Rome, 7 January 1989

The devil's advocate

Questions and answers on the paper

"The ECU in the monetary union process"

QUESTION: The proposed mechanism is very ambitious in terms of monetary coordination. For Italy, it implies that monetary policy will have to adhere to the restrictive course followed by "hard-currency" European countries (notably, Germany). How can this be reconciled with the Italian fiscal situation? Won't a more restrictive monetary stance worsen the prospects of an unsustainable high interest rate - high deficit spiral?

ANSWER: Italian monetary policy has been on a rigorous course since the beginning of the 1980s: real interest rates have been higher, on average, in Italy than in the other major European countries, an overwhelming portion of the public deficit has been financed on the market. Monetary accommodation is not an answer to a lax fiscal policy (see the divorce between the Treasury and the Banca d'Italia, and the EMS). Furthermore, we cannot exclude, on the basis of the experience so far, that European integration and the reduction of exchange rate uncertainty could facilitate fiscal adjustment by bringing about a reduction of interest rates (interest payments are now about 2/3 of the public deficit); this could complement the action on the primary deficit: the current fiscal plan envisages its elimination by 1992. In any case, we have already agreed that monetary integration will have to be complemented by more stringent coordination as regards fiscal policy.

QUESTION: The mechanism involves a two-step control, with the central monetary institution controlling the volume of ECU reserves available to the national central banks, and the latter, in turn, regulating the liquidity of the commercial banks. However, while the commercial banks have a well defined incentive to react to central bank action (profit maximization), what factors would induce the local monetary authorities to respond to central monetary institution signals in the desired way?

ANSWER: A reduction in the supply of ECUs by the central monetary institution has to be accompanied, beyond what could be accommodated by the availability of free reserves, by restrictive monetary measures in the individual countries, leading to a reduction of their domestic monetary bases. An expansion would initially tend to increase the volume of free reserves; this is welcome by (at least some) central banks, since they participated in the decision to expand, and will give them room to create additional monetary base. If a central bank was reluctant to follow the commonly decided expansion, it would soon find its exchange rate under upward pressure, interventions would be needed to stem the pressure and monetary accommodation would follow. This mechanism ultimately leads to an increase in the monetary base and compulsory ECU reserves and a reduction of free reserves. The mechanism described in the paper is admittedly quite rudimentary, but it could develop to the point where an interbank market for ECU official reserves was part of the mechanism: to the extent that central banks are sensitive to profit considerations -- and ultimately they are -- this market could facilitate the working of the system, by conveying signals to the domestic authorities in a more flexible way.

QUESTION: Even supposing that a link is established between ECU reserves and the domestic monetary bases, there is no guarantee that the mechanism would work properly; for example, fully sterilized interventions would still be possible since they would only change the composition of the asset side without variation in the overall liabilities of the central bank concerned. In addition, individual countries would be free to carry out an independent monetary policy, for a given monetary base, by changing the coefficient of required reserves. In conclusion, there is ample room for potentially serious loopholes.

ANSWER: It is clear that the system requires fair play from members, even if some problems could be dealt with in detailing and articulating the broad proposal presented. Fair play is not an unrealistic assumption: it is conceivable that if sufficient consensus can be gathered around the project, then the same consensus will be sufficient to generate proper behaviour. Thus, one would expect that member central banks would not carry out sterilized interventions or change national reserve requirements just to void the actions of the central monetary institution. If that happened, however, a dangerous contrast could emerge. The central monetary institution could counter-react in turn. For instance, it could reduce ECU credit to a member central bank who tried to depress the exchange rate by sterilized buying of reserves or it could increase the ECU reserve coefficient as an answer to a reduction of the national one.

QUESTION: In the paper the private and official ECUs are separated. In this respect the situation would not be so much different from the present one. How then can this mechanism contribute to the creation of a unique money?

ANSWER: Yes, in the proposed framework, the private and official ECUs remain unlinked in the intermediate phase in which private ECUs would coexist with national currencies. This feature of the present proposal makes it substantially different from the "parallel currency" approach which considers the creation of an additional currency whose supply would be under the responsibility of an additional central bank. In the present setup, instead, the private ECU develops as an inside money, through a demand determined process. Private agents autonomously choose to hold ECU assets on the basis of its intrinsic characteristics and comparative advantage. Since the ECU remains in the initial stage a private market phenomenon, its use and substitution from national currencies does not involve any increase in the overall money supply in the area (which should be defined to include monetary instruments denominated in ECUs), but only a change in its composition between the various denominations. This eliminates fears of the loss of price stability within the area. In the long run, with the ECU having become the major currency of denomination in European transactions, exchange rates irrevocably fixed and the process of money supply closely coordinated among national central banks, national central banks could be allowed to denominate their money base in ECUs.

QUESTION: Are fixed exchange rates required for the present mechanism to function?

ANSWER: A general remark is that only the broad outline of the project is presented. Much more detail and precision will be needed to make the system operational. This is true also in this field. The basic requirement is that all member countries whose currencies are included in the ECU basket participate in the exchange rate agreement. Exchange rates do not necessarily need to be irrevocably fixed in the initial stage for the mechanism to start functioning. Some accounting provisions should however be considered to avoid the distortionary effects produced by possible changes in the exchange rate of the ECU on the assets owned by member central banks. In fact, a country that devalues its currency with respect to the ECU would see an increase in the domestic currency value of its total ECU assets (among which those received by the central institution) and, on that basis, could expand its base money. This would be unacceptable, since the country that devalues would be able to expand rather than having to adopt contractionary policies. The problem could be solved by some accounting device accompanying exchange rate changes, that would for instance take the form of a compensating official ECU transaction with the central institution.

QUESTION: If the ECU remains a basket currency, it will hardly be competitive with the most stable currencies. In its present form the ECU can therefore not be seen as an instrument for bringing about monetary integration.

ANSWER: The basket characteristic of the ECU is not a disadvantage. Precisely because the ECU is a basket currency, it will not be as competitive as the stronger currencies unless there is full convergence of price performance and highly stable exchange rates. This implies that the process of currency substitution from the national to the common money will need an increase in monetary stability within the area. If, instead, the inflation rate in one of the member countries rose and the exchange rate depreciated, the stability of the ECU would be affected and private agents would decrease their holding of ECUs. Setting the ECU, with its present basket definition, at the centre of monetary unification is a strong condition for the process to occur through an increase, not a weakening, of monetary stability. This is however not sufficient. For monetary stability to be brought about simultaneously in all countries a mechanism of money supply coordination needs to be devised. The paper just proposes a mechanism of this sort.

QUESTION: Why do we need at all a scheme based on a central monetary institution?

ANSWER: In this scheme, the central monetary institution plays the role of a common institutional anchor, enforcing the respect of the commitment to stability on each member central bank, through appropriate technical arrangements and constitutional provisions. The process of monetary policy coordination in the EMS has been so far rooted on the existence of a "national" anchor performed by the country with the best price-stability results. A national anchor may nonetheless be too weak for the whole Community, both from an economic and an institutional point of view. Mere coordination of monetary policy, without some binding instruments, is no viable alternative either. In addition, if the ECU is the natural candidate to become the currency of the future European Monetary Union, a proposal in which the official ECU plays an increasing role in the formulation of Europe's monetary policy would also accelerate and strengthen the development of the ECU through market forces.