Jacques RIBOUD

A MONETARY MECHANISM with THE CONSTANT EURO (The Eurostable)

Standard for reference and measurement with an invariable real value

Neutral payment and reserve medium for international trade

Key to exchange rates stabilisation

Centre Jouffroy pour la Réflexion Monétaire
J.R.S.C. Editions

FOREWORD

There are some fields in which innovation is more necessary and more expected than in others but in which, paradoxically, it is harder to gain acceptance for it.

Money, in the conceptual sense given to this term, is one example. The reason for this state of affairs is probably the very special symbol of money as it has developed from the universal use of money since time immemorial, the vital importance of money in everyone's lives, and the questions that are asked as to its real nature.

This has given rise to a feeling that may be compared to religious experience, faith in something very important but which is known to be beyond human understanding ; the corollary to this is the reaction of hostility and sometimes even ill will to anything that may appear to be undermining this belief. This is the obstacle that the two exceptional and not properly understood properties that are expounded in this book by the "Centre Jouffroy pour la Réflexion Monétaire" will have to overcome.

The first of these two properties is the inherent stability in real value of an external transaction numeraire, independently of time and place, conditions which are essential for an anchor currency but which have never been achieved.

The second property is its suitability for successfully defending exchange parities and eliminating any risk of crisis with no increase in inflation and with no effects on national currencies. This is enough to make of it the ideal stabiliser which the world has been looking for since the beginning of this century.

It so happens that these properties are the very ones that monetary authorities and political leaders are calling for now because they would contribute, within the context of the Treaty of Maastricht, to the working of the single currency and, outside that context, because they would give monetary policy a freedom of initiative and decision which it tragically lacks.

That is why the "Centre Jouffroy pour la Réflexion Monétaire" hopes to find its recompense for twenty years of hard work in the reception given to this book.

CENTRE JOUFFROY
Pour la Réflexion Monétaire
88 bis, rue Jouffroy d'Abbans 75017 PARIS
Tél. : 01 46 22 10 50 - Fax : 01 47 64 49 62

SUMMARY

1

INTRODUCING THE AUTHOR AND THE BOOK

I must warn the reader right at the outset : this book was not written by an economist, a banker, a financial manager or a politician. It was written by an engineer working in a discipline that is not widely recognised and not widely practised : monetary mechanics. This term covers the conception and the assembling of the component parts responsible for the creation, circulation and destruction of money. I must specify that money is viewed here, to use Keynes' terms, as *"a mere intermediary, without any intrinsic value, which is passed from hand to hand, is received and disappears as soon as its job is done"* (1).

The monetary mechanism implied by this movement is of unparalleled importance. The extraordinary recurrences of crises which have distinguished the history of money throughout the present century is due to deficiencies in the way this monetary mechanism operates, which have been too often misunderstood or misinterpreted.

Until recently, the technical means available were insufficient to adapt international monetary organisation to a rate of change which is accelerating in all parts of the world. The expansion of international

(1) "Essay on Money and Economics". This view of money is very far from the one that prevailed until recently, of "money as representative of a commodity, defined by what stands as its guarantee". It is illustrated convincingly in the diagrammatic presentations of the eurodollar and Eurostable.

trade in goods and services has become more and more out of phase with the monetary mechanism used in such trade.

At the heart of this mechanism lie a number of *numéraires*, all of them, without exception, nominal national currencies, designed for use within a State, and none of them designed specifically as a means of payment between States, even though the conditions of use are quite different when a *numéraire* circulates for payment purposes within a national territory, from when it circulates as a means of payment between nations, in that vast space between them which is called the xenomarket (which is preferable to the term "euromarket", so as to avoid any confusion with the future european euro).

A nominal national currency is unstable by nature and is unsuitable for use as the anchor that is needed by an international monetary system. We must look for that anchor elsewhere.

The euro is a happy initiative, if only because it substitutes a fully-fledged currency issued by the European Central Bank (ECB) for the present ecu, which is a composite currency compound of several national currencies, created for transaction purposes by a private association (the Ecu Banking Association or EBA).

But the euro will still be a nominal currency, like the Mark, the Franc or the Dollar. From a conceptual viewpoint, the euro does not imply any innovation. It confines itself to transposing the very system whose shortcomings are so obvious, to a broadened and diversified territory, that of the European Community.

But present-day technical resources (electronic transmission, computerised real-time clearing, etc.) make it possible to exploit a concept that has so far been ignored : THE INHERENT STABILITY, IN TERMS OF REAL VALUE, OF AN EXCLUSIVELY EXTERNAL TRANSACTION CURRENCY. This characteristic of exceptional stability gives such a *numéraire* the ability to carry out the functions assigned to an anchor currency better than any other nominal currency : a) MEASUREMENT AND REFERENCE STANDARD, b) EXCHANGE AND RESERVE MEDIUM BETWEEN NATIONS, c) INSTRUMENT OF REGULATION AND INTERVENTION.

