rest of Europe. Now the Treasury has come up with an altogether more convincing proposal, and it has done so by tweaking somebody else's ideas (see below).

Fundamentally, this is an attempt to defeat the plans put forward by the European Commission president, Jacques Delors. It may not work, for political reasons, but at least may receive a serious discussion, unlike the Lawson plan.

Delors proposes a three stage movement towards economic and monetary union in Europe. During stage one, which begins on Sunday week, the economic and monetary policies of countries within the European Monetary System are expected to converge, and those countries – including Britain – which are not in the Exchange Rate Mechanism are expected to join.

In stage two, new community institutions would be established, based on some form of central banking system whose details, particularly the question of whether or not it is accountable to national governments, are now being fought over.

In stage three, the one to which the Prime Minister objects most vehemently, European currencies would be irrevocably locked together and possibly replaced by a single European currency. Allied to this would be a single community monetary policy, run by the then fully-fledged central banking system.

An intergovernmental conference will start at the end of the year to consider treaty changes necessary to achieve the latter two stages. But at the moment governments are committed only to the first stage and shape of the rest is quite unclear. It will be discussed at the Dublin summit next week. Meanwhile the Bundesbank has thrown in the suggestion that we could have a two-speed Europe, in which those countries committed to monetary union would press ahead, leaving the others to join later.

What would the Major plan achieve? It would delay but not kill Delors stage three, satisfying Mrs Thatcher's objections. But it would be sold to the Bundesbank, which has reservations about a over-rapid move to monetary union, as something which could easily evolve into stage three over time. The new European Monetary Fund would increasingly take on the role of a central bank.

The key is the Ecu, which is at present an artificial construction based on the average of a number of currencies. In the new 'hard' form proposed by Mr Major it would become a currency in its own right, working alongside the others, but with a life of its own. The EMF would be responsible for managing it within the Exchange Rate Mechanism, and for ensuring that rather than being an average it becomes – and remains – the strongest currency in the system.

Now these so-called parallel currency plans, in which a rival money is introduced with the aim of gradually displacing national currencies, were rejected by Delors on the grounds that they are inflationary. That was the Treasury's objection to the original Butler plan: if a member of the ERM were suffering from chronic and rising inflation, it could use the system to bail itself out. The EMF would be obliged to buy the weak currency, leading to monetary expansion if the government concerned failed to bear down hard enough on inflation.

The new version, modified by the Bank of England, is designed to stop this. The recalcitrant member could be told to buy back its own currency from the EMF, using its own foreign exchange reserves which would be gradually depleted. Thus the EMF, staffed by central bankers, would have a central banking role in that it could discipline a member country by influencing its monetary policy. The ultimate weapon is that businessmen and consumers would eventually despair of their own currency and turn to the new 'hard Ecu' instead. The punishment for the government would be that without a useful national currency it would have lost control of monetary policy and its central bank would have no role.

This is very clever. But the argument now raging is political not intellectual, and that is where the Major plan does not measure up to the aspirations of the majority in the Community.

COMMENTARY

Edited by Hamish McRae

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remarked in a memorandum to the Delors Committee, a parallel currency would be useless for day-to-day payments.

Tactically the new proposals risk creating an unnecessary gulf between the UK and the Bundesbank. The latter body has been disposed to make haste slowly by accepting the Delors concept, but making sure that conditions were right before it could recommend to the German people that they give up the Mark. The UK Government would do well to follow the same path.

But the basic objection was best expressed in another Delors memorandum by the head of the Netherlands central bank, Mr W.F. Duisenberg. "Economic and monetary union requires economic convergence and the acceptance of loss of sovereignty implicit in the abolition of the exchange rateas the 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 realisation."

But I will give the final word to a report, European Monetary Union, just issued by the Institute for Public Policy Research, the (very mildly) left-wing think tank. The authors' preferred option is some version of the Treasury's original "evolutionary approach." But they then add: "The majority of our European partners now prefer a rapid transition to EMU ... For Britain to remain outside would be the worst of all worlds ... The elimination of exchange rate risk within EMU countries would marginalise the UK as a trading partner. It could also make Britain less attractive for inward investment from the US and Japan ... The role of London as a financial centre would be put at risk." If a gradualist approach is not ottainable, "the UK should accept the majority EC view, since the alternative of standing aside from the whole process would be far worse."

Whichever British political party first accepts this common sense advice will receive some brownie points from Economic Viewpoint.

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Thursday, June 21, 1990

Political Notebook

FINANCIAL TIMES

Major plan nudges No 10 in direction of Europe

■ THERE were audible sighs of relief at Westminster as the curtain fell yesterday on the latest act in the long-running political drama of Britain in Europe.

The fervent hope of most ministers is that Mr John Major's alternative blueprint for Economic and Monetary Union will inject some much-needed Europeanism into the Government's credentials at the Dublin summit.

Mrs Margaret Thatcher was persuaded finally of the political imperative for such a strategy at a lengthy meeting with Mr Major and Mr Douglas Hurd on Tuesday morning.

The Chancellor dotted the i's and crossed the t's over lunch with Mr Robin Leigh-Pemberton, the Governor of the Bank of England. Then both the Treasury and Foreign Office spent a night of anxious anticipation before the Prime Minister initialled the final draft yesterday morning.

Mr Major's plan, described by one relatively unbiased insider as "technically brilliant," marks the latest in the series of political compromises which began at last year's Madrid summit.

It follows weeks of skilful Whitehall diplomacy by the Chancellor and Foreign Secretary, and is a victory in their increasingly bitter internal wrangle with Mr Nicholas Ridley.

For her part, Mrs Thatcher is said to have recognised that her partners in Europe are quite ready to leave Britain behind in their drive for closer monetary integration. More importantly, she has acknowledged also that her Government is neither strong nor united enough to allow that to happen.

Mrs Thatcher has not accepted that the pound must be abolished in favour of a single European currency. Nor is she likely to drop the idea – apparently being pushed by Mr Ridley – of a wider, looser North Atlantic monetary arrangement embracing the dollar as well as European currencies.

Her colleagues, however, believe she has been nudged into the critical, and essential, concession needed before Britain could hope to play a part in the discussions on EMU.

Mr Major's proposals may leave open the future of sterling but the progressive steps it envisages point unerringly in the direction of the single European currency that Mrs Thatcher believes should be delayed for another generation.

So the Tory Euro-enthusiasts view the proposals – predicated on early participation in the EMS exchange rate mechanism – as another step towards unequivocal acceptance of a single currency.

What they – and many ministers – are far less sure of is whether they will be enough to prevent Britain's European partners from pushing ahead regardless with the Delors blueprint. The most telling insight into just how high the stakes are came yesterday from Mr Leigh-Pemberton.

He told a House of Lords subcommittee that he had commissioned a study of the economic impact in the event that Britain finds itself left outside a "core" monetary union established by France, Germany, the Netherlands, Belgium and Denmark.

Stars in waiting

■ The approach of July is prompting growing excitement among the NCOs on the Tory benches.

Mrs Thatcher has ruled out a radical Cabinet reshuffle but that still leaves scope for considerable changes lower down – and the promise of that first Whitehall-issue Maestro for a lengthy queue of bright young hopefuls.

Party managers disclaim all knowledge of such plans, but Mr Timothy Renton will be ready to hand Mrs Thatcher a list of the deserving stars early next month.

They in turn are wondering just when they should ask friends and sponsors to put in a good word with the Chief Whip or directly with the Prime Minister.

Most of the promotions on to the first rungs of the ministerial ladder come traditionally from among parliamentary private secretaries who loyally trudge around as unpaid bag carriers for senior and middle-ranking ministers.

At least half a dozen are being tipped either for a move into the Whips' Office or for title of Parliamentary Under-Secretary.

Mr Tim Boswell, PPS to Mr Peter Lilley at the Treasury, and Mr Tim Yeo, who performs the same role for Mr Hurd, are among the frontrunners. Mr Robert Key, who has shielded Mr Chris Patten from some of the flak directed by colleagues at the poll tax, is another hopeful.

Mr David Nicholson is regarded as one the best of the 1987 intake, while Mr Tony Favell – PPS to Mr Major – has been waiting in the wings for some time.

There is one MP, however, for which a reputation as being one of the brightest on the back benches is apparently not enough. To the dismay of colleagues, Mr Nigel Forman's past role as PPS to Mr Nigel Lawson is said to rule him out.

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Philip Stephens

Daily Telegraph

Britain finesses with the hard ecu card

SARAH HOGG

EVER since Jacques Delors launched his plan for a single European currency last year, with the somewhat embarrassed support of the Governor of the Bank of England, the British Treasury has been struggling to come up with an alternative. The job has become more urgent — "stage one" of Delors is supposed to start next month — and the new willingness of the Prime Minister to contemplate full membership of the existing European Monetary System does not answer the question of what comes next. But it was not only the Prime Minister, after all, who disliked the thought of the pound disappearing in favour of a "franc-fort", the favourite Franco-German nickname for a single European currency; the Labour party in particular and the House of Commons in general have made their views plain on the matter.

