MON/90/02

COMMITTEE OF GOVERNORS OF THE
CENTRAL BANKS OF THE MEMBER STATES OF THE
EUROPEAN ECONOMIC COMMUNITY

MONETARY POLICY SUB-COMMITTEE

SPECIAL REPORT ON
THE OPERATIONS OF A EUROPEAN CENTRAL BANK SYSTEM

17TH AUGUST 1990

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INTRODUCTION

The present report deals with the questions raised in the two last indents of the attached mandate from the Committee of Alternates[1], namely:

- the extent to which instruments will have to be harmonised in order to ensure the efficiency of monetary policy and not to create incentives which would induce commercial banks to seek refinancing from a particular national central bank;
- the extent to which national central banks will have room for manoeuvre in executing instructions issued by the Centre of the System.

Both issues are closely inter-related and will be treated hereafter under the general heading of the degree of centralisation in the execution of operations.

This report is of a preliminary nature. It is based on the discussions held by the Sub-Committee during two meetings but given time constraints the present text has been established under the sole responsibility of the Sub-Committee's Chairman and does not commit its members. The text will be finalised at the next meeting of the Sub-Committee.

I. BASIC PRINCIPLES

1. When assessing alternative models for the execution of the System's operations, one should bear in mind a number of factors which will determine the environment of the System and influence its functioning. They include:

- the exchange rate regime and in particular the credibility of parities;
- the degree of integration of financial markets and the interconnection of payments systems;
- the degree of harmonisation of instruments.

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1 The issue raised in the first indent of the attached mandate has been examined by the Sub-Committee in document MON/90/01-final, dated 14th August 1990.

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2. In Stage One of EMU, which started on 1st July 1990, the national central banks will conduct monetary policies in a co-ordinated way but ultimate policy decisions remain within the national competence.

According to the Delors Report Stage Two would be similar to Stage One in that monetary policy decisions would still be taken by the national authorities; however, the creation of the European Central Bank System would contribute to reinforcing the co-ordination of monetary policies and common decision-making would apply to the performance of certain central bank functions, for instance in the foreign exchange field.

3. As stated in paragraph 58 of the Delors Report, "the final stage would commence with the move to irrevocably locked exchange rates and the attribution to Community institutions of the full monetary and economic competences described in Chapter II of this Report". In the monetary field, this would mean the transfer of monetary sovereignty to the European Central Bank System. This intermediary stage (which is sometimes called Stage 3a) would precede the definitive replacement of national currencies by a single Community currency.

The formulation and implementation of a single monetary policy is necessary in order to make the irrevocable character of the parities credible. If this condition were not fulfilled, the markets might question the ability of maintaining locked parities and the country with the least credible policy would suffer the heaviest loss of reserves. Such a system would appear to be unstable and would in fact be an extension of Stage Two.

In Stage 3a, as described in the Delors Report, permanently fixed parities, a single monetary policy and the absence of any restriction to the conversion of one currency into the other would make national currencies perfectly substitutable[2]. This situation would in reality mean a single currency. The use of national currencies would be governed exclusively by reasons of comfort and tradition.

4. The credible blocking of parities or the existence of a single currency in the final stage would have the consequence that this currency (these currencies) would be traded everywhere at the same exchange rate

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2 Except if there was a risk of opting out for political reasons.

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vis-à-vis the currencies outside the Union; any difference in rates which might appear between the local markets would immediately be eliminated through arbitrage flows.

The yield on a given type of transaction would be the same on all local markets, temporary differentiation giving rise to arbitrage flows. Such a situation would first prevail on the interbank money market where operations already now show a high degree of similarity in respect of techniques and methods. The System would thus act on the Union's global interbank money market where a decentralised operation undertaken by one member central bank would impact on banks' liquidity in the whole area.

