Consideration of Some Problems Arising in the Transition to the Third Stage of European Monetary Union

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1. Problems created by the third stage of Monetary Union

Now that the first deadline for the initiation of the third stage in the Maastricht process for European Monetary Union has passed, it is becoming increasingly clear that only a minority of the members of the EU are likely to meet the convergence conditions at the final deadline which is set for the middle of 1998. This has produced suggestions that the deadline might be delayed, or that the conditions might be changed. However, the former solution would require an amendment to the Treaty. While this is a possible solution, it would open up so many other issues that it is likely to be resisted. As a result, some have suggested that delay might be possible due to ambiguity in the drafting of the original Treaty. There are thus two responses to the small number of countries which might qualify for the third stage, either to postpone or to change the entry conditions. The next two sections deal with these two possibilities by reference to official sources. The following Section 4 raises a question which does not seem to have been foreseen in official documents or discussion, but which is of fundamental importance to the operation of the third stage.

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2. Postponing the third stage

Proposals to postpone implementation of the third stage appear to ignore the very specific language of the Treaty and in particular the "third stage transition" protocol. This protocol states unequivocally that, independently of any economic conditions, the Community will enter the third stage without exception on 1 January 1999 and that the European Central Bank and European System of Central Banks will "start their full functioning from this date". This would appear to mean that, irrespective of the number of countries which qualify for the third stage by 1 July 1998, the "countries concerned", (which must be interpreted as Eurospeak for those countries that have been judged to have satisfied the convergence conditions) are obliged to proceed to stage three and to render the European monetary institutions operative.

The protocols specify exceptions for countries with a "derogation", such as exemption from subscription to the capital of the ECB, and so forth. It is the possibility of countries with a "derogation" that makes necessary Article 44 of the statute of the ECB which requires it to "take over those tasks of the EMI which ... still have to be performed in the third stage" for those countries which have not met the convergence conditions. Thus, while the EMI will cease to exist, certain of its functions and institutions will live on under the tutelage of the ECB.

The "derogation" of member states for entry into the third stage arises as the result of their failure to meet the conditions specified for the introduction of the single currency only when the date for the introduction of the single European currency has been "decided". It is not clear if the same conditions apply when the date of entry is not decided, but rather imposed via Article 109j(4) and the "third stage protocol" which specify that "If by the end of 1997 the date for the beginning of the third stage has not been set, the third stage shall start on 1 January 1999" with those countries that meet conditions necessary for the creation of a single money.[1]

This also implies that from that date the functions of the EMI with respect to the countries with derogation will be taken over by the ECB. Since the tasks set out for the EMI are to monitor the

[1] It is this language which suggests the possibility that a date might be agreed *before* the end of 1997 for the third stage to start after 1 January 1999. It also seems clear that this was not the intention of the Treaty.

functioning of the European Monetary System (and the associated Exchange Rate Mechanism), as well as the development of the ecu and the ecu clearing system, it seems plausible that the ECB will be responsible for overseeing both the new single currency, the euro-eco, which will become "a currency in its own right" and the old EMS-ecu, which will remain a notional basket currency for purposes of the operation of the ERM of the EMS.

It is interesting to note that despite the insistence that the Maastricht Treaty cannot be changed or amended, the decision to drop the "ecu" in favour of the "euro" as the name for the single currency unit, for example, requires rewriting the Treaty itself, as well as the responsibilities of the EMI laid down in the protocol to the Treaty, which include preparation of "ECU banknotes", and the responsibilities of the ECB, which is required to introduce them.

A close reading of the Treaty thus suggests that the ERM of the EMS will remain in existence after the beginning of the third stage for those countries with derogation. Since the ecu has been replaced by the euro in the Treaty, one must suppose that the intention of the drafters of the Treaty were that the ERM of the rump EMS should remain in operation as a system of adjustable bilateral and ecu parities with the ecu suitably redefined to allow the euro-eco to replace the presence of the individual currencies of the countries which do proceed to the third stage.

