Bxl, March 6 1989

(1)

Dear [redacted],

here are remarks on the BXL-draft. Having read it carefully I find your judgment of last Friday excessive. With a [heavy] editing the draft can be saved. I would much prefer to use it as the basis, because there is a lot of work in it and I frankly doubt you or we can do better

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in one day only. Not to mention the "diplomatic" aspect.

My remarks are on a retyped version, but I hope they are clear. You can reach me at the Bxl office of Banca d'Italia (513.88.90) until noon.

On the "method", I confirm what we agreed on Friday: the basis of the Annex should be the papers contributed by members, and we should both be convinced of what is in the Annex.

Best regards

Tommaso.

Committee ...

3rd ~~March~~, 1989
CSEMU/13/89

Provisional ~~draft~~

ANNEX

<u>Operational Considerations for Monetary Policy</u>
<u>in Stages ~~2~~ and ~~3~~</u>
two three

(k)

I. INTRODUCTION

Any concrete step towards economic and monetary union needs to address the problem of how to organize monetary policy during the transition from the present system of fixed-but-adjustable exchange rates to a full monetary union with a common currency. The main Report has discussed the three stages that might lead gradually to the introduction of a common currency; this annex discusses what operational frameworks might be used to formulate and implement a common monetary policy in the intermediate stages, that is in a system of quasi-fixed exchange rates (stage 2 of the main Report) and in a monetary union consisting of irrevocably fixed exchange rate (stage 3 of the main Report).

add that a series of ideas and possibilities have ~~been~~ examined and are here reported

In discussing operational frameworks for the intermediate stages 2 and 3 this annex starts from the principles for the organization of the European System of Central Banks (ESCB), set out in part II of the main Report. The most important of these principles is that the main aim should be the stability of the purchasing power of the common currency. This principle is taken as given in this annex, though its interpretation is briefly discussed.

not needed

Part III of the main Report outlines the principles that should govern a step-by-step approach to economic and monetary union. For the purpose of this annex the most important of these principles are:

a) Each step should be discrete, but evolutionary; this implies that the institutional arrangement to be created initially should be capable of evolving gradually within each stage so that they can still be used in subsequent stages.

b) Although progress should be gradual within each stage there should never be any ambiguity about which institution (Community or national) has the "last word" with respect to the use of any particular instrument of monetary policy.

This last point is discussed more in detail in the next section together with some general considerations concerning the relationship between the domestic and external aspects of monetary policy. The first point constitutes an important element in the analysis of the institutional arrangements. Section II of the annex discusses some general considerations for monetary policy in the intermediate stages 2 and 3 and Section III analyzes some operational arrangements.

NOT NEEDED

II. GENERAL CONSIDERATIONS ABOUT MONETARY POLICY IN THE INTERMEDIATE STAGES

Before the authority over a ... will be attributed in the final stage to

determining a joint approach to monetary should have emerged:

~~The~~ common monetary policy ~~for stage 3 that will be formulated by~~ the ESCB ~~requires the emergence of~~ three elements ~~in the course of stage 2 - and the pre-institutional stage 1~~: (i) consensus on the ultimate objective(s), (ii) a common analytical framework for intermediate objectives and for the design of monetary policy and (iii) ~~an advanced state~~

an experience with common operations
~~of joint operational experience~~. The evolution of these three elements, ~~all~~ form part~~s~~ of the learning process involved in stage ~~2~~ two.

Ultimate Objectives

A general formulation concerning stability of purchasing power of the currency is more easily interpreted in a national economy where all prices can be expected to move rather closely together throughout the entire area. For a national economy price stability is therefore usually interpreted as approximate stability ~~in~~ of such broadly-based indices as the consumer price index. However, in an area as large and as diverse as the Community it can be expected that prices of less intensively traded goods and of services that ~~form a large part of~~ enter the consumption-based indices may diverge substantially even over the medium term. In spite of this drawback of consumption-based indices it has been argued that they would nevertheless be the appropriate indicator since they are widely accepted ~~and are broadly based, which implies that they are more directly related to~~ and are perceived to reflect the cost ~~which~~ of inflation to ~~is perceived to impose on~~ the economy. As an alternative it has been suggested that the Community-wide objective of price stability should be interpreted as ~~implying an objective of~~ approximate stability of the producer price index of manufactured goods. These prices should tend to equalize across the internal market that will exist after 1992.

A common analytical framework for intermediate objectives and the design of monetary policy

While the Report indicates a consensus about ultimate objective(s) ~~is emerging from the main Report~~, a similar consensus about intermediate objectives and the design of monetary policy ~~does not exist. The analysis of the operational framework in Section III therefore has to assume implicitly that such a consensus will~~ will have to emerge during stage ~~2~~ two as a result, in particular, of the joint, and hence consistent, analysis of

In the absence of such evidence there would be a danger that

monetary developments proposed for this stage. Markets would ~~be unlikely to~~ regard a declaration at the beginning of stage ~~3~~ three that exchange rates are henceforth irrevocably locked as fully credible ~~without~~ evidence of an analytical and operational consensus; market participants ~~might therefore in its absence occasionally~~ tried to test the exchange rate commitment for particular currencies.