The search for alternatives has led us down some uncertain channels. First, towards "competing currencies": the idea being that pounds, marks, francs and so on would all circulate throughout the Community in a kind of monetary beauty contest. This was received politely but unenthusiastically by other governments. Now, however, that approach has been refined into something more credible. Last night, the Chancellor nailed his colours firmly to the mast of the ecu — a pan-European currency that would circulate in parallel with national ones. He proposed that ecu bank notes would be legal tender, but would replace pounds only to the extent to which ordinary citizens might prefer them.

The ecu, of course, already exists. It is not a real currency, but, at the moment, only a unit of account. It is a composite of real currencies, weighted according to the importance of the economies they represent; one pound is currently worth about 1.4 ecus. The European Commission expresses its budget in ecus; some financial instruments are denominated in ecus. The total ecu deposit market amounts to about 110bn ecus. But you cannot take a fistful of ecus to spend on holiday, and there is no central bank whose responsibility it is to create and control the supply of ecus.

The idea of a parallel currency is a pretty obvious solution to the EC's little local difficulty of national currencies that are expensive or tedious to keep changing between. But it was rejected by the Delors committee as a route towards monetary union, largely out of fear it would be inflationary. If everyone could change their national currencies into and out of fixed-rate ecus without limit, a loose monetary policy in just one country would affect all. The ecu would become as bad as the worst currency in the Community, not as good as the best.

Hence John Major's proposal for what he calls "hard ecus". The monetary steel would be in two conditions. First, if the new European Monetary Fund were asked to change too much of one of Europe's weak currencies into ecus, it could oblige the central bank of the country concerned to buy them back in exchange for harder currencies — a powerful incentive to get their monetary act together. And second, whenever European currencies were realigned against each other, the "hard ecu" would have to go up with the strongest.

That certainly sounds tough enough to appeal to (say) the Bundesbank; but Europeans have still to be convinced it is preferable to the Delors plan for totally fixed rates between all EC currencies, which would then essentially become one and the same thing. The Chancellor's argument is that the ecu route is more gradual, allowing Europe to proceed towards union at the speed allowed by national economic differences. Indeed, though he did not say so, it would enable some countries to move faster to full monetary union than others.

It is, therefore, plainly a way in which the British government could hope to finesse its way through the inter-governmental conference on monetary union due at the end of the year. But the Treasury was anxious to make it clear that the "hard ecu" is not a diversionary tactic designed to put off full British membership of the European Monetary System yet again. It is based on the assumption that everybody is already in the Exchange Rate Mechanism, allowing their exchange rates to fluctuate only 2·25 per cent either side of a fixed parity, and looking to take monetary union farther.

This then is a proposal that deserves to be taken seriously by the rest of the EC. It is a neat piece of footwork, not a piece of foot-dragging. It should cause no explosions at Number 10 (or among such "family friends" as her former adviser). It is supported by the Bank of England. Mr Major's speech still contained a lot of standard political guff about the danger of an unaccountable European central bank, when independence, not control by a lot of European politicians, would make for good monetary policy in Europe. The kind of fund he proposes would be best run by a committee of existing central banks, no more or less accountable than they are right now. Never mind. The point of this speech was to send Britain decently clothed into the conference chamber on monetary union, and it is an improvement on the last suit of motley.

FINANCIAL TIMES

EC urged to be more flexible in Gatt talks

By Tim Dickson and David Buchan in Brussels

MR Renato Ruggiero, Italy's Trade Minister, is urging the European Community to be more flexible ahead of next month's critical Uruguay Round negotiations in Geneva.

Mr Ruggiero condemned the "silly debate" over farm subsidies, and called on all parties to adopt a "new spirit of practical compromise".

He said: "When you see the problems in Geneva you see it is not impossible to find this necessary compromise. We must be sure that negotiations do not fail because of a theological debate, as we had in Paris (at the recent OECD ministerial meeting) between ourselves and the Americans."

Mr Ruggiero's remarks are important because Italy assumes the Presidency of the EC on July 1, and because of the cat and mouse game being played out between the EC and the US over negotiating positions on the key issue of farm trade reform.

Washington is not only sticking to its demand that global farm supports be dismantled by the end of the century but appears to be trying to put pressure on the EC to single out for separate discussion the EC's "trade distorting" export subsidies.

Community foreign ministers, by contrast, affirmed their backing for the EC's so called "global" approach though diplomats close to the meeting said particular concern was expressed by Italy, as well as by the UK and the Netherlands, about the need to break the Paris impasse. Mr Ruggiero suggested in his briefing that the EC needed to talk about "specific sectors" while continuing to take the "overall price" into account.

While the US and Cairns group can be expected to exploit any differences of emphasis within the member states, they are also pinning their hopes on a more flexible approach inside the Commission from Mr Frans Andriessen, the EC's External Relations Commissioner.

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THE INDEPENDENT

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Monetary union will not wait

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BRUSSELS: What used to be called the British Question is no longer much of a question. It merits a shrug these days, nothing more. On Monday the European Community's summer summit opens in Dublin. On the eve of previous summits the question has usually been: "Will it be 11-1", "Battling Maggie stands alone" and all that? This time, nobody seems to care. The reason is that Europe is surging forward like a great, unstoppable juggernaut, its destination set.

In December the creation of a monetary union will be decided, the foundations laid for a strong and independent Eurofed. Britain will have to choose. The strongly held view around the European capitals is that their worst days with Margaret Thatcher are over, that she will squirm but sign. In this they may be prematurely sanguine, making too much of her laid-back response to the latest stirrings towards "political union" and underestimating the force of her hostility to any breach of monetary sovereignty. But if, when it comes to it, she says "no", then most probably the others will go ahead without Britain.

A strange phoney war has been going on around this issue. The Prime Minister continues to insist that it will happen over her dead body – "not in my life time", she told Jimmy Young only on Monday. The British, meanwhile, are participating in detailed discussions about what sort of monetary union it would be, its rules, the constitution and powers of its central bank, the Eurofed.

Not only are officials from the Treasury and Bank of England participating in this work, but senior ministers, the Chancellor, John Major, and the Foreign Secretary, Douglas Hurd, are joining in political understandings subject to the "reserve" that Britain has placed on the whole enterprise.

These discussions have been moving at speed and with a high degree of unanimity on the central questions relating to internal monetary union; external questions are proving more contentious.

But what is taking shape is a monetary union based upon a strong and independent central bank with powers similar to those of the Bundesbank. It would be instituted by statute and free from day-to-day political interference. It would be answerable to the European Parliament but only in the sense of reporting to it once or twice a year. It would otherwise report to the Council of Ministers, which means that it would be answerable, within the terms of its autonomy in monetary control, to the governments of member states.

All of this, it is said, the British are going along with. Meanwhile, Mr Major unveiled in London last night Britain's rival plan for an evolutionary approach to monetary union which would avoid the federalistic outcome contained in stage three of the Delors Report.

Instead of a supranational central bank there would be an intergovernmental institution – called the European Monetary Fund – charged with managing the Ecu in parallel with national currencies and other central banking functions including, perhaps, operating the exchange rate mechanism of the European Monetary System.

Britain would be better placed to argue for a prolonged stage two of the Delors Plan if it were prepared to envisage eventual arrival at his stage three, which is a common currency administered by the Eurofed. The most Mr Major could say on this was: "In the very long term, if peoples and governments so choose, it [the Ecu] could develop into a single currency. But that is a decision we should not take now, for we cannot yet foresee what the size and circumstances of the new Europe will be."

Other countries are unlikely to be ready to postpone the decision for a full monetary union, although some might welcome a longer transition to Delors stage three. In the end, Britain is likely to have to decide whether to join wholeheartedly in the enterprise, pressing her interests from within, or risk exclusion with the grave economic and political consequences that could result.

It is a familiar argument in British politics, with the Foreign Office to the fore in arguing for swimming with the European tide, the anti-Europeans warning against proverbial slippery slopes. By the first argument, early membership of the exchange rate mechanism of the EMS would make it easier to press for a prolonged stage two; signing up for an eventual union would make it easier still. The Treasury's view is similar, although it is not quite clear whether Mr Major himself is reconciled to the full inevitability of what is happening on the European Continent.

By Peter Jenkins

From the other side, the loudest and most influential voice is the Trade Secretary, Nicholas Ridley, who asks why take steps, however small, towards an end we do not will? Why, by this reasoning, join the ERM at all, why engage in discussions about the form of a monetary union we do not wish to join? Mr Ridley's access to the prime ministerial ear is frequent, his arguments congenial to her.

The political reality may be that Mrs Thatcher would like to see all decision about moving to monetary union on the Delors model postponed until after her General Election. That would get her out of an awkward spot. But Europe may not wait. A great momentum has built up behind monetary union, gaining force from the break-up of the Communist empire and the imminent reunification of Germany. A prolonged and evolutionary transition may be a feasible goal, but any scheme for something less than union has little hope of success.

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FINANCIAL TIMES

Thursday, June 21, 1990

Moves to monetary union outlined by Major

EXTRACTS from a speech by Mr John Major, the Chancellor, to the German Industry Forum in London last night.

"What we decide about economic and monetary union should be determined by our view about the kind of Europe we want to see. Our vision is of an open Europe: open to trade and investment; open too to new members from Europe, east and west... We should develop a form of EMU that permits them to join us and does not put up barriers against it.

