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The European Community; In Search of a Key Currency

by

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I

The year 1992 has been marked in the calendars of Europe's leadership as the major turning point in a progression of events which, if successful, is expected to culminate in the establishment of Western Europe as an economic super-power. The merger of the participant States' into a single economic union would generate a cumulative Gross National Product comparable to that of the United States and is additionally seen by many as a significant step towards the establishment of a single Western European political entity.

Perhaps the most ambitious aspect of the Western European plan for political and economic integration is the drive for a European Monetary Union. Central to this proposal, and the subject of often heated negotiations among the 12 member States of the European Community (EC), is the creation of a single European currency known as the European Currency Unit (ECU).

This medium of exchange has been designed to ultimately eliminate the national currencies of each member State and replace them with a single monetary unit of exchange common to the entire EC. Of particular significance is the fact that this would require each of the participants to relinquish sovereign control over their respective monies and cede this power to a commonly managed central banking authority whose jurisdiction would encompass the entire European Community. While the rationale behind the implementation of this monetary system has been centered on the logistical problems presented by the planned integration of 12 separate economies and a deep rooted desire to develop a stable medium of exchange; long term expectations are hinged on a desire to establish a viable medium of exchange that is capable of competing with the U.S. dollar (USD) as an International Reserve Asset.

II

The aspirations of the EC to develop a monetary union is not representative of a new development born of recent negotiations, but instead is the latest in a series of inter-European exchange agreements which is seen by many as the final phase of a natural progression which was initiated shortly after World War II.

The first such agreement was the "Treaty of Coal and Steel". Signed in 1952 by W. Germany, France, Italy and the *Benelux countries, this agreement was the culmination of a series of negotiations, initiated by France and Germany, which effectively supplanted sovereign control over the coal and steel industries, in the signatory countries, with that of a common authority. Highly significant was a clause in this agreement which provided for the establishment of a common unit of currency; which in turn served as a unit of account and was utilized for accounting purposes in tracking coal and steel transactions between the signatories. This unit of exchange, officially known as the Unite de Compte European (UCE), was pegged to the value of .888 grams of gold; which coincided with the gold value of 1 USD.

* Benelux - Belgium, Netherlands and Luxembourg

Although the Treaty for Coal and Steel was expanded in 1957 by the Treaty of Rome, which created the European Economic Community (EEC) and Euratom, no monetary provisions were included in the agreement. This was due to the prevailing stability in exchange rates that had been agreed upon in the Treaty of Bretton Woods, which established an adjustable fixed rate between the currencies of the Free Market Economies and pegged the rate of exchange explicitly to gold and implicitly to the USD. The collapse of this international monetary system in the early 1970's resulted in erratic fluctuations of all freely traded currencies. As a result, the Europeans made a second major attempt to establish a zone of stable exchange rates through the implementation of a medium of exchange that would not be subject to the fluctuations of the USD.

Immediately after the U.S.' retreat from the gold standard, France, Italy, Benelux and W. Germany entered into a European Joint Float Agreement. This arrangement, established in early 1972, became known as the European "snake" and ultimately resulted in the participation of Great Britain, Sweden, Denmark and Norway. Contrary to expectations, this exchange structure failed to achieve monetary stability. In fact the inequitable economic performance of the member countries was so widely divergent that participants were constantly withdrawing and re-entering solely on the basis market conditions. In short, the snake failed because the participants could not devise an artificial means of overcoming market forces. By 1978 the snake had ceased to exist.

While the snake had been devised as a means of fostering a stable rate of exchange, the role of the UCE as a means of tracking coal and steel transactions remained unchanged until 1975. By this time, Great Britain, Ireland and Denmark had joined the EEC and had also adopted the UCE as a unit of account for coal and steel transactions. In April of 1975 the European council redefined the value of the UCE in terms of an index based on the nine participating currencies, which were in turn weighed on the basis of each country's performance relative to Gross National Product (GNP) and the volume of inter-EEC commerce. This became known as the European Basket of Currencies.

Still intent on establishing some system of monetary stability, France and W. Germany proposed

the establishment of a European Monetary System (EMS). This proposal, known as the Schmidt - Giscard Plan and introduced to the European Council in 1978, was adopted in December of 1978 and was finally implemented on March 13th, 1979. The enactment of the EMS also marked the birth of the European Currency Unit (ECU). Simply put, the ECU performed the same accounting function as had the UCE, but on a widely expanded basis which encompassed all trade within the EEC. The transformation of the UCE into the ECU also involved the revaluation of the relative values of the currencies of the Basket. See Table 1

On a functional basis the European Monetary System, in addition to its utilization of the ECU as a common medium of exchange, is comprised of three major components which are specifically designed to achieve an eventual monetary unification.

