

THE CONSTANT EXTERNAL ECU

THE ULTIMATE IN MATTERS OF HARD ECU

EUROPEAN MONETARY UNION

How the hard ECU could turn into an international medium of exchange and reserve with a fixed real value, able to assume the role of a monetary standard which was formerly the privilege of gold.

The Essence of "A Stable Currency for Europe"
by Jacques Riboud,
Author of "The Mechanics of Money"
(Macmillan London and St Martin New-York)

I - A TIME FOR MONETARY INNOVATION

The creation of a single currency to take the place of the national currencies of the European Community States is seen as the final culmination of European unification, for reasons which are more political than specifically monetary and economic.

However desirable a single currency may seem to many, its adoption by twelve different States will pose too many problems for such an aim to be considered achievable in the near future. In the meantime the de facto predominance of the Deutschemark can only increase, at the risk of destabilizing the European Monetary System (EMS) and perhaps even of disrupting the still fragile state of harmony at present prevailing among the peoples of the Community.

There is something else : a single European currency will do nothing to correct the acknowledged vice of the international monetary system, which is the absence of any reference, payment, and reserve instrument with stable value in real terms.

The evils that have afflicted the economies of the world can trace their origins mainly to this deficiency. But it can be corrected. Opportunities to create brand-new international monetary systems are rare : so far this century, there have been only two. We should therefore take advantage of the one that exists now in order to create what is lacking, namely and extranational payment unit with a real value that is independent of time and place.

We shall not succeed in doing so however if we limit ourselves to doing nothing more than in transposing the kind of national system, which experience has shown to be inadequate, to the Community level. Instead we must go further along the path of innovation and seize the

opportunity that is offered to us by the very innovations that have transformed financial relations over the last fifty years.

These innovations are the Euromarket and its Eurocurrencies.

The Euromarket is the fictitious or real space that exists between national frontiers (the off-shore sector). Eurocurrencies are currencies that are used as external payment instruments mediating between national currencies.

For a payer or a payee a currency is external when it is not the national currency of the country of which he is a resident.

The US dollar is the most frequently used Eurocurrency and functions as a third currency between the currencies of the 170 States that exist on the planet. For 169 of those States it is an external currency.

Such a currency originates from the need for a common denomination and a universal medium of exchange. This currency has gradually arisen as international trade developed and the number of national currencies has grown. To satisfy this need, each Eurobank created a pool of the principal currencies for exchange. The medium or third currency that makes up the pool (mostly the US dollar) has quite naturally ceased to be a mere intermediary and has become a monetary instrument in its own right.

For example : A refiner importing oil into France pays the Arab exporter in dollars ; the exporter's bank then lends those dollars to a Brazilian importer of Mercedes. The exporter's bank in Hambourg lends the dollars -- and so on. This is how the Euromarket came into being, starting with pools of liquidity to which reserves capitalised in the world's main currencies were then added.

A Eurocurrency is first and foremost a national currency and, as such, originates from its national banking system.

Within the off-shore territory of the Euromarket, it loses its nationality but retains its national real value (and loss of real value) in terms of purchasing power. Indeed the real value is not affected by the circulation within the Euromarket but aligns itself with the real value within its national territory.

This blatant anomaly alone is enough to justify the creation of a neutral extranational currency with inherent constant purchasing power.

An exclusively external payment currency benefits from a special property that has been sought after in all ages but never achieved. That property is the ability to retain its purchasing power in real terms, provided it is defined with that object in mind. This advantage is the prerogative of an exclusively extraterritorial currency.

It is not available to a national currency circulating within a national territory, nor is it granted to a currency which functions as both an internal and an external currency (e.g. the dollar).

