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9th March, 1989

Monsieur Jacques Delors,
President,
Commission of the European Communities,
200, rue de la Loi,
B-1049 Brussels,
Belgium.

Dear President,

In the excellent new draft of our rapporteurs, circulated on 2nd March, two separate aspects worry me as sources of potential weakness and ultimate erosion of the impact of Part III of our Report. I have tried to formulate amendments on these points.

The first amendment relates to paras. 65 and 66 in Part III. The rapporteurs explain in the former the purpose of a European Reserve Fund (ERF). In the latter (para. 66) the text severely criticises an ERF as a viable proposal for the first stage. Since this is the only place in the Report where differences of view are strongly expressed, these two paragraphs are bound to attract much attention. There is a danger in my view that the discussion of pros and cons may undermine the proposed action for stage two where the essentials of the ERF proposal are taken up again (para. 69). Although that would not be reasonable, since (1) the Treaty will then have been ratified at the beginning of stage two, and (2) the proposed joint exchange market interventions would in the second stage be part of a wider strategy to develop gradually a joint monetary policy, readers - and before them no doubt several members of the Committee - will ask themselves why our Report in para. 66 dissociates itself so strongly from a proposal which is subsequently taken up for the following stage. It might be wise to tone down both the positive and the negative analysis on the ERF for the first stage and to make some explicit comments that this proposal - as well as Mr. Lamfalussy's on the pooling of operations, still to be discussed at our March meeting - had been deferred to stage two, since the first stage should in any case be seen as a rather brief span of time.

The second amendment relates to the proposed action for stage two, which is not insubstantial, but still less explicit than one might wish. The argument that early Treaty revision is essential is weakened, if the proposed action in stage two does not convey some sense of urgency and is justified primarily as a transition to stage three (para. 60). If there is an annex to Part III, the draft of which is about to be circulated by the rapporteurs, in which the more substantive discussion of how an increasingly joint monetary policy might be formulated and executed is to be concentrated, it would also seem justified to be more explicit in the main text on the main actions that could be envisaged than merely by a brief reference to the annex as in the present text. If, as in my view, stage two is not only a learning period, but also desirable in itself as a qualitative improvement over the pre-institutional stage one, the substance of stage two deserves more affirmative description. With this purpose - and hopefully without losing anything the rapporteurs have included in their text - I have tried to set down a substitute formulation of para. 69 to replace the text from "In addition,..." at the bottom of page 48. In making that draft I found it more logical to bring forward the reference to a possible narrowing of the bands of fluctuations to page 48 where it could replace the sentence at the end of the first section with the reference to the annex, since the latter is now referred to more fully in my proposed amendment.

Respectfully yours

Niels Thygesen

Niels Thygesen

Suggested Amendment to Part III, paras. 65-66.

<u>Replace whole of paras. 65-66 by</u>

(1) 65. "While the content of the first stage would already indicate a significant effort over a brief span of time towards more structured and intensified coordination of monetary policy, several members of the Committee have proposed innovations of an operational nature which would give more visible expression to a qualitative change in the nature of coordination. One possibility would be to pool part of their international reserves in a permanent way and manage them jointly through a <u>European Reserve Fund</u> (ERF) which would foreshadow the future European System of Central Banks. Another possibility would be to pool part of operations in foreign exchange markets and in domestic financial markets in a jointly owned subsidiary, whose facilities, notably a trading floor, they would share, but without any formal transfer of authority to a collective body.

(2) 66. These proposals share the virtue that they would (1) provide a training ground for implementing an increasingly joint policy, and (2) appear to financial markets to be a major concrete step, since the risk of conflicting signals from the separate actions of individual central banks would be minimized. They differ to the extent that pooling of operations could be based on an agreement between central banks, while permanent pooling of reserves in an ERF would involve an institutional change. They also differ in that the joint operational facilities could be shared by all Community central banks, while the element of collective management of international reserves through an ERF could only be open to participants in the EMS exchange rate agreement. In return, the set up of an ERF would be bound to give a stronger impetus to concerted management of exchange rates; it might also give a more credible sign that the the process towards economic and monetary union had been reinforced.

Since the first stage has to be seen as a brief span of time, the proposal of institutional changes or of potentially far-reaching operational innovations might overburden the agenda. Leaving these proposals as possible elements for stages two and three would in any case imply that they be discussed during the first stage as part of a comprehensive Treaty revision."

Suggested amendment to Part III, para. 69

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(i) p. 48, last three lines of first section:

Replace "Some possible schemes for coordinating monetary policies in the course of this stage are discussed in the Annex to the Report" by
"The margins of fluctuations within the ERM would be narrowed as move towards the final stage of the monetary union in which they could be reduced to zero."

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(ii) p. 48, third last line:

Replace "In addition,... until end of para. by:

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"In addition, a certain number of actions would be taken in stage two. They would be designed to give the new institution visible means of influencing the overall rate of money and credit expansion in the participating countries as well as the ability to conduct limited exchange market interventions against third currencies. They would also comprise the attribution of regulatory functions to the ESCB in the monetary and banking field in order to achieve minimum harmonization of provisions such as reserve requirements or payments arrangements that are necessary to the conduct of a common monetary policy.

Intermediate monetary objectives would be set for the Community as a whole, derived from the ultimate objective of medium-term price stability, and underpinned by objectives for national contributions to aggregate money creation and a presumption that participating central banks would refrain from offsetting the monetary consequences of interventions in other participating currencies.

Incentives for individual central banks to stay close to commonly agreed objectives would be provided through a mechanism which would sanction deviations. This could be done most directly and with the prospect of gradual evolution towards collective monetary control in stage three, by linking the money creation by each central bank to its ability to satisfy reserve requirements vis à vis the ESCB in analogy to one method by which national central banks exert influence on the rate of credit expansion of their banking system.

Various methods of applying such a system to the capacity of national central banks to create money are explored as illustrations in the annex. They all rest on the basic notion that the ESCB would be in a position to control fully the supply of the asset which the central banks have to hold to meet the reserve requirements. This asset could take the form of a unit, defined as the present ECU; it would be supplied by the ESCB in quantities matching the demand for reserves which would arise, if each country followed its collectively targeted rate of money or credit expansion. The interest rate on the reserve asset would reflect the degree of scarcity of required reserves which the ESCB wishes to produce. The system might subsequently be extended to apply to individual banks, but in stage two could be confined to the relationship between the ESCB and the central banks.

The advantage of attributing an instrument of this type to the ESCB is that it would give focus to the operational efforts of the new institution. It would introduce in a limited, but significant sphere, a hierarchy in the relations of the ESCB to the component central banks while respecting the autonomy of the latter in managing their respective short-term instruments to preserve interest differentials conducive to exchange market stability."