There is no reason to believe that this should create any formal difficulties for those countries with a third stage derogation. It does, however, make clear that there will be a *de facto* policy of concentric circles, at least as far as currency matters are concerned, with the euro-ecu forming the core of the basket ecu which will remain in function as part of the ERM of the EMS for countries in derogation. One might want to think of the euro-eco playing a role similar to that of the DM in the current system. For example, Article 109 dealing with currency relations with non-community countries, also speaks of the Council being able to "adopt, adjust or abandon" the central ecu rates, which might also be interpreted as applying to community countries with derogation. Articles 109k(2) and 109l(5) provide for the reconsideration of the position of derogation countries at least every two years and the procedure for removal of derogation and the introduction of the (euro)-ecu in that country. Since one of the conditions for the revocation of a derogation is to have maintained the exchange rate within its EMS parity and not to have devalued, this also suggests

that the ERM of the EMS was presumed to have a life after the third stage for countries with derogation.

There is one difficulty, however, with the arrangement of concentric circles of monetary regimes. Since the ECB will take over control of all the financing and support mechanisms of the EMS, it is not clear what this will imply for the intervention obligations of the ERM members' central banks. Under the conditions of the second stage, the EMI has taken over the control of the European Monetary Cooperation Fund, and is responsible for the associated short and medium-term financing in relation to exchange rate interventions. When the ECB inherits the functions of the EMI, it must be presumed that this task will also pass to the ECB. This means that the ECB should also inherit the exchange stabilisation obligations of the individual country central banks, for example the requirement to intervene to support a weak currency when it reaches its bilateral limit relative to the euro-ecu. It should also be presumed to adjust interest rates when the euro-ecu reaches an intervention threshold against the currency of a country with a derogation which is still participating in the ERM of the EMS. Since the day to day operations of the ECB will be carried out by the ESCB, composed of the individual national central banks, one or more national banks must be delegated this exchange stabilisation responsibility.

There seems to be little question that the Treaty makes provision for these exchange stabilisation functions of the ERM of the EMS to continue after the introduction of the euro-ecu and that the ECB will be responsible for them, but there is no clear specification of how the ECB should satisfy this function. Nor is it clear what instruments the ECB will have available for this purpose. There is a clear potential conflict with the requirements of the ECB to follow a policy of price stability and the requirements of exchange rate stability if the ECB has to intervene to support the currencies of countries with a derogation, for this means that the ECB sacrifices control of the money supply in euro-ecu to control of the exchange rate. The same conflict which plagued the Bundesbank under the old EMS would simply re-emerge for the ECB. On the other hand, if the defence of EMS parities were left to the countries with derogation, this would contravene the propositions of the Treaty which clearly specifies that exchange rate policy remains a common EU concern for all countries, irrespective of whether they qualify for the third stage. It would also

put an exceptional burden on the central banks and economic policy of countries with derogation, making it even more difficult to satisfy the convergence criteria. There would be little incentive for a central bank to intervene unilaterally to defend its ecu parity, thereby losing reserves.

Whether the ERM of the EMS can continue among the countries with derogation is unclear. It does seem probable that this might generate an increase in the instability of the exchange rates of the currencies of those countries with derogation participating in ERM relative to the euro-ecu within the 15% fluctuation limits. It also suggests that a narrowing of the bands is highly unlikely. Given that a number of countries, such as France, have objected to the competitive advantages gained by countries who have left the EMS, such as Italy and the UK, there should be some interest in finding a way to resolve this problem without compromising the Statutes of the ECB. The solution, however, is not obvious, unless it comes in terms of the use of regional adjustment funds. If it is not resolved it may create a two-tier system, in which the second tier becomes a permanent float against the euro-ecu and thus little different from non-community third countries.

3. Changing the convergence criteria

The second alternative that has been proposed is to change the convergence conditions for entry into the third stage. In particular, in the light of economic data which suggest that neither France nor Germany will meet the deficit limits of 3% of GDP as a result of a slowdown in European growth rates, there have been proposals to reinterpret the deficit conditions as applying to structural deficits. This is an indication of the difficulties created by the convergence conditions, for the weak growth in Europe is in part the result of governments attempting to reduce levels of outstanding indebtedness by operating their budgets with structural surpluses. It also shows the way the conditions constrain monetary policy, for higher interest rates automatically increase the interest burden on the outstanding debt and thus require even larger budget surpluses. This creates strong pressures for the use of monetary policy to be tempered.