"The key is to build on Stage 1 further steps to promote convergence of economic performance, low inflation and stable exchange rates; and to do so by building up our infant common currency – the Ecu.

"A first practical step towards this might be to encourage the use of the existing Ecu by issuing Ecu bank notes for general circulation in the Community. This would require a new institution which I shall call the European Monetary Fund. The fund, acting as a currency board, would provide Ecus on demand in exchange for Community currencies. This can be done in such a way as to avoid increasing the Community's total supply of money. To ensure this, we would insist that the fund could only issue Ecu notes that were fully backed by its own holdings of the various currencies which make up the Ecu. So there would be no new money creation, and no threat to inflation. Interest rates on Ecu deposits and loans would be determined, as now, by the weighted average of interest rates on the Ecu's constituent currencies, and so the fund would play no role in setting interest rates.

"Ecu bank notes could provide a natural currency for tourists and business travellers. The idea could catch the popular imagination; and as notes came to be used more frequently it could help the development of large-scale markets in Ecu deposits. But these are modest steps, and I think we could and should go further.

"In my view, the best approach is the creation of a new 'hard Ecu.' Under this approach the Ecu would no longer be defined as a basket of currencies but would become a genuine currency in its own right – a new and international currency – which would never devalue against other Community currencies. A version of this approach has been canvassed in a recent paper by the British Invisible Exports Council under their chairman, Sir Michael Butler. Our proposals are rather different, but I readily acknowledge the debt they owe to his.

"Under our approach the European Monetary Fund, which I have suggested, would manage the hard Ecu to ensure that, in the ERM, it stayed within its margins, and that at realignments it was never devalued. The EMF would issue Ecu deposits or notes in exchange for national currencies. It would set interest rates on hard Ecu. Initially, it would do this by setting rates on the interest bearing deposits it took, probably largely from commercial banks. Later on, as the private hard Ecu market developed and commercial banks built up hard Ecu deposits taken from the public, the EMF could move to setting interest rates by the normal central banking techniques, namely through the creation of money market shortages which would then be relieved at the chosen interest rate.

"A traditional criticism that has been made of certain parallel currency proposals is that they could raise inflationary dangers. I share that concern. But a crucial element of the scheme I propose – indeed, my very reason for advocating it, is that effective safeguards could be built in to prevent this. So a key feature of the proposal is that there would be an obligation placed on all member states' central banks to repurchase their own currencies from the EMF for hard currencies. This repurchase obligation would ensure that the combined effect of the fund's own money creation – through the issue of hard Ecu liabilities and the influence it exerted on money creation by national central banks – was not inflationary.

John Major: proposes monetary fund to act as EC currency board

"It will be noted that both these ideas for developing the Ecu envisage the development of a new institution. Let me explain why I have no qualms about such an institutional development. We are not opposed to new institutions where there are new jobs that genuinely need to be done. And that is certainly the case here. For not only would we be looking at the job of managing the Ecu; there are other important roles such an institution might usefully take on. These might include the tasks involved in managing the ERM and its financing facilities, including the functions of the central bank governors' committee and the existing European Monetary Co-operation Fund (EMCF) in this area. An additional function could be medium-term balance of payments lending: to the extent that the Community is involved in this, the new institution could help in managing it.

"It might also take on the essential task of co-ordinating member states' intervention against external currencies: in particular, the dollar and yen. By the end of Stage 1, all Community currencies will be members of the ERM and will share a common interest in the value of their currencies against the dollar and the yen. This co-ordination would not involve member states giving up part of their foreign currency reserves. Instead, intervention would be co-ordinated through the EMF, which would draw and repay tranches of dollars, yen and national currencies, as necessary, from member states. Market operations, as now, would be carried out by individual national central banks.

"All these are key functions that will be vitally necessary in the world beyond Stage 1. It makes practical sense to have a new institution – an EMF – to carry them out.

"[The proposals] will, I know, be controversial to some. But they are practical. They are progressive. They offer choice, not prescription. But they evolve naturally from Stage 1 and have the potential to evolve further. In time the Ecu would be more widely used: it would become a common currency for Europe. In the very long term, if peoples and governments so choose, it could develop into a single currency.

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THE INDEPENDENT Thursday, June 21, 1990

Chancellor finds a half-way house on the road to EMU

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Peter Rodgers extracts the key part of John Major's speech calling for a gradualist approach to European monetary union

THE Chancellor's alternative proposals for a gradualist approach to economic and monetary union, launched in a speech last night, were derived from a paper by Sir Michael Butler, chairman of the British Invisible Exports Council, and Paul Richards, first published in *The Independent* this year. The new version of the plan has been developed by the Treasury with the help of the Bank of England.

Speaking to the German Industry Forum at the Institute of Directors, John Major paid tribute to the Butler plan and said of other ideas for economic and monetary union that the Government had "fundamental reservations."

A European Community central bank, proposed by the Delors Committee, would not be accountable to elected governments and would not deliver the economic and inflation performance the Community needed.

The significant differences in inflation between the economies of the Community probably required that for inflation performances to converge, interest rates must diverge, as they do now.

That did not suggest a swift move to a European monetary authority but argued strongly against it.

A premature attempt to implement it would be unsustainable,

> 'Ecu banknotes could provide a natural currency for tourists and business travellers'

and induce a huge setback. It would not lead to unity, but to disunity.

There were, he said, better ways of achieving economic convergence and low inflation throughout Europe. Mr Major argued for a gradualist and evolutionary approach and against "any attempt to move to a rigid and closed structure." The key, he said, was:

"to build on Stage 1 [of the Delors plan] further steps to promote convergence of economic performance, low inflation and stable exchange rates. And to do so by building up that infant common currency — the Ecu.

■ A first practical step towards this might be to encourage the use of the existing Ecu by issuing Ecu banknotes for general circulation in the Community. This would require a new institution which I shall call the European Monetary Fund. The fund, acting as a currency board, would provide Ecus on demand in exchange for Community currencies. This can be done in such a way as to avoid increasing the Community's total supply of money. To ensure this, we would insist that the fund could only issue Ecu notes that were fully backed by its own holdings of the various currencies which make up the Ecu. So there would be no new money creation, and no threat to inflation. Interest rates on Ecu deposits and loans would be determined, as now, by the weighted average of interest rates on the Ecu's constituent currencies and so the fund would play no role in setting interest rates.

■ Ecu banknotes could provide a natural currency for tourists and business travellers. They also could catch the popular imagination, and as notes came to be used more frequently it could help the development of large-scale markets in Ecu deposits.

But these are modest steps, and I think we could and should go further. In my view, the best approach is the creation of a new "hard Ecu". Under this approach the Ecu would no longer be defined as a basket of currencies but would become a genuine currency in its own right — a new and international currency — which would never devalue against other Community currencies. A version of this approach has been canvassed in a recent paper by the British Invisible Exports Council under their chairman, Sir Michael Butler. Our proposals are rather different, but I readily acknowledge the debt they owe to his.

■ Under our approach, the European Monetary Fund which I have suggested would manage the hard Ecu to ensure that, in the ERM, it stayed within its margins, and that at realignments it was never devalued. The EMF would issue Ecu deposits or notes in exchange for national currencies. It would set interest rates on hard Ecu. Initially, it would do this by setting rates on the interest bearing deposits it took, probably largely from commercial banks. Later on, as the private hard Ecu market developed and commercial banks built up hard Ecu deposits taken from public, the EMF could move to setting interest rates by the normal central banking techniques, namely through the creation of money market shortages which would then be relieved at the chosen interest rate.

■ A traditional criticism that has been made of certain parallel currency proposals is that they could raise inflationary dangers. I share that concern. But a crucial element of the scheme I propose — indeed, my very reason for advocating it — is that effective safeguards could be built in to prevent this. So a key feature of the proposal is that there would be an obligation placed on all member states' central banks to repurchase their own currencies from the EMF for hard currencies. This repurchase obligation would ensure that the combined effect of the fund's own money creation — through the issue of hard Ecu liabilities and the influence it exerted on money creation by national central banks — was not inflationary.

■ It will be noted that both these ideas for developing the Ecu envisage the development of a new institution. Let me explain why I have no qualms about such an institutional development. We are not opposed to new institutions where there are new jobs that genuinely need to be done. And that is certainly the case here. For not only would we be looking at the job of managing the Ecu, there are other important roles such an institution might usefully take on. These might include the tasks involved in managing the ERM, and its financing facilities, including the functions of the Central Bank Governors Committee and the existing European Monetary Co-operation Fund (EMCF) in this area. An additional function could be medium-term balance of payments lending: to the extent that the Community is involved in this, the new institution could help in managing it.

■ It might also take on the essential task of co-ordinating member states' intervention against external currencies, in particular, the dollar and yen. By the end of Stage 1 all Community currencies will be members of the ERM and will share a common interest in the value of their currencies against the dollar and the yen. This co-ordination would not involve member states giving up part of their foreign currency reserves. Instead, intervention would be co-ordinated through the EMF, which would draw and repay tranches of dollars, yen and national currencies, as now, would be carried out by individual national central banks.

■ All these are key functions that will be vitally necessary in the world beyond Stage 1. It makes practical sense to have a new institution — an EMF — to carry them out.