The purpose of this book is to explain and demonstrate this concept, as well as the appropriate mechanism for applying it.

On June 12, 1974, I presented to the *Société d'Économie Politique* (chairman : Professor Jean Marczewski) a proposal for an exclusively external transaction currency that would be constant in terms of real value ; I called it the "Eurostable". I renewed this proposal in September of the same year in Brussels, at the annual meeting of the *Association du Mont-Pèlerin* and then again a few months later at the same Association's meeting at Hillsdale University in the United States, at a meeting chaired by Milton Friedman. Finally, on January 19, 1981, at the *Académie des Sciences Morales et Politiques*, I presented a paper entitled *"How to Institute a Constant Extra-National Currency and Put Gold at its Service"*.

The concept of an exclusively external constant transaction currency, as well as the procedure for applying it, challenges some traditional notions about monetary mechanisms, particularly with respect to bank money and clearing. I was thus led to widen the field of my studies aimed at backing up the theoretical foundation of the Eurostable and to investigate how it could be put into practice. With this in mind, the "Centre Jouffroy pour la Réflexion Monétaire" was created and the *Revue Politique et Parlementaire* was used as a vehicle for the promotion of these ideas.

Professors Henri Guitton, a member of the *Institut de France*, Fritz Machlup (University of Princeton), Robert Mundell (Columbia), Milton Friedman (Stanford), Sir Alan Walters, private advisor to Mrs. Thatcher and Robert Triffin (Yale), all of them well-known figures in the world of economics and monetary experts, gave me precious help in confirming a radically new thesis that disconcerts many people. Indeed, since money was invented, there has never been a currency that retained its purchasing power whatever the circumstances in which it was used.

The fact is that there is an apparent anomaly between the continuous use of a *numéraire* for payment purposes and unvarying purcha-

sing power. The resolution of this anomaly is not easy to accept. Professor Jean Marczewski said : *"The demonstration of the concept is perfectly sound. I have no objection to make to it. But it is too much for me. Deep down inside, I do not believe in it."*

The titles of my books, which are listed at the beginning of this book, reflect the divergences between received ideas and the construction of the Eurostable.

Resistance to what looks like a departure from common sense is not the only obstacle. However fruitful an anchor currency that was immunised against the universal currency disease of instability would be, merely taking it into serious consideration would demand an international consensus at all levels : scientific, administrative, governmental, etc. That explains why there are extremely few opportunities for innovation in such domains.

The project of Economic and Monetary Union (EMU) offers one such opportunity. THE ECU, WHICH WILL BECOME THE EURO, IS BIPOLAR BY NATURE. THE CONSTANT EURO WILL BE A EURO JUST AS MUCH AS THE NOMINAL EURO. There is not even any need to seek a consensus for an innovation of this kind, wich falls within the framework of the Treaty.

The Eurostable's exceptional property of being able to stabilise exchange markets, without having any effect on inflation, makes of it the instrument which the European Commission has called for so as to solve the problem of exchange rate instability between the members states, IN and OUT the euro zone. The initiative would symbolise European unification in the eyes of the world and would rally public opinion, at present disappointed and disorientated.

Looking beyond EMU, the time will inevitably arrive when public opinion, in Europe and in the world, becomes aware of the irksome and singular fact that we have enjoyed, increasing progress in all sectors except the one that is most important to human well-being, namely the monetary sector. Then the time will be ripe for the creation of several

large currency zones in the world, each with its own neutral, extra-national and constant anchor currency.

These currencies will be linked by commitments between national goverments at the highest level and will help to correct any external instability which hinders the growth of trade between nations, as well as internal instability which interferes with regulation aimed at maintaining a currency's real value (or purchasing power).

What follows is a guide that will enable the reader to find his way through the **121** pages of this book. Let me begin with one piece of advice : don't look for what is not there, namely, political, economic or other considerations about the advantages or the disadvantages of the single currency. The only purpose of this book is to set out a proposal aimed at correcting shortcomings in the way monetary mechanisms function, with or without a single currency.

To begin with, there is a summary of what the euro, and then the Eurostable, would bring to the European Monetary System in the three-year preparatory phase III, the launching of which is recommended here on the scheduled date of January 1, 1999, convergence or no convergence.