Small yield differences would persist for technical reasons relating to the lack of integration of national payment systems, different value dates and transaction costs. In addition, the European financial market would show some degree of segmentation, given differences between Community countries in the types of financial assets and fiscal treatment. However, one could expect that over time the segmentation of the Union's global financial market would be reduced following harmonisation of legal, administrative and fiscal provisions, the integration of national payment systems and the pressure of competition between the local markets.

II. MONETARY POWERS OF THE CENTRE

1. In Stage Three the responsibility for monetary policy will be vested with the Centre of the System (Council, Executive Board, Central Institution). The Centre will be the only body which can at any moment assume the responsibility for the development of the exchange rate of the single currency and its interest rate(s). The Centre will also determine the way in which monetary policy is implemented, the extent to which operations are decentralised and the margin for initiatives which could be delegated to national central banks.

The Centre might decide to implement the System's monetary policy through the control of the monetary base in the short-run, as exercised by the Federal Reserve System in the United States in the period 1979-1982. This would give little room for manoeuvre to national central banks but would not preclude a decentralisation of back-office functions (see Chapter III, section 2.2.1). However, a short-term monetary base approach is for the time being not a very realistic scenario in Europe since it

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would inevitably lead to unacceptably sharp fluctuations in money market rates. Therefore, it might be more realistic to expect that the Centre would decide to control a representative short-term interest rate of the single currency. In this case, more leeway could be given to national central banks which would receive guidance from the Centre in respect of the desired development of this interest rate.

2. For the purpose of implementing monetary policy decisions, the Centre will need adequate information about factors determining money market conditions. Part of this information will stem from national central banks, namely:

- changes in balances held by the Treasury of each member country;
- variations in the amount of bank notes in circulation in each member country (denominated either in the respective national currency or in the single Community currency);
- transactions effected by the national central banks with banks or non-banks in the framework of operations which are not regarded as part of the System (see Article 13.5 of the draft Statute).

Information about the autonomous sources of high-powered money is especially important in the case of a monetary base approach but also necessary if a representative interest rate is controlled.

To the extent that interventions on the foreign exchange market were carried out by the Centre, it would be possible to inform the national central banks of the impact of these transactions on the liquidity position of credit institutions in the respective country.

If the Centre decided to fix the volume of operations on the Union's money market, it would need not only ex post data on the autonomous sources of high-powered money, but also projections from the national central banks. National experience shows that such projections are not always reliable. Furthermore, to the extent that the execution were delegated to the national central banks, the Centre would have to receive instant - "on line" - information about the volume actually carried out.

III. EXECUTION OF OPERATIONS

Centralised execution of money market operations is normally associated with the concept of a single monetary policy for a single

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currency. Nevertheless, bearing in mind the variety of countries which constitute the Community, different degrees of decentralisation can be envisaged. The feasibility and the comparative advantages of each possible scheme will depend on the prevailing degree of segmentation on the European capital market (see Chapter I) and on the nature of monetary control adopted by the Centre (see Chapter II).

1. Centralised execution

A centralised execution of operations would either involve the Centre of the System or one national central bank of the System acting as its Agent. It could be convenient for the Centre or the Agent if credit institutions held their accounts with them but this would not be indispensable, as shown by the example of the Federal Reserve System and the Deutsche Bundesbank.

A centralised execution, in principle, has the advantage of being simple and efficient from the viewpoint of monetary policy. The Centre is able to take immediate corrective action if operations fail to meet the intentions of policy makers. In addition, a centralised execution would increase pressure in favour of a more rapid integration of financial markets.

However, before full integration is achieved, this approach would encounter certain difficulties resulting from the diversity and heterogeneity of the financial systems in the Union. The dealers of the Centre or the Agent will not only have to collect information and projections from the national central banks about the sources of high-powered money, but will also have to take account of the diversity of legal and administrative rules of each local market, deal in, or accept as collateral, assets with specific national properties and overview a variety of interest rates in a large number of market segments. Conversely, it would be difficult to confine the Centre's operations to one or two national markets since this would discriminate between the local markets. In addition, the volume of transactions will be important and thus might not be easily absorbed by one or two national markets[3].