■ There is much discussion about the final stages of EMU. And more than one version of it. In these discussions, the UK will play a full and constructive part. But whatever the outcome of that debate may be, the evolutionary process advocated by the UK, the further ideas I have sketched out this evening — for promoting greater economic and monetary integration beyond Stage 1 — must be fully considered. They offer a way forward around which all Europe should be able to unite.

> 'In the very long term, if peoples and governments so choose, the Ecu could develop into a single currency'

■ They will, I know, be controversial to some. But they are practical. They are progressive. They offer choice not prescription. But they evolve naturally from Stage 1 and have the potential to evolve further. In time the Ecu would be more widely used; it would become a common currency for Europe. In the very long term, if peoples and governments so choose, it could develop into a single currency. But that is a decision we should not take now, for we cannot yet foresee what the size and circumstances of the new Europe will be. In addition the development of a hard Ecu should promote lower inflation and thereby greater exchange rate stability. And most importantly of all, the steps we propose have the advantage of retaining choice, diversity and flexibility. I believe they represent a practical and sustainable way forward for Europe."

John Major advocated setting up a European Monetary Fund

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ECONOMIC VIEWPOINT

Spare us a 13th

By Samuel Brittan

The ECU's composition

Currency	Amount*	Weights**
Belgian / Lux Franc	3.431	8.11
French Franc	1.332	19.24
Lira	151.8	10.05
Dutch Florin	0.2198	9.49
D-Mark	0.6242	30.33
Danish Krone	0.1976	2.52
Irish Punt	0.008552	1.11
Peseta	6.885	5.42
Drachma	1.44	0.72
Sterling	0.08784	12.25
Escudo	1.04741	0.77
		100.00

* These amounts have applied since 21 September 1989
** Weights based on exchange rates on [illegible]

The Ecu is a composite or basket currency. It consists of specified amounts of each Community currency. The relative amounts of the component currencies reflect their countries' economic weight and are normally revised every five years. The amounts were last changed in September 1989, when among other changes the Ecu basket was enlarged to include the Spanish peseta and Portuguese escudo. Even with unchanged amounts, the weights of the currencies constantly change as they strengthen or weaken against each other.

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Much midnight oil has been burned by British officials and advisers to devise European monetary proposals, alternative to those of the Delors Report, before the coming EC Summit in Dublin.

The attempt has been to make them positive and forward-looking, without compromising Mrs Thatcher's passionate opposition to a single European currency or European central bank. Their labours are not without precedent, as previous generations of schoolmen tried to square circles or find a philosopher's stone which would turn base metal into gold.

But even if my initial reaction is unfair and their merit turns out to be great, the latest British proposals have been put forward far too late to influence opinion in the Community, most of whose members are already committed to a single currency to be achieved by the Delors route, involving the setting up of Eurofed, a European central bank along the lines of the Bundesbank and at arm's length from national governments. They are prepared to go ahead on their own, leaving Britain and the weaker Mediterranean countries to join later if they wish.

Whatever happens in Dublin, the British Government will be presenting its latest proposals to the Intgergovernmental Conference (IGC) on Monetary Union, due to start in December. The original 1989 British counterproposals, were entitled An Evolutionary Approach to Economic and Monetary Union. Their essence was a development of the generally accepted Stage One of the Delors Plan. This starts on July 1 and involves membership of the Exchange Rate Mechanism by every member – a commitment strongly reiterated for Britain by the Chancellor, John Major, last night.

If there is a Single Financial Area, with no exchange or capital controls, and realignments become rarer and eventually disappear, the different European currencies will become effectively interchangeable; and the EMS could evolve into a system of permanently fixed exchange rates.

By then (although the 1989 Treasury Paper did not draw the inference) the pointlessness of having 12 different kinds of pieces of paper and coin would become clear, and as the Bank of England Governor said yesterday: "Europe should move to a single currecy as quickly as possible."

There is thus a continuum running from: the early version of the EMS as a system of managed exchange rates; to the EMS of recent years with its emphasis on avoiding realignments; to the EMS of tomorrow where realignments are eliminated; to the EMU of the day after tomorrow with irrevocably fixed exchange rates, and finally a common currency. *The biggest single transfer of sovereignty is in joining the EMS.*

The British Government's emphasis shifted to the "evolutionary approach" when it realised how extremely reluctant people are to give up a familiar currency except at times of hyperinflation and monetary chaos. Unfortunately it has now shifted back to competing currency ideas. But instead of competition between existing currencies the competitive element is to be provided by a 13th one, the so-called "hard Ecu." This is a step backwards.

The first or Stage One version of the latest UK proposals seems innocent enough. It is for a European Monetary Fund to put Ecu bank notes into circulation based on the existing currency basket. The Fund would act like a currency board and would exchange Ecu notes for Community currencies, keeping an exact basket of national currencies as assets to match the notes issued. Thus there should be no creation of money and no risk to the Fund's sc[...] would as now be a weighted average of the constituent currencies and the Fund would have no monetary role.

In the more interesting Stage Two, the "hard Ecu" would be created. This would no longer be just a simple basket of currencies, but the Ecu would be defined so that it could never be devalued against any Community currency. If the Mark were revalued, then the quantity of other currencies in the basket would – in contrast to present practice – be increased to maintain its DM value. But should the German currency pass through a weaker phase and the Dutch guilder appreciate at its expense, then the basket would be enlarged to maintain its guilder value.

The "hard Ecu" first emerged in a Report for the Invisible Exports Council by Sir Michael Butler of Hambros and Mr Paul Richards of Samuel Montagu. This was originally presented to Mrs Thatcher on whom I am told on all sides that Sir Michael performed "a magnificent selling job." But Mr Major was anxious to emphasie last night the differences between Butler and the British Government's latest proposals.

In Stage Two the EMF would issue hard Ecu deposits or notes in exchange for national currencies. Initially, the interest rates it would pay would be derived from a weighted average of the interest-bearing deposits it received in different currencies. But eventually, as the market developed, the EMF could in Mr Major's words move to "setting interest rates by the normal central banking techniques, through the creation of money market shortages which would be relieved at the chosen interest rate."

Such techniques presuppose that the hard Ecu would have developed sufficiently towards a European money for banks to wish to hold reserves at the EMF, as they do at the Bank of England or Bundesbank. If the EMF were to develop thus far, then it would be an embryonic European central bank, with all the supranational elements the Prime Minister dislikes. Its objectives could be achieved more simply, and without excursions into unresolved monetary theory, by the Delors route.

The Bundesbank has always opposed parallel currencies, partly out of understandable fears that they would be inflationary, and partly on the grounds that they would be unnecessary. I doubt if any a priori reasoning could determine in advance whether the proposed techniques could eliminate the inflationary danger. But as the head of the Bundesbank, Karl Otto Pöhl,

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THE DAILY TELEGRAPH, THURSDAY,

Thursday, June 21, 1990

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Major's evolutionary path to a single currency

THE market in Government stocks got itself into a high old state of excitement yesterday, after the realisation that our story here heralding the proposal of the "hard ecu" was to form the basis of the Chancellor's speech last night.

Mr Major is anxious to bridge the gap between the current exchange rate mechanism, which Britain will almost certainly join later this year, and the distant dream of a single European currency.

While everyone can see the advantages of realising the dream, not many of the single currency's proponents have surveyed the ground in between. The Treasury is attempting to.

The current thinking, if that is the word, in Brussels, is for a Big Bang along the lines of the explosion which is due to take place the week after next in Germany, when the Ostmark becomes of interest only to collectors.

Yet as the Treasury is trying to point out, it is one thing to consummate a deal which both sides agree is nothing less than a full-scale takeover of one state by another, and quite another to set about replacing currencies like the pound, lira or French franc which, for all their problems, are freely exchangeable and a fair store of value.

The British argument is that the only way to do this is by evolution, a sort of reverse Gresham's Law, by which the good European money drives out the bad domestic money because the citizens of the countries of Europe demand to be paid in the good money.

In its original version, the Treasury's evolutionary approach to currency union in Europe would have simply lifted all the barriers to choice and allowed Greeks to demand to be paid in French francs and Englishmen to take out mortgages in Deutschemarks. The political impracticality of allowing one national currency to eventually dominate all the others has, however, led to a rethink. The mark two version avoids this trap by the creation of a completely new currency. Wonderful as that sounds in theory, it is extremely difficult to imagine how such a scheme would work in practice.

Some clarification will be needed before the scheme can fly. Broadly, however, the suggestion appears to be that a new institution, the European Monetary Fund, will be created which will swap ecus for individual currencies at an agreed rate of exchange, thus taking pounds, francs, pesetas and marks out of circulation as fast as the ecu printing press churns out the new style banknotes at the other end.

This way, the system will avoid the danger of increasing the supply of money in Europe in an inflationary way. And by juggling the ecu interest rate and operating on the exchanges, it is hoped that the new fund will be able to keep the ecu looking pretty come rain or shine. The pitfalls are many, and the planners will have to keep on their toes if they are to prevent City whiz-kids running rings round them and their new currency.

