Il Governatore della Banca d'Italia

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Dear Sir,

Please find attached the paper "The ECU in the monetary union process", prepared as my specific contribution to the Committee for the study of economic and monetary union chaired by M. Delors.

Sincerely,

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"THE ECU IN THE MONETARY UNION PROCESS"

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I. INTRODUCTION

1. The purpose of this paper is to describe the role the ECU could play in the process of European monetary unification. The paper does not seek to provide a comprehensive treatment of the manifold issues raised by the nature and functions of the ECU in the official and private spheres. To keep this note as simple and concise as possible, no attempt is made to demonstrate every statement analytically. Whenever technical details are included, it is only to show that the ideas presented are operationally viable, without pretending to exhaust the issues involved.

2. The paper is based on two basic assumptions and on two convictions that should be kept in mind in reading it.

The assumptions are:

- one, that a political decision has been taken to the effect that the Monetary Union will eventually require a common currency;
- two, that a "parallel currency approach" -- whereby an autonomous process of monetary creation in ECUs is an instrument in achieving monetary union -- has been rejected.

The convictions are:

- one, that the private ECU market is an established reality, largely brought about by market forces, that will continue to develop and that will be influenced by the process of monetary unification;
- two, that there is a limit to what can be accomplished in the field of monetary policy coordination by non-institutional, pragmatic arrangements.

3. In the following sections two schemes are proposed for the private and the official ECUs respectively. The aim of the private ECU scheme is to allow economic agents to

use the ECU as a convenient common denomination for their transactions and thus gradually gain familiarity with the future common currency. The aim of the official ECU scheme is to bring about the transition from a fairly advanced stage of monetary policy coordination to the early stage of a common monetary policy based on the ECU as the main reserve asset. The two schemes are meant to be adopted jointly, as they obviously complement and reinforce each other; however, there are no compelling logical reasons requiring parallel progress in their implementation. Both involve an element of gradualism and foresee the ECU remaining a basket until the final stage of the process (i.e. the irrevocable locking of exchange rates). Neither of them requires the private and official ECU circuits to be linked.

II. A MARKET-LED SCHEME FOR THE PRIVATE ECU

4. As Governor Duisenberg suggested in his paper, the private ECU could develop autonomously, driven by market forces, as an additional denomination of trade and financial contracts, including bank deposits and other monetary instruments. ECU monetary assets would thus circulate alongside those denominated in national currencies and, to this limited extent, the ECU would be a parallel currency. It would not, however, be a parallel currency in the sense of there being an autonomous supply of money denominated in ECUs. The total money supply would be entirely determined by national monetary authorities, with the sole objective of creating just as much money as is needed to ensure price stability; on the other hand, its composition in terms of the various national currencies and the ECU would be decided by the market.

5. The pattern of the ECU's development so far suggests that it would appeal especially to operators, such

as firms and financial institutions carrying out substantial foreign transactions, that place a high value on the advantages of a common monetary standard and, in particular, on the reduction in transaction costs deriving from a multiplicity of currencies.

6. The ECU would retain its basket nature. The stability of the ECU's purchasing power will remain the main factor determining its attractiveness and the willingness of the market to hold it in place of national currencies. In view of the ECU's basket nature, its stability will depend on inflation in all the participating countries: as long as there are differences between national inflation rates, the ECU will be less attractive than the best-performing currency and its development confined to the weaker-currency countries. In any case, even if it were as stable as the most stable national currency, the ECU would only be used by private operators if it offered advantages in terms of transaction costs. Under these circumstances, the role of the ECU will grow only if conditions of "fundamental soundness" are preserved.

7. If the ECU is to be evaluated by the markets on the basis of inherent merit, it will be necessary to remove the legal provisions hindering the general use of ECUs in the place of national currencies. For instance, national laws could allow ECUs to be used for the keeping of company accounts and the payment of public services and hence to denominate procurement and foreign contracts. If a system such as the one presented in Section III is put into place and price stability achieved, exchange rates will become more stable, national currencies will be increasingly good substitutes and their relative supply will be more tightly coordinated, thus gradually eroding the distinction between the ECU and the component currencies. The basket definition would then become progressively redundant and the final move

to a common currency could take place with the ECU having

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stage, in which there is still a plurality of currencies and monetary policies are closely coordinated but not yet completely unified. From a technical point of view, the scheme could be implemented before the locking of parities, provided that realignments were exceptional events and small. Two basic ideas underlie the proposed scheme. Firstly, the monetary policy of each member central bank would have to be consistent with the one jointly agreed in the central monetary institution. Secondly, such consistency would be assured by new arrangements for the supply of official ECUs, which would become the ultimate basis for the aggregate stock of money in the Community.

