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**To:**  
M. Jean-Paul Redouin  
Directeur Adjoint  
Direction des Changes  
Banque de France  
Paris

Telefax No.: (0033) 1 42 96 04 23

**From:**  
Gunter D. Baer  
Assistant Manager  
Monetary and Economic Department

**Ref./Comments:**

If this transmission is not complete, please advise us at your earliest convenience.

TRANSMITTED BY:  
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B.I.S., Basle/Switzerland  
Code and Registry  
Telefax number: 61 23 85 07  
Telex number: 962487  
Telephone number: 61 20 85 12

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Dear Jean-Paul,

Please find attached a copy of the English text of Governor de Larosière's paper on the European Reserve Fund with hand-written suggestions for language changes proposed by our translators. I would suggest that you clear these changes - possibly with the Governor himself - and let me know early next week which ones we should incorporate in the final text.

With best regards,

Yours sincerely,

Gunter D. Baer

FIRST STAGES TOWARDS THE CREATION OF A EUROPEAN RESERVE BANKThe creation of a European Reserve Fund

Obviously, the economic and monetary construction of Europe will not be achieved in a single stage, although much has been secured already. This construction calls for a pragmatic approach, centred around the gradual fulfilment of the final objective ultimately chosen.

The purpose of this note is to sketch out some ideas on the nature and pace of possible initial steps that could lead ultimately to Economic and Monetary Union.

To ~~come~~<sup>pass</sup> through the different phases, monetary authorities will need a clear vision:

- not only of the medium-term direction <sup>in</sup> towards which they should be channelling their initiatives in the monetary sphere;
- but also of the <sup>day-to-day</sup> daily implementation of the policies they are responsible for framing and co-ordinating.

With a view to giving more practical and more visible form to their co-operation on exchange rate and interest rate management, the gradual construction of a permanent body <sup>for joint action and deliberation</sup> ~~to act and reflect together~~ would be a highly significant step forward. There would be three advantages to this:

- it would demonstrate politically, and to the markets, the <sup>governments'</sup> determination ~~of the governments~~ to progress more actively towards Economic and Monetary Union;
- it would rapidly create effective means, on the eve of the opening of the single European market and in a spirit of co-operation with the other currency zones, to ensure with more efficiency the smooth functioning of the markets;
- it would enhance the efficiency of central banks' monetary management <sup>domestic</sup> both <sup>at</sup> internal and European levels.

European Reserve Fund (ERF)

The ~~ERF~~ would be built up progressively. Its powers would depend on progress towards the construction of Europe and on the responsibilities

that the Member States would be prepared to devolve upon it. Its immediate creation - <sup>as a</sup> first step towards a European Reserve Bank - would <sup>establish</sup> produce a <sup>nucleus</sup> ~~hard-core~~ around which more ambitious functions could gradually <sup>be assembled</sup> aggregate, the final stage being the realisation of an Economic and Monetary Union.

I. THE SPIRIT OF THE PROPOSAL TO CREATE A EUROPEAN RESERVE FUND

The proposal is inspired by four <sup>guiding</sup> leading ideas.

1. Initiating a training ~~ground~~ process *is*

The creation of a European Reserve Fund aims at promoting <sup>joint</sup> ~~common~~ <sup>deliberation and a common</sup> reflection and approach with regard to monetary issues in a framework which would allow permanent information exchanges, regular comparison between analyses and <sup>a closer</sup> ~~deeper~~ knowledge of short-term economic developments and <sup>of the</sup> policies implemented in individual countries.

The target is to initiate a training ~~ground~~ process allowing *is* individual member countries to improve not only the co-ordination of their monetary policies but also the management of the increasingly growing interaction between exchange rate and monetary policies.

2. Strengthening the impact of intervention policies in the foreign exchange markets as designed within the Group of Seven

*is* The aim of intervention <sup>undertaken by</sup> ~~that~~ the European Reserve Fund ~~would be~~ ~~led to make~~ will be to underline as far as possible and considered useful central banks' will to act on a co-ordinated basis within the EC framework.