X

to the extent to which there will be

X The ultimate objective would have to be translated into operational guidelines. ~~The locking of parities leaves the level at which interest rates in participating countries must be aligned undetermined,~~ and the ultimate objective in terms of price stability is linked to day-to-day monetary actions in too tenuous a way to provide sufficient guidance. A common judgement would be required to prevent conflicting national opinions and policies from emerging. ~~Practices~~ procedures would need to develop for containing divergence from the agreed monetary stance. In short, participating central banks can not confine themselves to declaring that they will pursue a common objective in a coordinated way; they must be seen to be doing so at every moment. This may require both the formulation of consistent intermediate objectives to underpin a collective monetary target and explicit agreement on the nature of reactions to national departures from intermediate objectives.

emphasises

X

A

Part II of the ~~main~~ Report ~~has pointed out~~ emphasises that once exchange rates are irrevocably locked at the transition to stage ~~3~~ three, a common monetary policy is required and will have to be formulated collectively in the framework of the ESCB. In contrast, during stage ~~2~~ two, when there is still some exchange rate flexibility national authorities will retain the "last word" concerning exchange rates and ~~therefore~~ their monetary policies. However, the same considerations that lead to the conclusion that the irrevocable locking of exchange rates requires a common monetary policy also imply that to the extent that exchange rates become progressively more and more stable national monetary policies will, in practice, become more constrained. Increasing exchange rate stability

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therefore requires a framework for co-operation and co-ordination of monetary policies. The more explicit the degree of exchange rate fixity, and the higher the degree of capital mobility, the closer must be the coordinaiton and the extent to which the overall policy stance of the system has to be decided in common.

~~yes~~

Although during stage 2 the final authority for exchange rates and thus monetary policy would remain with the national authorities, significant further improvements in monetary coordination could be made by centralizing money and exchange market operations of national central banks in a new, jointly owned institution without any transfer of authority.

Start perhaps with something like "A first possibility..."

III. **Pooling of operations** capital letters

For example, an important part of exchange market and other monetary operations could be pooled by assembling the dealers of all central banks on one trading floor. They would still be acting under instructions from and for account of their own national central bank, but to the outside they would appear in the name of the common institution when intervening in foreign exchange markets. If, in addition, the execution of some domestic monetary policy operations were centralized as well, all national central banks would also be informed instantaneously about the domestic actions of all the other central banks. The advantages of such an approach might be that (a) it could have a powerful demonstration effect, (b) it would provide a training ground for the joint implementation of a common monetary policy and (c) would provide an institutional set-up that would evolve gradually towards the ESCB in stage 3. Aspects of this approach could be combined with all of the operational framework discussed in Section III of this annex. To the extent that this approach does not require Treaty revision, because no formal transfer of monetary sovereignty is involved, initial steps might even be taken in stage 1.

say: "... are possible..."

[A further description of this proposal, drawing on the BIS note of 31st January 1989, awaits discussions in the Committee's March meeting.]

necessary? perhaps yes.

~~III. OPERATIONAL FRAMEWORKS FOR A COMMON MONETARY POLICY IN THE INTERMEDIATE STAGES~~

The more specific operational frameworks discussed in this section are not necessarily mutually exclusive; in some cases it might even be useful to combine elements of different approaches. However, the discussion treats them as distinct in order to highlight their specific characteristics. Although these frameworks use the ECU to denominate certain transactions, this does not imply that they rely on the ECU to become a parallel currency or that there would be a refinancing of the private ECU circuit by any official institution. The use of the ECU to denominate certain transactions in the formulation and/or execution of a common monetary policy in the intermediate stages is therefore completely independent of developments concerning the use of the private ECU in the markets.

Although there is conceptually a clear break between stages ~~2~~ two and ~~3~~ three in the sense that the final authority for exchange rate and monetary policy would no longer rest with national authorities in stage ~~3~~ three this ~~section~~ approach of setting up an operational framework does not distinguish sharply between these two stages. Given the high degree of exchange rate fixity that can be expected to prevail towards the end of stage ~~2~~ two, the economic constraints at that point would anyway be very similar to the ones operating during stage ~~3~~ three. ~~Moreover~~ Consequently, the institution~~(s)~~ (or structure) to be created for stage ~~2~~ two should be able to function in stage ~~3~~ three as well. ~~For these reasons it has been preferred not to take the conceptual difference between stages 2 and 3 into account in the discussion of this section.~~

under this scheme

These two paragraphs, appropriately edited, should go into I. or II.

The thrust of the common monetary policy could in principle be determined through the external or the domestic aspects of monetary policy, i.e. through the relationship of Community currencies with third currencies, or directly through measures that have an impact on domestic sources of liquidity creation. This section discusses some specific examples of these two approaches, which could in some cases be combined and which might be viewed as two extremes of a continuous spectrum. The first approach would rely mainly on joint foreign exchange interventions, while the second approach would rely on a system of required reserves which could be implemented in a number of different ways as illustrated in the second part of this section.

delete

IV. Reserve Pooling

in capitals

B

~~Even in an international monetary system in which~~ the main reserve currencies are floating interventions play an important role in determining the monetary policy of most countries. It can therefore be expected that foreign exchange interventions against third currencies, especially in the US dollar, will also play an important role in the formulation of the common monetary policy in the intermediate and the final stages.

perhaps, draw more from de Larosière's papers.