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The Guardian

Thursday, June 21, 1990

At last, something better to bite on

JOHN MAJOR dropped another cat among the Euro-pigeons last night when he advocated the introduction of a new currency (the ecu or European currency unit) into circulation in all EC countries as a "gradualist" alternative to going for the "Big Bang" solution of full monetary union. The trouble with big bangs is that they are sometimes followed by other explosions; and the Chancellor is worried that the creation of a new, all-powerful European Central Bank, unaccountable to national parliaments and backed by a common monetary policy, will not secure the inflation free zone which everyone wants. He argues that countries need differing levels of interest rates in order to eliminate inflation before even thinking about anything as radical as full monetary union.

The trouble with this argument is that it sounds suspiciously like saying that Britain won't join a monetary union until she doesn't need one — ie when inflation has been brought down permanently by our own efforts. Meanwhile the Major scheme would sanction monetary permissiveness in any country that felt so inclined (for example in advance of an election). Moreover, would the new proposals have street credibility unless the ecu became common legal tender?

But that doesn't alter the positive side of Mr Major's gradualist approach. Most people would welcome and benefit from the first step: which is to encourage the use of the existing ecu (largely confined to bond issues by international banks) by issuing notes for general circulation. A new European Monetary Fund would provide ecus on demand in exchange for community currencies (thereby avoiding, it is claimed, the inflationary dangers of printing money). This would be an instant hit with business travellers and tourists who are perpetually worried about what currency they should change their money into.

The second stage would be to create a new "hard" ecu which would not just be a fluctuating average of existing currencies (the existing ecu is revalued every day) but a genuine currency in its own right which, Mr Major says, would never devalue against other community currencies. This, as he readily acknowledges, is similar to a suggestion made recently by the British Invisible Exports Council.

The whole notion clearly needs considerable scrutiny and debate; but it does appear to be a positive improvement on the "competing currencies" proposal of his predecessor Mr Lawson. In particular, the Bank of England and its sister institutions in other countries would be required to repurchase their own currencies from the Fund for hard currencies in order to eliminate the inflationary possibilities associated with the Fund's money-making powers. Given time — and legal respectability — once the ecu is released from captivity, it could become the common currency which the Government has until now eschewed.

It remains to be seen whether Mr Major's proposals are treated with the same European disdain as Mr Lawson's earlier version. The first signs are of an idea still underbaked. But that is better than no baking at all. Germany and France have stirred up an almost unstoppable momentum towards full monetary union — with British authority sadly undermined by our absence from Exchange Rate Mechanism. It will do Mr Major's bargaining (and political) power no harm at all if his further thoughts prove, as well they may, positive enough to attract still further thought amongst our partners.

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THE TIMES THURSDAY JUNE 21 1990

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Ecus, madam? They'll do nicely

COMMENT

DAVID BREWERTON

This afternoon, the French Treasury has invited selected journalists for a briefing session on some of the practical implications of European monetary union. Not to be outdone, or indeed outmanoeuvred, Her Majesty's Treasury hurriedly convened a briefing yesterday afternoon, in advance of a speech last night from John Major on much the same subject. There was a degree of "hype" in the whole procedure. The chancellor's number two, Norman Lamont, had been scheduled to speak last night to the German Industry Forum: instead of the understudy, they got the star.

This flurry of last-minute activity suggested to a market straining every nerve for news of Britain's entry into the exchange-rate mechanism that the chancellor was going to say something positive. Sterling advanced 2 pfennigs. Instead of news, however, the chancellor set out a bargaining position.

The bottom line in the debate about monetary union is which currency comes out on top. We can be sure it will not be sterling, and we can be equally certain that if we go down Nigel Lawson's competing currency route, the mark will emerge top of the tree. So Mr Major has picked up Sir Michael Butler's theme of a European Monetary Fund, this institution then administering the ecu, so touchingly termed "our infant common currency". The chancellor seems to have adopted the "new man" image that is besotting the advertising industry, and it is likely to be equally unsuccessful.

We would be wrong to doubt the honesty of the chancellor's proposals, but they are unlikely to do more than slow the pace. Wholehearted acceptance by the community is unlikely. Leaving aside the flights of fancy, such as the notion that ecu notes "could capture the popular imagination", the community is unlikely to buy the idea of a hard ecu, making its own way across Europe. Like the unfortunate camel, the ecu could end up with the attributes of a horse designed by committee, but less useful.

Much more, however, is expected of this animal than was ever likely to be achieved by the current "soft" ecu. In time, the ecu would become the common currency for Europe, and in the very long term, said Mr Major, picking his words with a skill learned around the cabinet table, "if peoples and governments so choose", it could develop into a single currency.

The ecu out of the basket would not suffer the "average" effect that is so objected to by Karl Otto Pöhl, but if brilliantly administered by a fiercely independent central bank would naturally attach itself to the best in Europe rather than hover around the mean. A currency without an economy will presumably need an anchor, and to tie it to strength rather than to a cocktail should have a salutary effect on inflation-prone economies.

The initiative was not surprising in itself, but the adoption of the hard ecu as the European monetary candidate suggests two themes to warm the hearts of those who advocate early entry into the exchange-rate mechanism. The first is that entry is now taken entirely for granted. The time for discussion on the merits of Delors stage one is past. We are going in, the timing to be dictated as much by politics as economics. The government will do its best to make the timing of entry a surprise. We will wake up one morning, and be there. The second is that Britain does want to play a full part in the shaping of the world beyond stage one, and is setting out its stall in front of the inter-governmental conference in December.

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21 June 1990

FINANCIAL TIMES

Coal funds 'fail' in raid on Globe shares

By Nikki Tait

BRITISH Coal Pension Funds yesterday made the long-awaited increase in their £1bn-plus bid for Globe, Britain's biggest investment trust. The announcement was combined with an instruction to its stockbrokers to raid the stock market for up to 95m Globe shares. Added to the Coal Funds' existing 34 per cent stake this would have taken the bidder to more than 50 per cent.

By the close of business, however, it appeared to have failed by a considerable margin in this objective. Globe, meanwhile, rejected the new terms and later claimed that its advisers knew of no UK institutions which had sold in the "failed market raid."

The announcement of the increased offer came in the early afternoon, with BCPF raising its cash terms from 191p to 205p a share. The new offer values Globe at £1.11bn, compared with £1.03bn previously.

Earlier in the day, Globe had already announced that, as a result of the agreed offer from Svenska Cellulosa for Reedpack, there was likely to be an increase of 2.8p a share in its net asset value. Globe owns a 5.5 per cent stake in Reedpack, which it acquired for £12m. This had been revalued to £14.6m, but Globe should now realise £29.9m.

BCPF said that it had taken this uplift into its calculations when setting the new terms. It claimed that the new offer was arrived at by taking a basic net asset value of 214p for Globe. It then adjusted upwards for Reedpack and dealing investments and properties. It also made certain deductions for Globe's bid defence costs and the write-off of its holding in British & Commonwealth.

After taking account of those alterations, BCPF argued that its new offer represented a 4.4 per cent discount to assets – "extremely attractive" claimed Mr Paul Whitney, chief executive of CIN Management.

Globe, however, protested that the offer fell substantially short of its total value at June 4 of 233p a share. It argued again that the value of its fund management subsidiaries, debenture stock, retained earnings for the current year, and recommended final dividend should all be taken into account in arriving at the valuation of the company's worth.

"The diminutive increase in the Coal Funds offer shows that they continue to seek a profit at the expense of the general body of shareholders," said Globe.

The revised level of the BCPF's bid, which is declared final unless a competitive situation arises, also fell short of most analysts' expectations.

The stock market raid, meanwhile, brought an inconclusive result. BZW, BCPF's stockbrokers, declined to say how many shares had been acquired but the Stock Exchange Automated Quotations service showed 51m shares traded. Allowing for double-counting that would suggest that upwards of 26m shares changed hands – around 5 per cent-plus of the equity. BCPF already owns just under 34 per cent of the shares, and had acceptances for a further 1.42 per cent at Monday's close. That took it to 35.4 per cent at that date. Globe's share price ended the day 1p lower at 204p. The new terms for the Globe convertible loan stock are £498.15 in cash for every £100 nominal of stock.

THE TIMES

Major looks to Butler service

John Major looked further afield for advice on his keynote speech last night to the Institute of Directors than his usual clutch of Whitehall advisers. Step forward none other than Sir Michael Butler of Hambros Bank. Sir Michael, a former British ambassador to the European Community, would normally have sunk without a trace (though not without a hefty salary) on retiring from public service. But in a rare instance of Whitehall operating the Washington revolving-door policy, he worked closely with Treasury officials on the Major plan. This was remarkable also in that Butler was a noted "European", not an obvious enthusiast for Major's Machievellian piece of Delors sabotage.

"I worked very closely with his officials over the past week on the subject of the speech," was all Butler would say. But while the City anxiously awaited the speech, Butler was given a sneak preview. "It was discussed with me, and I was very happy with what I was told", he said coyly last night. The Treasury was obviously equally happy with the result. Initially Norman Lamont, the chief secretary, was to make the speech. Yesterday he was booted off the platform to be supplanted by his boss in a deft instance of Whitehall news management.

Thursday, June 21, 1990

FINANCIAL TIMES

EUROPEAN UNION

Hurd gives his backing to the Chancellor

By Ivor Owen

BRITAIN's latest proposals for securing progress towards economic and monetary union were aimed to counter suggestions that there should be a "two-speed" European Community, Mr Douglas Hurd, the Foreign Secretary, said yesterday.

