Il Governatore della Banca d'Italia

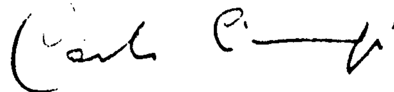
Rome, 7 April 1989

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,



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Rome, 8 February 1989

Overcoming the limits of coordination in conducting a common monetary policy

1. The note on "The ECU in the Monetary Union Process" outlined a scheme for the conduct of an integrated monetary policy with distinct national currencies and central banks. The analysis was based on the conviction that a monetary union cannot lastingly operate on the basis of informal policy coordination. The first purpose of the present paper is to elaborate on this point. It will be argued that a monetary union lacking an operational framework for an integrated monetary policy and involving only perfect mobility of capital, full convertibility of currencies and an irrevocable locking of parities would not be viable. The second purpose is to define the minimum institutional arrangements needed to ensure the lasting viability of the union. The scheme outlined in the earlier document will be shown to have a broad spectrum of possible implementations, and to allow different modalities for the conduct of monetary policy, such as the control of interest rates rather than monetary aggregates. Responses to some of the technical questions raised during the Committee's discussion of the ECU paper are set out in an annex.

2. The Werner Report assigned the basic rôle in the working of a monetary union to the irrevocable locking of parities. The Report recognizes that a perfect monetary union implies a common currency, but argues that creating a fixed link between currencies produces an equivalent result. However, the Report suggests that this only applies if the irrevocable locking is akin to the fixed relationship between notes of two different denominations of a given currency. In

other words, the irrevocable locking of currencies coincides with a monetary union only if it implies a common monetary policy. Since this is manifestly not the case, the irrevocable locking of parities can be regarded as a necessary but not sufficient condition for the achievement of a monetary union. In the following paragraphs it will be argued that without an <u>operational framework for an integrated monetary policy</u> a monetary union is not likely to survive for very long; sooner or later the credibility of the "irrevocable" locking would be undermined and the commitment revoked.

3. As a starting point, it will be assumed that a solemn declaration in a Treaty announcing exchange rates to be irrevocably locked with zero margins will be sufficient to ensure they are actually fixed in the market. Each monetary authority would therefore be committed vis-à-vis the market to buying and selling unlimited amounts of its national currency at the parity rate. In addition, each central bank would be required, even if only informally, to refrain from manoeuvring monetary levers in ways that would result in diverging levels of interest rates on similar assets denominated in different currencies, apart from differences attributable to market imperfections and to structural and risk factors.

4. How would this arrangement work in practice? Markets have learned from experience that the substance of official declarations has to be ascertained by trial and error. The aspect of the new system that the market would want to test would be the lack of a binding operational framework embodying the commitment to pursue a coordinated monetary policy. This is likely to be interpreted as reflecting national monetary authorities' desire to retain some scope for autonomous action, at least in exceptional circumstances. Market participants would try to identify

those circumstances and be the first to recognize them, with the aim of getting out of a weakening currency in time but also with a tendency to react to rumours, however unfounded. Whenever the market perceived a country to be on the point of diverging from the common monetary stance, it would test the credibility of the exchange rate commitment. Market participants would be reluctant to trade among themselves and would seek to have central banks as their counterparts: potential buyers of foreign exchange in a weak currency country might have difficulty in finding a counterpart, other than the central bank, willing to sell at the parity price. The opposite would occur in the strong-currency countries.

5. Obviously, if the feared divergence from the common monetary stance was groundless, the turbulence would be temporary. In a system based only on monetary policy coordination, however, cases of divergence from the agreed monetary course are likely to occur and this would provide the market with facts to feed its fears.

6. One instance is related to the general problem of translating the final objective of monetary policy into operational guidelines. Indeed, the locking of parities leaves the level at which interest rates in participating countries must be aligned undetermined. Nor is it sufficient to establish monetary stability as a final objective for the system to provide unambiguous operational guidance to the participating central banks. The link between this goal and day-to-day monetary action is too tenuous, and no econometric model could be relied upon to provide the answer. A common judgement would be required, but this is precisely what is lacking in the system, so that conflicting opinions and policies are likely to emerge. Another instance is related to the difficulties of ensuring continuous compliance with the agreed monetary policy stance. Indeed, a country's monetary policy may be forced to diverge, openly or otherwise, from

the coordinated stance. For example, monetary policy could be forced to relax, albeit temporarily, to support the level of economic activity, or to finance a budget deficit. As soon as the market realized that the cornerstone of the system, mutual trust and voluntary compliance, no longer existed, parities would cease to be irrevocably locked. To sum up, it is not sufficient for central banks or member states 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.