In its implementation, intervention by the European Reserve Fund would, in a first phase, strengthen the impact of operations agreed in common by central banks, without necessarily increasing their volume. Such intervention would thus have no additional effect, either directly or indirectly, on <sup>the domestic</sup> ~~internal~~ monetary policies of Member States. <sup>Indeed,</sup> ~~As a matter of fact,~~ it could be agreed that the E/R/F's intervention should only take place after unanimous agreement has been reached between <sup>member</sup> ~~central banks~~ <sup>of</sup> ~~member countries~~.

3. Creating a permanent think-tank on monetary analysis

In order to continue to play its strategic role in the construction of Europe, monetary policy must <sup>have the support of</sup> ~~rely on~~ a common think-tank on monetary developments. In this area, the current framework of co-operation may be

further improved, not as a substitute for national decision-taking, but in order to harmonise, in a first phase, concepts, analyses <sup>and</sup> ~~as well as~~ instruments available for monetary policy.

Obviously, decisions are not to be reached at the level of the experts in charge of such <sup>a</sup> surveillance. Policy choices in this area will still be made by individual <sup>c</sup> Central <sup>b</sup> Banks, but, prior and parallel to these decisions, analyses and recommendations will be made in common. This phase is therefore of <sup>a</sup> major significance in order to promote a consistent analysis of monetary developments and to <sup>reaffirm vis-a-vis</sup> ~~reassert~~ to the markets the <sup>highest</sup> priority given to the common objective of price stability.

4. Increasing the role of the Committee of Governors

With such <sup>a goal in mind</sup> ~~views~~, the role of the Committee of Governors will have to be strengthened. However, in order to ensure that <sup>the</sup> Governors do not limit themselves to exchange <sup>ing</sup> ~~views~~, but can <sup>enter into</sup> ~~open~~ discussions which might result in recommendations, <sup>the</sup> regular <sup>a</sup> ~~advice~~s of their experts will have to be made available to them, not only <sup>on</sup> ~~with regard~~ specifically ~~to~~ monetary issues, but also, <sup>is</sup> ~~as~~ <sup>the case</sup> ~~already arranged~~ each month for the foreign exchange market, <sup>on</sup> ~~with regard to~~ any matter influencing monetary policy implementation, including short-term economic developments.

It is thus in this spirit that my proposal calls for the creation of an institutional embryo, i.e. the European Reserve Fund, which has the advantage of gathering within a permanent framework monetary and foreign exchange policy experts <sup>from</sup> ~~of~~ participating central banks in order to make available to the Governors regular and global assessments of monetary developments. This is <sup>a</sup> ~~one~~ major aspect of the proposal, as it is indeed necessary, from the initial phase of the process, to create between central banks a common ~~thinking~~ <sup>for deliberation</sup> framework which goes beyond the continuation or even a deepening of co-operation between central banks.

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\* \*

II. FUNCTIONS AND STRUCTURE OF THE EUROPEAN RESERVE FUND

This Fund could be built up <sup>e</sup> ~~according to~~ <sup>on</sup> the following <sup>basis</sup> ~~scheme~~:

- A. <sup>i</sup> It would <sup>be given</sup> ~~receive~~ certain functions in the foreign exchange and ~~X~~ <sup>is</sup> the monetary sphere;
- B. <sup>i</sup> Its organisation would foreshadow the structure of a European Reserve Bank;
- C. <sup>i</sup> It would have to fulfil certain legal and institutional conditions.

A. The functions of the ERF

In an international monetary system in which <sup>the</sup> main reserve currencies are floating, markets are worldwide and capital moves freely, close co-operation is required among central banks responsible for keeping their currency <sup>ies</sup> within fluctuation margins. Central banks would significantly enhance the impact of their foreign exchange interventions if, under certain circumstances, they were to decide not only to consult among themselves, but also to act through the agency of a common body. Operations conducted through the ERF would have the advantage of reinforcing the effect of central bank action while permanently focusing attention on visible progress towards the construction of a European monetary union.