He told a Parliamentary Press Gallery luncheon that the ideas outlined by Mr John Major, the Chancellor, to the German Industry Forum were "more persuasive, more detailed and more practical" than previous ones.

Mr Hurd said the new approach was consistent with the objections expressed by the Government to the original proposals in Stage three of the Delors report which went "considerably further than we could accept."

He believed that Mr Major's speech would convince other members of the European Community that Britain would not seek to delay decisions.

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MAIN POINTS OF INTEREST IN THE PRESS

21 JUNE 1990

1 Europe, EMU

The Governor's appearance before the Lords Select Committee is covered by the FINANCIAL TIMES (5) which highlights his preview of the Chancellor's "hard ecu" proposal.

Wide coverage is given to the Chancellor's speech and the accompanying briefing (6-23). Most commentators take a positive line, giving the Chancellor full marks for steering a difficult path between the Prime Minister and his European counterparts. Some are stuck by the extent to which Stage 1 is now taken for granted - a sign that Messrs Major and Hurd are winning the battle. The TIMES sees the "hard ecu" as cunningly crafted "to pass muster with Margaret Thatcher, a currency that manages to be anti-inflationary, European yet not German, an astonishing creation" (12). At the same time the paper feels that Mr Major will not satisfy the enthusiasts in Europe, but at least he will keep Brussels talking through a delicate period. Sarah Hogg speaks for most when she says that the new proposal is superior to the competing currencies model - a proposal that deserves to be taken seriously by the rest of the EC. The TELEGRAPH Comment column points out that many have the distant dream of a single European currency, but only the Treasury is attempting to survey the ground in between.

The only discordant note comes from Samuel Brittan, who dismisses the "hard ecu" as a backward step. He sees some form of EMU as an inevitable outcome of ERM entry, which he feels is the biggest

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ECONOMIC AND MONETARY UNION

Thursday, June 21, 1990

Governor outlines how Ecu may develop

By Peter Norman, Economics Correspondent

MR ROBIN LEIGH-PEMBERTON, the Governor of the Bank of England, yesterday gave peers a preview of Britain's plans for a market-based evolutionary approach towards economic and monetary union using a development of the European Currency Unit (Ecu).

He told a meeting of the House of Lords Sub-committee on European Economic, Monetary and Political Union, that Britain would be prepared to promote the Ecu after Stage one of economic and monetary union had been running for about four to five years.

By this time, operation of the exchange rate mechanism of the European Monetary System would have successfully minimised currency movements in Europe.

At this point, which would mark the end of Stage one of the Delors committee programme for achieving EMU, the Ecu would be virtually constant in that it would no longer consist of 12 diversifying national currencies. A European Monetary Fund (EMF) would be set up to issue Ecus as a parallel EC currency in return for national currencies.

Central to the plan, which owes much to earlier proposals put forward by Sir Michael Butler, a former diplomat and director of Hambros Bank, is the idea that the Ecu should be as strong as the strongest EC currency and so gradually play a bigger role in EC monetary affairs.

Britain was now proposing a firm rule by which any issue of Ecus against a national currency by a future EMF would have to be matched by the withdrawal of that national currency to the same value, the Governor said.

Mr Leigh-Pemberton said this proposal for a "hard Ecu" would overcome one of the problems surrounding development of the Ecu as a parallel currency. Other central banks, and the West German Bundesbank in particular, had objected that a parallel Ecu would risk increasing the EC's money supply and so pose an inflationary threat.

The Governor said the new proposal would be a means of enforcing strict monetary policy in the EC. It would not amount to imposing one currency on the Community. Instead, it would give institutions the opportunity to choose the Ecu if they thought it was more sound than their national currencies.

There were "some very attractive elements" in the latest plan, the Governor said. Initially, he had been sceptical about Sir Michael's ideas, he said. "But I've been converted."

He said he would hope to convince his fellow EC bank governors of the merits of the proposals at their next meeting on July 10 in Basle, Switzerland.

Mr Leigh-Pemberton described the latest British proposals as "a very useful intermediate step between the 12 existing EC currencies and a single EC currency."

However, he made clear that in his view Europe should move to a single currency as quickly as possible, if and when it achieved a locking together of existing currencies.

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THE TIMES

Major proposes issue of Euro currency

By RODNEY LORD AND ROBIN OAKLEY

A RADICAL plan to issue banknotes denominated in the European Currency Unit (ecu) was unveiled yesterday by John Major, the Chancellor of the Exchequer. The aim is to take a practical step towards a common European currency while avoiding the inflationary dangers and surrender of sovereignty involved in the Delors plan.

The Chancellor's idea, which owes something to earlier suggestions from the British Invisible Exports Council, is to set up an institution called the European Monetary Fund (EMF), which would create an entirely new international currency. At present the Community does not issue ecu notes and the currency has no existence independent of the national currencies on which it is based.

Mr Major sees the new ecu as providing a "natural currency" for tourists and business travellers.

Colleagues believe it is an ingenious combination, signalling a more sympathetic approach from Britain while safeguarding economic sovereignty in a week in which the prime minister said that a single European currency, with the degree of sovereignty over economic policy that had to be sacrificed, was not for her political lifetime.

The Chancellor's speech had been agreed in advance with Margaret Thatcher and, significantly, with Nicholas Ridley, the trade secretary, who has been leading a counter-attack within the Cabinet against what he sees as a drive by Mr Major and Douglas Hurd, the foreign secretary, to push Britain into the European exchange rate mechanism (ERM).

Mr Major's plans, flagged as Britain's contribution to the debate on economic and monetary union leading to the intergovernmental conference on European Monetary Union (EMU) in December, were set out in a speech last night to the German Industry Forum.

Mr Major put forward two versions. The less ambitious would be for the new EMF to act as a currency board, only issuing ecu that were backed one for one by national currencies. His preference is for a more ambitious "hard ecu", a genuine new currency managed by the EMF through open market operations.

FINANCIAL TIMES

Thursday, June 21, 1990

Major calls for creation of hard EC currency

By Peter Norman, Economics Correspondent

MR JOHN MAJOR, the Chancellor, last night proposed that the European Community should have a new international currency backed by a European Monetary Fund as an alternative to existing proposals for EC economic and monetary union (EMU).

The Chancellor's proposals are Britain's riposte to growing pressure on the Continent for a federal Europe. They were presented in a speech to the German Industry Forum in London and call for the creation of a "hard ECU" derived from the existing European Currency Unit.

He said that the hard ECU would be a parallel currency alongside existing EC monies that might in time become a common currency for Europe and "in the very long term" a single currency if peoples and governments so chose.

Mr Major's speech presented Britain's plans for the medium-term future, after the so-called Stage 1 of the Delors programme towards EMU has been completed.

It was timed to coincide with next week's EC summit meeting in Dublin and allows Mrs Margaret Thatcher, the Prime Minister, to appear as a good European who is not automatically opposed to greater monetary integration in Europe.

Mr Major's proposals are also intended to broaden the debate on Europe's monetary future before December's conference of EC member states which is due to decide on how to progress towards EMU.

Stage 1 of the Delors plan, which has been agreed by all EC governments, starts next month. It entails the creation of a single financial area in the EC with the free movement of capital and eventual membership on equal terms of all EC currencies, including sterling, in the exchange rate mechanism of the European Monetary System.

Beyond Stage 1 the proposals envisage progress towards EMU, culminating in a single EC currency and central bank. These have strong backing elsewhere in the Community but have been firmly rejected by Mrs Thatcher.

Last night, Mr Major proposed as "a first practical step" the issuing of ECU bank notes in the EC, which would require the establishment of a European Monetary Fund (EMF).

The EMF would act as a currency board to provide ECUs on demand for EC currencies. To prevent any inflationary expansion of the money supply the Fund should only issue notes that were fully backed by its own holdings of the various EC currencies that make up the ECU.

As a further step, he advocated the creation of a new hard ECU. In this stage, the ECU would become a currency in its own right and no longer defined as a basket of the EC currencies as at present.

The hard ECU "would never devalue against other Community currencies," he said. In that way it could gradually win support at the expense of existing EC currencies and so provide a gradual, market-related way for Europe to evolve towards EMU.

The EMF would manage the hard ECU, eventually setting interest rates for it through normal central banking techniques. The Fund would also co-ordinate the member states' intervention against the dollar and the yen.

Rules would also be needed to prevent the Fund having to support weak Community currencies.

It was clear that many details remain to be fleshed out. These include the nature of the EMF and the timescale of the developments.

Yesterday, in evidence to a House of Lords committee, Mr Robin Leigh-Pemberton, the Governor of the Bank of England, suggested that it could take four or five y[...] before Stage 1 ended and [...] Major's proposals could [...] its place.

