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## Comment      Peter B. Kenen

I have no quarrel with the main message of this paper. Central banks due to participate in EMU will have no trouble fixing the bilateral exchange rates between their currencies at the close of foreign exchange trading on the last day before EMU. They can therefore meet the restrictive conditions imposed by the Maastricht treaty. The real-time gross settlement system (TARGET) due to come into being when EMU begins will allow them to finance unlimited intervention on the day before EMU begins. Flood and Garber rightly draw an analogy with the short-term credit arrangements available under the ERM of the European Monetary System, and the analogy can be carried further. The exchange rate regime prevailing in the first years of EMU, before the national currencies are replaced completely by the euro, can be viewed as a new version of the ERM. There

will be no exchange rate band; there will be no need to repay reserve credit obtained from other central banks; and there will be no ceiling on the volume of credit obtainable from those central banks. (There is no formal limit under the ERM, but the Bundesbank reserved the right to impose one unilaterally in the so-called Emminger letter.)

The paper, however, raises two questions: (1) Why should there be any doubt about the central banks' ability to intervene on a scale sufficient to meet the requirements of the treaty? (2) Might TARGET itself break down because its credit facilities are too liberal? I will take up both questions shortly, after raising two technical objections to the Flood-Garber paper. It is too kind to the European Monetary Institute (EMI). It is unkind to Maurice Obstfeld.

In descriptions of TARGET published by the EMI (e.g., EMI 1997), TARGET is described as a network of bilateral correspondent (interlinking) accounts connecting the participating central banks, and Flood and Garber borrow that terminology. But they also borrow an example from the EMI that is inconsistent with it.

Flood and Garber describe a transfer from a French bank to a German bank. It starts when the Banque de France debits the account held by the French bank at the Banque de France and ends when the Bundesbank credits the account held by the German bank at the Bundesbank. In the process, the Banque de France incurs an obligation to the Bundesbank, and it will be recorded, Flood and Garber tell us, "by incrementing the Bundesbank's bilateral correspondent . . . account at the Banque de France and reducing the Banque de France's correspondent account at the Bundesbank by the same amount."

But that cannot be right. It involves double counting. When the Banque de France credits the Bundesbank's correspondent account, the Bundesbank acquires a claim on the Banque de France, which should appear automatically on the books of the Bundesbank. When the Bundesbank debits the correspondent account of the Banque de France, the Bundesbank discharges a debt to the Banque de France, which should appear automatically on the books of the Banque de France. If both pairs of entries are made, then, the Bundesbank's net position vis-à-vis the Banque de France will change by *twice* the amount of the transfer between the French and German banks.<sup>1</sup>

The example provided by the EMI and borrowed by Flood and Garber would be quite right if TARGET were constructed differently—if each national central bank were to hold a single clearing account with the ECB. The transfer between the French and German banks would then be re-

1. In table 5.1 the entry "–100 Due to Banque de France" on the liability side of the Bundesbank's balance sheet should appear instead on the asset side as "100 Due from Banque de France."

corded by debiting the clearing account of the Banque de France and crediting the clearing account of the Bundesbank.<sup>2</sup> But the national central banks rejected this simple, sensible scheme because they sought to minimize the operational responsibilities of the ECB.

How are Flood and Garber unkind to Obstfeld? In the final section of their paper, they take issue with Obstfeld's finding that the variance of spot exchange rates will rise as the start of EMU approaches (Obstfeld 1997). They ascribe his result to his use of a model in which central banks target monetary aggregates rather than interest rates, and they go on to show that interest rate targeting can smooth the transition to EMU. They are quite right to say that the day-to-day conduct of monetary policy should be modeled as interest rate targeting, not money supply targeting, even for central banks that claim to adhere to a money supply target. But the difference in the modeling of monetary policy is not why exchange rates behave differently in the Obstfeld and Flood-Garber papers.

In Obstfeld's model, the variance of exchange rates rises because exchange rates float freely; central banks do not try to influence them by manipulating the nonstochastic component of the "fundamental" (i.e., the ratio of the monetary aggregates). In the Flood-Garber model, by contrast, there is a smooth transition to EMU because the central banks deliberately manipulate interest rates in order to regulate exchange rate behavior (i.e., they set  $\delta = \lambda = 0$  on the eve of EMU).

Returning to the larger questions posed at the start of these comments, let us see why Flood and Garber feel the need to explain how the existence of TARGET will solve the so-called endgame problem. Is there, in fact, a problem?