The ERF's functions would include:

- 1. intervening in the foreign exchange market;
- 2. ultimately taking over the powers of the EMCF;
- 3. progressively setting up a body to exercise surveillance over monetary and interest rate trends;
- 4. preparing <sup>for the</sup> harmonisation of national money markets <sup>with a view</sup> ~~in order to~~ <sup>the institution</sup> ~~put into place~~, in successive stages, ~~the institution~~ of a <sup>is</sup> European Reserve Bank.

1. Intervention in the foreign exchange market

(a) Areas of intervention

In the first place, <sup>the focus would be on</sup> ~~this would concern~~ interventions in third currencies which would be agreed in common by members, thus preventing any operation from hindering the domestic policy followed by any given country.

The role of the ERF would be to intervene directly in the markets, thus embodying the cohesion of the monetary authorities in pursuing a

common policy towards third currencies. It is here that the role of the ERF would be most directly perceptible and would illustrate the tripolar structure of the international monetary system: the United States, Japan and Europe. This role would of course be exercised in line with the broad thrust of ~~the~~ <sup>policy</sup> orientations.

Secondly, the ERF could intervene in Community currencies - with the agreement of the central banks concerned - either intramarginally or at the limits, in order to supplement individual action by central banks when strains appear in the system and require visible affirmation of solidarity.

Obviously, in a first phase, the ERF's role with regard to intervention would be a complementary one, while there would continue to be concerted intervention by the different central banks. But the ERF would have the advantage of ensuring close co-ordination between the individual actions of the central banks and the overall policy of participants in the Fund.

In a second phase - to be agreed upon unanimously - the shareholding central banks could decide to hand over to the ERF the power to undertake certain operations on its own initiative in compliance with the guidelines set by the Governors on the Board of Directors.

(b) Means of intervention

In order to play the role assigned to it in the foreign exchange markets, the ERF would require sufficient currency reserves to enable it to assert vis-à-vis the markets its capacity for intervening. These reserves would consist of:

- an initial endowment, which would be independent of current contributions in gold and dollars to the EMCF and would represent, for example, initially 10% of the gold holdings and 10% of the foreign currency holdings of each of the central banks participating in the European <sup>e/</sup> Exchange <sup>r</sup> Rate <sup>m</sup> Mechanism. The currency stock would be ~~paid~~ <sup>made over</sup> in dollars; there would be an additional contribution by participants in their national currency, based on a formula to be defined. This endowment would be made <sup>on a permanent basis</sup> ~~definitively~~ (and not in the form of renewable swaps as is the case with the EMCF);
- additional resources in the form of swap lines with the Federal Reserve Bank and, possibly, with the Bank of Japan.

foreign currency component?

permanent

As a counterpart to their ~~final~~ contributions, central banks would receive shares. The question arises whether <sup>the</sup> contributions of individual central banks should be periodically readjusted.

There are two possible approaches:

- on the one hand, ~~it could be considered~~ as is the case with the EMCF, ~~to maintain~~ a fixed ~~relation in~~ percentage <sup>ratio could be maintained</sup> between the amount of reserves held by the shareholding central banks and their contributions to the ERF. Such a solution <sup>permanent nature</sup> which calls in question the ~~final character~~ <sup>the</sup> of initial contributions <sup>would</sup> ~~turns out~~ to be rather complex; <sup>in practice</sup>
- on the other hand, it could be decided not to establish an automatic link between the volume of <sup>the</sup> ERF's assets and the amount of reserves held by its shareholders. The <sup>permanent nature</sup> ~~final character~~ of the contributions would be confirmed by the decision to <sup>forgo</sup> ~~renounce~~ any periodical readjustment; <sup>moreover,</sup> ~~as it is,~~ the relatively low level set in the proposal for shareholders' initial contributions should prevent any central bank from <sup>pointing to</sup> ~~putting forward~~ a decrease in its reserves <sup>as grounds for</sup> ~~in order to~~ reduce <sup>ing</sup> its contribution to the ERF and ~~to~~ strengthen <sup>ing</sup> its own means of intervention.