The efficiency of the foreign exchange interventions, so far undertaken separately by individual countries, could be increased if national central banks were to act through the agency of a common body. This common body would intervene directly in the markets, at first only in those for third currencies. To enable the common body to fulfill this role it would have to acquire sufficient reserves to have an impact on the market. The common body could acquire some reserves via swap lines with third country central banks, but the main source would be an initial endowment which could be equal to a certain percentage of the gold holdings and foreign exchange reserves of the participating national central banks. This contribution would be made definitely. ~~would be independent of~~ the current contribution to the EMCF and could later ~~be augmented by~~

~~contributions in national currencies.~~

new institution

Initially the interventions of this ~~common body~~ would be complementary to ~~the~~ those interventions of individual national central banks. But as the relative importance of the interventions through the common body grows interventions by national central banks could be gradually reduced and the thrust of the common monetary policy could then be determined in conjunction with an operational mechanism for the domestic component of the balance sheets of the participating national central banks as discussed later in this section.

V.

~~A three-tier system: ESCB, participating central banks, commercial banks~~ } change title?

V.1

~~Given that during stage 2 the ultimate authority for exchange rate policy, and therefore also monetary policy, will remain with national authorities it has been suggested that it might be useful to build the monetary organisation of the Community on~~ a system consisting of three tiers: a central monetary institution (the ESCB), national central banks and commercial banks. The central monetary institution would deal only with national central banks and it would act as the central bank for the national central banks. The latter would continue their present relationships with domestic commercial banks but they might settle part of their transactions with other national central banks through their accounts with the central monetary institution.

would be set up

With this organizational structure the scheme would have three fundamental components:

- An autonomous balance sheet for the central monetary institution so that it can take operational decisions rather than serving simply as a forum for concertation.

- A mechanism ensuring ~~direct~~ control of the liabilities of the central monetary institution, in analogy with the control exercised by national central banks on their

Support

domestic liabilities that constitute the monetary base.

- A set of provisions to create demand by national central banks for the liabilities of the central monetary institution by making their liabilities a necessary ingredient in the national money supply process.

The first component, the autonomous balance sheet of the central monetary institution, could be implemented by giving it a capital formed by contributions of international reserves from national central banks. In return, national central banks would receive shares of the central monetary institution and would therefore share in its profits and losses.

The second component, control over the liabilities of the central monetary institution, could be achieved by giving the central monetary institution the power to determine the conditions under which it supplies credit to the national central banks. The central monetary institution could be given wide discretion in these decisions in analogy to the discretion national central banks exercise in their transactions with commercial banks.

The liabilities of the central monetary institution could be expressed in official ECU; this would then require that the current mechanism for creating official ECU, the revolving swaps, be abolished because the amount of ECUs created this way depends on such exogenous factors as the gold price and the US dollar exchange rate. These swaps could be replaced by an initial contribution of international reserves. The credit mechanisms that constitute the other channel of ECU creation would also need to be brought under control. This could be done by giving the central monetary institution the power to grant member central banks discretionary credit in ECU, in the same way as a national central bank finances commercial banks through open market or rediscount operations. In turn, the existing credit mechanisms could be significantly reduced, by limiting their

2

ECU as the common

here, and again below, I would not give the impression that the demand for ESCB reserves will have to be entirely and "for ever" artificial, i.e. induced by regulation. If this were to be the case, the system would have failed. A "transaction demand" for ESCB-money is to be regard as a natural consequence of growing settlement between member currencies. This should be said. Thus I would say something like "support" instead duration, limiting their applicability to marginal intervention, eliminating automatic renewals and making them more expensive.

Z

~~However, if the liabilities of the central monetary institution were not expressed in official ECU, and if it was therefore clear that the existing facilities could not be drawn upon to make up for any shortfall of required reserves, such a reduction in the availability of the existing credit facilities denominated in official ECU would not be required. But in that case, there should in principle be no substitution between the ECU in the two roles as an asset for intra central bank settlements and as required reserves. The interest rate on the two would be different: that on the former would continue to be an average of interest rates on the component currencies, that on the latter would be set by the ESCB to reflect the degree of scarcity of required reserves which the central institution wishes to produce, as explained below.~~

not necessary, I think

~~The third component, creating a demand for required reserves, that constitutes the main liability of the ESCB, could be organized~~ by requiring member central banks to hold deposits of official ECU with the central monetary institution in the form of reserves.

See remarks on previous page

Basis for reserve requirements

(a) Liabilities of national central banks: Monetary base

No do not put (a)(b)(c under the same roof

V.2.

For example, The ESCB could have the power to ask member central banks to hold compulsory reserves in ECU, amounting to the equivalent of a certain percentage of their total liabilities, or of the increase thereof. The reserve requirement in official ECU would link the supply of base money by member central banks and therefore also the aggregate money supply in the Community to the amount of official ECUs created by the ESCB.

The manner in which the central monetary institution could manage this system would be very similar to that of a national central bank. For example the governing body of the central monetary institution could decide each year how much money should be created in the Community in order to support economic activity in a non inflatinoary environment. Given the required reserve coefficient applied to the monetary base of each national central bank this could then be translated into a target for the creation of official ECUs. Since total monetary base creation in the participating countries would also be affected to the extent that they undertake net unsterilized interventions in third currencies, a necessary complement of this objective would be guidelines regarding intervention policy in third currencies, especially the dollar. National central banks could conduct autonomous foreign exchange operations against third currencies, however, they would have to sterilise the monetary effects of these interventions by offsetting changes in credit extended to domestic counterparts.