The first element defines the currency exchange rates of participating States, to be confined within a band that cannot fluctuate beyond 2.5 per cent (+ or -) of the declared value, relative to the ECU. Thus, while these currencies may fluctuate on the open exchange markets, vis a vis, non-participant currencies such as the USD, they are in effect tied to ECU, and through it, to the currencies of other EMS participants. The success of this facet of the EMS has met with mixed reviews. While some economists argue that a primary benefit of the EMS has been the dispersal of inflationary trends in specific countries throughout the entire system, others have pointed to the constant need of member countries to revalue or devalue their respective currencies as an indication of the economic disparities that could foreclose on the success of any total economic merger of the EEC.

The second major principle of the EMS established the ratio of participation in the ECU. Each member of the EMS contributed 20 per cent of their international reserves in return for ECU credits directly proportionate to their respective contributions. Thus, the degree of control that can be exercised over the ECU is not equal but rather is relative to the economic strength of the individual participants.

The final ingredient of the EMS, and one which has yet to be realized, calls for the establishment of a Central European Bank which, under the management of all of the

members of the EMS, would ultimately control the total cumulative international reserves of the entire European Community. Despite the fact that laissez-faire inter-European trade has been generated, as a result of the EC and ensuing EMS agreements, the current attempts to achieve this final phase of the EMS, the establishment of a central bank and an absolute monetary union, may prove to be an insurmountable stumbling block.

III

The ambitions of elements within the EC Commission, largely at the behest of France, to establish the ECU as the sole monetary unit of Western Europe have culminated in the development of a comprehensive plan to establish a European Monetary Union (EMU) by the year 1993. This transition has, however, proven far more difficult than the utilization of the ECU as a mere unit of accounting, issuance of institutional financial instruments or even as the thirteenth "monetary" unit of the European Community. The proposal to integrate the currencies of the EC countries, into a single currency, has for the first time created rifts between the member States which may well develop into irreconcilable differences.

Those countries in favor of monetary integration are those whose currencies have undergone consistent de-valuation since the creation of the ECU in 1979. At the forefront of this pro-monetary union is France, which has faced currency devaluations vis a vis the ECU of about 20 per cent. This coupled with the West German Mark's revaluation of approximately 20 per cent relative to the ECU, over the same time period, is perhaps the driving force behind the French desire to introduce the ECU as a common currency. Such a move would offer France a considerable degree of control over a single strong European currency instead of absolute control over a regionalized weak currency. See table 2

Conversely, West Germany is adamantly opposed to such a union for the simple reason that the full control over its own strong currency would be supplanted by partial control over a relatively weaker common currency. Thus in the eyes of many West Germans, France's potential gains are seen as Germany's likely losses. This coupled with the perceived risk that Germany, under such a union, would inherit the inflationary trends of the weaker currency countries has

generated considerable concerns in an area that Germans are particularly sensitive to. The general fear of inflation, precipitated by historical events which brought the German economy to its knees in 1923 and in 1948, could cause serious political repercussions for any German administration which might be seen as opening the doors to an externally induced inflationary trend.

Despite Germany's resistance to the notion of an integrated European currency, recent events in Eastern Europe did serve to bring Germany to the bargaining table, specifically in order to offer some trade in return for Western European approval of German reunification. Official action towards this possibility was initiated by the West German government shortly after November 9th, 1989, when the dismantling of the Berlin Wall marked the marked the first opportunity to discuss the possibility of reestablishing a single Germany.

The German efforts were dampened by the European Council, which on meeting in response to the events in Eastern Europe, on November the 18th dismissed outrightly the idea of reunification. The conclusion drawn that such a plan was "... premature, too sensitive to deal with in public and not on the agenda." Ten days after this announcement, German Chancellor Kohl, acting independently of the other Council members, announced a ten point plan outlining the reunification of Germany. Kohl's undertaking to ultimately reunify Germany was, however, endorsed by the European Council at a special summit held in Strasbourg on December 9th, 1989.

Interestingly, in another announcement made subsequent to this emergency summit meeting, Helmut Kohl announced that Germany would finally agree to set a date for an inter-governmental meeting to discuss the next phase of European monetary integration. France hailed this as a great success for the future of Europe since Germany had hereto refused to consider any participation in any negotiations directed at establishing the monetary union. Germany's agreement to negotiate the issue during the latter part of 1990 should, under the circumstances, not be ascribed to any change in Germany's position relative to the latent risks posed by a unified monetary system.

