2nd March 1989
NT/uk

Thygesen
(not considered)

**Suggested Amendments to Part I**

para. 4, p. 4 to be replaced by :

4. Within the framework of the EMS a zone of increasing monetary stability has evolved gradually over the past decade. During an initial period the system had to concentrate on the containment of divergence, due both to large external disturbances and differences in the macroeconomic responses in the main participating countries. In this period the system did succeed in maintaining broadly stable competitive conditions among the participants. From 1983, as instability in international currency markets persisted, a more rigid adherence to stable nominal exchange rates in the EMS greatly helped a number of participating countries to gear their monetary policy increasingly towards the objective of a high degree of price stability. In this latter phase, now lasting for more than six years, the EMS has become a zone of monetary stability in the double sense that seemed unrealistic at its inception, providing both exchange rate stability and convergence of inflation rates at a level not observed since the 1960s. Significantly, convergence has been achieved without undermining the efforts of the least inflationary members to reduce their inflation rates of the early 1980s substantially.

In the light of these achievements those participants who had in the initial phase relied on capital controls as part of their monetary defenses have found it possible to accept Community decisions to liberalize capital movements fully by mid-1990, in some cases end-1992. The process of liberalization has not so far been upsetting to the stability of the EMS despite the major increase in the scope for capital movements with which the participating central banks may be faced in managing their respective monetary instruments. The major explanation is that the EMS has been managed in a flexible and cooperative way, revising its mechanism as the need arose, in particular through the Basle-Nyborg Agreements of 1987.

4A. The record of monetary cooperation is - apart from the failure to make EMS-membership attractive to all Community states - sufficiently positive to ask whether it is possible to improve, through an explicitly designed step-by-step approach the economic and monetary union, on the system's own momentum towards closer coordination and integration. There are grounds for believing that this momentum may not prove sustainable.

- First, conflicts between participants in particular situations have arisen in the past, as policy-makers have argued publicly over who should adjust their national policy instruments relative to those of others. Such incipient crises, and the tensions in exchange and other financial markets to which they lead, are difficult to check in a system where monetary authority is effectively divided between the participating national policy-makers while monetary one policy is becoming increasingly necessary.

- Second, the implicit premise on which the EMS has functioned, viz. that participants could concern themselves primarily with the position of their currency or their interest rates relative to the main currency of the system, leaving the overall thrust of monetary policy to be determined implicitly by policy in the least inflationary country, may not continue to be realistic. As capital mobility increases further, financial markets develop strongly in several countries, and currency substitution develops, the ability of the Bundesbank to keep its chosen monetary aggregate close to targets, hence providing a nominal anchor for the price levels of the participants, is becoming gradually impaired. Efforts at correcting monetary divergence within one national framework would then become destabilizing rather than, as in the past experience, on average stabilizing.

- Third, if an objective of medium-term price stability is as generally accepted across participating countries and within them, the low-inflation credibility which the EMS has derived from the perceived design of German monetary policy could be transferred to a Community monetary institution, operating under that explicit mandate, with some gain in efficiency.

On balance, an extrapolation of past EMS experience could not be relied upon with confidence to overcome the problems and to achieve the potential of monetary integration.