It arises, they say, because some central banks might refuse to intervene just before the beginning of EMU. Suppose, for example, that holders of French francs started to sell them for deutsche marks on the eve of EMU. The franc would depreciate vis-à-vis the mark, jeopardizing adherence to the requirements of the Maastricht treaty. Under an ordinary pegged rate regime, the Banque de France might not be able to keep the franc from depreciating because its reserves are too small. Under ERM arrangements, the Banque de France could borrow marks from the Bundesbank, but it would have to repay them, and it might not want to incur that sort of debt to the Bundesbank. But the Bundesbank can buy francs freely to stabilize the franc-mark rate because it can print unlimited quantities of marks. And if it is willing to do that, there can be no endgame problem.

But what if the Bundesbank declines to intervene because it is "lukewarm" about EMU? That is where TARGET comes to the rescue. Spot

2. As Flood and Garber note, that is how imbalances are cleared within the Federal Reserve system (but they are cleared at the end of each day, in a single net settlement, not on a real-time gross settlement basis, which is the principle on which TARGET will operate).

transactions in the foreign exchange market are settled with a two-day lag. Transactions undertaken on the last day before EMU will be settled two days later, after EMU has started and TARGET is up and running. Hence, the Banque de France—or any other central bank—can intervene on the scale required to keep the franc from depreciating. It can sell marks to the speculators and use TARGET to pay for them two days later. It will credit the euro-denominated interlinking account held by the Bundesbank at the Banque de France and instruct the Bundesbank to complete the transaction by crediting the euro-denominated accounts that German banks hold at the Bundesbank. The German banks will then credit the mark-denominated accounts of the speculators who bought marks from the Banque de France. In effect, the Bundesbank will automatically extend euro-denominated credit to the Banque de France in the amount needed for the Banque de France to defend the franc-mark exchange rate, and the credit need not be repaid.<sup>3</sup>

But is it realistic to assume that Bundesbank would try to sabotage EMU by refusing to defend the franc on the eve of EMU? If the Bundesbank is lukewarm about EMU, it will make its doubts known openly and earlier. It will not try to subvert EMU at the last minute. In short, the endgame problem is a nonproblem, and it does not need to be solved—not by using TARGET, as proposed by Flood and Garber, nor by using forward transactions, as proposed by Obstfeld (1997).

Nevertheless, Flood and Garber raise an important problem that has received little attention. The long-run viability of EMU will depend crucially on the willingness of the national central banks to build up big claims on their partners—claims that need not be repaid. That is what happened in my example, where the Bundesbank built up large claims on the Banque de France. It will also happen after EMU starts if holders of one country's currency fear that the country will defect from EMU and allow its currency to depreciate. It could even happen after the euro replaces the national currencies; holders of euro-denominated deposits at one country's banks would shift them to other countries' banks if the first country was expected to defect.<sup>4</sup> It could also happen if no country was

3. In the example given by Flood and Garber, the credit *is* repaid, because the speculative attack takes a different form—short sales of francs for marks. In that case, the speculators must acquire the francs they have already sold to the Banque de France, and they do that by converting their newly acquired marks back into francs. German banks then use TARGET to effect the conversion; they instruct the Bundesbank to credit the interlinking account of the Banque de France, which credits the euro-denominated accounts of French banks held with the Banque de France and instructs the French banks to credit the franc-denominated accounts of the speculators, giving them the francs they need to settle their foreign exchange transactions with the Banque de France. In the process, the Banque de France extends credit automatically to the Bundesbank and thus offsets its debt to the Bundesbank. I have used a different example, in which the speculators liquidate long positions in francs, to emphasize the open-ended nature of the credit lines available through TARGET.

4. Garber (1998) examines these possibilities.

expected to defect but one country ran a large, persistent current account deficit with a partner country and the deficit was not offset by private capital flows.

To the best of my knowledge, the EMI has not discussed this issue, not in its reports on TARGET nor in those on the conduct of monetary policy. Whenever I have raised the problem, moreover, I have encountered a certain ambivalence. Central bankers agree that the viability of EMU will depend on the willingness of the national central banks to build up unlimited claims on their partners. But some of them were clearly uncomfortable with that possibility. When I wrote my first monograph on EMU (Kenen 1992), I drew attention to the problem. Readers of the manuscript did not disagree with my warning that EMU could break down unless the national central banks were utterly indifferent to the size of their claims on their partners. But some of them wondered whether the Bundesbank would be indifferent to the size of its claims on the Banca d'Italia, and one of them distributed a paper recently arguing that EMU is more likely to break down if the ECB does not impose limits on the size of the claims that the national central banks as a group are obliged to accumulate on any single central bank or, more generally, on any euro-area country. He does not tell us, however, how "excess" claims should be paid down.

The treatment of imbalances within TARGET may be the most important piece of unfinished business for the ECB to tackle when, on 1 July 1998, it starts to adopt the formal rules under which it will operate.

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