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3 A centralised approach would be facilitated if the distribution of funds could be left to private primary dealers. In this case, there (Footnote Continued)

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2. Decentralised execution

2.1. General remarks

2.1.1. A decentralised execution by the national central banks would overcome the above-mentioned difficulties resulting from the heterogeneity of financial markets which would especially prevail at the beginning of the final stage. The national central banks have a better knowledge of their respective local markets than the Centre of the System or a single national central bank acting as the System's agent. Most of them are responsible for, or at least involved in, banking supervision which will presumably remain within the member countries' competence.

The advantages, however, have to be seen against the risk that the decentralised approach weakens the efficiency of the System's action on the money market and the credibility of the single monetary policy. Such a development would have serious drawbacks especially in a situation where tensions on foreign exchange markets or inflationary pressures necessitated a firm control of money market conditions. These risks are at variance according to the different examples of decentralisation described below.

2.1.2. Each credit institution would be obliged to hold its account with the central bank of its respective country. This would permit each central bank to know the position of its banking system in terms of central bank money. In addition, as mentioned earlier, it would also have the knowledge of most counterparts of "local base money".

2.1.3. The decentralisation of the credit institutions' accounts with the System would not hamper the transfer of funds within the Community. Payments made by banks of country A to banks of country B would give rise to the following movements on central bank accounts:

- on the balance sheet of the central bank of country A, a decrease in banks' reserve holdings and an increase (decrease) in its net liability (asset) position vis-à-vis the rest of the System;
- on the balance sheet of the central bank of country B, the contrary would occur.

(Footnote Continued)
would only remain the choice of collateral unless the Centre effected unsecured operations. However, the Sub-Committee did not discuss in greater detail this possibility.

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2.2. Examples of decentralised execution

The execution of operations could be decentralised at varying degrees. The Sub-Committee considered essentially three different examples, the first and third constituting the extreme ends of a spectrum.

2.2.1. The "back-office" model would mean a decentralisation of the back-office functions whereas the front office would be centralised. It is similar to the way in which open market operations are executed by the Bundesbank. For instance, the Centre would decide to carry out a repo tender on the basis of the global liquidity needs of the banking system in the Union. The national central banks would receive from their respective banks the bids and transmit them to the Centre which in turn would subsequently allot the amounts among the different banks. The national central banks would then conclude the contracts with their respective banks for the amounts and rates fixed by the Centre and carry out all related work including settlement and acceptance of collateral.

This kind of decentralisation focuses on the global character of the Union's interbank market. It would give national central banks little room for manoeuvre; their role would largely be of a technical nature. It would be best suited to ensuring the coherence of actions decided by the Centre and would entail standardisation of money market techniques.

2.2.2. According to the "sharing out" model and taking up the example in section 2.2.1 above, the Centre would decide the global amount of central bank money to be supplied to the banking system as well as the terms and conditions of the operation. The global amount would be shared out among the national central banks on the basis of the local factors affecting bank liquidity on their respective markets (i.e. without taking into account arbitrage flows between the member countries). Each central bank would then be responsible for the execution of its share; it would receive bids from its banks and would itself allot the amounts. Operations would be executed on the local markets at the same date but there might be scope for execution at different dates. An illustration of this approach on the basis of a selected list of most commonly effected operations is given in Annex II.

The model under consideration would decentralise not only the System's back-office function, but also its front office, at least to a large extent. It relies on a high degree of harmonisation of money market

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techniques but would provide national central banks more leeway in respect of methods. It would also mean that the liquidity requirements on a given local market would essentially be met by the respective national central bank.