After that, two sections summarise the progress of thought, from the ecu to the euro and then from the euro to the Eurostable. The fact is that no one can understand the proposal advanced in these pages without taking into account, first of all, the progress in European monetary organisation that the replacement of the ecu, a dependent composite currency issued by a private association, by the euro, a fully-fledged and autonomous currency issued by the ECB, would represent. Chapter 5 provides a demonstration of the concept of a constant external currency, on which all the rest relies. In chapters 6, 7 and 8, the Eurostable is looked at in each of the functions it carries out : as an anchor currency, and reference standard with an unchanging real value, independent of time and place ; as a medium of exchange and reserve instrument ; as an instrument for intervention and regulation of the foreign exchange markets freed from the two handicaps now affecting the

use of a strong currency in that role (a harmful secondary effect on inflation and a related restriction on issue in volume terms). Chapter 9 presents the "Eurostable Banking Association" a private group of banks for issuing and circulating the Eurostable in the euromarket, proposed as an innovation intended to open the path to public institutions. Chapter 10 shows how clearing is at the heart of the mechanism for the creation and circulation of the Eurostable and how it applies the latest technological developments. In chapter 11, there is an extrapolation of the lessons drawn from European experience for the international monetary system. Finally, chapter 12 offers a recapitulation of the history of money in this century and a plea for a monetary policy focussing on recent technology, rather than on a mere revamping of what is already in use.

Underlying all these pages : the two key properties of the Eurostable, first, its constant real value (purchasing power in the euro zone) in real terms, and, second, its suitability as an instrument for solving the thorny question of the instability of the exchange markets - a problem that has not been solved since the disappearance of the gold standard.

It should be pointed out, for the benefit of those who may read just part of the expose rather than all of it, that the essential features of the Eurostable have been reiterated whenever that is useful, with no apology for repetition.

An analogous concern has led me to add to the explanations and demonstrations of principles - the only ones that really count - some additional details which bring the discussion closer to the concrete and which, I acknowledge, sometimes go beyond the limits I have set for myself, and encroach on fields which are outside the scope of this essay.

The reason for such digressions is that, in the absence of a model which could be examined and a base on which the mind can rest, nu-

merous doubts and questions arise, which divert the discussion from the real subject.

The reader will have no difficulty in focussing on what is essential and distinguishing it from details that are simply intended to appeal to the imagination.

J. R.

2

IN SUMMARY

Europe is the great project of our time. It is a rallying point for peoples who have at last become aware of their common heritage.

The project of Economic and Monetary Union (EMU) is part of this overall aim. It is intended to put one and the same currency into circulation in the member States of the Community.

The single currency, long ignored by the public, the media and even politicians, now occupies centre stage in the debate. There are those who are for or against, those who are lukewarm and those who are indifferent. Overcoming their differences, most people now agree that there must be some kind of monetary organisation in Europe, and that, looking beyond Europe, the time is approaching when an international monetary system that has, to its own detriment, remained untouched by the fantastic technological changes that have occurred in the closing years of this century, will have to be renovated.

Trade in goods and services between Community member states represents more than a third of their output. Industrialists, traders, exporters and importers all unanimously complain that exchange rate instability is hampering the growth of their businesses, and all demand ways of moving from one currency to another at predictable rates that do not vary (see Note **1** on the next page).

Failing this, the abolition of internal frontiers and the creation of the Common Market, will prove harmful rather than beneficial. The structure that has been patiently built up over a period of forty years will be threatened.

NOTES SUPPLEMENTING THE TEXT OVERLEAF

1. Investment usually has two objective : a) to find new outlets and to increase production or to launch a new product, b) to purchase more productive equipment and thereby cut labour costs.

In the first case (a) trade with foreign countries is factored into the forecasts ; in addition to the risks and uncertainties involved in any attempt to predict the future, there is the effect of unpredictable exchange rates, variations which in the past have often been greater than the margins that were anticipated.

In the second case (b), the project provides a sure guarantee of reduced expenditure.

It is not surprising that the increased risk that results from exchange rate instability should orientate investment towards reducing labour costs rather than to expansion, thus helping to increase unemployment rather than economic growth.

2. Any bipolar currency has a nominal form and a constant form. In the nominal form, its real value (purchasing power) is what it is worth on the day on which it is spent. In the constant form, its real value is what it was worth on the day it was created. On one day the value of one unit in it constant form is thus equal to the value of the nominal unit multiplied by the figure for the consumer price index for this day. The daily price index is calculated on the basis of the latest reported increase in the monthly index. Example : on September 1 the index stands at 150. The latest reported monthly increase is 0.2 (annual inflation rate of 2.4%). The daily index coefficient for the month is calculated by adding 0.01 to the previous index two days out of three.

3. The euro will be a nominal currency and will be used for both internal and external transactions. Constant currencies have never been used for any other purpose than as units of account. This book proposes that the Eurostable should be used for payment purposes in external trade, like the dollar, as a medium between national currencies for international financial and trade transactions.

