

The Economy in Perspective

Where to, EMU? ... Many European nations have been working hard over the past several years to lower their inflation rates and trim public sector deficits. The success of these moves, which are beneficial in their own right, will also qualify these nations for full admission into the European Monetary Union (EMU). In May 1998, participants will form a new European central bank and introduce a new currency, the euro. If plans go according to schedule, the European System of Central Banks will assume responsibility for monetary policy on January 1, 1999. What will make this institution unique is that it will be a central bank without a country.

Within nations, central banks are public or quasi-public institutions that perform a variety of financial services for the state and for private financial organizations. Central banks can facilitate government debt placement, disburse currency to the public through the banking system, and maintain the government's checking account. They also provide clearing and settlement for private firms that participate in the payments system. More important, central banks create their country's monetary standard of value and give the financial system the liquidity it needs to absorb adverse shocks.

Does the credit quality of a central bank's assets matter? Well, yes! First, if for no other reason, the government ordinarily receives net revenue from its central bank, and poor asset quality may diminish earnings. Second, lower asset quality may render the central bank's portfolio less liquid, leading to flexibility problems should it need to contract its balance sheet. But the principal reason to care is that asset quality gives government and private financial institutions an incentive to be concerned about their own credit quality, since it is their debt that the central bank would consider purchasing. To ensure credibility, a central bank must be designed so that it is restricted to holding assets of impeccable quality.

The European System of Central Banks (ESCB) will consist of a new European Central Bank (ECB) located in Frankfurt and the existing National Central Banks (NCBs). Monetary policy will be set by the ECB, but carried out on a decentralized basis by the NCBs. For our purposes, what is relevant about the arrangement is that the ESCB's security portfolio will contain the debt obligations of the constituent sovereign nations and perhaps also of other entities (such as credit institutions) headquartered in those nations. The ESCB will conduct both its monetary

policy and liquidity-enhancing operations by taking these debt obligations onto its books. Accordingly, the euro itself is ultimately backed by the credit of the EMU nations.

In the United States, the Federal Reserve holds nearly all of its assets in the form of U.S. government obligations—about \$400 billion. Hypothetically, suppose that the federal government had little or no debt outstanding. Then the Federal Reserve would have to hold other securities in its portfolio, most likely the obligations of state, and possibly municipal, governments. Should the Fed regard the debt of various state and municipal governments as equally credit-worthy? A constant worry, of course, is that the central bank could be used as a back-door device for channeling credit to "preferred" interest groups—unless the bank were legally bound to reject poor quality assets.

There is a possibility of adverse selection in open-market operations. Suppose the ESCB announced its willingness to purchase and then resell securities in the amount of 1 billion euros at a rate of 4%. Wouldn't it receive offers of the poorer quality assets from dealers before the better quality instruments were offered? Will the ECB allow the NCBs to accept all eligible securities on an equal basis, or will they discount for quality? There are obvious political issues here.

Interest rates vary among the EMU countries today, even in real terms, reflecting differences in such factors as tax policies, regulations, and saving rates. Although the participating nations have converged their deficit/output ratios around the 3% Maastricht target, the ratios still vary widely. The diversity of these fiscal positions, together with many well-publicized structural economic problems in Europe (costly welfare and agricultural support programs, to name just two), further challenge the ability of EMU governments to harmonize their economic and fiscal conditions.

Establishing a supranational central bank, the ESCB, creates an interesting, novel experience. Sovereign states relinquish their ability to issue non-interest-bearing claims on their governments—money—so they will be under even more pressure to manage their fiscal obligations prudently. Under the worst of circumstances, the ESCB may feel severe pressure to use its liquidity or monetary policy to address problems for which it is not suited. Under better circumstances, however, the ESCB can play a positive role in easing the structural changes that will be required of European nations in the years ahead.