Communication by Lamberto Dini on monetary policy in the EMU (19 January 1990)

Caption: On 19 January 1990, Lamberto Dini, Director of the Bank of Italy and member of the Monetary Committee of the European Communities, raises the issue of monetary policy within the Economic and Monetary Union (EMU), with particular emphasis on the role of the European System of Central Banks (ESCB).

Source: Monetary policy in the EMU - Communication from Mr Dini (Brussels, 19 January 1990). [ON-LINE]. [Brussels]: European Communities, [02.09.2005]. II/037/90-EN. Disponible sur http://europa.eu.int/comm/economy_finance/emu_history/documentation/chapter13/19900119en10monetarypolicyemu.PDF.

URL: http://www.cvce.eu/obj/communication_by_lamberto_dini_on_monetary_policy_in_the_emu_19_january_1990-en-b702513e-724c-4901-9285-5aeb1d44079f.html

Publication date: 21/10/2012

Monetary policy in the EMU – Communication from Mr Dini (Brussels, 19 January 1990)

Introduction

One of the crucial aspects of the Economic and Monetary Union is the implementation of a common monetary policy for the whole Community. This represents a major change and requires the creation of a new framework for the conduct of economic policy, not only in the monetary sphere but also in other interrelated spheres and, in particular, in budgetary policies. This paper concentrates on three issues: i) the institutional structure of the ESCB, ii) the operational framework for monetary policy and iii) the interaction with budgetary policy.

The institutional setting of monetary policy

The Delors report, which deals extensively with the institutional arrangements of the monetary union, makes the ESCB the cornerstone of the new monetary constitution. The ESCB would be created at the beginning of Stage 2, binding together the existing national central bank (NCBs) and creating a central monetary institution through the contribution of capital by the NCBs. The ESCB would integrate the NCB's monetary policies and progressively assume the responsibility for the Community policy stance. In Stage 3 the ESCB would be the result of the integration among NCBs; this would leave just one authority in charge of the conduct of monetary policy in the Community(1). National legislations will have to be adapted to allow such a change to occur.

One of the basic aspects of the status of the ESCB is its independence. This implies that full financial autonomy must be granted to the ESCB and, therefore, that it cannot be subject to instructions or guidelines regarding the composition and/or size of its balance sheet (2). Any compulsory financing of budgetary or balance-of-payments imbalances is thus excluded. The operations undertaken by the ESCB should be protected from any outside interference. In particular, transactions in the secondary market in member countries' government paper should be carried out only for monetary policy reasons. Further, for the action of the ESCB to be homogeneous across regions that may remain financially segmented, it should be carried out in a relatively decentralized way.

Independence requires that the ESCB be endowed with all the instruments necessary to fulfil its tasks and that its final objectives, first and foremost price stability, should be clearly laid down.

Independence requires appropriate decision-making procedures (voting, disclosure of minutes, public statements...) to ensure that the members of the Council and the Board, although of different nationalities, represent and pursue only the interests of the whole Community. They should be nominated for their competence and have appropriate security of tenure.

The accountability of the ESCB is provided for through the evaluation of its action in terms of the primary objective of promoting price stability. Specific procedures are envisaged, such as the submission of regular reports and hearings with the European Parliament and the European Council. Nominations to the Board of the ESCB would also have to be subject to approval by the European Parliament.

The operational framework for the integrated monetary policy

In the final stage of Economic and Monetary Union, when the NCBs and ESCB have merged and a single currency exists, monetary policy will be carried out in the Community in much the same way as in member countries today.

As long as we have national monetary denominations and distinct central banks, there will be two other problems in addition to those usually encountered by monetary policy in a national setting: firstly, an appropriate currency distribution of the Community aggregate money supply; secondly, compliance by national central banks with the common stance decided in the ESCB. The first derives from the need to prevent member countries' growth rates from diverging, which could engender runs on reserves and jeopardize the credibility of the monetary policy of the whole system. The second reflects the need to forestall any suspicion that an NCB might try and shift the monetary policy of the system towards its own desired stance and away from the one decided in the ESCB.