This is why, faced with the failure of all the attempts that have been made over the last 75 years to correct the congenital vice of instability that plagues the money markets, the radical step of doing away with the said markets by creating a single currency in place of the national currencies is undertaken despite the risk entailed in a project that has never yet been tried.

But the final goal will not be reached as long as there are some among the fifteen, soon to rise to twenty, member states of the Community which have been unable, or unwilling, to join the "European Currency Zone" or which, having joined, are unable to remain within it. This is why the Commission in Brussels calls for the strengthening of the EMS, even though the EMS is the very institution that the single currency is setting out to replace.

To this end, the Centre Jouffroy is proposing the creation of an external constant euro (Eurostable) and the procedures for the creation, management and circulation of such a unit, the culmination of two decades of studies.

The Eurostable is the constant form of the nominal euro (2). It will be reserved for foreign trade (cross-border) transactions and for circulation within the xenocurrency zone (3). Its extra-territoriality makes it possible to endow it with constant real value (purchasing power in the zone) that is independent of time and place, and to use it as an intervention currency on the foreign exchange market in sufficient volume to meet any demand (4) without any pernicious secondary effects on the national currencies used in transactions in their own territory.

To be sure, this proposal differs radically from conventional ideas on money. It is understandable that people should find it disconcerting. But once the single currency programme is accepted, rejection of a proposal on grounds of incomprehension or rivalry is unjustified, when it supplements that same programme without modifying it, and offers a chance of success to the ambitious but still uncertain undertaking of launching the single euro.

Public opinion concentrates on the "convergences". In fact, though the viewpoints expressed regarding strict application "of a signed treaty" lead one to think that the convergence conditions will be relaxed

4. It will always be possible to satisfy "demand" for Eurostable (against weak currencies) whatever it is, because the Eurostable created will have no internal effect on inflation or on interest rates since they will remain outside States, in the xenomarket. A foreign exchange crisis leads to the creation of national currencies that are "in demand". The perverse effects of such creation of national currency on its inflation rates, and on interest rates, restrains such "intervention".

The markets are aware of this ever-increasing limitation on the power of creation of the currency that is in demand. This is the real cause of market panics and of the speculation that follows them.

5. The fact that politicians, the media and public opinion are focussing on the "convergence criteria" has the disadvantage of distracting attention from the real problems of the current programme.

6. One of the problems that the future "European Monetary Zone" will raise, will be that of preventing a Member State from tolerating, or even causing an excessive issue of euros, taking advantage of the fact that the dilution of its own money supply in that of the euro Zone masks the inflationary effect.

7. The reason is that, at any given time, the value of the ecu in terms of another currency depends (because the ecu is a composite currency), on the simultaneous values, in terms of that currency, of all the other component currencies - and there are now 11 of them. The preeminence in Europe of the Deutschmark is owed to the inferiority of the ecu as an instrument for the main functions required of an anchor currency and, more particularly, a pivotal currency in the forex.

8. Any margin within which a currency is allowed to float is a standing invitation to speculation, since it makes it possible for speculations to bet repeatedly on a further rise or fall in the currency's exchange rate as soon as the rate approaches the guaranteed limit. "Intervention" at unannounced exchange rate levels is preferable, since it increases the uncertainty about the rate trend and hence the risk of betting on it.

and that the loopholes offered by the Maastricht Treaty will be fully exploited, to everyone's advantage (5).

But there is still the problem of convergence after the introduction of the single currency (6). That is a political problem, but solving it will require the EMU to be provided with an anchor currency worthy of the name.

The stage of the "scenario" drawn up by the European Monetary Commission that should be considered first is the intermediate stage, between January 1, 1999 and January 1, 2002. The euro will be in circulation during those three years, but it will not be a single currency. It will merely be a parallel common currency, equivalent to the national currencies, the mark, the franc, etc., which will all remain in place and will continue to be used.

This period must be considered by the advocates and supporters of the single currency as one stage in the progress toward the final objective ; sceptics will view it as an experiment.

In any case, such an experiment will be worthwhile because, before looking far ahead, we need to look at what is closest to us. What is closest is the euro, an autonomous currency in its own right, which will be issued, starting in 1999, by the European System of Central Banks, and which will be linked to the national currencies with which it circulates at fixed parities.

This euro system already marks great progress compared with the present system based on the ecu, a composite currency that is the captive of the national currencies in terms of which it is defined and incapable of property carrying out the functions assigned to the pivot currency of a monetary system (7).

That is why, whatever one's opinion of the single currency, and whatever the ultimate fate of the "scenario", one must hope for the institution of a European central bank, the replacement of the ecu by the euro, and the fixing of parities without fluctuation margins (8) among a few strong currencies. A programme of this kind is feasible whilst still leaving the future uncommitted.