7. In theory, the possibility of achieving a "perfect coordination" of monetary policies through informal arrangements cannot be ruled out. The probability of such event occurring in practice, however, is presumably very low. The prerequisites to arrive at such coordination are likely to be very demanding and costly: the gathering, 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 views into account in order to reach a consensus will not always prevail. 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 a lasting viability of the irrevocable locking of parities.

8. Any definition of these arrangements, and hence of the minimal requirements of a workable monetary union, must include: 1) an unambiguous procedure for setting the specific objectives of the aggregate monetary policy of the system; 2) the instruments to ensure national monetary authorities'

compliance with the decisions taken in common.

9. As regards the 'setting of objectives, the system must have both a final goal -- monetary stability -- and procedures and bodies for the transformation of this final goal into day-to-day monetary action. Since, as already indicated, there is no mechanical rule that can do this, the system must permit the exercise of common judgement and discretion. The framework for this exercise could have the institutional features of the proposed European System of Central Banks, outlined in the Committee's work in the papers of Professor Thygesen, Governor Pöhl and in paragraphs 17 and 18 of the draft report (Part II CSEMU/10/89).

10. As for the instruments of compliance, the fact that the relationship between national central banks and the central monetary institution will normally be characterized by a spirit of cooperation does not exclude the need for an operational framework to maintain the system's policy cohesion in adverse circumstances or, rather, to forestall them, since any lapse, or even just the fear of one, could have devastating effects on the markets. Such a framework is needed at the Community level to reproduce the relationship existing in individual member states between the monetary authority, financial intermediaries and the private sector and would serve to elicit the desired responses at the Community level, such as a change in the interest rate and the stabilization of the price level.

11. The paper on "The Ecu in the Monetary Union Process" provides an example of how this may be done. In doing so, it implicitly recognises 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, i.e. the money provided by 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.

12. The scheme can accommodate different operational approaches to the conduct of monetary policy (see Annex). For example, the scheme could operate without national compulsory reserves in some of the participating countries. Similarly, it would work if monetary policy were conducted through control of domestic interest rates instead of focusing on monetary aggregates. In reality, the scheme is a highly simplified model having a broad spectrum of possible implementations to deal with the problems encountered when simple coordination of monetary policy is insufficient and a unified monetary policy based on a single currency is not yet in place. Naturally, other variations on the basic theme of the establishment of an operational framework for an integrated monetary policy are possible, and the system that will emerge may well represent an accretion of ideas from different intellectual streams.

13. Summing up, in the preceding paragraphs the following points have been made:

(i) the irrevocable locking of parities is a necessary but not sufficient condition for a monetary union;

(ii) to be viable, a monetary union also requires an operational framework for an integrated monetary policy.

It follows from the above that in charting the intermediate steps to arrive at a monetary union, the establishment of a framework for an integrated monetary policy should precede the locking of parities. Indeed, such an operational framework is in itself a step towards monetary union and, in any case, it may be necessary to test it for some time before the actual irrevocable locking.

Annex

In the brief discussion that took place last January on the paper "The ECU in the Monetary Union Process" the following three issues were raised:

i) problems that could emerge from the differences between national money base multipliers, due in particular to different reserve requirements, including the case in which there are no compulsory reserves;

ii) the applicability of the monetary cooperation scheme to a framework in which the interest rate rather than the monetary base is the main policy instrument;

iii) the fact that, differently from commercial banks, national central banks are not profit maximizers, and therefore might not have the necessary incentives to react to the action of the central monetary institution.

These three issues are examined in turn in this annex which also deals briefly, in point iv), with the issue of the exchange rate policy of the Community.

i) The scheme is described in the paper on the basis of the simplifying assumption that the national money base multipliers are equal. In reality this parameter differs across countries. Two considerations answer the question of how the scheme is compatible with differences between national multipliers. Firstly, some convergence towards a common range should be expected as competitive pressure on banks will induce supervisory authorities to harmonize reserve requirement ratios. Secondly, even allowing for differences in this parameter across countries does not alter the principle of the mechanism.

