**COMMISSION**
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DIRECTORATE GENERAL
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The Director General

Brussels…....,………………….

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# N O T E

Subject : Some Problems in connection with proposals for a European Parallel Currency

1. Proposals for a European Parallel currency normally envisage a medium of exchange circulating alongside or in competition with existing national currencies. In general most proposals envisage an ultimate substitution of the EPC for the EPC for national currencies but there are differences between the proposals with regard to timing and the ultimate extent of the loss of national currencies. However, while there are obvious difficulties on the supply side e.g. the control and extent of issue etc. and these difficulties have received attention, it seems to me that there has been less attention paid to the demand side of such currency proposals other than what might be termed naive assumptions of the attractiveness of an inflation proofed asset.

2. In considering the demand for a currency one must distinguish between the medium of exchange function of money and the asset function of money. The medium of exchange function of money involves a very small demand for money to hold; money in this case must have very few attractions as an asset otherwise it will become an asset and will be held and not circulated. This can be called $M_1$ type money; at a point of time there is an existing stock of money but over time most of the money is circulating from hand to hand and is only momentarily held. On the other hand money can be an asset or a store of value and in this case money is held or stored in balances – $M_5$ type money. Now for any existing money the assetness of money will vary from time to time depending on interest rates, expectations etc. However if there are two co-existing monies the 'strong' money will have more 'assetness' than the weak and it will be accumulated in balances. An essential condition for a circulating money is that it must not be too strong.

3. In considering parallel currencies, or co-existing monies, it appears to me that nearly all the proposals spend their time concentrating on creating an asset which will perform the store of value function while somehow they assume, without making any

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analysis that the creation of such an asset meets the conditions of demand for a circulating medium – which is essentially minimal demand to hold. Now this arises partly because existing monies perform both functions of circulating medium and store of value and the literature on demand functions for money are essentially asset demand studies. The circulating medium function is normally simply assumed to exist; of course it does exist but normally in the context of a single money system. In multimoney systems – most monies are really assets and although they may derive from transactions most balances perform in an asset manner – e.g. Euro currency balances, international reserves etc.

4. Thus, if we take the SDR for example, although it can and does finance transactions (indirectly) it is essentially an asset. Proposals could be made to expand its use, for example in the private sector and to some degree it would take on all the range of money functions. But supposing one were to propose that it should take over the functions of an existing money or monies e.g. the US $ then what would be required to achieve this? To take an extreme it could be achieved rapidly by simply flooding the world with SDRs and making the existing $ extremely attractive. In this case today's situation would be precisely reversed; the SDR would circulate with very little demand to hold and the $ would be accumulated in balances to hold as an asset.

There would still be a large stock of $ but they would only be used for transactions to a minor extent. (I have assumed away the exchange rate problems of SDR/US $ rate). Now this proposal is obviously extreme but it does illustrate a point namely that it it probably impossible to deliberately create a money in the full sense of the concept i.e. a device that will perform all the functions of money.

5. Now existing monies have come about through historical factors but their asset functions have come about secondarily with the development of banking functions and financial markets. The more sophisticated financial markets the more money can have a broad range of asset functions. Financial markets develop because money is used (that is demanded for transactions not to hold) and use leads to the build up of balances which, at first, must be and subsequently as markets develop, can be voluntarily held. The growth of the Euro-$ and other Euro-currency markets are the most recent examples of this process (although they are not parallel but external markets to the national currencies except for the US $). One of the problems of the EPC proposals is that they are trying to reverse this process – starting with complex highly sophisticated

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financial markets they are trying to create a circulating medium of exchange from an asset. This involves creating a strong asset to create demand for it and then, by assumption subsequently weakening it so that it becomes a circulating medium.

6. Let us suppose now that such an asset has been created : how can it become extensively used as medium of exchange with a relatively low demand to hold vis-à-vis other assets/currencies? One obvious answer is by catastrophe i.e. by the weak or national currency becoming so weak that people do not wish to hold it even momentarily, for transactions. In this case the weak currency will vanish through a process of excessive circulation and the strong currency will begin to take on transactions functions but as it does so its asset attractions must diminish, or some other assets if they exist will begin to take on the transactions functions.

7. However the main process that appears to be envisaged in the substitution of a parallel currency for a national currency is what might be called longterm speculation or more accurately a long drawn out speculation. People using the weaker currencies will at first be attracted by the attractiveness of the new asset (the EPC) and will slowly begin to shift their assets into the EPC, thus diminishing national money balances. What happens next, if anything, is unclear but there appears to be an assumption that in the long run or the very long run depending on the proposals, the national currencies will wither away. Now this in my view is entirely wrong. People will continue to use the national currencies for transactions, for the essence of speculation or asset protection is that the gain only appears on conversion back out of or into the weak currency. Thus an Englishman is unconcerned about the external value of the £ (except indirectly) if he is never able to buy foreign currencies or assets. If he is allowed to buy foreign currencies or assets, which appreciate relative to the £, the gain/protection only comes on conversion back into the £. If he cannot complete the speculative process there is no gain; shifting all your assets into Deutschmark assets which can be only spent as Deutschmarks involves no gain. Thus creating a new strong international asset will not only increase the range of speculative opportunities, both long and short, but will insure also the continuation of the existing currencies. A strong asset is only important when there are weak assets. Hence while a new strong EPC will undoubtedly bring about a long term shift in Asset portfolios, transactions will be met by conversions into national currencies. It is this asset shift that will be the essential consequence of the creation of a strong EPC and it is this that must be analysed rather than the vague assumptions of the withering away of natural currencies etc. It is my firm belief that

these portfolio shifts will be deletrious both in the long and short run for the European economies. Indeed while the Euro-currencies may not be parallel currencies themselves, the Euro-markets are good illustrators of the potential effects of an even wider range of strong assets. Imagine what would happen in the long and short run if all exchange controls between European national currencies and the Eurocurrency markets were abolished, so that currencies could circulate in parallel. It is true that there would be more integration of financial markets but we must not be so naive as to think that all integration is necessarily good per se!

8. In summary, while a great deal of attention has been given to the technical aspects of a European parallel Currency there is still, in my view, great vagueness about a) the ultimate achievements of such a currency and b) the transition process in moving to these achievements. Above all the possible demand function for such a currency, assuming it is to be a currency in the full sense of the word, including transactions demand, especially in the context of a multicurrency situation appears to me to have been almost totally undiscussed. Even a simple equation that would describe the transactions demand for a single money in a multicurrency situation seem to me to require a great deal of thought and work. The existence of a strong asset, although it may be called a money does not guarantee a wide circulation. Undoubtedly if the asset is strong there will be a strong demand for it and one can safely turn to considering the supply and substitution problems. But a strong demand for a strong asset does not constitute a parallel currency, unless, it is defined so, and once it exists the potential problems appear to be great as compared to the as yet undefined achievements.