The primary objective of monetary management, taking precedence over all the others, and recognised by everyone, is the stability of the

9. The regulation of a currency's internal stability (its purchasing power) and that of its external stability (exchange rate) become dependent on each other, either because of the use, for regulating these two values, of one and the same instrument, or because of the pernicious side-effect of one regulation on the other. This is true, for example, of the interest rate, which curbs inflation but attracts foreign capital, thereby pushing up the exchange rate. It is also true of issuing strong currency in support of a weak one, which boosts inflation.

The Eurostable, as a strong intervention currency, would have no effect on domestic inflation because it is exclusively external. It would thus break this undesirable effect of mutual dependence of one form of regulation on the other, thus contributing to both internal and external stability.

10. In a future that may not be so remote, people will not understand the modern world's persistent attachment, for use as a standard and as a reference, to a currency that behaves like a perpetual yo-yo on the foreign exchange markets, whereas no measurement unit has a greater need of stability than the one that is "the only one for comparing all things in value terms" (Montesquieu - *De l'esprit des lois*).

11. The spontaneous emergence, just after World War II of the euromarket (a term to which, as already stated, one should prefer the expression "xenomarket" given that the ecu will become the euro) is one of the most striking events of monetary history. The xenomarket is a vast space bounded by real or virtual borders and distributed over and between the five continents. The currencies that circulate for transaction purposes within that space are all currencies whose domestic counterparts are national currencies used for making payments within national territories, and hence subject to all the uncertainties of value.

The Eurostable, which is strictly external, will circulate for transaction purposes only on the xenomarket. As it will be independent of the factors that determine a currency's purchasing power, it will retain its real value.

numéraire in terms of real value. Such an objective implies severe and even rigorous constraints if it is to be achieved.

For that reason alone, the division of the Community into two groups of States will persist well beyond 2002 : some will be inside and others outside the "European Currency Zone" **(9)**.

There will thus continue to be a problem of parity changes, what is called "competitive devaluation", which will undoubtedly be made profitable by the disappearance of customs duties, even if the subsequent rise in costs finally restores balance. Such ups and downs would be the ruin of all the hopes that have been placed in the single currency. The euro, a national currency just like the dollar and the franc and, like all anchor currencies used in international monetary systems, will not solve the problem. There will still be a need for a "stabiliser" to calm *"the almost paranoiac worries of the markets in their neurotic quest for tranquillisers"* and also to discourage speculation(1).

This stabiliser is the anchor currency that has long been sought for the international monetary system. In the absence of any alternative, the role of anchor currency has been played *de jure*, or simply *de facto*, by one or the other of the national currencies (the dollar, the DM, etc.). But a national currency, which is inevitably a nominal currency because it circulates for payment purposes on its own territory, is incapable of properly carrying out the functions devolved to an anchor currency, which are to act as a reference standard **(10)**, an exchange and reserve medium between States, and as an efficient INTERVENTION INSTRUMENT for the purpose of regulating the foreign exchange markets.

Only a non-national unit, one that is neutral, excluded from circulation for payment purposes on a territory and reserved for international settlements, can meet the required conditions.

Keynes realised this and, in 1944 at Bretton Woods, he proposed the "bancor", a neutral, non-national bank money defined by a weight of gold that could be adjusted so as to maintain its purchasing power. But Keynes was not listened to. It is true that the technical means available at that time would have made it necessary to reserve the bancor for dealings between Central Banks, but recent financial and technolo-

(1) Charles Delamare, France Forum, December 1975.

12. Those same factors, by facilitating the creation and circulation of bank money to an extent that was unimaginable a few years ago, risk depriving the monetary authorities of the remaining means available to them for "controlling" the money supply. They will complicate the management and discipline problems entailed in the creation of a "European Monetary Zone".

13. Competitive devaluation is not the only problem : there is also the problem (for example the German mark), in an opposite and more general sense, of chronic overvaluation resulting from constant search of capital for a safe haven. This is proof of the fact than the international monetary system needs an anchor *numéraire* that will be non-national and will be able to offer guaranteed stability.

14. If only in the interest of employment and good relations among the Community Member States, such a form of stabilisation is required well before 2002, or even 1999.

No one disputes the fact that merging, into a single *numéraire*, the currencies of States and peoples with very different institutions and mentalities, has no chance of success unless the institutions, pending a change in the mentalities, have been adapted in advance.

The measures needed for such an adaptation, known as "political union", should be decided on, if not implemented, before 2002, because that is when the national currencies will disappear and the promises of union will be consummated.

A political union will include many things. Foreign affairs and defence are involved, but without any direct relationship with the currency. The budget, finance, taxation, social security, etc. are all directly concerned. There are the elements in respect of which the adaptation measures should be specified.