What is the origin of this singular property ? The explanation can be found in a mechanism with which VAT has familiarised the public : the conversion of production into final consumption, a process for which the payment money acts as the instrument within a national territory. The real value of a currency unit depends on a comparison of production and the money supply. *It is not possible to make precise adjustments to that value by deliberate intervention.*

The result is variation in the purchasing power of the currency unit from which no national system, even at the time of the gold standard, has ever been exempt. Schumpeter (quoted by Sam Brittan) cites for Germany the following indices : 1880, 96 ; 1886, 80 ; 1890, 96 ; 1894, 80 ; 1900, 100 ; 1902, 90. Keynes noticed (in his *Essays on Persuasion*) that from 1826 to 1914 the maximum spread of the R P I in U.K. (1914 = 100) was 30 plus and minus 30.

This wide range of oscillation contradicts the idea of perfect stability that is commonly associated with the gold-standard.

This instability derives from the elasticity of the money supply's volume and the function of its monetary unit as an instrument of consumption of the goods produced. Outside the frontiers of States, the situation is the opposite. There is neither production nor final consumption. The currency unit is thus able to acquire the privilege of stable value.

The difference between an exclusively external currency and one that is simultaneously an internal and an external currency - which is what all national currencies are, and which is what the Community's single currency will also be - is a fundamental one. It is the keystone in an edifice of innovation capable of transforming the international monetary system. It may be achieved in the near future by an enterprise on the model

of the present private ECU, which is issued and managed by the 85 member Eurobanks of the ECU Banking Association (EBA).

An external currency of this kind would anticipate the Community's single currency. It would pave the way for it, and, once this single currency had been introduced, it would then go on to supplement it in external transactions. In the international sector it would constitute the standard of reference and value and the stable payment and reserve medium which the nations of the world are in need of for their commercial and financial transactions.

A currency equipped with a property that no other currency, not even gold, has ever been able to boast, would be a source of prestige for Europe and would help to affirm its identity.

II - HOW TO BE COMPOSITE, EXTERNAL, CONSTANT, AND A MONETARY PAYMENT UNIT

Before going any further, we must stop for a moment and look closely at the real nature of the ECU and, even more important, of the constant ECU something that may be incorrectly interpreted.

The ECU is a composite currency unit. It was originally created to function as a unit of account and as a position indicator, on the foreign exchange markets, for the component currencies of the EMS system. *At this point, if we wish to avoid getting bogged down in analysis, we must straight away remember that a payment unit (and, as a corollary, a reserve unit) is something quite different - and by a wide margin - from a unit of account or a position indicator with no physical consistency.*

A payment unit takes the material form of a "claim on itself" (a deposit) issued by an institution. Such is the case of a unit with an autonomous value (a national currency) or of a composite unit whose value is determined by its component sums of foreign currencies (nine for the ECU).

A unit of account serves the purpose of calculating a value. A payment currency serves the purpose of forwarding a "value" from someone to somebody else. The value of a monetary unit is measured (as the rate of inflation is) through the "retail price index" (the R.P.I) established in every country by its statistical services. A basket of goods and services is carefully selected so that it figures the average consumption in the national territory. Its cost on the market is periodically counted (recorded) and translated into an index that measures a variation : the R.P.I.

This concept of value is a prerequisite for defining - and understanding - what really constitutes a "composite" currency such as the ECU.

The basket which a quantity of national currency can purchase on day D consists of the same articles as on the starting date, but the amount of each article is proportionately reduced, in inverse ratio to the price index increase. The Community basket that one nominal ECU (the present private ECU) will buy on day D is made up by putting together, in a single container, the contents of the various baskets that each fixed amount of national component currency will purchase on that day in its state of origin. Thus are put together the sauer-Kraut of the Germans, the fries of the French, and the spaghetti of the Italians.

The overall dimensions of this container contract in inverse proportion to the increase in the Community price index (the sum of the national indices adjusted according to the weights of the component currencies in the ECU formula).

The constant ECU is defined in the same way as a constant currency unit. Each day it will purchase a Community basket made up of national baskets, each of which, instead of contracting, remains identical to what it was in the beginning, in terms of both composition and dimensions, as measured by what it would buy on the starting date.

The formula that links the constant ECU to the component currencies is that of the nominal ECU ; the amounts of component currency have the same magnitudes but the nominal currency units have been replaced by constant units in effect from the starting date, e.g. the nominal franc and the nominal Deutschemark have been replaced by constant franc and constant Deutschemark.