The differences in money multipliers (due to differing coefficients of reserve requirements or to their absence and to the differentiated structure of the financial

and payments systems) imply, for instance, that a shift of ECU reserves from a central bank which imposes no compulsory reserves to one which does, will arguably bring about a restriction of the aggregate money supply. This does not represent a completely new problem with respect to those presently confronting national authorities when steering monetary policy in the course of the year to achieve a target aggregate. They must approximately know the value of their own multiplier and the extent to which they need to vary their money base (instrument) to modify the money supply (target) in the desired way. Through the same link it would be possible to establish the amount of official ECUs that they should receive from the central monetary institution to be able to expand the money supply in the desired way. Operationally, the conclusion would be that the central monetary institution has to take into account the distribution of ECU reserves among national central banks in establishing its overall creation.

In any event, even if the value of the money base multiplier was unstable, the proposed scheme has the advantage that miscalculations regarding the relative value of the national multipliers could be corrected. If, for instance, the money base multiplier of one country was underestimated, the resulting excess of liquidity would produce tensions in the money and foreign exchange markets: this would induce the central institution to call back official ECUs from the national central bank, which in turn would have to reduce its domestic money base.

ii) In the paper the main policy instrument is taken to be the national money base. However, the scheme could also function with <u>the interest rate as the instrument</u>. National interest rates would have to be set at such a level as to guarantee investors an equal expected rate of return across currencies for equivalent assets. That level would of course be established by the central monetary institution

consistently with overall price stability.

In this setup, if a country experienced an excess of liquidity, tensions would appear on the foreign exchange market and the amount of reserves would tend to fall. The corrective action by the central monetary institution would be to call back official ECUs and induce the national central bank to reduce its own supply of liquidity, for instance through open market operations, thus restoring equilibrium to the money market without a change of interest rates.

iii) The monetary cooperation mechanism designed in the paper is based on a two-step control, with the central monetary institution controlling the volume of ECU reserves available to the national central banks, and the latter, in turn, regulating the liquidity of the commercial banks. However, while the commercial banks have a well-defined incentive to react to central bank action (profit maximisation), it may not be clear what factors would induce the national central banks to respond to the actions of the central monetary institution in the desired way.

This problem can be answered by examining briefly how the mechanism works. In the proposed scheme a reduction in the supply of ECUs by the central monetary institution to national central banks would imply, just for the mechanical effect of the reserve requirement, a reduction of their liabilities, through restrictive monetary measures (for instance open market sales of securities or a decrease of advances to commercial banks). An expansion should instead induce a country to proportionally expand its money base. However, if a national central bank was reluctant to follow the commonly decided expansion, it would soon find its exchange rate under upward pressure, and interventions would be needed to stem the pressure. Such interventions may be carried out by the same central bank or by any other participating in the system. In either case, liquidity would be injected into the system and the required expansion of the

monetary base would take place.

iv) In order to concentrate on the very core of monetary policy the paper discussed in January said little about the <u>exchange rate policy</u> of the Community. It admitted that exchange relationships of the Community with the dollar and the yen would continue to be characterized by a managed floating and that this would entail foreign exchange interventions; because of their monetary consequences, these interventions would have to be agreed in common. The paper, however, did not elaborate on the point.

The elements necessary to extend the scheme to endow the Community with an exchange rate policy would be the following:

a) foreign exchange interventions should be instrumental to the final objective of the system: monetary stability;

b) the operational connection between the final objective of monetary stability and day-to-day exchange rate interventions should be established discretionally by the governing body of the central monetary institution; of course, any decision in this field should be reflected in the quantity of ECU reserves supplied by the central monetary institution (increasing it in case of purchases of third currencies and decreasing it in case of sales);

c) as it is presented, the scheme could allow, however, national central banks to conduct autonomous foreign exchange operations against third currencies as long as their monetary effect was sterilized by offsetting changes in the credit extended to domestic counterparts; this could be acceptable given the limited monetary impact of sterilised interventions.