For example, while in both stages the supply of official ecus should be firmly controlled

The strictness with which the reserve requirements must be observed could differ between the two stages. For instance, during stage two reserve obligations could still be indicative and serve as a guidelines in a learning process but in stage three they would become compulsory.

The management of the system would be different in stage two 2 and stage three 3. ~~In stage 2 the supply of official ECUs would be less rigidly~~ firmly controlled by the central monetary institution. ~~For example, some very short term financing might still be available and member central banks might have~~ the right to acquire ECUs for international reserves to meet requirements. These degrees of freedom could be gradually reduced as stage 3 approaches to ensure a smooth passage to this stage where the central monetary authority would need to have absolute control over all channels of official ECU creation.

I do not like this way to make the scheme now binding (for stage II). I would prefer
- firm control on ECU supply, but make
- the reserve requirement only indicative

The effects of realignments and the distribution of reserves among national central banks.

~~The implementation of such a system leads to a number of issues:~~

V. B.

However, while the basic operational features of a system of reserve requirements on national central bank liabilities are relatively simple, the implementation of the scheme "counter" difficulties arising from differences in national money multipliers, the influence of currency substitution

~~(i) Allowing for differences in national monetary multipliers~~

II. As far as National monetary base multipliers are concerned, they will differ considerably at the margin and on average, in particular because of different (and sometimes absent) national reserve requirements on commercial banks. This would imply that even with a given total quantity of official ECU a transfer of official ECUs from a national central bank with high reserve requirements and consequently a low multiplier to another one with lower reserve requirements and therefore a higher monetary base multiplier would increase total liquidity in the system and would thus have an unwanted expansionary effect. This would not represent an entirely new problem since in national systems different reserve coefficients usually apply to different types of deposit so that a shift across deposits always affects the observed multiplier. The initial allocation of official ECUs could take the differences in multipliers into account, the problem would therefore become relevant mainly in the subsequent operations of the system. While not new, the problem would, however, be an additional element of uncertainty and it would require the central monetary institution to observe carefully the distributi~~ves~~on of official ECUs and to intervene, adjusting the overall quantity it makes available to the system, in order to offset the net expansionary or contractionary effects that arise from transfers of official ECUs between national central banks. ~~To the extent that differences in national base multipliers are caused mainly by differences in reserve requirements the problem should become less acute as the integration of European financial markets leads national central banks to some convergence in national reserve requirements.~~

F from p 14

~~(ii) Operational objectives related to interest rates~~

¶ Finally, ~~A~~at first sight, the scheme would appear to imply that the main monetary policy instrument has to be the aggregate of national monetary bases. However, the central monetary institution might also be guided in its supply of official ECU by national interest rates. Given fixed exchange rates national interest rates would tend to stay within a very narrow band so that the central monetary authority could also target some average level of interest rate. If liquidity

G to p13

G

increased too much in any given country, interest rates in that currency would tend to fall and there would be tensions on the foreign exchange markets. The appropriate response of the central monetary authority would then be to call back official ECUs to induce the national monetary authorities to rein in the expansion of liquidity.

relating to the distribution of ecu reserves among the participating national central banks. This

~~(iii) Absence of a true market for reserves~~

title is far too categoric

More generally there is an

A ~~more fundamental~~ issue arises from the fact that ~~differences in~~ the behaviour of commercial banks and national central banks, is likely to differ ~~which are official institutions~~. National required reserve systems work predictably and affect all banks in the same manner because commercial banks act mainly on the profit motive. There is therefore in most cases an active market for the assets that can be used to satisfy national reserve requirements in which the price, i.e. the interest rate, determines whether any given bank is willing to supply or demand additional reserves. ~~It is unlikely that a similar market will develop among national central banks.~~

why not? delete

Especially on inception of the scheme it would not be certain that in response to an expansion in

~~If the central monetary institution expands~~ the supply of official ECU ~~it could therefore not be certain that all~~ national central banks would ~~expand~~ increase their national monetary base, and individual national central banks wishing to expand more than others, perhaps because of stronger growth in economic activity could not rely on a market to obtain additional official ECU. ~~The system might then work asymmetrically~~ if the national central banks with excess of free reserves in ECU refuse to sell them to the others. This asymmetry in the system might be mitigated to the extent that exchange rates are fixed through the working of the intervention obligations. The currency of the country whose monetary base was expanding less than the average would come under upward pressure on the foreign exchange markets. If intervention obligations work symmetrically this would then imply that this country needs to intervene which would tend to have an expansionary effect on its monetary base, unless ~~the monetary authorities of that country were able to sterilize the impact of these interventions.~~

In this case the

necessary?

