Il Governatore della Banca d'Italia

Rome, 7 April 1989

Dear President,

At our last meeting we considered that a good way to give more depth to our Report, without, however, engaging the responsibility of the whole Committee, would be to attach the papers that various members, the rapporteurs and outside experts have prepared.

I agree with this idea and enclose a paper which unifies my two previous contributions. In preparing this new version I have drawn freely on the suggestions, developments and comments raised in the Committee about my proposal, in particular those of Professor Thygesen.

Yours sincerely,

Carlo Ciampi

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AN OPERATIONAL FRAMEWORK FOR AN INTEGRATED MONETARY POLICY IN EUROPE

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I. INTRODUCTION

1. The purpose of this paper is to organize thinking on how to carry out, from an operational point of view, an integrated monetary policy in Europe. The scheme illustrated below is designed to stimulate further reflection and does not pretend to provide a fully-fledged blueprint. The present contribution is a synthesis of two earlier documents discussed in the Committee and incorporates comments and suggestions made by some of the members, particularly Professor Thygesen. The paper focusses on the institutional aspects of the development of monetary cooperation towards full unity and does not address the equally important issue of the market development of the ECU, which has been thoroughly examined by Governor Duisenberg.

2. The paper is divided into two sections. The difficulties inherent in moving towards monetary unification exclusively on the basis of ad-hoc cooperation among the member countries are examined in the first section, while a possible solution to these difficulties is described in the second.

II. THE LIMITS OF COORDINATION IN CONDUCTING A COMMON MONETARY POLICY

3. The Werner Report assigns the basic role in the working of a monetary union to the irrevocable locking of parities. It recognizes that a perfect monetary union implies a common currency, but argues that creating a fixed link between currencies can produce an equivalent result. However, the Report suggests that this only applies if the irrevocable locking is akin to the fixed relationship between notes of different denominations of a given currency. In other words, the irrevocable locking of currencies brings about a monetary

union only if it implies and is supported by a common monetary policy.

4. The theoretical possibility of achieving "perfect coordination" of monetary policies through informal arrangements cannot be excluded, but the probability of this occurring in practice is very low. The prerequisites of such coordination are very demanding and costly: the collection, processing and evaluation of the information needed for the conduct of monetary policy would be cumbersome and inefficient; more importantly, the willingness to take each other's views into account in order to reach a consensus may fall short of what is needed.

5. The first problem in this respect is that exchange rate fixity leaves the level towards which interest rates in participating countries must converge undetermined. Nor is it sufficient to provide unambiguous operational guidance to establish monetary stability as the final objective of the system. The link between this final objective and day-to-day monetary policy is too tenuous, and no econometric model or other formal device could be relied upon to establish it univocally. A common judgement, exercised through appropriate procedures, is needed, but this is precisely what is lacking in a system of coordination, and conflicting opinions and policies are likely to emerge.

6. Another shortcoming of ad-hoc coordination is the difficulty of ensuring continuous compliance with the agreed monetary policy stance. It is conceivable that monetary policies will be forced to diverge, openly or otherwise, from the coordinated stance. For example, monetary policy could be required to support, albeit temporarily, the level of economic activity, or to finance the budget deficit. This would have devastating consequences: as soon as the market realized that the mutual trust and voluntary compliance

underpinning the system were in danger, it would test the commitment of monetary authorities to maintain parities, entailing the risk of large capital movements that could jeopardize the irrevocable locking of parities.

7. To sum up, it is not sufficient for member central banks to declare that they will pursue a common objective of monetary stability and informally coordinate their action; they must be seen to be doing so at every moment; otherwise the market may suspect a policy disagreement, particularly when intermediate objectives are reformulated in the face of changing circumstances.

8. This is why an operational framework for an integrated monetary policy is required. Such a framework would ensure that monetary policies which were distinct, though coordinated, would be operationally merged into one policy, thereby meeting the conditions for the lasting viability of the irrevocable locking of parities. Any definition of these arrangements, and hence of the minimal requirements of a workable monetary union, must provide: 1) an unambiguous procedure for translating the final goal of monetary stability into specific objectives; 2) the instruments for ensuring national monetary authorities' compliance with the decisions taken in common. The first issue has been discussed in the contributions to the Committee on the institutional aspects of the ESCB, the second is covered in the following section.