(c) Management of reserves

The ERF would manage these reserves itself, thereby further reinforcing - including in the view of the markets - the degree of co-operation between central banks.

2. Subsequent taking over of the powers of the EMCF

In working towards greater exchange rate policy co-ordination among the members of the EMS, and for reasons of simplicity, the body responsible for carrying out interventions probably ought not to remain permanently separate from the one responsible within the Community for managing the holdings of <sup>official ECUs</sup> ~~public Ecus~~ and the Community credit mechanisms.

Consequently, it would be appropriate to give immediate acknowledgement to the intention that the ERF should ultimately assume the powers of the EMCF once all the EEC's central banks have joined the European Reserve Fund.

3. Monetary surveillance

Alongside the creation of a foreign exchange department, the ERF would set up a monetary policy department responsible for:

- analysing in particular interest rate trends, monetary aggregates and domestic demand;
- thereby underpinning from both a conceptual and a Community point of view the concerted management of exchange rates and the co-ordination of monetary policies among the different participating central banks.

This phase could go hand in hand with the creation of a monetary policy co-ordinating <sup>ion</sup> committee, which would define common surveillance instruments, propose harmonised objectives, and ~~would~~ progressively graduate <sup>is</sup> from ~~an~~ ex post analysis to an ex ante approach to monetary policy adjustment.

In a second phase, one could envisage vesting in the ERF powers to act in support of central banks' actions in their respective money markets, by ~~engaging itself in~~ <sup>underraking</sup> swap operations for limited amounts, with commercial banks. Such supporting action would in any case be marginal, but pending more structured action (cf. para. 4 below) it could be a first step towards operational functions in the monetary field.

4. Harmonisation of national money markets

A third phase would ~~occur~~ <sup>begin</sup> once harmonisation of the fundamentals of monetary and exchange rate policies ~~would be~~ <sup>was</sup> practically completed and co-ordination of domestic demand adjustment (in fiscal terms notably) ~~would be~~ <sup>constructively</sup> an accomplished fact. It would then be possible to work <sup>profitably</sup> towards harmonising the instruments and policies of intervention in national money markets.

<sup>Throughout</sup> ~~All along~~ these different stages, the ERF would be ~~assigned to~~ <sup>responsible for</sup> ~~preparing the coming of a common currency.~~ <sup>ing the way for the advent</sup> In this regard, effective progress in the development of the ECU - without prejudging its future definition and issuing process - should be secured alongside the process leading to the ultimate phase of ~~the~~ Economic and Monetary Union.

B. Organisational arrangements

The structure of the European Reserve Fund should clearly reflect the conditions prevailing at the time of its creation, in other words it should be sufficiently:

- flexible, so as to adapt to changes in its powers and to the gradual adhesion of all the members of the ~~EC~~ <sup>EC</sup> to its operational function; *NS*
- ambitious, so as to foreshadow the broad outlines of a future European Reserve Bank.

Its officials should also be assured of the continuity they need in order to operate effectively.

The organisation of the ERF would be based on a collegiate and consensus principle, guaranteeing that its operations are coherent with those that the central banks will continue to perform individually, which implies <sup>in particular</sup> ~~notably~~ active participation in all the concertations. *NS*  
*NS* <sup>se</sup> The few ~~above~~ principles are not intended to <sup>give an exhaustive definition</sup> ~~define~~ the ERF's <sup>of</sup> operating ~~procedures in full~~, which should be <sup>the subject of</sup> ~~dealt with by~~ appropriate discussions.

1. Eligibility

*NS* All the ~~EC~~ <sup>EC</sup> central banks would be eligible to join the ERF. However, membership would be subject to:

- the pooling of a portion of their reserves;
- participation in the exchange rate mechanism, the reason being that the EMS implies specific constraints on monetary policy and foreign exchange interventions, both of which require a common approach of the central banks concerned.

2. Management

Foreshadowing the future organisation of a European Reserve Bank <sup>1</sup> the management of the ERF would consist of:

(a) **A Board of Directors:** this would comprise, ex officio, the Governors of each central bank participating in the ERF. The Chairmanship would rotate, every two years for example, among each of its members. The Board of Directors would decide on the organisation and administration of

the ERF, would approve the accounts and decide on the appropriation of ~~results~~ *profits*.