- ~~see long remark on p. 9~~
- ~~Also, I do not see why ESCB-ECUs would not circulate (as the system develops) among member central banks~~

~~I would simply say that the~~ ESCB could intervene to ~~supplement market redistribution~~ guide and adjust the distribution of ecu reserves among national central banks

G from p12

A similar problem would arise

Ⓕ to p 12

~~(iv) Currency substitution~~

~~The absence of a market mechanism to distribute official ECUs across countries would be particularly important~~ if there is currency substitution in the form of large international shifts of certain deposits across the currencies of the system. Such shifts would net out for the entire system, so that the central monetary institution would not need to adjust the overall supply of official ECU, but they would necessitate a redistribution of official ECU across national central banks because they would lead to an increase in the monetary base of the country towards which the currency substitution was going.

could be deleted

~~(v) Allowing for the effects of realignments~~

Similarly, a realignment or just a change in the market exchange rate inside the bands would imply that the central bank of the devaluing country would be left with free reserves of official ECU. The central banks of the remaining currencies, which would appreciate against the ECU would instead need to acquire additional official ECU. There they could obtain only from the central bank of the devaluing currency, which would thus be put in a strong position. In general changes in market exchange rates would also have an effect on the overall demand for official ECU reserves if the distribution of monetary bases across the Community does not correspond to the ECU weights. ~~Since for some countries the ECU weights differ considerably from the shares in the total Community monetary base this implies that in stage 2 the central monetary institution might have to adjust the overall supply of official ECU continuously to offset these effects. To the extent that exchange rates become more stable towards stage 3 this effect should, of course, become minor.~~

VI. (b) Assets of national central banks → change title (in capitals)

The potential problems mentioned so far except possibly the last one, would appear to be less severe if the required reserves, national central banks have to deposit with the central monetary authority, were based on part of the assets of national central banks. Two solutions would appear to be possible in this respect:

VI.1 ~~a)~~ b) A reserve requirement on ~~Credit to~~ credit to the domestic sector

If the required reserves were imposed on the credit extended by national central banks to the domestic sector instead of the total monetary base the instrument would impinge more directly on all elements of monetary financing of the public sector; the direct elements that show up in credit extended to the public sector and the indirect elements that show up as credit to the private sector because the central bank is undertaking larger open market purchases at a time of major public deficits. — no underlining

Under this modified scheme the central monetary authority would estimate the overall amount of domestic credit expansion that was compatible with approximate stability in prices (allowing for anticipated reserve flows) and would expand the supply of official ECU by the same proportion. The overall expansion of the monetary base in the system would then be the sum of the national domestic credit expansion plus the net effect of unsterilized foreign exchange markets 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 the guidelines of the central monetary institution. Given the target rate of domestic credit expansion there would be no presumption that these interventions would be sterilized. X

VI.2. ~~d)~~ c) A reserve requirement on Credit to the domestic sector plus extra-EMS foreign exchange reserves

If the required reserves were imposed on the sum of domestic credit plus extra-EMS foreing exchange reserves additional guidelines concerning unsterilized interventions against third currencies would no longer be needed. However, some guidelines concerning sterilized interventions might still be needed to the extent that the latter are believed to be effective. In all other respects this scheme would operate like the one based on domestic credit alone. The basis for including extra-EMS foreign exchange reserves is, of course, the assumption that these reserves are used only in intervention against third currencies.

Under the two schemes which envisage the imposition of reserve requirement on national central bank assets,

~~Under these two modified systems~~ differences in national money base multipliers would remain a source of shifts in overall supply of money for any given overall domestic credit target. But the problem of the distribution of ~~absence of a market mechanism to distribute official ECUs~~ ECU reserves among national central banks would become less important since shifts in money demand due to currency substitution could be accommodated through reserve flows without any need for transfers of official ECU. For example, if the demand for deposits in a certain currency increases, either because of a shift in the activity in the country, the monetary base of that country could expand following the interventions the monetary authorities might have to undertake. Since the cause for the expansion of the monetary base would be reserve inflows at a constant domestic credit of the central bank there would be no need for this central bank to acquire additional official ECus. The opposite reserve flows that would take place in other countries would also not require any transfers of official ECU.

see earlier remark

Make sure VI.1 VI.2 VI.3 are all in Thygesen's paper. What is not, should be dropped

~~VI.3~~ (c) A reserve requirement on Domestic credit expansion by the national banking system

In principle, the differences in national monetary base multipliers would be incorporated fully into the system of monetary control, if the reserve requirements were based not on the domestic sources of money base creation, but on domestic credit expansion in the total national banking system, i.e. on the domestic sources of broad money creation.

no modelling!

Such a system would still leave each central bank free in its choice of which instruments it wanted to use to discharge its accountability for controlling credit expansion in its country; for the same reason it would not necessarily contribute to the convergence in the conduct of policy which is part of the purpose of stage ~~2~~ Three. It might also leave too much slack in the control mechanism. Despite the more direct linkage to a natural intermediate objective underpinning fixed exchange rate - domestic credit expansion - it may on balance have disadvantages compared to the first two variants which are based on items that appear directly on the balance sheet of the central banks. ~~(total monetary base creation or the domestic component thereof) or compared to the additional possibility of imposing requirements on commercial banks directly which is discussed below.~~

VII. **Three-tier systems and the evolution towards a common currency**

In the three-tiers systems desribed so far the central monetary institution would not have any direct contact with commercial banks or the financial markets in general. This would imply that it would be difficult to use the same operational framework beyond stage 3 since the European Central Bank that would manage the common currency would presumably have direct transactions with commercial banks, as does any national central bank at present. In contrast an operational framework that allowed the central monetary institution to deal directly with commercial banks might, in principle, be adaptable to stage 4 without fundamental institutional changes. Moreover, if the central monetary institution were able to make some transactions directly in private financial markets it would be in a position to have some direct influence on liquidity conditions and would not have to rely on national central banks to follow its indications.