The "value" of a payment unit is measured by what it can purchase. The value of a payment ECU can be established by adding up what each of the component currencies is capable of purchasing. The formula that defines the ECU in terms of its components is thus arrived at by starting with this definition.

The costs of the articles which compose one basket are extracted from the market once a month. In the interval the costs varies. One determines the R.P.I. of the day by extrapolation : The price index for day D

(day 0 = 100) is calculated by adding to the index for day D-1 the last known monthly increase, divided by the number of days in the month.

Example : on 12 May the index stands at 120.13. The last known monthly increase was equal to 0.31 (the present monthly inflation rate in France), so the daily rate of increase of the index during the month is $0.31/31 = 0.01$. The index on 13 May will therefore stand at $120.13 + 0.01 = 120.14$. The ECU index is the sum of its weighted component's indices (with their weightings in the formula).

Each morning, the exchange rates of the present ECU (nominal ECU) are calculated by applying to its formula the previous day's closing rates for the ECU's components on the exchange market ; the component sums being fixed, the real value of the ECU decreases in line with inflation. The exchange rates of the constant ECU will be calculated every day in the same manner, but each component sum for the day will be adjusted as shown above. The constant ECU's real value will remain unchanged.

In order to grasp fully what a payment and reserve unit actually is, a mere definition is not enough. It must be completed by a faithful representation of the mechanism of which this unit is the instrument.

Payment money is the blood of the Economy. Transaction is the mechanism by which the economy's life is sustained ; a quasi-biological process that has nothing to do with the role of a unit of account or an exchange market indicator.

A unit of payment money is created by the entry in a current account of a sum lent by a bank to its customer or of the proceeds of a conversion of foreign currency. It is defined by its denomination (value reference : franc, dollar, ECU, etc.) and by the institution for which it constitutes a debt (guarantee of exchange).

This unit of money (the payment ECU), once created, moves from one bank account to another as transactions take place. If, at one of the stages in the process, it is converted into a different currency unit (such as a foreign currency) or is used for the purpose of repaying a loan, that unit of money is then "destroyed" : it disappears from circulation and is no longer part of the stock of money corresponding to the unit in which it is denominated. (Contrary to common belief, the creation of money by a bank is not dependent on the prior creation of money by a Central

Bank. The private ECU is used for payment. It is issued by the "Banking ECU Association" without any previous "central ECUs").

The building-up of this stock of money and the very existence of a genuine payment currency are factors that depend not only on the creation of a unit of money but even more on the maintenance of that unit as an active component of the money supply throughout its various movements from one bank's current account to another in a variety of different establishments (on average, such movements number 10 in a typical month). *In other words, all of this depends on the unit of money in question NOT being converted into a foreign currency during its movements from account to account.*

That is the major problem standing in the way of any attempt to introduce a new type of payment unit on the international market. In a sector where the force of habit is the decisive factor and where choice in the matter of which currency to use for which transaction is entirely free, this has not been properly understood.

Each time a unit of the currency is transferred to a different account, the success of the venture will depend on two key decisions : the payee's decision to accept payment in the unit and his banker's decision to open an account in the unit. Such decisions will only go in the payment ECU's favour provided it is attractive from the commercial point of view and provided its public image is a positive one. *The CONSTANT external ECU satisfies these conditions more than any other currency.* It meets Pr H. Watnam's assertion : "*The key for a new currency to succeed is to be seen as the Rolls Royce of the currencies*".

That is the commercial side. There is another one of a broader scope : the opportunity for the unity to stand as a monetary standard with a degree of stability in real value which gold never attained. True, as a store of value, the precious metal has unchallenged merits thanks to its intrinsic qualities, that a claim-currency cannot have ; but, for the measurement of purchasing power it is exposed to the market's hazards. Its relative stability ($\pm 30\%$ in U.K. during the XIXth Century) was due to fortunate circumstances : a permanent growth of supply from mines' discovery in Brazil, California, Russia, South Africa, that matched developments of activity.