Major's speech, Page 10; [...]ernor on future of ECU, [...] 12; Economic Viewpoint, [...] 22; Money Markets, Page [...] London Stocks, Page 44

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THE TIMES

Thursday, June 21, 1990

Major unveils plan for hard European unit

By Colin Narbrough, Economics Correspondent

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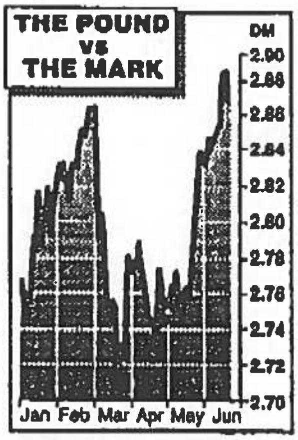
THE chancellor, John Major, last night proposed a "hard" European currency unit parallel to European Community currencies that could become the single EC unit.

The hard ecu would be managed by a new institution, a European monetary fund, rather than the EC central bank, or "Eurofed", foreseen in the Delors plan for European monetary union and so strongly opposed by Margaret Thatcher.

But Mr Major's idea is not warm endorsement of a single currency. This is seen as a possibility for the "very long term, if peoples and governments so choose". His proposal comes before next week's community summit in Dublin where monetary union is high on the agenda.

While the chancellor said the single currency question was not a decision to be taken now, Robin Leigh-Pemberton, governor of the Bank of England, made clear that he did not share the prime minister's view that the decision is not for this generation. Before a Lords select committee, Mr Leigh-Pemberton supported the hard ecu plan, but underlined that he would not back anything inconsistent with the ultimate Delors goal of a single currency and a Eurofed.



Mr Major's proposal, based on an initiative last month by Sir Michael Butler, a former British ambassador to the community, fulfils the government's pledge to produce alternatives to Delors plan. For the government, the scheme has the attraction of retaining the Treasury's "evolutionary" approach to monetary union, allowing the market to decide which currency it favours. It provides for currency competition, a concept launched by Nigel Lawson, the former chancellor, without necessarily leading to mark supremacy.

The ecu would not be allowed to weaken when parity realignments take place in European monetary system currencies. This would make the unit the firmest ERM currency. The hard ecu is foreseen coming to play when all community currencies have been brought into the monetary system exchange-rate mechanism.

Mr Major reaffirmed the government's commitment to joining the ERM, but only when its conditions are met. Expectations of fresh guidance on the mechanism, boosted the pound on the foreign exchange markets. The trade-weighted index closed 0.4 higher at 90.8.

In his address to a German Industry Forum dinner in London, the chancellor made clear his proposal was based on a completed stage one of the Delors plan, when all community currencies would be in the mechanism.Echoing Mrs Thatcher's view that the community should not create institutions that exclude the emergent democracies of Eastern Europe, he said conclusions were needed that "take all of Europe's nations forward." He restated the government's rejection of a Eurofed for its lack of political accountability, and because a single monetary authority would not be able to deliver the necessary economic and low inflation performance.

Mr Leigh-Pemberton said the central bank governors of West Germany, France, the Benelux countries and, possibly Denmark, believed they could already operate fixed exchange rates between themselves, creating an inner, fast-track group in the EMS. But Mr Major gave a warning that attempts to impose rapid, total solutions presumed far greater economic convergence than exists. "It is far from self-evident to me that such convergence is to be achieved by means of a single common monetary policy."

The key to progress, he said, is promoting convergence of economic performance, low inflation and stable exchange rates "by building up the infant ecu". The European monetary fund would act as a currency board, providing Ecus on demand in exchange for community currencies. It would only issue ecu notes fully backed by its holdings of community currencies, thereby presenting no threat to inflation. Interest rates on ecu loans would be based on a weighted average of interest rates in its constituent currencies, giving the fund no role in setting rates.

Comment, page 25

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Daily Telegraph

Thursday, June 21, 1990

Major seeks to break EC deadlock

Euro-currency plan for tourists and business

By Anne Segall, Economics Correspondent

A NEW EUROPEAN currency which businessmen and tourists could use throughout the Common Market was proposed by Mr Major, Chancellor, last night as the cornerstone of a radical alternative plan for monetary union in Europe. His initiative, which was agreed at a Downing Street summit only 24 hours earlier, is an attempt to break the deadlock in Europe over the future direction of the Community — and prevent Britain being left behind as the pace of economic and monetary integration intensifies.

The Major plan involves a new currency based on the EC's existing monetary unit, the Ecu. It would operate alongside existing currencies, but not replace them — and would be exchangeable for pounds, francs or Deutschemarks.

He told a meeting in London of the German Industry Forum: "The idea could catch the popular imagination, and as notes came to be used more frequently it could help the development of large-scale markets in Ecu deposits.

"In time, the Ecu would be more widely used. It would become a common currency for Europe. In the very long term, if peoples and governments so choose, it could develop into a single currency. But that is a decision we should not take now, for we cannot yet foresee what the size and circumstances of the new Europe will be."

Mr Major was so keen to find a platform for his initiative that he asked Mr Lamont, Chief Secretary, who was due to speak, to stand down.

He drew a strong distinction between creating a single currency through a process of evolution, based on consumer choice, and the "big bang" approach favoured by Brussels. The plans for monetary union developed by M Jacques Delors, EC President, would abolish individual currencies and wrest control of national finances from the individual governments of Europe.

Mr Major said the Government had "substantial objections" to the Delors approach, but that did not mean progress could not be made.

The Chancellor warned that attempts to foist a single currency on Europe without allowing member states to feel their way towards it risked ending in failure, particularly as EC members are still at different stages of development. "Without greatly increased convergence, monetary union simply would not work," he said.

"A premature attempt to implement it would be unsustainable and hence a huge setback, damaging both economically and politically, and would lead not to unity, but to disunity."

Yesterday's speech underlines the determination expressed in recent weeks by the Chancellor to take Britain into the European exchange rate mechanism as soon as practicable and play a constructive role in developing future plans.

The possibility of an autumn entry date has given the pound a huge boost on the exchanges, allowing it to appreciate by five per cent against the German mark.

The Government has accepted stage one of the Delors Plan which begins on July 1 and which requires all the currencies of Europe to come together in a managed exchange rate system. But it remains fundamentally opposed to the final stages of the plan, involving the abolition of national currencies and the creation of an independent European central bank.

The Chancellor's "hard Ecu" plan is designed to spark a wide-ranging debate on the future of Europe at the forthcoming Dublin summit and at the inter-governmental conference in December, and appeal to the Germans.

There has been some concern that Britain could be left behind in a two-speed Europe by failing to take a positive approach but Mr Major made it clear yesterday that he would not be prepared to countenance arrangements which applied at different times to different countries.

The British plan is a refinement of an earlier scheme for competing currencies developed by Mr Lawson when he was Chancellor, and presented by Mr Major last November.

It is based on the view that Europe should work gradually towards a united currency and should allow the market to set the pace. It also enshrines the principle of "subsidiarity" which means Brussels should not be allowed to encroach on the powers of individual European countries unless absolutely necessary.

The "hard Ecu" would be managed by a European Monetary Fund in such a way as to avoid increasing the supply of money in Europe in an inflationary way. Exchange rate and interest rate adjustments would be allowed to ensure it was always worth more than the strongest individual currency in Europe.

● Philip J[illegible] Mr Major unveiled his proposals less than a week before a Common Market summit in Dublin.

Mr Major, supported by Mr Hurd, Foreign Secretary, secured Mrs Thatcher's final agreement yesterday, the most positive acknowledgement so far that Britain cannot stop the momentum for economic and monetary union in the Community.

The meeting was also attended by Mr Ridley, Trade and Industry Secretary, and a leading opponent of British membership of the European exchange rate mechanism. The Prime Minister finally initialled the draft of Mr Major's speech yesterday morning.

The Major plan will be seen as a further indication that the Chancellor and Mr Hurd are winning their battle to persuade Mrs Thatcher to adopt a more positive attitude towards the ERM and to take an active part in Common Market talks on monetary union in order to avoid Britain being shunted into a second tier behind France, Germany and the Benelux countries.

Mrs Thatcher remains implacably opposed to a single European currency which would replace the pound. Mr Major's initiative is intended to put forward a practical alternative and demonstrate the Government's goodwill.

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The Guardian
Thursday, June 21, 1990

Chancellor proposes fund to manage new currency

Major sets out Europe alternative

Will Hutton
Economics Editor

JOHN Major, the Chancellor, last night launched an important substitute proposal for the second stage of the Delors plan for European Monetary Union. Instead of a European Central Bank, Mr Major proposes establishing a European Monetary Fund that would steward a new European currency, still to be called the Ecu, that will be permanently guaranteed to hold its value against the strongest currencies in Europe.

Politically, the plan will be seen as a victory for the Major-Douglas Hurd camp inside the Cabinet, urging a more purposeful approach to the whole debate on European union, especially in monetary matters.

It also has the attraction, for the Conservatives, of outflanking the Labour party, whose early commitment to the European Monetary System won it political advantage, and allowing the Prime Minister to present herself as a "good European" at the summit of European Community ministers in Dublin next week.

Speaking to the German Industry Forum at the institute of Directors in London, Mr Major reiterated his commitment to taking the pound into the exchange rate mechanism of the EMS as soon as "our well-known conditions are met", and underscored his enthusiasm by outlining his own proposals for what should follow.

The central plank in his initiative is the creation of a new European Monetary Fund that would manage the ERM, lend money to those countries with medium-term balance of payments difficulties, and co-ordinate intervention between EMS member currencies and non-member currencies like the yen and the dollar.

