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To: M. Lamfalussy

From: Gunter D. Baer

Ref.: The feasibility of the Ciampi/Thygesen scheme

Having expressed to you strong reservations about the workability of the Ciampi/Thygesen proposal for a three-tier system based on reserve requirements in official ecu as the principal monetary policy instrument in the hands of a central institution, I owe you some explanation. Without having sufficient time to go into greater detail, I can see at least three major problem areas:

1. Determination of the appropriate amount of ecu reserves

It is by far not clear how a consensus on the ultimate objective of monetary policy can be translated into an operational intermediate target in the form of ecu reserves issued by the central institution. One approach could be to ask each central bank what its targeted rate of reserve money would be, add up the national targets at the prevailing ecu/national currency exchange rate and then apply to the aggregate monetary base the ratio for mandatory ecu reserve holdings. This would seem to be a straightforward approach which would also provide for a distribution key of the ecu reserves to be created during the period under consideration. Unfortunately there are at least two obvious drawbacks. Firstly, it would imply that each central bank is in a position to translate its final objective into a monetary base target. The difficulties of this approach are well-known. (Incidentally, it would, however, not imply that in the conduct of monetary policies each central bank would have to operate strictly in the context of a monetary base concept.) Secondly, it would not contribute to a convergence of national monetary policy, unless the central institution was allowed to overrule the nationally

determined target for monetary base increase as too expansionary or too restrictive.

An alternative approach could be that the central institution determined autonomously the amount of ecu reserves to be issued during the period under consideration. This would, however, presuppose a reliable relationship between changes in ecu reserves and the final objective (e.g. price stability on average throughout the Community). Apart from serious doubts that any such clear relationship would ever evolve, the estimation of the equation would initially have to be based on a constructed European monetary base (the aggregate of national monetary bases at prevailing exchange rates) and a European price index in terms of one currency or the ecu. One possible flaw of this method might be that the results would be distorted by the fact that differences between national inflation rates were partly offset by exchange rate realignments in the past. This approach would also leave open the question of how to allocate newly issued ecu reserves to individual national central banks.

2. Allocation of ecu reserves

Even if some acceptable solution could be found for expressing the ultimate objective in terms of an intermediate ecu reserve target, not much is gained as long as there is no reasonable way of allocating the newly issued ecu reserves to individual central banks. There are essentially two interrelated issues: firstly, what should be the key for the distribution of ecu reserves and, secondly, what would be the procedure for channelling them to the central banks? If the purpose of the exercise is to develop a common monetary policy compatible with price stability and stable exchange rates between the participating central banks' currencies, it would not be possible to let each central bank determine autonomously its rate for base money expansion and thus its demand for ecu reserves for the period under consideration. The distribution would therefore have to be made either at the discretion of the central institution in accordance with objective indicators, or the central institution would only determine the total amount of ecu reserves to be issued but leave their distribution to some sort of market mechanism.

The first possibility would appear to be extremely mechanistic, having the features of a credit allocation system without sufficient

flexibility. There is also serious doubt whether any meaningful criteria (shares in aggregate Community money supplies? GNP?) could be found and would be accepted by the countries. Moreover, the difficulties of relating ecu reserves to an ultimate Community target for monetary policy would certainly be compounded by this mechanistic allocation, since the distribution of ecu reserves would greatly affect the ecu reserve multiplier (this is, however, a more general problem which would arise under all types of ecu reserve allocation).

The second possibility, a market-determined distribution of ecu reserves, is extremely difficult to imagine. For such a system to work, a price mechanism would have to exist which would balance the demand with a supply of ecu reserves that is fixed (or expanded along a predetermined path) for a certain period by the central institution. Of course, it is conceivable that the central institution would use an auction system and then distribute the ecu reserves in accordance with bids. But what would be the motives of individual central banks to make different bids? In this context, it has to be remembered that ecu reserves constitute nothing but a "license to create a certain amount of national money". Would there really be a price at which central banks would be willing to forego bidding for ecu reserves that they require for what is felt to be the appropriate policy stance? I could imagine that central banks would be deterred from bidding if the price involved a "loss" for the central bank, for instance, in the sense that the cost of ecu reserves exceeded the returns derived from domestic money creation. This would be a rather ridiculous "market-determined" system.

However, it could also be imagined that in addition to its function as a license for national money creation, ecu reserves could be used for other purposes and that thereby national central banks' demand for ecu reserves would be governed by different considerations. For example, ecu reserves could also be a settlement instrument for intra-Community intervention debts. In this case it could be argued that in bidding for ecu reserves national central banks would also be guided by a comparison of the cost between ecu reserves and alternative settlement instruments (such as US dollars). But unless national central banks pay different interest rates on US dollar debt, because they represent in the eyes of the lenders markedly different credit risks, the cost comparison would yield pretty much the same result for all central banks and would therefore not help to

guide the distribution of ecu reserves. More importantly, however, there would be a close relationship between the two functions of ecu reserves. For instance, a national central bank that bid aggressively for ecu reserves would probably intend to pursue a comparatively expansionary monetary policy course (and not simply wish to acquire ecu reserves to hold them as a settlement instrument). A relatively easy monetary policy would, however, create downward pressure on the exchange rate, trigger intervention obligations and a loss of ecu reserves through the settlement of intervention balances. In short, it is difficult to see that adding the function of settlement instruments to ecu reserves would result in a meaningful market-determined distribution process for newly-issued ecu reserves.

3. Problems in operating the system

Even if the tricky issues concerning the determination of the amount of ecu reserves and its allocation to national central banks could be sorted out, there will remain a host of operational problems. To mention only two: how would the system cope with shifts among Community currencies and how would it respond to excessive strength or weakness of third currencies.

If, for instance, there was a shift from Community currency A to Community currency B, both central banks concerned would be forced to intervene and respond at the same time to the effects on their monetary bases. If country A did not sterilise the intervention, its monetary base would contract and excess ecu reserves would be built up. For country B not to sterilise the expansionary effect on its monetary base it would be necessary either that it had excess ecu reserves or that it could obtain them in an immediate settlement of the intervention from country A. As a consequence, the whole system could work only if countries held precautionary excess ecu reserves or if (in contrast to the EMS) intervention balances were immediately settled.

It is also conceivable that both central banks assess the situation as a temporary exchange market aberration and therefore resort to sterilised intervention. Obviously, the ecu reserve obligations of the two central banks would not be affected under this assumption, but it would

imply that ecu reserves could not be used as a settlement instrument for intervention balances.

Similarly, it is not clear how the system would operate in a situation of dollar weakness or strength. Leaving aside the possibility that the movement vis-à-vis third currencies could create intra-Community tensions, the system would have to be able to accommodate the intervention effects on each national central banks' monetary base - unless such interventions were fully sterilised.

4. Concluding remarks

Perhaps I have exaggerated some of the issues and overlooked easy solutions. But I am afraid that there are still many open questions (even if one is willing to accept a concept of monetary base control as an appropriate approach to monetary management - which many experts do not) which need to be answered before the Committee could publicly advocate this approach as one possible solution. I feel there is too much at stake for the Governors as monetary experts if after publication of the Report further exploration of this idea inside and outside the central banks shows that it is not a workable scheme.