Niels Thygesen 13th March 1989

Suggested amendments to Annex

Add in Part V, p. 13 after present para. 27:

28. In the variants of an operational framework for an integrated monetary policy described so far, the ESCB would not have any direct contact with commercial banks or with financial markets in general. Its sphere of operation would be confined to transactions with the second tier of the three-tier system, the national central banks. This would be unduly confining from the time during stage three when a common currency is introduced. To manage a common currency the ESCB would need to have direct transactions with commercial banks, as does any national central bank at present. To prepare for this during the earlier part of stage three, possibly already in stage two, it may be useful to explore in what ways the ESCB could be put into a position to have some direct influence on liquidity conditions without always relying on its ability through guidelines and incentives to exert its influence indirectly via the national central banks. In any case, since legislation enabling the ESCB to deal directly with financial markets in the final stage of economic and monetary union would also be part of a comprehensive Treaty revision, attention to the nature of such contacts is not premature.

29. One way to give the ESCB such influence would be to allow it to make open market operations in national markets. The ESCB might, for example, use the securities it has acquired from the national central banks for such open market transactions. One could impose, initially, limits on the total amount of purchases and sales which can be made within any given period. This would be especially important at the start, when the ESCB would mainly be purchasing securities, since its initial stock would be small. These limits could be raised over time, allowing in stage three the operations of the ESCB to become more important than those of the national central banks in their respective markets.

30. A different and complementary approach, more directly in extension of the reserve requirement system applied to national central banks, would be to introduce a uniform European <u>reserve requirement on commercial bank deposits</u>, or on increases thereof. A small fraction of such deposits would be held with the ESCB and denominated in ecu. A federal funds market, in which the ESCB as the only issuer would have strict control of the total supply, could then develop in which commercial banks would trade among themselves the reserve balances they need to satisfy the European reserve requirement. The approach would imply that the ESCB be given direct influence on a market which reflects system-wide liquidity conditions.

31. The approach could be implemented by giving the ESCB the authority to set, within limits set in its statutes, a compulsory reserve requirement on all deposits of Community residents with Community commercial banks. To give banks initial access to deposits with the ESCB, the latter could initially buy the appropriate amount of securities in the market; hence the system could be regarded as complementary to the idea outlined in para. 29 to permit the ESCB to undertake limited open market transactions in initial periods. The securities purchased could be denominated either in ecu or in national currencies, provided, if introduced in stage two, the proportions of the latter correspond to the weights in the ecu basket. Once the initial amount of reserves has been created and absorbed into required reserves, the ESCB could engage in additional marginal accommodation by supplying federal funds through modest discretionary open market operations. A tightening of the federal funds market would come about if required reserves were to run ahead of this process of supplying them, and a rise in the federal funds rate would induce banks to slow down the underlying deposit creation. The approach is compatible with the usual range of operating procedures for a central bank from interest rate to reserves targeting.

32. Different operating procedures would presumably be appropriate as the ESCB extends its authority from stage two to stage three and to the ultimate management of a single currency, but the basic mechanism would not have to be modified. In effect, the ESCB could, from its beginning, act in some respects as a true central bank, reinforcing its more indirect and orchestrating functions inherent in the way that the earlier proposals constrain it to being a bank for the central banks only.

33. Suggesting some form of reserve requirements as the major instrument for an emerging joint policy to influence the domestic sources of money creation - as a complement to the control over the external sources which a joint exchange rate and intervention policy vis-à-vis third currencies would provide - is bound to raise critical questions on the approach. Although reserve requirements have historically been the prime method by which central banks have achieved monetary control in most countries, reliance on that instrument may appear to be limited in the Community today. In most industrial countries the banking system has become indebted to the central bank to an extent that makes it dependent on the terms on which marginal accommodation of reserve needs is provided. The mechanisms suggested in the present section of this Annex illustrate ways in which an analogous influence may be brought to bear through a reserve requirement system on the relationship between the ESCB and the participating central banks (the three-tier system) and gradually extended to financial markets in general. A direct contact between the central institution and financial market would provide a smooth passage to the final stage when the ESCB is to manage a common currency.

VI. CONCLUSIONS

34. (Text of present para. 28.)