15. In the days of monarchy, princes and princesses were betrothed by treaty before they had even met. The possibility of breaking off the engagement, or later of a divorce, was not even contemplated. The reason for this odd practice was to give concrete expression to a form of

gical developments (the xenomarket **(11)**, electronic transfers, computer systems **(12)** now make it possible to turn Keynes' proposal into a reality.

This is where the Eurostable comes in. Thanks to its characteristics of constancy in terms of real value and of neutrality with respect to national currencies, it meets the conditions required of an anchor currency.

Creating the Eurostable is quite compatible with the provisions of the Maastricht Treaty. It will not interfere in any way with the choice, at the start of 1998, of the countries which will participate in the "European Currency Zone", or with the process of fixing parities.

It meets an imperative need ; namely the strengthening of the European Monetary System, and it would be the instrument the European Commission has called for to cope with the risks caused by "competitive devaluations" **(13)**.

Only the final stage of the shift to the single currency might have to be delayed. The intermediate stage (1999-2002) would go ahead in any case, and the euro would be introduced at the scheduled time **(14)**. In this way, the essence of the EMU project would be maintained.

The Eurostable's prestigious characteristic of perfect stability in terms of real value, something which no currency - not even gold - has ever had, would convert the disappointed and sceptical peoples of Europe to the EMU project.

While divergences of view with respect to the single currency, would disappear, for some because of the maintenance of the programme and respect of the "commitments entered into" ; for others : because of the prospect of a "strengthened" EMS able to stabilise the foreign exchange markets would make it possible to delay, if appropriate, generalisation of the single currency and to see it as the culmination of a process of institutional evolution, rather than as its motive **(15)** political union without having to ask for the opinion of the interested parties, still less the opinion of the peoples.

As far as the single currency is concerned, the "engagement" must be concluded, according to the treaty, at the start of 1998, and the official wedding ceremony is planned for January 1, 1999. The "consum-

mation" of the marriage (abolition of the national currencies) comes three years later.

From this viewpoint, the irrevocable nature of the commitments entered into will inevitably pose some questions, especially as these commitments are not just for a lifetime, but "for eternity". But let us remember that the purpose of proclaiming the irrevocability of the commitment is to assert, as all treaties do (and as the institution of marriage long did), the seriousness and the permanence for the relationship.

3

FROM THE ECU TO THE EURO

On January 1, 1999, the euro will replace the ecu with the same value - one ecu will be equal to one euro. Public opinion, as well as commentators, see this innovation as only a change of name, but actually there is something more involved. The euro is intrinsically different from the ecu. This fundamental difference alone, quite apart from all the implications of the single currency and its "scenario", must be considered a great progress. This step forward is what we should look at. If we do so, we shall discover an euro "in itself" capable of serving Europe well, even without being a single currency.

Anyone who has "manipulated" the ecu since its birth, and who even took part in its delivery, who has immersed himself in the varied calculations to which the "formula" lent itself, or rather which it demanded, cannot but feel satisfaction that the euro is replacing the ecu, a composite currency that is the captive of its component national currencies, and is issued for transaction purposes solely by an association of private eurobanks, without any relationship (but the formula) with the official ecu used as a unit of account by the European Community.

The euro will be a fully-fledged transaction currency. It will be autonomous and will be issued by a central bank, as all national currencies are, a fact that will free it from the handicaps that affect a currency which is composite and private by nature.

It is true that the ecu was created not as a *numéraire* for transaction purposes but rather as a unit of account. Its (informal) develop-

ment into a transaction currency is an odd phenomenon, something that was not really intended and planned, and which was not even really spontaneous. It is worth recalling how it happened.

Its androgynous nature originated in the differences in point of view and intention - as well as of interest - among the Community member states and, first of all, between the French and the Germans. The former saw the ecu as the embryo of a currency that would become the currency of the European Union, whilst the latter, although they shared that ambition, feared, more than the French, the effect on their own currency of such an experiment that had never been attempted before.

This accounts for the ensuing ambiguities, the hints, the ambiguous directives and the "constant changes of tack". On the one hand, use of the ecu as a symbol of European unification was encouraged, while, on the other, all measures suitable for fighting inflation (by issuing as few ecus as possible) were recommended.

In addition to that handicap, which is to some extent political, is its composite nature : the ecu has no autonomous value. Its value is defined as the total of the values of the amounts of the eleven national currencies that compose it.

The value of a currency is defined by what it can buy. What one ecu can buy in a country using national currency X is the total of what can be bought by the amounts of the national currencies that make up the ecu, after conversion into currency X. It follows that the exchange of one ecu into currency X is equal to the sum of the exchange rates into currency X of the component currencies, weighted, according to their amounts used in the formula.

The complication resulting from such a definition in the use of the ecu for transaction purposes along with the national currencies is one reason, inter alia, why the private ecu is used more for reserve than for transaction.