X To be changed or dropped. Do not mention a Stage 4. Direct ESCB-Commercial banks could be mentioned in a problematic way.

Alternatives and complements: Direct interaction ESCB - financial markets

a) Open market operations

One way to give the central monetary authority the possibility to intervene directly in financial markets would be to allow it to make open market transactions in national markets. For example, the central monetary institutions could use the securities it has acquired from the national central banks for such open market transactions.

In order to guarantee that initially the influence of the central monetary institution remains modest compared to that of the national central banks it would be useful to impose some limits on the total amount of purchases (and sales) the central monetary institution can make within any given period. This might be especially important at the start, when the central monetary institution would mainly have to make purchases since its initial stock of securities would be small. These limits could be raised overtime to allow the relative importance of the operations of the central monetary institution to increase gradually, until, towards stage 3, they become more important than the operations of each single national central bank.

b) Reserve requirements on commercial bank deposits

A different approach that would allow the central monetary institution to have some direct impact on conditions in the financial markets could be pursued by imposing a uniform European reserve requirement on commercial bank deposits or on increases thereof. All Community commercial banks would have to hold a certain, small fraction of their deposits as compulsory reserves with the central monetary institution. The only asset that could be used to satisfy this reserve requirement would be "federal funds" which could be denominated in ECU.

From here to the concluding remarks, I would perhaps delete everything. There could be a short section VII covering the second half of

The aggregate supply of these federal funds would be strictly under the control of the central monetary institution, since that would be the only institution that could issue them. The distribution of the total across countries and banks would be left to a federal funds market where commercial banks could trade among themselves the deposits with the central monetary institution they need to satisfy the European reserve requirement. This scheme would therefore work like national reserve reequirements, but on a European scale. The European reserve requirement could therefore be in addition to and independent of national reserve requirements.

page 17 and saying something about what is "beyond intermediate schemes (this could be the title)

This approach would imply that the central monetary institution would intervene directly in a market that reflects system wide liquidity conditions. This might be preferable if the tasks of the central monetary institution are to be concerned with overall conditions as opposed to the specific conditions in national markets. It would also be possible to combine this approach with the idea sketched out above, by imposing limits on the total amount of open market transactions the central monetary institution would be allowed to undertake within a given period.

This approach could be implemented by giving the central monetary institution the power to impose a compulsory reserve requirement on all deposits of Community residents with Community commercial banks. To given banks access to deposits with the central monetary institution the latter could initially buy the appropriate amount of securities in the market. These securities could be denominated either in ECU, or in national currencies, provided the proportion of the different national currencies correspond to the ECU weights. Once the initial amount of federal funds has been created the central monetary institution could regulate the total amount of federal funds in the system simply by additional open market purchases or sales.

Through its open market conditions the central monetary institution would be able to influence directly overall liquidity conditions in the system. If it makes an open market sale, which would reduce the total amount available, commercial banks everywhere in the Community would tend to restrict their deposits because the interest rate on the federal funds market would rise. By limiting the total amount of federal funds that the central monetary institution makes available to the system it would always be in a position to limit total liquidity creation.

This approach would be compatible with different operating procedures for the central monetary institution. For example, it could choose an interest rate target and restrict the supply of federal funds whenever the actual ECU or federal funds interest rate fell below the target and vice versa if interest rates go above the target. But it could also target the quantity of federal funds by not intervening in the federal funds market and letting the interest rate adjust to bring supply and demand in equilibrium.

Different operating procedures would presumably be appropriate for stages 2 and 3, but the mechanism in itself would not have to be modified for the passage to stage 3. The different ways of allowing the central monetary institution to have transactions with the market would have in common that they would require only some 'enabling legislation' to be enacted initially. The subsequent evolution of the system, also with regard to its symmetry, would then be gradual and could even lead to a smooth passage to stage 4 without additional substantial institutional changes. In effect the central monetary institution would, from the beginning, act, at least in some respect, as a European central bank.

VIII. ~~X.~~ CONCLUDING REMARKS

This annex has discussed in an illustrative way various methods by which a common monetary institution could contribute to the ultimate objective of price stability through a joint intervention policy and/or by influencing the overall rate of money and credit expansion in the Community in the intermediate stages outlined in Part II of the Report. The basic premise of the annex is that it would not be enough to establish the necessary credibility for the new institution to formulate monetary objectives collectively, if the ESCB were not to have attributed to it one or more policy instruments putting it in a position to check departures of aggregate money and credit expansion from the agreed path.

Reserve requirements, supplemented by a joint intervention policy, seem to provide the most direct method for achieving this linkage from instruments to objectives. It is the prime method by which central banks historically have achieved monetary control in most countries. The observation that varying reserve requirements to-day plays a more limited role in influencing national banking systems is less relevant for the issue of how to assure control of the overall money and credit expansion in stage 2 and 3. In recent years the banking system has in most countries become heavily indebted to the central bank and hence dependent on the terms on which marginal accommodation of reserve needs is provided. The mechanisms that are suggested in this annex illustrate ways in which an analogous influence may be brought to bear through a reserve requirement system on the relationship between a central institution and financial markets. This last element seems desirable to assure a smooth passage to the final stage when a European Central Bank manages the common currency via direct interactions with the Community financial markets.