The most significant function of the fund would be its role as a currency board, managing the European Currency Unit (Ecu).

The Ecu already exists as a common currency for Europe, its value determined as an average of all member country currencies — weighted to reflect their varying economies.

Mr Major wants his fund to issue Ecus as bank notes for use across the community, and for the Ecu to enter the exchange rate mechanism like all the other European currencies.

The Treasury's proposal last year for competing currencies in Europe — its first sally into the debate on monetary union — was criticised as inflationary because the supply of Ecus would be potentially limitless.

Mr Major said the new EMF would only be allowed to issue Ecus to banks if they were backed by the various currencies that made up the Ecu. To ensure that the Ecu held its value against the strongest currencies, he proposed that in any ERM alignments the Ecu would always be revalued in line with whichever currency moved up.

To add to the currency's anti-inflationary credentials, if the fund felt it had swapped too many Ecus for any one member country's currency then it could insist the central bank in question give it another hard currency as a substitute.

Ecus "could provide a natural currency for tourists and business travellers," said Mr Major, although the Government, for example, would still expect to have its taxes paid in sterling.

European monetary union is on the agenda in Dublin and Mrs Thatcher and Mr Hurd, the Foreign Secretary, are expected to float the new British plan — the first significant new EC institution Mrs Thatcher will have proposed.

Reactions, however, are likely to be cool. Bundesbank sources last night said the proposals did not seem to provide for "a real independent Central Bank with the power to create hard currency autonomously".

Without a central authority relating the amount of currency to the amount of goods and services, there was always a danger of monetary policy being too lax or too tight, they said. The simplest and cleanest approach to monetary union was that proposed by the president of the European Commission, Jacques Delors.

There should be an independent central bank administering a single currency, and countries should accept that their spending, taxing and borrowing plans need to be co-ordinated to ensure the new regime is introduced as painlessly as possible.

The Government will stress the practicality and gradualism of its proposals, and the fact that whatever EC countries say in public, few relish giving up sovereignty over their monetary and budgetary policies.

Even if the initiative advances little beyond the Dublin summit, it will be taken as evidence of the progress Mr Major and Mr Hurd are making in persuading Mrs Thatcher to modify her approach to Europe.

No East German spending spree, page 8; City Notebook, page 11; Leader comment, page 18

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THE INDEPENDENT Thursday, June 21, 1990

Chancellor's speech brings Ecu in the pocket nearer

Britain warms to European monetary union

By Peter Rodgers and Colin Brown

JOHN MAJOR, the Chancellor of the Exchequer, last night firmly shifted government policy towards constructive negotiation over European monetary union with a plan for a new currency backed by a European Monetary Fund.

The fund would issue bank notes in the new European currency which Mr Major said could "provide a natural currency for tourists and business travellers. The idea could catch the popular imagination."

The proposal for a new currency developed from the existing European Currency Unit (Ecu) comes only days ahead of next week's EC summit in Dublin.

It takes a gradualist approach to monetary integration, and is the culmination of a campaign by the Chancellor and the Foreign Secretary, Douglas Hurd, to convince Margaret Thatcher to modify her outright opposition to the later stages of the EC's Delors plan for monetary union. This envisages a common European currency and central bank.

Mr Hurd confirmed at a Commons lunch that Mr Major's speech, to the German Industry Forum at the Institute of Directors in London, had been approved by Mrs Thatcher. Against the background of fierce attacks on closer monetary integration by Nicholas Ridley, the Secretary of State for Trade and Industry, Mr Hurd denied a ministerial split.

The priority given to the speech by the Chancellor was shown by his unexpected decision to ask his deputy Norman Lamont to step aside so he himself could use last night's speech as a platform.

The proposals, developed with the help of the Bank of England, were presented by officials as ideas rather than a blueprint. They will not be formally tabled in Dublin, though they are bound to be discussed.

The proposals might open the door to British participation in detailed negotiations on the shape of stage 2 of the Delors plan, without completely shutting the door on stage 3, the single European currency and central bank to which Mrs Thatcher so vehemently objects.

Mr Major said of his new proposal: "In time, the Ecu would be more widely used: it would become a common currency for Europe. In the very long term, if peoples and governments so choose, it could develop into a single currency. But that is a decision we should not take now."

On a technical level, the Major plan appears to be aimed mainly at convincing the West German Bundesbank that there is an alternative evolutionary way of setting up a European monetary body.

The idea is gradually to convert the Ecu, at present a basket of community money, into a currency in its own right, managed by a European Monetary Fund (EMF). Initially the EMF would be a low-key currency board, issuing ECU bank notes, aimed at tourists and business travellers.

Later, a new currency, the "hard Ecu," would gradually win acceptance as a community currency alongside existing national money.

It would be maintained by the EMF as the strongest currency in the Exchange Rate Mechanism. Mr Major said it would become "a genuine currency in its own right".

Although Tory MPs said no ground had been conceded because the Chancellor had rejected stage 3 of Delors, the proposed EMF would in its later stages have many of the characteristics of a central bank, and it would be a short step to adopting the "hard Ecu" as a single currency.

In the longer term, Mr Major said that as well as managing the Ecu, the EMF could manage the ERM and co-ordinate European exchange rates against the dollar and the yen.

Mr Major acknowledged that his proposal was derived from a paper by Sir Michael Butler, chairman of the British Invisible Exports Council, and Paul Richards, a director of the merchant bank Samuel Montagu, first published in *The Independent*.

It is far more sophisticated than a plan by the former Chancellor, Nigel Lawson, for a system of competing currencies which received a cool reception.

The Treasury and the Bank claim to have overcome the objection to the Butler plan for a "hard Ecu" – that it would be inflationary because the EMF would be forced to bail out countries whose currencies collapse because of mismanagement.

The Treasury proposal would allow the EMF to dump the currency of a country whose economy is badly managed back in its lap in exchange for the domestic central bank's foreign exchange reserves and, if problems continued, the "hard Ecu" would rapidly replace the unreliable domestic currency.

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THE WALL STREET JOURNAL EUROPE

U.K.'s Major Proposes ECU As the EC's Single Currency

By Tim Carrington
Staff Reporter of The Wall Street Journal

LONDON – British Chancellor of the Exchequer John Major proposed a new plan for European monetary union, based on raising the status of the little-used European currency unit into a widely circulated common currency. Under his plan, the ECU eventually would become the single currency for the European Community.

The proposal, which Mr. Major plans to bring up at next week's EC summit in Dublin, marks a significant departure from the Thatcher government's blanket opposition to the concept of monetary union and a single currency. Still, the idea may be seen by some of Britain's EC partners as a delaying tactic, or as an inadequate substitute for the blueprints already under discussion.

John Major

The new British counterproposal, sketched out in a speech Mr. Major prepared for delivery to a West German industrial group here last night, followed hints that the Thatcher government had softened its opposition to European monetary cooperation and that it planned to push the pound into the current exchange-rate mechanism of the European Monetary System. The perceived thaw, along with expectations that Britain would soon fully join the EMS, has strengthened the relative value of the pound and spurred a rally in U.K. stocks and gilts. (Story on Page 14.)

European Monetary Fund

Under Mr. Major's concept, the vehicle for elevating the 10-year-old ECU would be a new institution called the European Monetary Fund. This organization would act as a currency board, issuing ECUs in exchange for national currencies. However, the plan envisions making a "hard ECU" that would be guaranteed against any decline in value relative to existing EC currencies.

A Treasury official reasoned that the ECU "would be made more attractive by ensuring that it's going to be the strongest of the currencies." More businesses, governments and financial institutions would use the ECU in international transactions as well as internal accounting. Eventually, U.K. officials say, it would replace today's pounds, francs and marks.

"ECU bank notes could provide a natural currency for tourists and business travelers," Mr. Major said. "The idea could capture the popular imagination; and as notes came to be used more frequently it could help the development of large-scale markets in ECU deposits."

By emphasizing the play of market forces to promote the ECU, Mr. Major's proposal differs from approaches currently under discussion, which call for creation of a new central banking authority or "EuroFed" that would arrange a transition to a single currency. The Thatcher government opposes this approach on the grounds that the EuroFed wouldn't be politically accountable to national governments.

The proposed European Monetary Fund wouldn't be directly accountable either, but it would have fewer powers. Interest rates on ECU deposits and loans would be set by the weighted average of interest rates of the currencies making up the ECU. The arrangement would come after all EC nations have brought their inflation rates into convergence and joined the EMS exchange-rate mechanism, which holds currency fluctuations within set bands.

'Serious Proposal'

Malcolm Levitt of Ernst & Young Management Consultants, characterized the plan as "definitely a serious proposal that will present the U.K. in a much more positive light" in the push toward monetary integration. But he predicted criticism from the Continent along the lines that the plan could take too much time to enact, leaving too much to "the vagaries of the private sector."

The Thatcher government is hoping for some sign of approval from the West Germans, whose powerful Bundesbank plays a key role in shaping any future monetary arrangements. In the past, the central bank has been cool to the idea of creating a parallel currency alongside existing EC forms of money. Bundesbank officials have warned that such a system could increase the money supply and make it harder to control inflation.

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