ALL THE SAME, HOWEVER, THE ECU, WHICH WAS CREATED IN 1978, WAS A MAJOR INITIATIVE, from a twin viewpoint : politically, because it

was pointed to Europe ; economically, because it was an innovation at a time when monetary history had probably reached its low point.

The 1970s were a black period in monetary history. After President Nixon ended the convertibility of the dollar into gold on August 15, 1971, and once the Fort Knox exchange windows had been closed (where the foreign central banks had previously been able to exchange their dollars for gold at the advantageous rate of USD35 per ounce), the international monetary system drifted, anchor-less. Once again, society displayed its fatal inability to govern the instrument that is most necessary to it, namely money.

Confidence in the dollar as the international anchor currency had failed, so a replacement was found for it : the "market". Exchange rate variations were not only to reflect imbalances in trade and financial exchanges but were also to correct them, by way of their effects on prices.

This theory completely disregards the huge quantities of international capital to which the xenomarket gives rise, the emergence of a global economy, and the role of a national currency - the US dollar - as the international anchor currency, which continued unofficially afterwards, giving the American banking system the power of creating and lending its own currency worldwide.

The restraining influence represented by conversion of the dollar into gold at Fort Knox disappeared ; the system got out of control and inflation rates soared to as much as 20% in the United Kingdom, 12% in the United States and 7% in Germany, while the franc-dollar exchange rate varied from FRF4.90 to FRF10.20.

The need to restore order to the monetary system, as well as the search for an instrument that would contribute to European unification, justified the creation of the European Monetary System (EMS) and its exchange-rate mechanism.

The mechanism's centrepiece is the ecu. The exchange rates of the currencies belonging to it, among themselves and into the ecu, are fixed and may vary only within a certain margin (± 2.25% or ± 6%), known as the fluctuation margin (increased in 1993 to ± 15%).

As an anchor unit, the ecu is inherently defective because of its composite nature. An anchor currency's essential role is to act as a pivot for a monetary system's national currencies and to be an instrument of arbitrage, as well as for intervention, if needed. A look at the arbitrage mechanism, which definies the pivot role, shows how the ecu's composite nature stymies it.

A equals 4 B, and B equals 5 C. In a state of equilibrium, A would be exchanged for 4 x 5 = 20 C. On the market, its price happens to be 19 C. A, the pivot and arbitrage instrument, is first sold and is then later repurchased using B and then C, for a difference which gives the arbitrageur a profit of 1/20. Repeating this arbitrage operation has the effect of harmonising the exchange rates of B, C and D according to their position vis-à-vis the pivotal currency, A.

But such harmonisation is possible only if there is a simple and more or less fixed relationship between A, B and C during the arbitrage period, whilst its value in one currency is being compared with its value as calculated in the light of the exchange rates of the other two currencies. In the case of the ecu, because of its composition formula, its value calculated in one unit does not depend solely on the exchange rates of two currencies between themselves but on the rates of eleven currencies (the component currencies) among themselves.

The unsuitability of the ecu to act as the pivot and anchor of the system on the foreign exchange market has resulted in confirming the Deutschmark as Europe's currency.

A number of other anomalies handicap the ecu. The most shocking of them is the fact that the formula still includes a currency that has left and remains outside the exchange rate mechanism (the pound), when the ecu is the benchmark for regulating the exchange positions of the currencies belonging to that mechanism among themselves.

The substitution of the term "euro" for the term "ecu" to designate the future European currency was not well received by French public opinion. Valéry Giscard d'Estaing regretted the fact that the change had not been submitted to a referendum. His disappointment is understan-

dable, after all the efforts that had been made for more than a decade to win acceptance for the ecu.

Actually, a change of name is justified, if only because of the difference of nature between the euro and the ecu. The euro is incomparably better suited than the ecu to the role of anchor currency of the European Monetary System because it will be a currency in its own right, issued by a European Central Bank, just as the franc and the mark are issued by their respective Central Banks, rather than being a composite currency.

It seems that great efforts are going to be made to win European public opinion over to the euro and to get Europeans to forget the ecu. There is talk of a budget of millions of ecus. But when you look at the arguments brought up, the main one appears to have been left out : the difference in nature between the euro and the ecu and the euro's superiority for the role for which it is destined.

While acting as a pivot, an anchor currency must also be a standard of value, a benchmark that makes it possible to compare values over time. It is a poor benchmark, the position of which depends on the positions of the moving bodies it is guiding.

Lastly, there is the question of using the ecu in the functions that are expected of an anchor currency in the EMS : to act as an instrument for intervention and to defend exchange rates. The new paradox is that the transaction ecu is the most unsuitable instrument for this purpose, first of all, because the central banks do not issue any, and, secondly, because, by definition, the ecu is inferior in value to one or more of its component currencies. Why should it be preferred to a currency that is stronger than it is ?