2.2.3. The Sub-Committee has considered an even more decentralised model which is based on the assumption that the System will pursue an interest rate policy and that in the final stage of EMU the System will start its operations without there being a harmonisation of member countries' monetary policy instruments (for details see Annex III). The freedom of action enjoyed by national central banks would be limited by two constraints. First, in order to ensure consistency between the monetary policy stance decided upon by the Centre and the actions taken by national central banks, the Centre would set a band within which each national central bank would have to operate its respective marginal instrument, i.e. the instrument which it uses to influence market rates in day-to-day management. Second, there would be the rule that each central bank's net creditor/debtor position vis-à-vis the System, resulting from intra-Community transfers of funds mentioned in section 2.1.3 above, would have to be zero in the medium-run while daily balances would be subject to a ceiling which would have to be respected at any time. This two-fold restriction would be designed to avoid the use of non-harmonised instruments and intra-Community balance of payments disequilibria creating incentives for commercial banks to seek refinancing at a particular central bank. If a central bank supplied too much liquidity, this would be reflected in an increase in its net debtor position vis-à-vis the System. In order to correct this position, the central bank concerned would have to increase its "marginal rate". Over time, the mechanism would induce harmonisation of money market practices and possibly instruments since national central banks would try to reduce the disturbing effects on money market management of intra-Community transfers of high-powered money.

The Sub-Committee noted several issues which could raise difficulties and would need further study:

- the size of the limit on central banks' daily net positions vis-à-vis the System and the length of the period over which such positions have to average zero;

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- the lack of day-to-day control by the Centre over the amount of high-powered money created by national central banks. Some members felt that this would be a major drawback;
- the definition of the "marginal instrument" and the question of whether too great a differentiation in "marginal rates" would not bear on the credibility of the System's monetary policy;
- the relation between the scheme and intra-Community balance of payments flows. Some members questioned whether this scheme was compatible with the rationale behind monetary union.

IV. COMPULSORY RESERVES

The Sub-Committee did not discuss this question specifically. However, there was a broad consensus about the necessity to align provisions about reserves based on banks' liabilities because of the risks of delocalisation of deposits. If the Centre considered it necessary to set a given reserve volume for the credit institutions in the whole area, the reserve coefficients and the rates of remuneration (if any) would have to be the same and the methods of calculation would have to be broadly in line. Limited variations in national rules might only be justified by differences in the composition of banks' liabilities (some kinds of liability existing in one or several countries only).

In principle the Sub-Committee was opposed to using reserve requirements with a view to setting a ceiling on credit institutions' assets; it recalled the previous remarks made by the Group of Experts on the lack of efficiency which characterises such instruments in a deregulated environment. If such techniques were to be applied in cases of emergency, strict harmonisation would be required.

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The present report suggests that it is not necessary to wait for full integration of financial markets before starting Stage Three and that some decentralisation of the System's operations will remain possible during this stage.

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Committee of Governors

Committee of Alternates

Annex I

20th July 1990

MANDATE OF THE MONETARY POLICY SUB-COMMITTEE

The Sub-Committee has been requested to:

- review Chapter IV of the draft Statute with a view to examining the appropriateness of the provisions for the operation of the System;
- examine the extent to which instruments will have to be harmonised in order to ensure the efficiency of monetary policy and not to create incentives which would induce commercial banks to seek refinancing from a particular national central bank;
- examine the extent to which national central banks will have room for manoeuvre in executing instructions issued by the Council/Executive Board of the System.

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Annex II

17th August 1990

Money market operations by central banks under the "sharing out" approach

The Sub-Committee examined the main types of central bank intervention on the money markets without seeking to be exhaustive.

1. Open market operations in the broad sense

1.1. Repurchase agreements concluded at rates close to market conditions but of the nature of official rates

A decentralised execution would raise the question of how the supply of central bank money could be shared out among the national central banks.

The simplest way would be merely to split an operation decided by the Centre between the national central banks. The share to be distributed by each central bank would be determined on the basis of projections of the local factors affecting bank liquidity (i.e. without taking into account transfers of high-powered money between the member countries). It would be adjusted upward or downward to the extent that the Centre wished to increase or reduce the overall monetary base in the System. In order to avoid even minimal time differences in the announcement of the rate, the operations should be announced by the Centre in order to ensure that the whole area was informed simultaneously. Contracts and collaterals would be settled locally.