10. Under the scheme the monetary organization of the Community would have <u>three levels</u>: the central monetary institution, the national central banks, and commercial banks. At the top, the central monetary institution would only engage in transactions with the member central banks; these, in turn, would maintain their present relationships with domestic commercial banks. The central monetary institution would act as the central bank of the national central banks and use its creation of ECU reserves to influence the supply of base money by member central banks. The demand by national central banks for official ECU balances to be held with the central monetary institution would stem from the role of such balances as base money for national base moneys, as well as their power to settle mutual obligations arising from the operation of the system.

11. The ECU would still be a basket currency and only member central banks would hold <u>ECU deposits with the central monetary institution</u>. The situation would be similar to that prevailing domestically, where the bulk of deposits with the central bank are held by banks and provide the ultimate means for settling interbank accounts. As outlined in Section II above, commercial banks and their customers would, of

course, be free to denominate deposits and other monetary instruments in ECUs within the aggregate targets set jointly by the central monetary institution and the member central banks. The scheme proposed here is thus materially different from that in which the ECU loses its basket definition, becomes a fully-fledged currency with its own money supply process and is not functionally tied to the supply of national currencies.

12. The scheme involves three fundamental components. The first is an autonomous balance sheet for the central monetary institution, in line with the structure of all monetary institutions (national central banks, the IMF, the BIS); this would allow the central monetary institution to take operational decisions, rather than serving simply as a forum for concertation. The second is a mechanism for ensuring direct and firm control of the supply of ECUs by the central monetary institution, in strict analogy with the control exercised by national central banks on the domestic money supply. The third is a set of provisions to strengthen national central banks' demand for official ECUs created by the central monetary institution by making the latter a necessary ingredient of the process whereby they supply money to the private sector.

13. The balance sheet of the central monetary institution would be based on a capital formed by contributions of international reserves received from national central banks, along the lines of the proposal of Governor de Larosière. For instance, $4 or $5 billion of international reserves could be contributed according to a distribution key reflecting the relative economic importance of participating countries. In return, central banks would receive shares of the central monetary institution, i.e. a participation in its capital.

14. Firm management of the supply of ECUs by the central monetary institution requires that all the channels of ECU creation be brought under its direct control. Currently, the amount of ECUs created through the swap mechanism depends entirely on exogenous factors: changes in the gold price, the dollar exchange rate and the quantity of reserves. Such swaps will therefore have to be abolished. They could be replaced by an initial contribution of international reserves -- in exchange for ECUs -- by member central banks, amounting, for example, to the equivalent of 3 per cent of their respective monetary bases.

15. Credit mechanisms, the other channel of ECU creation, are similar to the rediscount facilities for commercial banks at the national level. However, while in national systems automatic rediscount facilities are generally on a small scale, with the supply of liquidity to commercial banks being mainly discretional, the EMS credit mechanisms are mostly automatic and for unlimited amounts up to 75 days. To bring the creation of ECUs from this source under stricter control, the central monetary institution should be given the power to grant member central banks discretional credit in ECUs, in the same way as a central bank finances commercial banks through open market or rediscount operations. The cost of this credit would also be fixed discretionally. In turn, this new mechanism would allow a significant reduction in the scope of Very Short Term Financing (VSTF), for instance by bringing its average duration to 15 days, limiting its applicability to the financing of marginal interventions, eliminating automatic renewals and making it more expensive, in the nature of a Lombard facility.

16. The third component needed to complete the scheme, after arranging for an autonomous balance sheet and firm control of the creation of official ECUs, is a specific and

exclusive use for the ECUs held with the central monetary institution. This is provided by requiring member central banks to hold the ECUs (created through the channels described in 15 and 16 above) as deposits with the central monetary institution in the form of both compulsory and free reserves.

17. The central monetary institution would have the power to ask member central banks to hold compulsory reserves in ECUs, amounting to the equivalent of a certain percentage (e.g. 2 per cent) of their total liabilities. The reserve requirement in ECUs would link the supply of base money by member central banks and the aggregate money supply in the Community to the creation of ECUs by the central monetary institution. By so doing, a strong relationship would be established between the action of the central monetary institution and that of each member central bank. Through this link, the stance decided in common would be transmitted to all the members of the system.

