

COMMISSION DES COMMUNAUTÉS  
EUROPÉENNES

Direction générale  
des Affaires économiques  
et financières



COMMISSION OF THE EUROPEAN  
COMMUNITIES

Directorate-General  
for Economic and  
Financial Affairs

1989 II 28 16:20

TELECOPIE - TELEFAX

Bruxelles  
Brussels 28 février 1989

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NOMBRE DE  
NUMBER OF PAGES : ..... 6 (+1) .....

NUMEROS D'APPEL  
CALL NUMBERS 02/235.89.81  
02/235.65.04

INFORMATIONS : 02/235.56.68

Veillez transmettre d'urgence à MM. BAER et T. PADOA-SCHIOPPA

J.P. Mingasson  
(p.o. D. LERAT)



COMMISSION  
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Directorate-General  
for Economic and Financial Affairs  
The Director-General

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BY TELEFAX

Dear Günther and Tommaso,

Please find enclosed some suggested amendments to Part III along the lines I mentioned yesterday. Number 9 is in my view something like the minimum of what is necessary to link up with the annex.

I am of course disappointed that President Föhl vetoed the technical meeting on Thursday. Wolfgang Rieke called me to explain at some length and I have dinner with him and Professor Gleske to-night. I think the objection is strictly procedural. I hope we can discuss over the phone what to do.

Best regards,

*Niels*  
Niels

Dr. Günther BAER  
Monetary and Economic Department  
Bank for International Settlements  
Basel

**Suggested Amendments to Part III**

1. para. 39, p. 30, l. 5

... stroke. Households, firms, unions, public authorities and governments themselves would ... ✓

2. para. 42, p. 31, l. 9

... first step. It could coincide with the decisions to draw up a new Treaty, thus anticipating the entry into force of the Directive for full liberalization of capital movements on 1st July 1990. It might be envisaged that this first stage will be completed with the implementation of the single market at the end of 1992. ✓

3. para. 43, pp. 31 - 32

43. Indivisibility and gradualism. Gradual progress in a step by step approach should not produce ambiguity as to who - a national government or the Community, which organ or institution - is in charge of particular policy decisions and their execution. Such ambiguity creates a risk of policy conflict and market uncertainty. Whereas in the budgetary field policy functions can be, and are, shared between different levels of government in all constitutional systems, monetary authority is less easily divisible. }  
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Authority will not be divided once exchange rates have been irrevocably locked, because - as explained in Part II of the report - a common monetary policy will be required and will have to be formulated collectively in the framework of the European System of Central Banks. On the other hand, as long as national governments retain the use of realignments of their central rates, as in the present EMS and in the stages prior to the irrevocable locking, ultimate monetary responsibility rests in national banks, though that responsibility is in practice severely circumscribed by the need to obtain the agreement of partner countries to a realignment and by the need to manage the instruments of monetary policy in a cooperative rather than a competitive manner; the latter would be detrimental not only to the stability of the exchange-rate arrangements but also to the interests of the individual participating countries.

In the stages prior to the locking of exchange rates the challenge is to devise rules and procedures which assign the responsibility for some monetary instruments to a collective body while leaving that for others to individual governments (realignments) and central banks (management of short-term interest rates). The description of the pre-monetary union stages below and the annex to the report takes up some suggestions as to how this might be done.

4. para 45, p. 33, l. 4

is it possible for some countries to participate in (delete "to set up") arrangements ... ✓

5. para. 49, p. 34, l. 3

... union. According to this approach the ECU would cease to be defined as a basket of currencies; instead national currencies would be defined relative to the ECU, the value of which would be regulated by the issuing policy of a European central banking institution. The ECU as a parallel currency ... ?

6. para. 52, p. 35, l. 5

... Central banks. This (delete "the") ECU ...

7. para. 54, pp. 36 - 37, final indent to be replaced by :

- the creation of a joint think-tank for monetary analysis and recommendations would be conducive to some harmonization of the analytical framework, including the formulation of intermediate objectives, in the participating countries while retaining the responsibility for policy decisions in the individual central banks.

8. paras. 60 - 61, pp. 41 - 42

(This should in my view be condensed into one para. giving the pros and cons of what is strictly additional to what is already proposed for stage 1. The redraft might also include a reference to the Lamfalussy proposal which does not require Treaty change. I shall send Governor de Larosière a suggestion Monday when the present draft report has been received - with copy to you.)

9. para. 64, p. 44 replace from "In addition, ... by :

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 future 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 sterilizing 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 3, by linking the money creation by each central bank to its ability to satisfy compulsory 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 supply could take the form of a unit, defined as the present ECU, which the ESCB would issue in quantities matching the demand for reserve which would arise, if each country followed its collectively targeted rate of money or credit expansion. The interest rate on the reserve unit 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 2 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.

Finally, in the course of stage two the margins of these fluctuations in the exchange-rate arrangement could be narrowed in order to prepare for stage three in which they will by definition disappear.

10. para. 66 and 67, p. 45

There is an ambiguity in the formulation of the relative powers of the Council of Ministers : "to decide on exchange rate policy" and of the ESCB. Where is the autonomy of the ESCB - it has to be clarified.