In order to replace gold as a standard, it is rational to have reference to a fixed basket of the main goods and services produced in the proportions they are consumed. This is the Constant ECU.

III - WHEN AND WHY “PARALLEL” CURRENCIES DIVERGE

If the unit of money is to conserve its purchasing power, production in volume terms must balance out the total sum of money spent for purposes of final consumption. Any new payment money that is added to the stock of money in excess of this quantity, without any increase in the production for each rotation, has the effect of reducing the real value (purchasing power) of the mass of means of payment which is in circulation, by a proportionate amount. The corollary of this is a proportionate depreciation of the unit of money.

The reduction in the money value is progressive (from one year and a half to two years). It takes place and affects any holder between the time he has earned a sum and the time he spends it. The total real value thus taken off is exactly equal to the purchasing power of the sum added to the stock of money (at an unchanged rhythm of production) after it had been issued. Such movements of production and final monetary consumption become aggregated ; their compounded effects being translated into the Retail Price Index (R.P.I.) for the day.

The gradual adaptation in value of a unit of payment money is a matter of fundamental importance. It is the very consequence of its function as the instrument for the conversion of production into “final consumption”. It is the material representation of the fact that nothing comes of nothing, that *if commodities are consumed by an amount of money that has been added, its value must be balanced by an increased rate of production, failing that, from the stock of money that is already in circulation.*

This is only possible provided the unit of money in question is suitable for contraction in real value. Such is not the case if it has invariable purchasing power “by definition”.

The imbalance of the stock of money and rhythm of production in volume is a “fact of like” in a national territory as already pointed out.

This is why if a constant currency circulates as a payment instrument in a national territory, in parallel with the nominal national currency, the imbalance between production in volume terms and expenditure on final consumption will exclusively affect the national currency. This will result in the public’s increased preference for the stable unit, thus precipitating a progressive contraction of the supply of nominal currency and an exponential acceleration of its rate of depreciation. The whole system will eventually collapse.

These observations apply to any currency that circulates as a payment currency in a national territory and in parallel with a national currency, whether that parallel currency is a constant one or simply a "hard" one, such as the "HARD ECU". Which by an appropriate amendment of the formula, is due to be compensated for any depreciation resulting from a change of parities.

The HARD ECU proposal contains little indication of how it would be used as a payment instrument. Previously, the British Government has suggested allowing the Community national currencies to circulate freely competing in all the Member States and trusting the market to select the best. The HARD ECU shows similar thinking, but is more realistic.

The British Government's proposal for a "HARD ECU" is a fruitful one. It has opened the door to the possibility of a parallel currency that would be more inflation-resistant than others. It is a step in a new direction and represents a welcome departure from the traditional models on which attention has hitherto been concentrated. The main and spectacular innovation here being that it takes advantage of a peculiar characteristic of the composite nature of the currency (which eludes a conventional national currency), that is : its value is defined by a formula, and thus is adjustable at will (a property which is taken to its limits by the constant external ECU).

But a "HARD ECU" cannot circulate within a national state in parallel with its national currency without degrading the latter and disrupting the monetary regulation. The adaptation of the imbalance, as described above, through the real value of the unit would be "undetermined". *This imbalance will be borne by the weakest of the two currencies in parallel : the national currency. Its rate of depreciation will accelerate. Such is the handicap that a HARD ECU circulating in parallel within the E C would face.*

But this disadvantage would be turned into a tremendous advantage if the HARD ECU, instead of competing with national currencies in their own territory, were external and circulating exclusively in the huge 2,000 billion dollar euromarket zone. There, it would join the exclusive club of international foreign concurrencies and would challenge them with an unrivaled advantage, which they have not had and cannot have, because they are all also national currencies : permanence in real value*.

*Assuming full convertibility and free movements of capital

IV - AN EXPERIMENT WITH POLITICAL, ECONOMIC, FINANCIAL REWARDS

The constant external ECU, being outside national territories and initially private, could be set up in the very near future. It lays within the scope of the search of a 13th European currency, agreed to by the Community Council at Mrs. Thatcher's request on behalf of the HARD ECU. How could it be launched ?