However, the realization of Germany's political re-unification, on October 3, 1990, coupled with the ongoing efforts of the new German state to merge into a single economic unit, must give rise to the possibility that Germany's recalcitrance towards any plan of a European Monetary integration may reemerge. In the first place, the task of converting East Germany's economy into a market oriented economic system has become a priority to German policy makers. Despite the fact that this has been going relatively smoothly, Germany's concern that her commitment to revitalizing the Eastern portion of the country may result in an inflationary trend, would preclude any eagerness on Germany's part to assume the inflationary deficiencies of some of her Western European partners. Secondly, as a primary by-product of German re-unification, the German government has committed itself to substantially underwriting the Soviet Union's and Poland's ongoing attempts to reverse their economic malaise. This new eastward orientation of German foreign economic policy is not only a matter of fulfilling the terms under which the reunification process was made possible. It must also be considered in light of the possible ramifications to the German economy should total penetration of the Soviet market place and access to resources become possible. It is entirely conceivable that the ambitions of Western Europe to integrate monetarily may take a back seat to Germany's interest in further developing her relationships to the East.

While this directly contradicts the assertions made in July of 1990 by Great Britain's then Minister of Trade and Industry Ridley, who accused Germany of harboring hegonomous ambitions towards Western Europe, the fact remains that Germany's current interests in maintaining sovereign control over her own currency are as clear as are those of Britain.

Certainly adamant, and quite active in seeking to deter the ratification of any plan seeking to establish a European monetary union, is Great Britain. Unlike Germany and the Netherlands with respect to this issue, Britain's resistance is not grounded in disputes of economic inequity, but rather is rooted in the belief that monetary integration would threaten the principles of British monetary sovereignty. This has been consistent with Britain's past refusal to become a full member of the EMS and to regard with suspicion, European economic fusion. Even though Britain finally agreed to fully participate in the E.M.S. as a full member, on October 15, 1990, the British position has continued to favor the implementation of the ECU as a common rather

than a single currency.

Also opposed to the notion of a European monetary union are the Netherlands, whose opposition is essentially founded in the same interpretations of the risks as have been expressed by West Germany. Like the German mark, the Dutch Guilder has appreciated consistently in worth relative to the ECU since 1979.

IV

The expressed desire of the European Community, to utilize the ECU as a mechanism for maintaining stable exchange rates, has met with considerable success. The ECU, as a composite currency, has enjoyed relative stability on the world market. This has been largely due to the diversity of its component currencies. The market fluctuations of one currency within the ECU basket have generally been offset by the specific performance of other currencies within the basket. In those instances where the fluctuations of any single EC currency exceed 2.25 percent of the central value of the ECU, stability is further maintained through the direct intervention of the EC States. (In the case of Britain and Spain, the fluctuation allowance is 6.0 per cent.)

As a result of the ECU's stability, this monetary unit has been generally accepted throughout the world as a financial instrument. For example, between 1981 and 1989 the value of bonds denominated in ECU totaled approximately 50 billion dollars. Furthermore, ECU futures and options are traded on the FINEX in New York and the Philadelphia Board of Trade. The value of these transactions has exceeded 5.5 billion dollars. Despite the performance of the ECU in the international financial markets, the emergence of this monetary unit as Europe's key currency is an ambition that has yet to be realized. It has yet to reach the specific levels of performance enjoyed by the USD, the Yen, the British Pound or the German Mark. The out-performance of the ECU by the Guilder and the Mark, in terms of volume traded, is of particular significance in that both Germany and Holland are major contributors to underwriting the ECU.

In practical terms, the ECU has been utilized throughout the ECU as a medium of exchange in

the form of traveler checks, credit cards, demand and time deposits. However, the high cost of transforming the ECU into a real medium of exchange has detracted from its popularity amongst European consumers. While the ECU has also been utilized for accounting and invoicing purposes by some firms in the private sector, such as Fiat in Italy, it has never been commonly accepted by the major inter-European consortiums such as Airbus and Eurospace. This is generally due to the fact that the ECU has not generated the confidence necessary to establish it as a key currency, but rather has become a means of hedging for those entities conducting business in countries whose monetary performance has been marginal.

In monetary theory, as well as practice, a genuine currency is defined as having three functions. These are: to serve as a medium of exchange, as a unit of account, and as a store of value. While the ECU, as an international monetary unit performs all of these functions, it is as yet not a real medium of exchange in that there exists no central banking authority which is empowered to issue bills and coins. This alone precludes the ECU from consideration as a genuine currency, a shortcoming which must be resolved prior to any further reaching ambition to establish the ECU as a key currency in Europe or elsewhere. The establishment of a central European banking authority may prove to be an impossible undertaking. In the first place, there are no historical precedents for the establishment of a single "State" currency prior to the realization of political integration. In short, the establishment of the USD, as a national currency, did not precede American confederation in 1776; nor was the German Mark issued as a key currency of the second German empire until 2 years after its formation in 1871. While certain elements within the EC have raised the possibility of ceding the political self-determinism of individual European States to the control of the European parliament, the establishment of a European empire has historically proven to be an illusive dream.