A bolder approach would consist of having the national central banks carry out the repo operations on different dates which they would propose in the light of the liquidity needs observed locally. In this case the rate for each repo operation would have the significance of an official rate for the whole System and the Centre would have to take account of the overall monetary base as the high-powered money distributed at one point would spread through arbitrage. However, this greater degree of freedom

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could have consequences if and when rates changed over time. Let us assume that on 1st August a thirty-day repo is carried out at 9% in country A to meet the liquidity needs of credit institutions mainly in that country and that on 3rd August the central bank of country B undertakes a repo which is executed at a rate of 9.5% because in the meantime the situation in the area demands such an increase in the key rate. In this case the credit institutions in country A will have obtained a 0.5 point advantage over those in country B for a period of twenty-eight days. In addition, it would have to be made clear that the change in interest rates reflected global (and not local) factors.

1.2. Repurchase agreements without preset interest rate ("volume tenders")

They could be shared out in the same way as those described under 1.1. The allotted interest rate may vary according to the different markets.

1.3. Outright sales and purchases of securities on the secondary market

In a decentralised system, an equitable distribution of such operations between national central banks would appear to be more difficult than in the case of repurchase agreements. Indeed:

- some central banks are at present unable to carry out outright purchases and sales of securities as their domestic markets in eligible assets are insufficiently developed;
- operations of this kind have to be carried out at the initiative of the operators present on the markets, and thus, it would be difficult to make every individual operation subject to a cumbersome prior authorisation procedure.

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However, the following positive arguments may be noted:

- there is, in principle, no reason why the System should forgo using such techniques once the appropriate markets exist in certain countries;
- interventions undertaken on one market would change the liquidity of the System as a whole. They could be carried out within a ceiling preset by the Centre, if it were willing to tolerate some degree of interest rate flexibility.

1.4. Swaps of foreign exchange against the common currency

These would, in principle, have to be concluded by the body responsible within the System for managing the exchange rate, in particular if the effect of interventions on the monetary base was to be sterilised.

However, in a decentralised system this authority could entrust the national central banks with the execution of such swaps with the credit institutions under their control.

2. Central bank credit facilities

2.1. Lombard facilities and similar techniques (five to ten-day "pensions" in France, special loans in the Netherlands)

If such facilities were to be maintained, they should be extended to all countries in the area and the operations could easily be decentralised, the rate and the conditions governing the use of these facilities being set by the Centre.

2.2. Rediscounting at a preferential rate

Articles 2.3 and 17.3 of the draft Statute (Alternates' version dated 24th July 1990) rule out unequal treatment of credit institutions between countries. In principle, therefore, if there was to be rediscounting at a preferential rate with ceilings by bank or for certain types of credit, it would have to follow the same rules in all the member countries.

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It was noted that in Germany the advantage given to the banks by the existence of rediscounting was offset by high reserve requirements, and that harmonisation should apply to both procedures at the same time.

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Annex III

17th August 1990

A more decentralised model

1. A more decentralised version takes as a starting point the following propositions:

- individual national central banks are in the best position to provide efficiently their domestic money market with the necessary liquidity;
- instruments are not harmonised;
- the System pursues an interest rate policy (as opposed to a policy of short-term control of the monetary base);
- rules and provisions are made in order to ensure efficiency of monetary policy and to avoid incentives for refinancing from a particular central bank, as mentioned in the mandate.

2. For an efficient implementation of the centrally decided policy stance it is sufficient that the Centre has adequate control over the Community-wide short-term market interest rate(s) through its instructions to the national central banks.