The ERF's operating income would ~~result~~ *derive* from the investment of exchange reserves. The ERF's income statement would take the operating costs of the Fund into account and the net income - possibly after allowing for provisions - would be allocated among shareholders in proportion to their contributions.

(b) **An Executive Committee**

Owing to the specific nature of its powers and to the role that it would eventually play directly in the markets, the ERF would have a permanent Executive Committee whose members would be selected by the Committee of Governors on the basis of competence.

This Executive Committee would be ~~of a~~ *in* small *is* size, consisting of three or four members who would have direct responsibility for the different departments of the ERF.

(c) **Two committees** would be given the task of supervising the *foreign exchange* ~~currency~~ and monetary policy spheres. These organs, inspired by the "US Federal Open Market Committee", would report regularly to the Committee of Governors and, in the framework of a more active "monitoring", would recommend appropriate action.

The members of these two committees (a Foreign Exchange Committee and a Monetary Policy Committee) would be appointed by the Committee of Governors from among its own members and those of the Executive Committee of the ERF, with the possibility of co-opting one or two outside personalities. Their term of office should be long enough to ensure continuity of action (five years minimum).

3. Internal organisation

Initially, the ERF would comprise a Foreign Exchange and Reserves Management Department and a Monetary Policy Department, which would both require a permanent staff.

Subsequently, its structure would be modified in order to incorporate the powers of the EMCF or other functions, when decided by the monetary authorities.

4. Location

The question of where to locate the ERF is obviously a difficult one and should be treated as a political matter. Before reaching a decision, it might be worth considering entrusting the management of the ERF to each of its members in turn. However, this kind of organisation would diminish the public impact of the Fund and would encounter very serious operational obstacles.

Another solution, initially, could be to locate the ERF temporarily in Basle, where the Secretariat of the Committee of Governors and the EMCF are already located.

C. Legal <sup>requirements</sup> ~~conditions~~ for the creation of a European Reserve Fund

It appears, at first sight, as if the legal foundation of the institution of a European Reserve Fund would have to be the provisions of Article 102 A of the EEC's founding Treaty, which were introduced by the Single European Act in July 1987. This is because the creation of a new organisation with monetary purposes - and its corollary, the abolition of the European Monetary Co-operation Fund (EMCF) - may be regarded as "institutional modifications" and therefore require, according to aforementioned Article 102 A, the Treaty review procedure provided for under Article 236.

The procedure in question would entail, in addition to consultation of the European Parliament and the Commission:

- the calling of a conference of representatives of the Governments of Member States, whose decisions are taken "by common agreement";
- ratification of the proposed amendments by all Member States "in keeping with their respective constitutional rules". In principle, this provision implies - although there is no explicit mention of this point in Article 236 - approval of the aforementioned amendments by the national Parliaments.\*

Presumably it would be desirable to secure Parliamentary ratification of a document that would lay the legal foundations for carrying the process

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\* The Article 236 procedure was used in 1986 for the adoption of the Single European Act.

of monetary integration through to its conclusion. In other words, the document should provide not only for the initial steps sketched out in this note, but also for the subsequent stages leading to Economic and Monetary Union and to a European Reserve Bank. It would be made clear that each stage would require the prior consent of the Member States.

concern One of the important questions that <sup>w</sup> should <sup>have to</sup> be dealt with <sup>would</sup> ~~will~~ refer to the relationships between the European Reserve Bank and the political authorities in charge of <sup>setting</sup> ~~the definition of~~ the exchange parities and <sup>framing</sup> <sup>lines</sup> the main <sup>orientations</sup> of the economic policy of the Community. In this <sup>respect</sup> <sup>it would seem that</sup> ~~regard,~~ the role of the Council of Ministers <sup>ers</sup> <sup>would</sup> ~~appears to~~ have to be <sup>decisive.</sup> ~~determining.~~