III. AN INSTITUTIONAL SCHEME FOR A COMMON MONETARY POLICY

9. This section outlines a scheme based on the creation of a central monetary institution. This, together with national central banks, would constitute a European System of Central Banks (ESCB). In terms of the steps towards

monetary union identified in the Report, the scheme fits into the second stage, in which there is still a plurality of currencies not tied by irrevocably locked parities and monetary policies are closely coordinated but not yet completely unified.

10. Under the scheme the monetary organization of the Community would have three levels: the central monetary institution, national central banks and commercial banks. At the top, the central monetary institution would only engage in transactions with member central banks; these, in turn, would maintain their present relationships with domestic commercial banks. The central monetary institution would act as the central bank of the national central banks and use its creation of ECU reserves to influence the monetary actions of member central banks. The basic principle underlying the scheme is that there is a link between the ultimate target of price stability, the undertaking to fix parities, the interest rate prevailing in each country and the underlying liquidity conditions, which in turn are determined by the action of each member central bank. This approach, which is based on the "fundamentals", leads to a system that will allow the central monetary institution to control the liquidity creation of the national central banks as the ultimate source of monetary developments.

11. The ECU would still be a basket currency and only member central banks would hold ECU deposits with the central monetary institution. In this latter respect, the situation would be similar to that prevailing domestically, where deposits with the central bank are predominantly held by banks and provide the ultimate means for settling interbank accounts. Of course, in this set-up, commercial banks and their customers would be free, within the aggregate targets set by the ESCB, to denominate deposits and other monetary instruments in ECUs.

12. The scheme involves three fundamental components. The first is an autonomous balance sheet for the central monetary institution, in line with the structure of all monetary institutions (national central banks, the IMF, the BIS); this would allow the central monetary institution to take operational decisions, rather than serving simply as a forum for concertation. The second is a mechanism for ensuring direct and firm control of the supply of ECUs by the central monetary institution, in strict analogy with the control exercised by national central banks over the domestic money supply. The third is a set of provisions to strengthen national central banks' demand for official ECUs created by the central monetary institution by making them a necessary ingredient of the process whereby central banks supply liquidity to the private sector.

13. The balance sheet of the central monetary institution would be based on capital in the form of contributions of international reserves by national central banks, along the lines of the proposal of Governor de Larosière. For instance, $4 or $5 billion of international reserves could be contributed according to a distribution key reflecting the relative economic importance of participating countries. In return, central banks would receive shares of the central monetary institution, i.e., a participation in its capital.

14. Firm management of the supply of ECUs by the central monetary institution requires that all the channels of ECU creation be brought under its direct control. At present, the amount of ECUs created through the swap mechanism depends entirely on exogenous factors: changes in the gold price, the dollar exchange rate and the quantity of reserves. Such swaps will therefore have to be abolished. They could be replaced by an initial contribution of

international reserves -- in exchange for ECUs -- by member central banks, amounting, for example, to the equivalent of 3 per cent of their respective monetary bases.

15. Credit mechanisms, the other channel of ECU creation, are similar to the rediscount facilities for commercial banks at the national level. However, while automatic rediscount facilities are generally on a small scale in national systems and the supply of liquidity to commercial banks mainly discretional, the EMS credit mechanisms are mostly automatic and for unlimited amounts up to 75 days. To bring the creation of ECUs from this source under strict control, the central monetary institution should be given the power to grant member central banks discretional credit in ECUs, in the same way as a central bank refinances commercial banks through open market or rediscount operations. The cost of this credit would also be fixed discretionally. In turn, this new mechanism would allow a significant reduction in the scope of Very Short Term Financing (VSTF), for instance by reducing its average duration to 15 days, limiting its applicability to the financing of marginal interventions, eliminating automatic renewals and making it more expensive, in the nature of a Lombard facility.

16. The third component needed to complete the scheme, after arranging for an autonomous balance sheet and firm control of the creation of official ECUs, is a specific and exclusive use for the ECUs held with the central monetary institution. This is provided by requiring member central banks to hold the ECUs (created through the channels described in paragraphs 14 and 15 above) as deposits with the central monetary institution in the form of both compulsory and free reserves. The reserve requirement in ECUs would link the supply of liquidity by member central banks, and therefore the aggregate monetary conditions in the Community,

to the creation of ECUs by the central monetary institution. In this way, a strong relationship would be established between the action of the central monetary institution and that of each member central bank. Through this link, the stance decided in common within the ESCB would be transmitted to all the members of the system.

