COMMENTS ON THE PAPER, "THE ECU IN THE MONETARY UNION PROCESS" BY GOVERNOR CIAMPI

1. Introduction

Governor Ciampi's paper treats the issue of institutional arrangements for a common monetary policy based on the ecu.

The present note assesses the general conditions for the success of the Ciampi proposals or of possible alternatives.

2. Assumptions underlying the paper

(i) Exchange rates

The proposal assumes that exchange rates will **either** still retain some limited flexibility (towards the end of the second stage) **or** already be totally fixed (as in the third stage. The comments in the present note are based on the assumption that exchange rates retain some limited degree of flexibility; otherwise, it would make little sense to speak of a national central bank operating a national monetary policy.

(ii) Financial market integration

The proposal must rest implicitely on the assumption that financial markets are highly integrated and that instruments of monetary control are similar across countries. In particular, it would have to be assumed that the required reserve ratios imposed on deposit-taking institutions are at least "approximated" across countries.

(iii) The status of private ecu

The proposals here rest on the assumption that the parallel currency route will not be followed. Thus, in the period before full monetary union, the private ecu will retain its basket status and will not be fungible with the official ecu.

3. Comments on the proposal

Governor Ciampi's paper proposes a two-stage system for monetary control: a central monetary institution (CMI) provides ecu reserve assets to the national central banks (NCB's) who are subject to reserve requirements related to their liabilities (i.e. to the national monetary base). The NCB's in turn provide reserves, in domestic currencies, to the commercial banks.

There are two difficulties here. First, both currency movements within the bands and realignments change the domestic currency value of an NCB's reserve assets with the CMI (denominated in basket ecus). Thus, for instance, a depreciation of a currency within the band would increase the domestic-currency value of the relevant central bank's reserve assets. It would thus increase the permissible rate of base money creation in the country concerned. Thus while the proposal might prevent an ex ante degree of base money creation that might produce a depreciation, it would not constitute an additional defence against currency movements provoked by other factors (such as market worries about budgetary problems, for instance).

Second, the relations between the CMI and the NCB's are implicitely assumed to be of the same type as those between the NCB's and their commercial banking sectors. However, the NCB's are not profit-maximizers. This has the important consequence that **the proposed system would be asymmetrical:** the CMI could impose its monetary policy on an NCB which wished, of itself, to pursue a more expansionary monetary policy. But it could not similarly impose itself on an NCB which wished to pursue a less expansionary policy. For example, if country x is tempted to expand its domestic monetary base by, say, 5% as against 3% in other countries, this would provoke exchange-rate tensions. However, if the CMI provides ecu reserves sufficient to support an increase of only 3%, the expansionary country can be frustrated (1). In the reverse case, however, a relatively-restrictive NCB will simply accumulate excess reserves with the CMI: because it does not attempt to maximize profits, it will have no incentive to expand its operations in the way that a commercial bank would (2). Thus a relatively-restrictive NCB would be able, as at present, **either** to appreciate its currency **or** induce other NCB's to follow its lead.

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(1) But non-profit maximizing behaviour by the NCB's implies that the CMI will not very easily be able to manage reserves via their cost - it will have to rely on quantitative restrictions on ecu credits.

(2) If NCB's were profit-maximizers, inflation rates would in general be higher than they are now, since, in the absence of currency substitution, profit-maximizing NCB's would have no incentive to maintain the reputation of "their" currencies. The situation would thus be radically different from a free-banking system.

This asymmetry is also evident in respect of intervention in the market for third currencies. Suppose, for instance, that the dollar is strong (1). The CMI may decide on the extent to which the European currencies should be supported (and thus the European monetary base contracted). But the proposal implies that intervention is actually carried out by the NCB's (perhaps in proportions given by some weighting key similar to that to be used to decide their initial contributions in the CMI's capital). However, if one or more NCB's wish to maintain the strength of their currencies to a greater extent than decided by the CMI (and thus to contract their monetary base to a greater extent), there appears to be no way in which the CMI could prevent them from doing so.