Further denuding the ECU's evolvement into a key currency are the realities of the marketplace. Key currencies cannot be implemented through governmental decree but rather are determined by the greater forces of the market. Just as the USD was transformed from a domestic currency into a major international medium of exchange, so too must any currency pass the test of the market. Key currencies have come and gone. The decline of the British pound, as a key currency, could not have been forestalled by governmental action on the part of the British any

more than the increased demand for the USD could have been thwarted by the American Congress. Thus while the value of the ECU has by and large been resultant of the manipulations of European governments, its role as an international, or even as a European, key currency can only be determined by the market.

Finally, it must be considered that, historically, currencies are reflective of the economic performance of specific political entities. In this light, one must question as to whether the relatively stronger European economic performers are willing to accept the liabilities of their weaker counterparts. This coupled with the emotional aspect of surrendering sovereign control over national currencies, in return for mere partial control over a common currency, would seem to suggest that the likelihood of a European Monetary Union is remote.

V

In the final analysis, the EC's drive towards establishing monetary stability throughout Europe must be realized through the implementation of economic policies which recognize the importance of market forces. Thus, the initial phase of establishing monetary stability does not lie in the ability of EC members to mandate exchange rates, but rather is contingent upon the willingness and ability of the individual member States to bring order to their own houses. This would entail the enactment of economic policies within each of these countries that would foster the highest degree of employment, price stability, and productivity. The incentive factor for the EC members would then change considerably. Those countries with less than adequate economic track records would not seek to overcome their deficiencies through the efforts of their more successful European counter-parts, but instead would endeavor to achieve economic strength within themselves. In this context, the intermediate goal of the EC States should be to achieve a relative degree of economic parity throughout the Community.

While the notion that absolute economic equality can be achieved throughout Europe is of course far reaching, the realization of maximum economic performance by each of the member States would establish a realistic foundation for the development of a coordinated European economic policy. This policy would be designed to further the economic interests of the EC, as a whole,

by enhancing the common interests of each member State to establish a healthy domestic economy. The outcome of a concerted European effort to eliminate, to the greatest possible extent, economic divergence, would ultimately result in stable exchange rates within Europe.

As to the question of which monetary unit will prevail as the key European currency; this should be left to market forces. This is also true for the ECU. Through the introduction of the ECU as a common rather than a single European currency, the European tourist and businessman would be well served as a matter of convenience. However, as a common currency, the ECU should not supplant other European currencies by decree but ought to be left to compete with those currencies in the marketplace. Thus the establishment or emergence of a key European currency would be left to the performance of that currency in the market. This would ensure that any currency to assume a position of prominence in Europe would not be a paper tiger, but shall have earned that right through its own specific performance.

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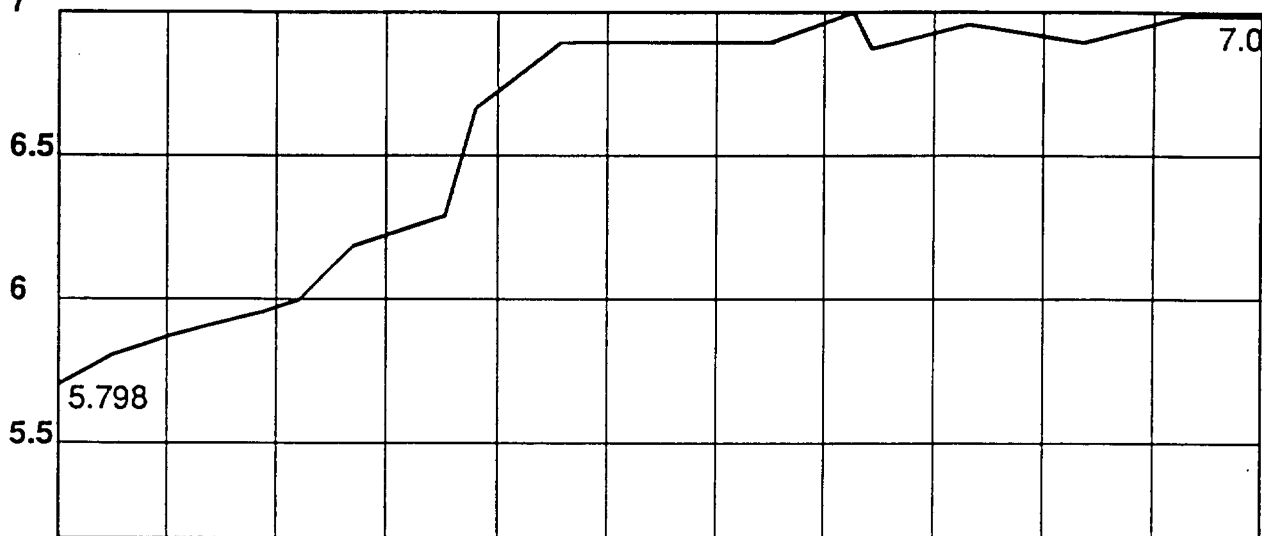
Sources for Tables