The E.B.A. might choose to endow its "product" (the private ECU) with an unrivaled commercial attraction. It is a remarkable organization and has done an excellent job in uncharted waters*. However the present nominal ECU must remain as it is : a position indicator on the exchange markets for the E.M.S. It may be assumed that disconnecting the E.B.A.'s private ECU from the E.M.S.'s ECU would raise objections from government quarters and from the banking industry.

That leaves us with the second option : the creation of a Consortium of Eurobanks which would promote, issue, and manage the new stable currency on the Euromarket. The banks of the City of London have a major part to play in this scheme : they created and still control the Euromarket, the natural territory for the constant external ECU and one may assume that they would benefit from the British Government's backing and even prodding.

The enterprise would provide fruitful lessons for a future recognition of the constant ECU by the Community and would open the door to the issuing of official constant ECU by an E C institution. Then

*The private ECU does not circulate for payment within national territories, thus is suitable for benefiting from the property of a specifically external unit.

a structure would be set up on a classical model, associating central money and bank money. Meanwhile the Consortium's experiment would give time for the reflections, investigations and negotiations which one may expect over the Delors program.

After having been set up as the payment currency of the Community, and having taken the place of their own currency, the "single currency unit" will inherit the problems of stability which are inherent in any national claim-currency. The need of a unit that would be an anchor for the monetary system, a standard of reference for measurement, and a stable international medium of exchange for traders will remain and will justify that the single currency be supplemented by the constant ECU.

All the more since the authorities cannot fail to discover that the constant external ECU gives them the means to disconnect both internal regulation (inflation) and external regulation (exchange rates).

Nowadays, the same instrument - the rate of interest - is used for both. But while it may work against inflation, it often has a harmful effect on the exchange rate and reciprocally. Corrective measures such as "sterilization of excess of liquidity" are utterly inefficient. One of the first aims of monetary research would be a process for independent control of internal and external money regulation without reciprocal interference. A question that is all the more urgent since deregulation of the banking system is to be completed in 1993. Then the paraphernalia of discipline and constraints will have to go.

A non-national currency with a real value which does not vary, can promote the disconnection of both regulations. Then may be battling inflation with a man-made economic recession will appear what it is : an aberration.

That's why there is reason to believe that the authorities will favorably consider the HARD ECU after it would have evolved into a constant external ECU, even if the enterprise is, at the beginning, private.

Meanwhile the promoters will reap prestige and profit : prestige from the creation of a long awaited fixed monetary standard ; profits from the seigniorage that the U.S. banks now collect by feeding the eurodollar system ; profits from a volume of business brought to them by millions of traders and depositors all over the world who want nothing more than a stable international unit in which they can place their trust.

V - BEYOND AN EXPERIMENT

A paradox of our time is these desperate attempts to “stabilize” by using national currencies which by nature always are and will be unstable.

The “single currency” will be no exception. It will circulate in a broad territory - the Community space - Yet, it will be a national currency submitted by nature, to the ills which affect national currencies ; the main one being instability in real value because it is the instrument for conversion of production into consumption. For the purpose of stabilizing the “single currency” one advocates and one relies on an “independant European Central Bank”. Discussions rage about penalizing the member State which would not rein in its budget deficit. This stance amounts to giving a major role to the deficit as a source of inflation. But Britain has the highest rate of inflation of industrial countries. It is also the only one with a budget surplus.

To rely on an “independent Central Bank” for stabilizing the single currency is to ignore that the true source of payment currency and the actual driving force of inflation is the money created by commercial banks (in France 90 % of the increase of the money stock) ; it is to neglect that control of inflation begins with control of the national banking system. If a Central Bank is independant from the Government, the opposite will also be true. Then how and by whom will the commercial bank be controlled, disciplined ?

The monetary models which are proposed for the E M U are the Bundesbank and the Federal Bank System of the U.S. (the FED) - from which the Bundesbank is issued. To serve the former : German discipline. As for the latter, a look at the past (and at the present too) is not a convincing proof of the Bank’s merits of independence.*

*Independence of the FED from the Government, later independence of the Government from the FED, are responsible for a large part of the Great Deflation in the 30 ; of the Great Deficit in the 80’S.