The Centre can effect this control by setting the interest rate level at which the national central banks have to operate their respective 'marginal' instruments, i.e. the instruments which the national central banks use to influence market rates in their day-to-day money market management. In order to take into account the circumstance that national central banks will employ different 'marginal' instruments, the level prescribed by the central institution should be defined in terms of an interest rate margin that all central banks have to observe. If the margin is set sufficiently narrow, the efficient control of market interest rates by the Centre will be assured. The necessary width of the margin will be discussed below.

3. Incentives for commercial banks to seek refinance at a particular central bank would derive from differences in the effective cost of

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refinancing. This would lead to transfers of central bank liquidity between central banks which would show up in the net creditor/debtor position of individual central banks vis-à-vis the System. To tackle the incentive problem it would thus be necessary to impose limits on central banks' net positions vis-à-vis the System.

3.1. The Centre would impose two restrictions on the freedom of the execution of monetary policy by the national central banks. Firstly, it would set limits to both the net debtor and creditor position to be allowed at any point in time for each individual national central bank vis-à-vis the System. Secondly, it would impose the obligation that each national central bank should strive for a net zero position against the System in the medium-run (which would, of course, have to be defined in a precise manner).

3.2. The individual central banks will be able to manage their net position by varying their marginal rates within the margin prescribed by the central institution. The size of the margin will, therefore, have to give some room for varying rates in response to the development of the net positions.

3.3. There will be a trade-off between the width of the interest rate margin and that of the limits set to the net positions of the central banks. The narrower the interest rate margin is set the wider the limits to the net position at any time will have to be. In order to ensure sufficient control of the central institution over Community-wide short-term interest rates as from the start of Stage Three, it seems advisable initially to set the interest rate margin relatively narrowly.

4. In addition to solving the incentive problem by way of self-imposed 'market forces', this approach to decentralisation would also have built-in incentives for national central banks to harmonise money market practices and probably also instruments. The reason is that the transfers of central bank liquidity between central banks will interfere with the intended money market management of the central bank concerned without this bank retaining any benefit from them. Thus, it will be in the interest of the central bank to adjust its practices and instruments in

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order to keep these disturbances as small as possible. Convergence of practices and instruments can, of course, be reinforced by co-ordination. Thus, starting in a decentralised way would not preclude attainment of the centralised system one might envisage.

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Committee of Governors of the
Central Banks of the Member States
of the European Economic Community

MONETARY POLICY SUB-COMMITTEE

List of participants

Chairman	Mr. R.J. Raymond
Banque Nationale de Belgique	Mr. T. Timmermans Mr. E. Verreydt
Danmarks Nationalbank	Mr. J. Kjaer(2) Mr. O. Nielsen(1)
Deutsche Bundesbank	Mr. P. Schmid Dr. H. Herrmann
Bank of Greece	Mr. T. Gagalis Mr. D. Moschos
Banco de España	Mr. J.L. Malo de Molina Mrs. B. Sanz(2) Mr. S. Fernandez de Lis(1)
Banque de France	Miss M. Alleron Mrs. E. Pauly
Central Bank of Ireland	Mr. P. Charleton Mr. T. Grimes(2) Mr. C. Guiomard(1)
Banca d'Italia	Dr. I. Angeloni
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Nederlandsche Bank	Mrs. H.C.J. van der Wielen Mr. G. Korteweg
Banco de Portugal	Mrs. T. Cardoso Mrs. A.Chr. Leal
Bank of England	Mr. R.D. Clews Ms. M. Lowther(2) Mr. J. Townend(1)
Commission of the European Communities	Mr. W. Schüle Mr. P. Jaillet(2)
Secretariat of the Committee of Governors	Mr. H.K. Scheller(3) Mr. M.-O. Strauss-Kahn(2)

The group held two meetings on: 31st July 1990
9th/10th August 1990

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(1) Attended only the meeting of 31st July 1990.

(2) Attended only the meeting of 9th/10th August 1990.

(3) Secretary and rapporteur of the Sub-Committee.

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