By contrast, in the reverse case (i.e. that of a weak dollar), the CMI could enforce its policy vis-à-vis an NCB that wished to intervene more: intervention (i.e. purchases of dollars) tends to increase the domestic monetary base, but this can take place only to the extent that the CMI, at its own discretion, provides the NCB with ecu reserves (since additional dollar purchases involve an expansion of the national monetary base and thus create a need for additional ecu reserves). In this case, the country concerned could depart from the course mapped out by the CMI only if its government requested an explicit realignment (which, as noted earlier, would increase the domestic-currency value of its NCB's ecu reserves).

4. Assessment of conditions for success

Because central banks are not profit maximizers, there seems to be no institutional arrangement except that of a fully-fledged European Central Bank that could prevent asymmetry.

The Ciampi proposal thus depends, in the stage before total rigidity of exchange rates, on the **goodwill** of the NCB's. In particular, it requires a self-denying ordinance on the part of the relatively "restrictive" NCB's that might not yet be forthcoming.

But a precondition for monetary union is that **all** NCB's and **all** governments have **both** a common inflation objective **and** a common model of the way in which

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(1) The present note assumes here that, in the stage of integration under review, the strength or weakness of the dollar no longer creates, simply as a result of imperfectly integrated financial markets, strains between the currencies of the system. This assumption simplifies, but does not fundamentally alter, the analysis that follows.

inflation is affected by changes in the monetary aggregates in exchange rates against third currencies and by other internal and external shocks. Once this condition is fulfilled, there is no possibility that one NCB or its government will be more "restrictive" or more "expansionary" than another. There is thus no possibility of asymmetry in the system.

5. A rôle for the Ciampi proposals: two-stage consensus?

The preceding analysis assumes that convergence of view on objectives and models is achieved by **NCB's** as a group at the same time as **governments** as a group. However, it may be that NCB's achieve - or have already achieved - such consensus ahead of governments. If that is so, then the asymmetry involved in the Ciampi proposals should be seen in a different light. It would make an explicit realignment necessary if the government of a country (perhaps for budgetary reasons) desires a faster rate of monetary base expansion than implied by the NCB consensus as embodied in the CMI's reserve provision. It might thus increase the political pressure on the government in question **not** to impose a faster rate of money base creation. It might thus provide an instrument at least for reducing and perhaps eliminating fluctuations within bands and perhaps also for reducing the probability of realignments.

6. Complementing the proposals: a route towards the final stage

Even if the argument of the previous section is accepted, the Ciampi proposals would still be faced with two problems related to the ongoing development of the system. One of these problems is technical, the other institutional. Both could be solved in the same way.

(i) Techniques: the choice of operating target

The Ciampi proposals are rooted firmly in the concept of monetary base control. This approach has much to commend it. In many, but not all, circumstances it may represent the best operating procedure. But as circumstances change over time, it might be that an alternative operating procedure - using interest rates as an operating target for instance - for achieving a monetary aggregates objective could become more appropriate. It would thus seem sensible to endow a CMI, from the outset, with an additional instrument. Specifically, the **CMI could be empowered to engage in open-market operations with commercial banks.**

(ii) Institutions: progress towards symmetry

As this note has already argued, there is probably no institution that neither retains the asymmetrical features of present arrangements on the one hand nor constitutes a fully-fledged European Central Bank on the other. The note has also argued that the "problem" of asymmetry will tend to be reduced as and when consensus among central banks and governments is achieved. Such a process is likely to be gradual rather than discrete, and some mechanism is necessary for transmitting, equally gradually, this gradual consensus-building to a more symmetrical system of monetary control within the system. Again, the answer seems to be to endow the CMI, from the outset, with powers to engage in open-market operations. However, limits could initially be placed on the extent of such operations. As consensus increases over time, these limits could be raised, **with the agreement of the NCB's.** When sufficient consensus is achieved for the final stage to be feasible, concrete expression could be given by removing the limits entirely. Before that point, the system would remain asymmetrical. But at that point, the CMI would in effect have developed into a fully-fledged European Central Bank. This process of development would match - not run ahead of - the necessary process of consensus-building.

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