Anyway it is to the Federal Government and not to the FED that the several agencies in charge of controlling the banking system report. Such is the case of the main Federal agencies : the Controller of the currency, the FDIC (Federal Deposit Insurance Corporation), the Thrift Supervisor.

An InterGovernment has been assigned by Brussels to investigate the main questions which the single currency will pose. Is not mentioned what will happen when thousands of commercial banks endowed with a clearing system using all the means of modern technology will issue a "bank-single" currency*, over the whole Community territory. This cannot fail to bear heavily on the E M U. The search for a solution will lead straight to a more thoroughly implemented "Federal Government" - maybe a desirable solution but one that is still far off in the future.

Meanwhile the D.M. will settle in its position of the money of Europe. One knows the force of practice in financial matters : Arab exporters still sell, and the French still pay for petroleum in dollars in spite of its dramatic fall from its former lofty status. It is a risky wager to assume that, in a distant future, the German will relinquish the prestige and power they derive from their currency's position.

Beyond this moment in history, one question remains which transcends it ; it concerns this vital element of Society : its money. It is unavoidable some day that the public recognizes that it flies in the face of all logic to grant the function of medium of exchange and reserve between the nations of the world to one or more national currencies, since each one of them is utterly dependent on political and economic conditions in its own country, and since each one of them is by nature, unstable whatever the merits of the Government who controls it.

It is unavoidable that some day, it will become obvious to all that the medium of exchange and reserve between the nations of the world must be extranational and neutral. Then, by nature, immune to inflation, it can be defined so as to be constant.

Never has the time been more propitious and the need greater for a breakthrough in the monetary field. The British banking industry as the leader in the extranational territory of the Euromarket, is in a better position than any to undertake it.

*Clearing is the key - a mechanism which enables a banking system to issue payment currency with a very small amount of working reserve (1,5 % in the U.K.).

VI - A CONCLUSION AND AN ANNOUNCEMENT

The model on which all monetary systems are built will reach the end of this century with a horrendous record of failures : deflation, inflation and desinflation, spoliation and ruins all over the world.

In seventy fixe years it has not been able to replace its vanished standard of value, though it is the one system which needs it most.

This monetary standard cannot be gold but it can and should be a fixed basket of the goods and services, most commonly produced in proportion with which they are ultimately consumed.

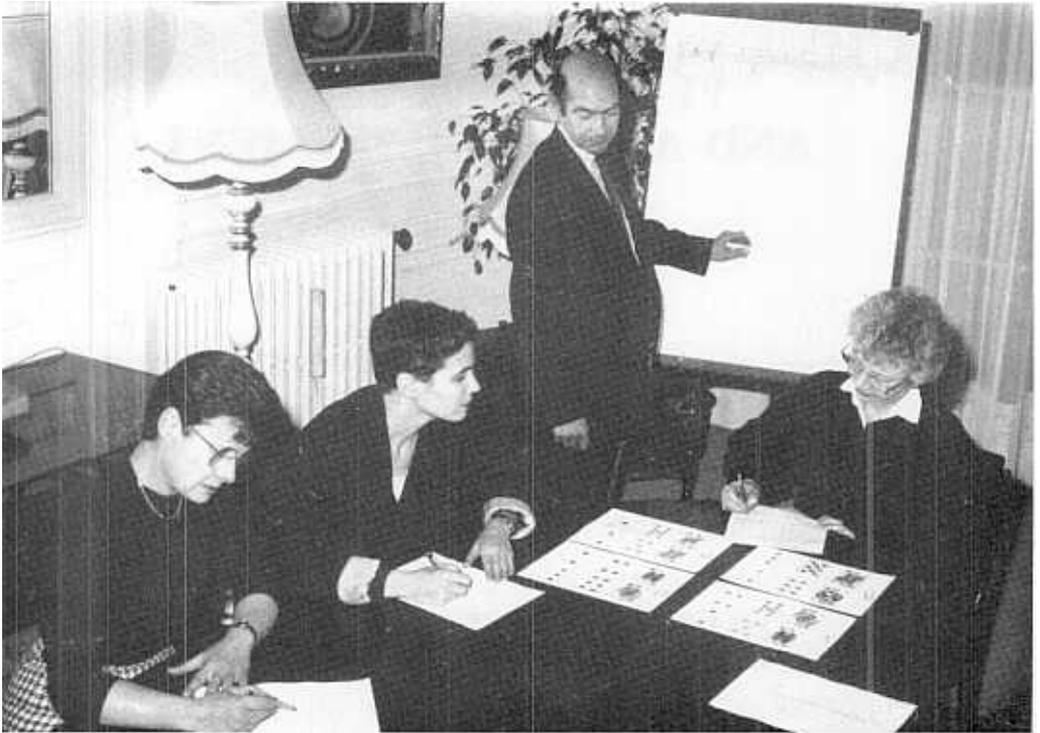
This is the definition of the ECU once it will have become constant and this is what the hard ECU can turn into. At its present stage, it has very rightly been presented with a broad scope of conceptions leaving enough room for a wide range of options. The principle of a parallel ECU which would be "better than the present one" has been laid out. It opens up a great future to the hard ECU.

