Confidential

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## Monetary policy co-operation in Stage Two

We have so far had little discussion - except in our tour de table on Governor Ciampi's note - on Stage Two, in general, and on its monetary policy component, in particular. The attached paper contains a proposal submitted to the Committee for organising monetary policy co-operation in a way which, in my view, could make a useful contribution to progress in such co-operation during that Stage.

This proposal is based on certain assumptions and premises concerning Stage Two:

- it is assumed that the Treaty is ratified and that the policy concertation carried out by the Committee of EEC Governors during Stage One has yielded results;

- in the monetary field, Stage Two is supposed to go beyond Stage One in three important respects: (a) at least the embryo of a federal central banking structure should be put in place; (b) while the final word on the conduct of monetary policy would remain with the monetary authorities of the member states, there should be a visible further strengthening in the co-ordination of national monetary policies; and, similarly, (c) while it would still be possible to alter intra-Community exchange rates, there should also be visible progress in co-ordinating intervention policy in the exchange markets;

- progress in these three areas should be such that it prepares the ground for stepping into Stage Three - i.e. the irrevocable locking of exchange rates and the full operation of a federal central banking system.

I can think a priori of three routes that could be followed, with these premises in mind, to enhance monetary policy co-operation during Stage Two. These three routes may be regarded as separate alternatives but could also be combined.

The first is the gradual but formal transfer of decision-making power from the monetary authorities of the member countries to the federal central banking system. This would seem to be the most logical procedure, but probably also the most difficult one to realise in practice: the "indivisibility" argument demonstrates the difficulties inherent in the gradual transfer of decision-making power; at the same time, there are wide differences among member countries as to who is responsible for monetary policy decisions.

The second alternative - exemplified by Governor Ciampi's proposal - would set up a formal system of federal monetary control. I see two advantages in this approach: firstly, it creates a framework which gives a measure of flexibility for handling the problem of power transfer (member countries would retain the freedom to choose their own monetary policy stance by changing their exchange rate vis-à-vis the ECU); secondly, the system could be operated in a way that gave it a conservative, anti-inflationary bias. The main problem is that the proposal provides for a monetary-base control technique which, if it is to be operated without too many problems in terms of collective decision-making, lacks the flexibility that, in my view, is much needed in today's innovative, highly mobile financial markets (for example, to respond speedily and effectively to exchange rate tensions both within the Community and vis-à-vis third currencies).

The attached note, drafted at my request and under my guidance by Mr. C.A.J.C. Butler, of the Monetary and Economic Department of the BIS, presents a third type of proposal, the essence of which is the centralisation of money and exchange market operations in a new, jointly owned institution without any transfer of authority to a collective body. The problem of the explicit transfer of authority is thus bypassed and no formalised system of federal monetary control is proposed. The centralisation of operations, however, (a) could have a powerful demonstration effect, (b) would provide a highly efficient training ground for, and a strong practical stimulus to, the implementation of joint monetary policy and exchange market intervention, and (c) would imply the setting up of an institutional framework that could evolve gradually towards a fully-fledged federal central banking system, as envisaged in Stage Three.

Whichever route, or whichever combination of routes, the Committee may want to favour, I believe that a distinct Stage Two is necessary if we want to fulfil our mandate (which talks specifically about practical steps - in the plural - towards an EMU) and that a report by a Committee in which central bank Governors form a majority cannot be credible unless it puts forward fairly specific technical proposals (even if only in a summary form) for monetary policy co-ordination at that Stage.

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