One possible operational scheme serving both in the last stage of the monetary union and in the transition phase (3) would be based on a three-level pyramid composed, from top to bottom, of the ESCB, the NCBs and the commercial banks. By means of this pyramidal system, monetary impulses originating from the upper levels would be transmitted to the rest of the economy. The ESCB would be the ultimate source of money creation, issuing ecu reserve assets to the individual NCBs, possibly in exchange for contributions by the latter of domestic and foreign assets. The NCBs would maintain a fairly stable proportion in their balance sheets between the amount of ecu reserve assets received from the ESCB and their holdings of domestic assets. Initially, this would be achieved through a compulsory reserve requirement applied to the asset, or liability, side of the balance sheet of each central bank. With the progressive development of the ecu as a proper currency, NCBs would spontaneously hold official ecu balances with the ESCB for payment purposes and this would give it the leverage to guide monetary conditions in the whole Community independently of any reserve requirement. This mechanism would give the ESCB firm control over the overall quantity of money in the Community. The issue of ecu reserve assets to the NCBs would take into account the development of the underlying fundamentals in member countries.

From the procedural point of view, the following steps could be considered in the conduct of monetary policy.

— Before the end of the year, the ESCB would define a target for the growth of the following year's aggregate money supply in the System that would be consistent with the objective of price stability and take account of internal and external developments. This overall target would be split among the currencies of the participating NCBS and ecu reserve assets would be issued by the ESCB to the NCBs accordingly.

— Regular monitoring meetings in the course of the year would be held to assess the consistency and appropriateness of these targets. Effective monitoring of monetary conditions would enable the ESCB and the NCBs to adjust rapidly to financial disturbances or to changes in the fundamental relations between targets and instruments. Information variables, such as the external component of national monetary bases, would be used extensively to allow prompt detection of divergent behaviour or shifts in the relative demand for the various currencies, especially in Stage 2 of the EMU.

— The implementation of monetary policy would be based on mechanisms that would bring about a quick response by the NCBs to the impulse given by the ESCB, eventually penalizing any delay in action. For example, if the aggregate stance were found to be too lax for the overall goal of price stability to be attained, the ESCB would reduce the issue of ecu reserve assets to the NCBs, thereby encouraging them to reduce domestic currency assets in their balance sheet proportionally. If one member NCB were found to have adopted an excessively expansionary stance, giving rise to a reduction in the foreign asset position of that NCB and a corresponding increase in that of the others, the ESCB could reduce the amount of ecu reserve assets issued to that NCB, thereby inducing it to reduce the domestic currency assets in its balance sheet. This scheme can be implemented independently of the variable used as intermediate target or instrument. If, for instance, the intermediate target were the rate of interest rather than a quantitative aggregate, the ESCB would modulate the supply of ecu reserve assets in order to reach the desired interest rate level, as occurs in countries that pursue this type of target.

The mechanism proposed above, while best exemplified in Stage 3, could be implemented in Stage 2, in which the task of the ESCB is, according to the Delors report, to set the general orientation of the Community monetary policy, with NCBs retaining ultimate responsibility for national monetary policies. In this stage, experimentation with the operational framework for setting the common policy of the Community would start. For instance, the balance sheet ratio between NCB's ecu reserve assets issued by the ESCB and their domestic currency assets could initially refer only to a part of the NCB's balance sheet, to be extended progressively until, in the final stage, the ESCB, merged with the NCBs, would have full command over the total monetary base.

The interaction with budgetary policy

In an Economic and Monetary Union, budget policies can be expected to remain largely a prerogative of national Parliaments, even if monetary policy is conducted in a unified way within a common institution. However, these national budget policies will need to meet certain common requisites if the Community is to have a coherent and sustainable overall economic policy. A quasi-philosophical contention has recently arisen between those who support the adoption of "binding" rules or constraints to guide budgetary policy coordination in the Community and those who emphasize "judgement" and "peer pressure". In our view, attention should be focused not on this somewhat artificial distinction but rather more pragmatically on the essential goals of monetary stability and financial discipline that we all want the Community as a whole to attain.

Following this approach, two sets of issues should be examined in the conduct of budgetary policy:

i) the need to preserve fiscal discipline, so as to avert threats to financial and monetary stability (in short, "soundness");

ii) the goal of attaining a coherent aggregate fiscal stance with a view to the overall Community policy mix (in short, "coherent stance").

These two objectives require two different sets of instruments. To attain the former, a system is called for guaranteeing financial discipline; such a system has to provide for the enforcement of the corrective action needed, in cases of non-compliance by a member country. The pursuit of the second objective requires a more flexible approach aimed at steering national budgetary policies towards the desired common course but is in no way binding. Precise rules characterize the former approach, while a common exercise of judgement and discretion is the main plank of the second.

The procedures that will regulate the pursuance of the two objectives should have constitutional validity and be specified in the Treaty, together with the basic principles to be followed by national budgetary policies. The specific rules or criteria embodying the principle of "soundness" and the actual design of the surveillance aimed at ensuring a "coherent stance" should be specified in a more flexible Community act (such as a Council decision or a directive).