But this future may not materialize if the hard ECU seeks nothing but immunization against devaluation at a realignment of parities ; and if it aims at circulating in parallel with national currencies in their own countries at cost of disrupting the ever fragile control of the money supply.

The future belongs to the hard ECU if it reaches the ultimate possibility of an extranational composite currency by being constant in real value. Then, through private initiatives, it would soon be the medium of exchange and reserve par excellence between the nations of the world.

And for Europe : a monetary beacon.

SIMULATION OF THE CONSORTIUM'S OPERATIONS for issuing and managing the Constant External ECU (U)



The Consortium operates according to the Euromarket's procedures in the off-shore zone outside national territories.

The two persons at the left represent member banks I and II (III and IV not seen). At the right : the representative of the Interbank Office, set up by member banks (its mission : transfers, clearing, equalization of currency resources, control of member bank's positions, etc.).

The various operations (transfer, loan, receiving or paying in various currencies, etc.) are monitored through playing cards.

All operations between member banks pass through the Interbank Office in "central U" which it issues (registered on the board, back of the picture). Operations with clients are made in "bank U" issued by member banks (registered on the sheets in front of I and II).

One verifies that the Constant External ECU's value is unaffected and that it performs like tokens in a casino. Their value is independent of the game's hazards and of the amounts at stake on the gambling table.

On June 12, 1974, Jacques RIBOUD presented the project of a external payment composite currency with a stable purchasing power, issued by a Consortium of Eurobanks, to the "Société Française d'Economie Politique". He submitted it again as a formal "Communication" to the "Académie des Sciences Morales et Politiques" on 15 January 1981. From then on he has never ceased his efforts to promote the project in the "Revue Politique et Parlementaire" and with the "Centre Jouffroy pour la Réflexion Monétaire".

He has written several books about money. The first one to be published in English is "The Mechanics of Money" (1980). It was presented to the press by the late Maurice Macmillan. His books that pertain more specifically to the Constant External ECU are :

"The Case for a New ECU : Towards another Monetary System" (1989) - Macmillan, London ; St Martin, New-York
and "A Stable European Currency" just published - foreword by Sir Alan Walters - translated by Stephen Harrison. Same editors.

To those who wish to get an idea of how the Constant External ECU could be practically implemented, we recommended an 18 pages notice which explains, with simulations, not only how the eurobanks that issue it would operate, but also why an external currency can hold its real value. Playing cards are used for simulation of events as they happen spontaneously without previous arrangements. The games give a clear picture of the system and sets before one's eyes the unit's circulation (see picture).

Available on request at the : "CENTRE JOUFFROY", 88 bis, rue Jouffroy - 75017 PARIS - Tél. : (1) 46 22 10 50