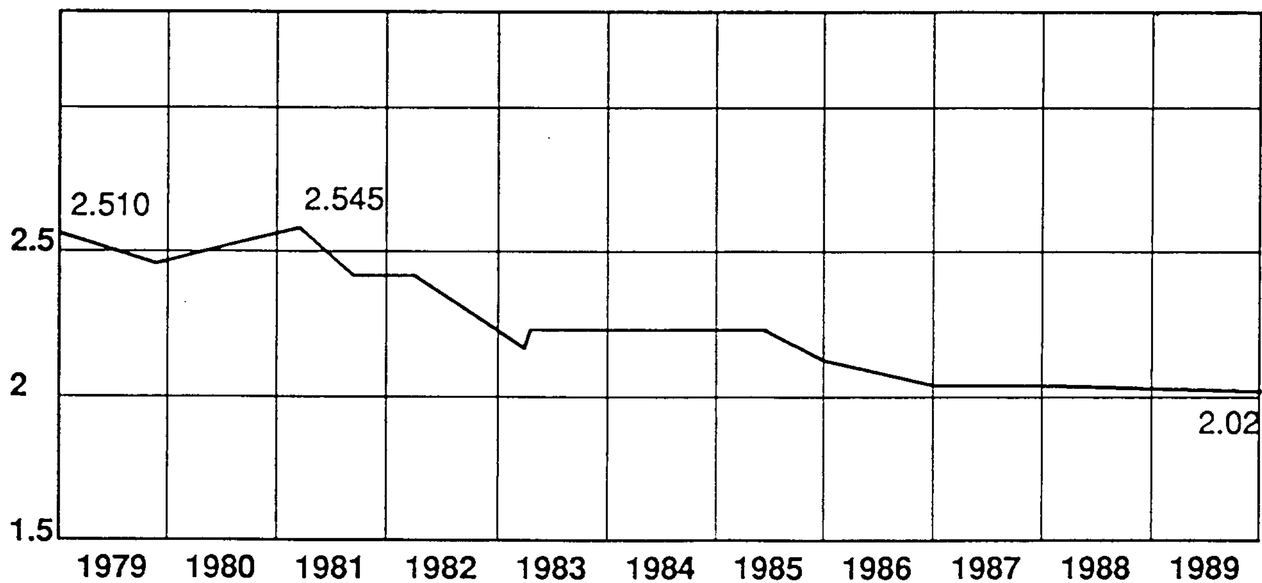
1. Eurostat (Compiled)
2. Official Journal of the European Community (compiled)
   Brussels, Belgium

TABLE 1.

EVOLUTION OF THE EUROPEAN CURRENCY "BASKET"						
Weight by Country	U.C.E. defined rate of exchange (%)	ECU fixed rate of exchange (%)				
Currency	4-21-75 (1)	3-13-79 (2)	3-23-83 (3)	9-17-84 (4)	9-23-88 (5)	9-21-89 (6)
DEM.	27.5	33	37	32	34.75	30.10
FRF	19.5	19.8	17.1	19	18.60	19.00
BRP	17.5	13.4	14	15	13.28	13.00
NLG	9	10.5	11.4	10.1	10.97	9.40
ITL	14	9.5	8.1	10.1	9.06	10.15
Belux F	8.1	9.6	8.6	8.6	8.77	7.90
DEK	3	3.1	2.7	2.7	2.76	2.45
IRP	1.4	1.1	1.1	1.2	1.12	1.10
GRD	—	—	—	1.3	0.69	.80
ESP	—	—	—	—	—	5.30
POE	—	—	—	—	—	.80
TOTAL	100.00	100.00	100.00	100.00	100.00	100.00

TABLE 2.





EXCHANGE RATE TRENDS OF FRENCH FRANC AND GERMAN MARK RELATIVE TO ECU.