In particular, the Treaty should provide that:

i) national budgetary policies, intended to achieve the objectives set by individual sovereign national governments and parliaments, must be "sound" and designed and implemented in a way that does not endanger monetary and financial stability, either in member states or in the Community as a whole;

ii) national budgetary policies should be consistent with and supportive of the overall fiscal stance agreed upon me by the member states at the Community level.

The procedures guaranteeing "soundness" and aimed at ensuring a "coherent stance" should be laid down in the Treaty. National budgets should be submitted, before approval by national parliaments and after the closing of the fiscal year to which they refer, to a review and discussion by the competent Community bodies. Once or twice a year the Council of Ministers should meet in special session to assess, ex-ante and ex-post, fiscal policy issues in the Community in terms of both "soundness" and "coherent stance".

As regards "soundness", the council and/or the European Parliament will have to establish, on the basis of documents prepared by the Commission, whether the budget plans and outturns are sound. Action could also be initiated and the preparatory documents be presented by the monetary authority — the European System of Central Banks — if it deemed that budget plans or outturns undermined monetary and financial stability. Budgetary policy will be presumed sound if it complies with the specific rules laid down by a Community act approved on the basis of the Treaty. These rules should be quantitative and explicit; however, they would only specify bounds or ranges which should not be gone beyond, not point targets

It is now widely recognized, and has been substantiated by the Monetary Committee, that the first rule of budgetary soundness is the prevention of monetary financing.

Other rules should prevent excessive budget deficits. Before entering Stage 2, member countries should correct existing fiscal imbalances through strong adjustment programmes. In other words, budgetary discipline ("soundness") should be sought and achieved during Stage 1, so that in stages 2 and 3 the issue would become one of prevention. Whether or not a budget deficit is excessive should be assessed with reference to specific criteria and, in particular:

i) whether the size of the public deficit gives rise to an unsustainable trend increase in public indebtedness;

ii) whether the current budget deficit (i.e. public saving) is negative on average over the business cycle;

iii) whether and to what extent the size of the budget deficit is compatible with the level of private domestic saving and private investment, and therefore with external equilibrium.
A decision by the Council and/or the European Parliament, drawing on technical work by the competent bodies, i.e. the EC Commission and the Monetary Committee, should establish the quantitative ranges for the criteria set out above, and the exact definitions of the variables relevant to the assessment of soundness; these criteria and definitions may need to be changed in the course of time in the light of new circumstances. The Council, deliberating on the basis of material provided by the Commission, the Monetary Committee and the ESCB, would also monitor the significance of national budget data, in particular to prevent distortionary "creative accounting".

Appropriate provisions could be envisaged permitting the necessary strictness of the rules to be tempered by limited scope for derogation in exceptional circumstances. Specifically, even if a member country were found to be outside the limits, the Council and/or the European Parliament, possibly deliberating with a qualified majority, could nonetheless declare the member's fiscal policy to be sound if exceptional circumstances were proven to prevail. Such a statement could be accompanied by a set of conditions to be met by the member. As experience is gained with the system, and if the need for stricter controls arises, the Council and/or the European Parliament might state that a member's action was unsound even though it was within the limits.

If a member's budgetary policy were not to comply with the specific rules established in the Community act and no statement of soundness was pronounced by the Council/Parliament, the case would be brought before the Court of Justice. If the Court confirmed the violation of the Community rules, it would pass judgement against the offending state. It could also be given, in accordance with the Treaty, the possibility of taking action to foster compliance by that state (suspension of structural aid…)

As regards the "coherent stance" area, the Council should evaluate whether the budgetary stance in the Community as a whole and in member countries is appropriate and consistent with the agreed targets and overall economic policy aimed at promoting price stability, sustainable growth and external balance. If the fiscal stance in the Community as a whole or in any country were not considered appropriate, the Council would publicly invite the member country concerned to adopt corrective action, in much the same way as now in the exercise of surveillance, based on consensus and peer-pressure.

(1) The experience of the merger in 1957 between the Bank deutscher Länder, a joint subsidiary of the Land Central Banks created in 1948, and the Land Central Banks themselves, which gave birth to the Bundesbank, may be a useful example in this respect.
(2) Except for the contribution of capital, the mechanism for which would be specified in the Treaty or related texts.
(3) Presented by Governor Ciampi as a contribution to the workings of the Delors Committee on Economic and Monetary Union.