17. The system could be implemented in different ways, depending on whether the reserve requirement were applied to the liabilities or the assets of the national central banks, as illustrated in the two following paragraphs.

18. If the reserve requirement were imposed on the liabilities of participating central banks, the central monetary institution would have the power to ask member central banks to hold compulsory reserves in ECU amounting to the equivalent of a certain percentage of the total monetary base, or of its increases. The reserve requirement in official ECUs would establish a connection between the supply of central bank money by member central banks, and therefore the aggregate money supply in the Community, and the creation of official ECUs by the central monetary institution. Since central bank money in the participating countries would also be created as a counterpart of net unsterilized interventions in third currencies, indirectly these would also be affected. National central banks would only be able to undertake autonomous foreign exchange operations against third currencies to the extent that they offset the latter's monetary effects by changes in the credit extended to domestic counterparts.

19. As an alternative, the reserve requirement could be applied to the credit extended by national central banks to the domestic sector. The total expansion of central bank money in the system would be the counterpart of the credit extended to the domestic sector plus the net effect of

unsterilized foreign exchange market interventions against third currencies. The central monetary institution would therefore have to take a stance on the desired overall amount of intervention. This could be achieved by allowing the central monetary institution to intervene directly in the market or by subordinating national central bank interventions to guidelines laid down by the ESCB. With the target rate of domestic credit expansion given, there would be a presumption that these interventions would not be sterilized. It would also be conceivable to apply the reserve requirement to the sum of domestic credit and official reserves in third currencies. In this case, guidelines on unsterilized intervention would no longer be needed.

20. ECUs held with the central monetary institution in excess of the compulsory level would constitute free reserves. Central banks would need such reserves to be able to expand their monetary base, settle obligations in the system and obtain international reserves from other central banks (negotiability) or the central monetary institution. The central monetary institution would be under no obligation to buy or sell international reserves against ECUs; it would only do so to the extent that such action was consistent with its monetary objectives, in analogy with central bank behaviour when deciding to intervene in foreign exchange markets. The convertibility of ECUs with the central monetary institution would thus be at the latter's discretion, and would be assured whenever it was deemed necessary to counter a monetary disturbance of systemic significance.

21. As far as the functioning of the system is concerned, the governing body of the ESCB would decide each year, in the light of an appraisal of the economic situation, how much money and credit should be created overall in the Community in order to support economic activity in a non-inflationary environment. This target would then be

translated into a figure for the central monetary institution's ECU supply, which would guide the liquidity creation of national central banks.

22. The mechanism described above would be instrumental in achieving the monetary policy objectives set for the Community. If, for instance, it were necessary to make the aggregate monetary stance of the system more restrictive, the ESCB could reduce credit in ECUs to member central banks, increase its cost and/or increase the ECU reserve requirement. Conversely, if the ESCB judged that a more expansionary stance were needed in the aggregate, it could increase ECU credit, reduce its cost and/or decrease the ECU reserve requirement and the resulting free ECU reserves would support the desired monetary expansion by some, or all, of the national central banks. If, on the other hand, the problem was the tendency for money to expand in a given country beyond the stability-oriented common plan, the ESCB could ask for a special deposit of reserves from the central bank of the country concerned. Analogously, if a currency came under speculative attack on foreign exchange markets while the underlying monetary policy was considered appropriate, the ESCB could provide ECU credit and help restore balanced conditions in the market.

23. The foregoing examples appear to imply that the main monetary policy instrument of a system based on ECU reserve requirements has to be a quantitative aggregate, but in fact the scheme can easily be generalized. The ESCB might also be guided in its supply of official ECUs by interest rates. In view of the degree of exchange rate fixity expected for phase two, interest rates in member countries would have to converge within a narrow band. The ESCB could then carry out its monetary policy by focussing on the level of interest rates. For example, if liquidity increased too much in a country, interest rates would tend to fall and pressures

would develop on foreign exchange markets. The appropriate response of the ESCB would be to withdraw official ECUs with the aim of inducing the national monetary authorities to rein in the expansion of liquidity. The opposite action would be warranted in the case of insufficient liquidity.

