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A proposal for Stage Two under which monetary policy operations would be centralised in a jointly owned subsidiary*

I. Introduction

1. This note describes an institutional reform that EC central banks could introduce to mark Stage Two of the transition to European monetary union. The proposal is based on the following premises concerning Stage Two:

- it is assumed that the new Treaty has been ratified and that the enhanced policy concertation carried out by the Committee of EC Governors during Stage One has yielded results;
- in the monetary field, Stage Two is supposed to go beyond Stage One in three important respects: (a) at least the embryo of a federal central banking system should be put in place; (b) while the final word on the conduct of national monetary policies is to remain with the member states, there should be a visible further strengthening in the extent of policy coordination; and similarly, (c) while it would still be possible to alter intra-Community exchange rates, there should also be visible progress in co-ordinating intervention policy in the exchange markets;
- progress in these three areas should be such that it prepares the ground for the move to Stage Three - i.e. the irrevocable locking of exchange rates and the full operation of a federal central banking system.

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2. With these premises in mind, three possible approaches to Stage Two suggest themselves. The first would be to implement a gradual but formal transfer of decision-making power from the monetary authorities of the member countries to a federal central banking institution. The second approach - outlined in Governor Ciampi's contribution to this collection of papers - would be to set up a formal two-tier system of monetary control based on the requirement that member central banks back their creation of local currency reserves with ECU reserves supplied by a federal central banking institution. Finally, at the core of the third approach set out in this paper is the idea that EC central banks should set up a jointly owned subsidiary, whose facilities they would share in performing certain of their functions - notably the implementation of monetary policy through the domestic money and foreign exchange markets - but which would not require them to give up any substantial degree of individual sovereignty over those functions.

3. The first two approaches implicitly assume that some element of central bank authority or resources would need to be put under collective control as a necessary condition for establishing a new operational institution in Stage Two. By contrast, the third approach essentially reverses the order of progress so that operations are centralised in a new institution <u>before</u> resources are formally pooled or authority is granted to a collective body. Following recent EC terminology, the resulting situation could be characterised as common operational facilities with "home country control".

4. Section II describes the central bank operations that would be centralised in the joint subsidiary, while Sections III and IV examine the likely benefits and costs of the scheme. Sections V and VI consider some more detailed questions of implementation. Section VII contains conclusions and poses some unresolved questions.

II. <u>What functions should be centralised?</u>

5. In principle, several functions of the EC central banks could be performed through shared facilities. However, the largest boost to the monetary union process would come from centralising the operations through

which national monetary policies are implemented. This would cover domestic open market and lending operations, as well as intervention in the foreign exchange markets. It would be achieved by establishing a common operations floor and accounting system within the jointly owned subsidiary which could be known from the outset as the European System of Central Banks (ESCB). 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 (see Section V). Although their operations would be performed through common facilities, and hence be completely transparent to their partners, individual member central banks would retain ultimate responsibility for the deployment of their national foreign exchange reserves, and for the supply of domestic bank reserves.

III. Benefits of the scheme

6. By centralising the implementation of national monetary policies in a single institution, the EC central banks would give a powerful demonstration, both politically and to the markets, of the progress that had already been made in the concertation of national economic policies, and of the seriousness with which they were pursuing the ultimate goal of monetary union.

7. To maximise the reform's impact on market perceptions the member central banks could agree fairly early on in Stage Two not to reveal the source of instructions for operations by the ESCB. Thereafter the market would find it much harder to exploit differences in emphasis among member central banks. Moreover, the risk of separate actions by member central banks being misinterpreted in the markets would be greatly reduced. At the same time the common use of the ESCB for exchange rate intervention would impose considerable discipline on member central banks to co-ordinate their actions so as to give consistent signals to the markets. This would apply to all users of the shared facilities, even those which were not full participants in the ERM.

8. The transparency of individual national operations, together with the experience of working closely together, would enhance the level of trust and understanding among the staffs of member central banks, at the

operational level and perhaps also at the policy-making level. When combined with the rapid interchange of information on both domestic and foreign operations, this would help to improve co-ordination on market tactics and might also lead to further advances in policy concertation.

9. Over the longer term the sharing of detailed information on national money market institutions and short-term transmission mechanisms, in conjunction with the "installation" of all EC control mechanisms on common facilities, would encourage efforts to clarify and converge the domestic operating mechanisms for each currency. This would not only ease the transition to a unified monetary control procedure, but would also help to ensure that the ESCB developed into an institution focused on the objective of price stability within the Community.

10. A less certain benefit of the scheme would be the cost savings that might result from centralising monetary operations. There could be substantial economies of scale, with the added interim benefit for small countries of being able to develop more sophisticated operating procedures than would be possible on an individual basis.

IV. Implications for national sovereignty

11. The scheme could impinge on national sovereignty in two respects. Firstly, member central banks would no longer be able to disguise the content of their domestic and foreign monetary operations from their EC partners. This loss of privacy is the key to many of the benefits described above, but to the extent that it does represent a sacrifice it provides an opportunity for all member central banks to demonstrate their commitment to the ultimate goal of monetary union. Indeed the inclusion of all important monetary operations in the scheme is essential to ensure that all EC central banks make an equivalent commitment to it, even those without well-developed money market operations.