All the same, the ecu will be seen to have constituted a stage in the slow evolution of the conceptual interpretation of money, of its creation and of its use. It will remain the first example of a parallel currency created from scratch, and it will also remain the first example of A TRANSACTION CURRENCY ISSUED BY A STRICTLY PRIVATE BANKING ORGANISATION, independently of the authorities (and probably against their

wishes, even if they have not said so for political reasons). This organisation is the "Ecu Banking Association".

To be sure, the banking system began encroaching on the privileges of the State and supplanting its currency long ago, but there are still links. What a bank transfers (and what is more or less cleared) in performance of a payment order is central bank currency. And there is cash money, which only the central bank or the Treasury alone is issuing.

The "Ecu Banking Association" (EBA) has neither a Central Bank nor a central currency. The ecu which it issues cannot be exchanged for official Community ecus which, for their part, do not circulate among the public. And there are no banknotes denominated in ecu. Its only link with the official ecu is its definition in value terms, not a guarantee of conversion into the component currencies, which would be consistent with its definition.

The creation of the EBA is probably without precedent in history, and the fact that the public and even economists are mostly not familiar with it, gives the measure of the prevailing lack of interest in monetary questions. Just like the euromarket, the EBA was a spontaneous development. There was no formal meeting, no European Community committee responsible for creating it. All there was an initiative on the part of a very small number of banks, with Crédit Lyonnais in the forefront. The gestation of the EBA took place in an office at the end of a long corridor in the Credit Lyonnais' Head Office on the Boulevard des Italiens.

During the initial years after its birth, the private ecu suffered from its status as an illegitimate child, outside the laws and traditions governing society. Its clearing organisation was of an elementary kind before it was computerised. It was some time before the BIS offered its cooperation in accounting management (but not its participation).

Experience with the private ecu should help to familiarise the public with the idea that it is possible to create a banking institution with

a new currency outside the rigid guidelines that are considered essential and, above all, without the support of the monetary authorities' well-known arsenal of more or less compulsory reserves, assistance as lender of last resort, etc.

What the ecu and the EBA have also provided is a glimpse of the extranational monetary space called the xenomarket, and the possibility of endowing it with its own currency, rather than national currencies. But the EBA did not take advantage of the opportunity thus offered to it (and advocated by the Centre Jouffroy) of freeing the ecu, in external use, from the pernicious effects of the fact that it was created as a nominal currency for internal use. As a result, the characteristic of stability in terms of real value that a specifically external transaction currency can offer, remained unexploited.

The dichotomy between the private ecu and the official ecu, and the absence of any government guarantee, did not stop the ecu being used as a unit of account for issues of bonds, a role in which it was very successful. But using it in this way resulted in discrepancies between the theoretical rates as calculated by application of the composition formula to the foreign exchange rates on the market of the component currencies, and the exchange rates applied by the market to the ecu, as if it were an autonomous currency. Such discrepancies reached as many as O,3 %, one more handicap, added to the others, along with a depreciation in terms of the strong currencies used in its composition.

(As a corollary to this, a legal problem that could become a political problem should be pointed out : when bonds issued in ecus mature, the borrowers will be entitled to insist on the application of the original definition of the ecu as a "basket of currencies" and, hence, on a conversion value that may be less than one euro to an ecu.)

In a March 1988 editorial, *The Economist* wrote :

"If the ecu is to win the hearts and minds of tomorrow's Europeans, it will take more than mere encouragement on the part of governments. It should have a new name and a purchasing power that does not vary".

The ecu has changed its name, and it is changing its nature.

The euro will fluctuate less than the ecu, but it will still fluctuate since it will be used both for external payments and for internal payments within its territory, the area of the "European Currency Zone".

EMU, the EMS and the rebirth of its exchange rate mechanism offer a splendid opportunity to make the euro something other than simply a new ecu, an improved one, to be sure, but not freed from the impediments from which the ecu has suffered as an anchor *numéraire*.

Opponents of the single currency are wrong to oppose the introduction of the euro in January 1999. And they are miscalculating. The euro will not become a single currency until 2002 - and then only partially - and not completely until much later. In the meantime, it will be of great service, if only as the pivot currency of the exchange rate mechanism.

That said, the euro, like all currencies, will have two states, nominal and constant. In the nominal state, its real value or purchasing power at any given time will be measured by what it can buy at that time. In the constant state, it will be the value of the day of origin, the day taken as the point of departure for the price indices.

It is broadly agreed that use of a *numéraire* as legal tender is, "by definition" antithetical to constancy in terms of real value. Indeed no transaction currency in the world has constant real value.

The following pages show how and why, with the Eurostable, use of the currency in payments can be reconciled with constant real value.