The illustrations in this annex have throughout taken as their point of departure the principles on which an ESCB could develop as described in Part II of the Report and the principles of the step-by-step approach outlined in Part III.

to be edited

III Three possible schemes

III 7. Centralised execution of domestic monetary) — central bank(?)

~~Pooling of~~ operations

a centralised execution of domestic monetary operations

To implement ~~this~~ ~~the member~~ central banks would establish a common operations floor incorporating all of their respective foreign exchange and domestic money market activities, together with a centralised system of custody accounts, within a jointly owned subsidiary. Initially, each ~~member~~ central bank would staff its own operations on the common floor, rather like a branch, but over time these separate national staffs would be merged into a single unit. The use of common facilities would mean, on the one hand, that the operations of each individual ~~member~~ central bank would be completely transparent to its partners, and on the other hand, that the ~~member~~ central banks could present a common front to the markets by agreeing not to reveal the source of the instructions for any of the common institution's operations. However, individual ~~member~~ central banks would at all times retain ultimate responsibility for the deployment of their national foreign exchange reserves, and for the supply of domestic bank reserves.

This approach would have four main advantages. Firstly, it would enable the ~~member~~ central banks to give a powerful demonstration, both to the markets and the wider public, of the progress that had already been made in the concertation of national economic policies and of the seriousness with which the ultimate goal of monetary union was being pursued. Secondly, it would provide an efficient training ground for, and a strong practical stimulus to, the implementation of a common monetary policy. It might also lead to further advances in the process of policy concertation itself. Thirdly, it would facilitate efforts to converge the institutional frameworks for the transmission of monetary policy in each country - this would not only ease the transition to a unified monetary control procedure in stage three, but would also help to give the common institution an early focus on domestic monetary policy and hence the requirements of domestic price stability. Finally, the institutional structure created would be a necessary component of the ECBS envisaged for stage three, thus making the evolution from stage two to stage three relatively straightforward.

Aspects of this approach could be combined with all of the institutional frameworks discussed in ~~Section III of~~ this annex ~~(?)~~. To the extent that the approach does not require Treaty revision because no formal transfer of monetary sovereignty is involved, initial steps could even be taken in stage one.

(x)

Experience with common

The existence of an analytical framework for intermediate objectives which would determine in a predictable manner the conduct of a common monetary policy, especially in response to changing circumstances, would be an essential requirement at the time when exchange rates were locked. However, prior to the development and implementation of that framework it might be useful to gather experience with joint monetary operations on a more limited scale. Growing experience with common operations would not only help to improve the coordination of national monetary policies but such operations could also expand progressively the compatibility of policies and help to prepare the ground for a more elaborate framework involving intermediate objectives in support of the common monetary target. Such schemes, serving primarily as a training ground without an effective abandonment of the central banks' authority over national monetary policy, could involve a centralisation of the implementation of all central banks' domestic monetary policies or the pooling of a certain amount of reserves for the purpose of limited exchange market intervention. These two possible approaches as well as an operational framework for an integrated monetary policy are described in detail in the following ~~two~~ three sections.

K

(1)

I Introduction —— capital letters!

As has been pointed out in the Report, an important technical issue in implementing a monetary union is how to organize monetary policy during the transition from a system of fixed, but adjustable exchange rates to a monetary union in which national currencies co-exist but their parities have been locked irrevocably.

→ A from p 4/5

The Committee has examined several technical schemes aimed at strengthening the cooperation among central banks and developing a common decision-making process with regard to certain monetary operations before the responsibility for monetary policy is transferred to the ESCB. The approaches and operational frameworks considered by the Committee are not necessarily mutually exclusive and in some instances it might be useful to combine elements of the different schemes. However, the following discussion treats them as distinct in order to highlight their specific characteristics. All three schemes envisage in some form the establishment of a new institution but they differ considerably in the degree of authority that they attribute to that new institution. Under a first approach, the authority over exchange rate and monetary policy would rest fully with national authorities, but the operational implementation of the domestic policies would be centralised in a subsidiary jointly owned by all central banks. A second possible approach would be to pool a certain amount of official reserves in a new institution which could facilitate a concerted management of exchange rates through joint interventions in the exchange market and serve as a training ground for achieving a better coordination of monetary analysis and decision. This new institution could conceivably be given the power to perform certain operations on its own initiative. A third approach would be to set up an operational framework for an integrated monetary policy in which a new central institution could be given the authority over a common monetary policy once exchange rates have been locked.

The Committee feels that these three possible approaches deserve to be explored more fully. Before describing them in greater detail it might, however, be useful to outline some general considerations about monetary policy in the intermediate stage on the way to monetary union.

capital letters

IV Pooling of official reserves and creation of a European central bank.

An alternative (or complementary) approach to strengthening monetary policy coordination through a growing experience with common monetary operations could be based on the pooling of a limited amount of official reserves in a newly created institution. The basic consideration behind this proposal is that in a world in which → B p7

The new institution created under this approach would have several objectives: it could serve as a training ground for achieving a better coordination of monetary analysis and decisions; it would facilitate, from a Community point of view, the concerted management of exchange rates and could intervene visibly on the foreign exchange market (in participating and/or third currencies) at the request of the central banks; and it could demonstrate the political will of the European countries, and thus reinforce the credibility of the process towards economic and monetary union.