18. ECUs held with the central monetary institution in excess of the compulsory level would constitute free reserves. Central banks would need such reserves to be able to expand the "national monetary base", settle financing obligations in the system and obtain international reserves from other central banks (negotiability) or the central monetary institution. The central monetary institution would be under no obligation to buy or sell international reserves against ECUs; it would only do it as far as this was consistent with its monetary objectives, in analogy with central bank behaviour when deciding to intervene in the foreign exchange market. The convertibility of ECUs with the central monetary institution would thus be at the latter's discretion, and would be assured whenever it was deemed necessary to counter a monetary disturbance of systemic significance.

19. As far as the functioning of the system is concerned, the governing body of the central monetary institution would decide each year, in the light of an appraisal of the economic situation, how much money and credit should be created in the Community in order to support economic activity in a non inflationary environment. A target for the central monetary institution's ECU creation would then be set in relation to the overall money supply. A necessary complement of the objective concerning money and credit expansion would be policy guidelines for the system vis-à-vis the dollar and the yen, in particular as regards intervention and its effect on money creation.

20. The management of the credit and compulsory reserve mechanisms described above would be instrumental in implementing the monetary policy objectives set for the Community. If, for instance, it were necessary to make the aggregate monetary stance of the system more restrictive, the central institution could reduce credit in ECUs to member central banks, increase its cost and/or increase the ECU reserve requirement. Viceversa, if the judgement of the relevant body of the central monetary institution was that, in the aggregate, somewhat more expansion was needed, it would be possible to increase ECU credit, reduce its cost and/or decrease the ECU reserve requirement; the amount of ECU reserves freed would support the desired monetary expansion by some, or all, of the national central banks. If the problem was, instead, the tendency for money to expand in a given country beyond the stability-oriented common plan, the central institution could ask for a special deposit of reserves from the central bank of the country concerned. Analogously, if a currency came under speculative attack on the foreign exchange market while the underlying monetary policy was considered appropriate, the central monetary institution would provide ECU credit and help restore

balanced conditions in the market.

21. An important point concerns the scope for gradual implementation of the scheme. The advance towards monetary union must be planned so that there is never any ambiguity about where the ultimate responsibility lies for conducting a monetary policy which is oriented towards price stability. Accordingly, an important aspect of the scheme described above is how it would work at a late stage (when responsibility for monetary policy has been put in Community hands) and the scope for implementing part of it at an intermediate stage (when central banks still have primary responsibility).

22. At an advanced stage such as the one described above in paragraphs from 9 to 20, the ECUs held with the central monetary institution would be the only asset permitting national central banks to expand their aggregate supply of high-powered money, albeit with a required reserve coefficient that could be initially small. They would not be able to acquire these ECUs automatically from the central institution: either through an unconditional right to convert reserves held in other currencies, or through access to any of the credit mechanisms. Scarcity of high-powered ECUs would provide effective control over the expansion of money and credit in the Community.

23. At an intermediate stage of the process some flexibility in the supply of official ECUs and in the way this is linked to the creation of high-powered national money would allow member central banks to expand or contract the money supply in their countries without being rigidly tied by their ECU reserves. In these conditions ECU operations carried out by the central monetary institution, using the mechanism described above, would serve primarily to highlight, and in part counter, divergences by individual

central banks from the commonly agreed monetary and credit objectives of the Community. The central monetary institution should initially take account of the specific needs of each participating country when making and carrying out its plans; its hold on the system's monetary policy would only be tightened gradually. Accordingly, some leeway could be provided by not making the automatic Very Short-Term Financing (Lombard-type facility) too strict, in terms of duration and cost, and by granting member central banks the right to exchange ECUs for international reserves and viceversa under certain specific conditions. As regards the link between ECU creation by the central monetary institution and national money supplies, some flexibility could be allowed by fixing ranges for the ECU compulsory reserves rather than strictly determining their level.

IV. CONCLUSIONS

24. The proposals presented in this paper amount to a very significant step towards monetary union. However, the capital mobility and the exchange rate constraint already drastically reduce the room for autonomous monetary policies. In practice, the ultimate responsibility attributed to national monetary authorities is severely limited and each national policymaker influences, and is influenced by, all the others. Seen in this light, the innovation in the scheme illustrated above is that the constraint would be explicit and exert an *ex ante* influence on the formulation of monetary policy, instead of being hidden and having an *ex post* effect in the exchange market. Accordingly, the pooling of monetary responsibilities would not so much be a new phenomenon, as an, admittedly important, development of the existing trend.

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