12. Secondly, there could be a tendency over the long run for national money markets to migrate to the country in which the ESCB operations were located. However, it should be recognised that the development of one dominant financial centre could well be an inevitable

long-run consequence of achieving monetary union, even with the adoption of a federal system for policy-making. The US experience illustrates this to the extent that monetary policy implementation is centralised at the Reserve Bank of New York. Indeed the individual reserve banks' open market operations were centralised at the FRBNY before a centralised approach to policy-making was clearly established.

V. Implementation

13. Structuring the ESCB as a jointly owned subsidiary would enable all member central banks to participate despite their heterogeneous legal structures.

14. Initially, each member central bank would staff its own operations on the common floor; thus the ESCB would essentially consist of a collection of "branches" of the member central banks, albeit sharing the same facilities. If necessary, individual banks could transfer their operations gradually, but they would all have to meet the same deadline for transferring their complete monetary operations to the floor.

15. Full transparency within the ESCB would exist from the outset. This would be essential both to achieve the key benefits of the scheme and to enable rapid progression to the point at which the various branch staffs of the member central banks could be reorganised as a single corporate unit. Direct home country control over operations could be maintained even after the merging of branches is complete, but it is more likely that the member central banks will be increasingly willing to give discretion to the ESCB staff to manage their respective operations within broad policy guidelines.

16. One look at the global treasury operations of a large commercial bank today should lay to rest any doubts regarding the technical feasibility of the plan. Such operations span multiple currencies and instruments with separate books and lines of responsibility to senior management for individual dealers.

17. A more difficult question is whether the geographic separation of a member central bank's operating personnel from their counterparties in the domestic private sector would lead to a loss of market "feel". This problem may in the long run be alleviated by the relocation of important domestic counterparties to the financial centre hosting the ESCB's operations. But in any case, any loss of domestic information would increasingly be compensated for by the growing relevance of the information on operations in other member countries made available through participation in the joint facilities.

18. At first the ESCB balance sheet could be structured as a collection of accounts owned by the member central banks and their private sector counterparties, mirroring the monetary accounts that at present exist on member central banks' balance sheets. However, as the ESCB increasingly raised its profile, it would be desirable to interpose ESCB-owned accounts in all monetary transactions between the member central banks and private financial institutions, and possibly in transactions with certain official entities as well. One could envisage a situation arising towards the end of Stage Two in which the entire monetary operations of the individual member central banks were captured in their accounts and in their transactions with the ESCB. At the same time, all the likely private sector participants in a Stage Three European "fed funds" market would, by the end of Stage Two, have well-established direct relationships with the ESCB.

VI. Treatment of non-monetary operations

19. At present the domestic monetary operations of some member central banks may be closely integrated with other financial tasks performed on behalf of the government or private sector. This could pose a problem since it is not the intention of the scheme to transfer the whole of a member central bank's financial activities to the ESCB. However, it should be recognised that the substantial disengagement of the monetary and non-monetary activities of member central banks would be a necessary precondition for achieving a unified monetary control procedure in Stage Three.

20. It is also possible that member central banks may wish to take advantage of the facilities provided by the ESCB to centralise more operations than would be strictly necessary to capture the implementation of monetary policy. For example, a natural complement to the transfer of monetary operations would be the centralisation of member central banks' "town" clearing systems used to perform the final daily clearing among the major commercial banks in each country. This role for the ESCB could have important side benefits since it would help to ensure that the progressive integration of European banking systems under the Single Market programme was closely monitored from the perspective of monetary policy and systemic risk.

21. The long-term management of member central banks' foreign and domestic assets is also closely related to their monetary operations and could easily be centralised at the ESCB using the principle of shared facilities with home country control. However, some countries may wish to make a distinction between foreign assets with monetary and non-monetary uses, and therefore retain some part of their foreign exchange reserves under the control of national treasuries.

VII. Conclusion

22. The scheme presented here has two distinctive elements. First is the implicit constraint that it places on member central banks by requiring them to implement their national monetary policies through shared facilities. By comparison with the various possible explicit mechanisms for demonstrating the existing level of monetary policy concertation and encouraging further advances, this approach involves a smaller risk of unintended disruption in national implementation procedures.

23. A second distinctive feature of the proposal is that the new institution would replace rather than duplicate facilities that already exist in the member central banks. This would minimise the risk of real or perceived conflicts emerging between the member central banks and the new collectively owned institution. It would also mean that once the merger of the different national operating staffs had been completed, the new

institution could fit, with little further adaptation, into the institutional framework that would ultimately be required in Stage Three.

24. There is much that the scheme presented here does not do. Most importantly, it does not attempt to solve the problem of how a Stage Three decision-making body will determine the appropriate EC monetary stance to achieve domestic price stability. In addition, it only ensures instantaneous as opposed to ex ante policy consultation, and it does not introduce any automatic mechanisms tending to discourage realignments. Finally, it does not do anything directly for the development of the ECU.

25. However, there can be little doubt that, as an institutional demonstration of the member states' Stage One achievements in policy concertation and of their commitment to reach the final goal of monetary union, the plan would have a major impact. Over the longer term the scheme could significantly improve the scope for convergence in monetary procedures and for further policy concertation, provided the political will for such goals existed. At the same time, the scheme would exert subtle pressures of its own by forcing member sates to present a consistent common front to the markets.

26. The proposal raises some questions regarding institutional arrangements which would require further clarification. For example:

- What would be the legal constraints on individual central banks in delegating their monetary operations to a mutually owned subsidiary while retaining sole ultimate control over those operations?
- What are the key monetary operations of each central bank? Would it be difficult to disentangle these from other financial tasks carried out on behalf of the government or the private sector?

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