The resources of the new institution would be provided by the pooling of a certain amount of reserves and, in order to manage these reserves, to intervene in the market and to analyse monetary trends with a view to enhancing policy coordination, the new institution would need to have a permanent structure and staff. All central banks of the Community countries would be eligible to join the new institution. However, as the management of fixed, but adjustable exchange rate implies specific constraints on monetary policy and exchange market interventions, both of which call for a common approach on the part of the central banks concerned, membership in the new institution would be subject to full participation in the exchange rate mechanism of the EMS.

In a first phase the interventions by the new institution would be agreed in common by the participating central banks and complement their own interventions without increasing the overall volume of interventions. For this reason the exchange market operations of the new institution would have no additional effect, either directly or indirectly, on the national monetary policies pursued by individual member countries. However, the efficiency of interventions undertaken in common would be expected to increase. In a second phase, which should be agreed unanimously, the participating central banks could decide to hand over to the new institution the power to conduct certain operations on its own initiative, in compliance with the guidelines set by the Governors or the institution's Board of Directors.

V An operational framework for an integrated monetary policy.

While there is conceptually a clear break between stages two and three in the sense that the final authority over exchange rate and monetary policy would no longer rest with national central banks once stage three has been reached, the setting up of an operational framework proposed under this approach would already take place in the course of stage two. The principal reason is that the high degree of exchange rate fixity which is expected to exist towards the end of stage two would in practice create economic constraints very similar to the ones operating in stage three. Consequently, in contrast to the two approaches mentioned above, the proposal to establish an operational framework for an integrated monetary policy would involve the establishment of an institutional structure which should be able to function also after the decision has been made to lock exchange rates irrevocably.

Under this approach ...

(2)

The third component would be a mechanism to ensure a demand for required reserves that constitute the main liabilities of the ESCB. Initially, this mechanism would rest on the provision requiring the participating central banks to hold deposits of official ecu with the central monetary institution in the form of reserves. However, in the longer run and as the system evolved a transaction demand for official ecus would be the natural consequence of a growing settlement in the accounts of the national central banks with the ESCB.

Within this broad framework there are several possibilities of operating the system, depending on which liabilities or assets the reserve requirements applied to.

a) ~~Imposition of~~ would be A reserve requirement on liabilities of participating central banks

central banks can lead banks
to hold excess reserves

b
if 'always' un(limited) [illegible]

only then can lead them
expand money supply
before settlement; otherwise
the reserve obligation would
force them to shrink!

As has been pointed out in the main body of the Report, one important technical problem in implementing economic and monetary union is the organisation of a common monetary policy.

Under this proposal the central banks of all C[ommunity] countries would set up a jointly owned subsidiary . . .

In principle there would be compensating transfer of ecu balances through the settlement process, the weak currency ~~cent~~ country intervening (without sterilisation) by buying its currency and accumulating a debtor position and a strong-currency country building up a creditor position would ~~obtain~~ shift ecu from the country with the contracting monetary base to that with the increasing monetary base;

but → would this be convergence of monetary policies!

→ more importantly, given different money multipliers, the impact could be expansionary or contractionary for the C as a whole and would be only by chance in line with the desired overall stance

This would have to be "corrected" by the Central institution → how?

a) recalling from or resupplying to ecus to an individual central
b) minimum bank reserves in the market concerned?

issue of unused reserves

↓

absence of a market for reserves

what would be the motive for selling res from countries with lower expansion to those with higher expansion

↓

if one country restricts, ex. rate ↑ → [illegible]

settlement through ecus

↓

lack of [illegible] → [illegible] changes

the same problem with currency shifts.

hence → assume a flaky increase in demand for DM,

~~BCBG interventions, market based~~

↓

accumulation ?? balances

↓

with [illegible] limit → sterilisation

↓

~~reinforces flaky~~

tendency in market

the money multiplier at the central level will be even more unpredictable than at the national level and require strong corrective action from the centre → [illegible] authorities would really have to go to the centre

Reserve requirement on central banks' DA

NFA + DA = CF + BD + OIN

↓

if reserve
requirement
applies

what would be the target?
ceiling on credit to Gov.
ceiling on credit to banks

determine overall DA expansion

~~but what about ΔNFA?~~

↓

no intervention in foreign currency?

~~or only by central authorities?~~

↓

& against what?

DM → then Σ of Commercial
money supply
Central, of course,
DM money
supply of (central)

i.e. only part of the
Common money being
transferred

↓

not not really, since
central institution
cannot issue DM!

intervention within the system

↓

still effect on overall money supply

due to different multipliers!

↓

/ but no need to transfer Ecus!

(8)

Reserve requirement on national banking system

$$NFA + DA = DD + TD + OMI$$

Reserves with central institution

Direct contact of central institution with market

only with single currency? if so, how would it operate,

what would be the function of national central banks?

open market operations

how would the central institution get marketable securities

what would they be bought for on an expansionary open market operation

what would they be sold for → which currency?

---

reserve requirements on commercial banks?

how would commercial banks acquire these reserve assets? against what?, an auctioning system? how would the harmonization process work?

would there be one, or one in each country, for [illegible]? or would it not make sense assume → anchoring of new reserve

if at the same time national reserves

which limit would be binding

if, for instance, the banks are loaned up, have used up the reserves made available from their central banks, could the central authorities not be powerless with regard to a more expansionary policy?

how does it work

central monetary auth. buys securities from banks for new fed-reserve funds