24. While the basic features of a system of ECU reserve requirements for national central banks are relatively simple, the implementation of the scheme would have to take account of a certain number of factors, such as differences in national money multipliers, the effect of realignments and the distribution of reserves among national central banks.

25. National monetary base multipliers differ considerably at present, in particular because of the disparities in national reserve requirements in respect of commercial bank deposits. These differences will be reduced by the pressure to converge produced by the liberalization of capital flows and financial services. Nonetheless, the remaining differences would result in a tranfer of official ECUs from a national central bank with a low multiplier to one with a high multiplier having an expansionary effect, even with a given total quantity of official ECUs. This would not be an entirely new problem since national systems often have different reserve coefficients for different types of deposit, so that a shift can affect the observed multiplier. However, the problem would undoubtedly complicate the task of the ESCB, requiring careful monitoring of the distribution of official ECUs and, whenever necessary, intervention to adjust the overall quantity available, in order to offset the expansionary or contractionary effects of transfers of official ECUs between national central banks.

26. As for the effects of a realignment on the operation of the scheme, the central bank with a depreciating currency would record an increase in the value of its ECU

reserves expressed in national currency and end up with free ECU reserves, while the central banks whose currencies appreciated against the ECU would need to acquire additional ECUs. The monetary consequences of these effects would have to be dealt with by appropriate technical devices built into the system.

27. More generally, there is the issue of the distribution of ECU reserves among the participating national central banks. This arises because national central banks are likely to behave differently from commercial banks. National reserve requirements work predictably and affect all banks in the same manner because commercial banks act mainly on the basis of profit motives. Accordingly, in most cases there is an active market for the asset that can be used to satisfy national reserve requirements, with interest rates determining whether any given bank is willing to supply or to demand additional reserves. Especially at the start of the proposed scheme, there is no guarantee that every national central bank would increase its national monetary base in response to an expansion in the supply of official ECUs. Furthermore, national central banks wishing to expand would not be able to count on a market in which to obtain additional official ECUs. In this case the ESCB would have to guide and adjust the distribution of ECU reserves among national central banks.

28. At an advanced stage such as that described above in paragraphs from 9 to 22, when responsibility for monetary policy is exercised at Community level, the ECUs held with the central monetary institution would be the only asset permitting national central banks to expand their aggregate supply of high-powered money, albeit with a required reserve coefficient that could initially be small. National central banks would not be able to acquire these ECUs automatically from the central institution either through an unconditional

right to convert reserves held in other currencies or through access to any of the credit mechanisms. Scarcity of high-powered ECUs would provide effective control over the expansion of money and credit in the Community.

29. At an intermediate stage of the process, when national central banks still have primary monetary responsibility, some flexibility in the supply of official ECUs and in the way this is linked to the creation of high-powered national money would allow member central banks to expand or contract the money supply in their countries without being rigidly tied by their ECU reserves. In these conditions, ECU operations carried out by the ESCB using the mechanism described above would serve primarily to highlight, and in part counter, divergences by individual central banks from the commonly agreed monetary and credit objectives of the Community. The ESCB should also initially take account of the specific needs of each participating country when making and carrying out its plans; its hold on the system's monetary policy would only be tightened gradually. Accordingly, some leeway could be provided by not making the automatic Very Short Term Financing (Lombard-type facility) too strict, in terms of duration and cost, and by granting member central banks the right to exchange ECUs for international reserves and viceversa under certain specific conditions. As regards the link between ECU creation by the central monetary institution and national money supplies, some flexibility could be allowed by fixing ranges for the ECU compulsory reserves rather than a specific level.

IV. CONCLUSIONS

30. In institutional terms the proposals presented in this paper involve a very significant step towards monetary union and a loss of monetary autonomy. In practice, however,

capital mobility and the exchange rate constraint already drastically reduce the room for autonomous monetary policies: the ultimate responsibility attributed to national monetary authorities is severely limited and each national policymaker influences, and is influenced by, all the others. Seen in this light, the only innovation in the scheme illustrated above is that the constraint would be explicit and exert an ex ante influence on the formulation of monetary policy, instead of being hidden and having an ex post effect in the exchange market. Accordingly, the pooling of monetary responsibilities would not so much be a new phenomenon, as the, admittedly important, development of an existing trend.

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