However, all of this seems to miss the main point of the specification of the convergence conditions. The interpretation of the convergence criteria for the passage to the third stage of the process of European Monetary Integration has been varied and diverse. It has been pointed out that they have no firm basis in any economic theory or practice. Indeed, some have viewed them as a conscious plot by the German central bank to defeat European integration, while others have pointed out that active policies to achieve them may be self-defeating. All of this against the background of the Maastricht protocols which state that irrespective of how many countries satisfy the criteria, the third stage will commence on 1 January 1999.

Many of the discussions of the convergence criteria separate the creation of community institutions, such as the European Central Bank and the European System of Central Banks, from the convergence conditions. This suggests that many commentators have not really grasped the reasons why the convergence criteria were set out. There appear to be two. The first, which emerges quite clearly from the Treaty, is that if there is to be any possibility of a uniform economic policy for the EU, decided and implemented by EU institutions, there must be a certain uniformity in the economic performance of the member states.

For example, the Maastricht Treaty inserts Article 3a into the original Treaty, specifying "the adoption of an economic policy which is based on the close coordination of Member States' economic policies ... and the definition and conduct of a single monetary policy and exchange rate policy the primary objective of both of which shall be to maintain price stability".

Convergence is thus first, and foremost a *sine qua non* for the operation of a EU economic policy. This does not mean absolute uniformity in performance, but a broad similarity of economic conditions. In a fully integrated single market it would be impossible to conceive of a monetary policy which could deal with price stability in Germany and 10% inflation in Italy. Neither would it be possible to allow independent policies by the individual countries. Thus, on a very practical level, if there is to be EU economic policy, under the responsibility of EU institutions, there must be some degree of convergence.

The second point is related to the institutions which are to carry out Community policies. In particular, the very existence of the European Monetary Institute as a transition institution represents the

German belief in the inseparability of the conditions for the existence of monetary union and the conditions for the successful operation of the European Central Bank in carrying out a monetary policy which may be evaluated and operated for the EU as a whole.

Since it is widely recognised that the ECB is more or less directly patterned after the Bundesbank, and that the Germans argued that it would be detrimental to the success of the ECB if it were to operate in inappropriate conditions, it is clear that the convergence conditions should be read as a summary of the conditions which are believed to be required for the successful completion of the task of the ECB of providing monetary stability, independently of government intervention.

During the recent difficulties that the Bundesbank has experienced in co-ordinating fiscal and monetary policy during the process of unification of the two Germanies, it has made it increasingly clear that it considers a primary prerequisite for the success of its monetary stability policy to be the existence of what it calls a "stability culture" in the economy. For example, Otmar Issing, a member of the Bundesbank Directorate, has frequently called attention to the fact that not only is it necessary "to transfer the responsibility for the value of money to the central bank", it is also necessary for society to be willing "to accept the consequences of a tight monetary policy"; "a society's readiness to back an anti-inflationary central bank policy is a bastion against a process of reciprocally escalating wages and prices. ... a concrete example, ... [is] the monetary targets the Bundesbank announces each year ... . In doing so, it is hoped that all those responsible for making demands on the gross national product take into account the limit to the rise in overall expenditure which we deem necessary. It is only the consensus about the leading role which the Bundesbank plays ... that will ... allow inflationary pressures to be eased without undue losses in output and employment" (Issing 1993, p. 49).

At the same time, a strict monetarist policy which attempts to offset any and every movement in the price level is rejected because such a stringent policy would undermine the stability culture and erode the public confidence in the central bank necessary for successful policy because of "the danger of high real costs in the form of sales and output losses as well as unemployment. I doubt whether the general public would be prepared to pay this price to see overall price stability maintained also in the short run at all times and in any circumstances" (p. 47). "In the long run not even an independent

central bank will be able to defend monetary stability against the front formed by an 'entitlement society' ..." (Issing 1993, pp. 49-50).

In this respect, the real goal of the Bundesbank, both in its internal policy and in its position on the role of the ECB, is to attempt to create and preserve a "stability culture" in which the major economic actors in the EU are willing and able to respond to the policy signals given by the central bank.

It is quite clear that when the Treaty was drawn up there were wide divergences in terms of the "stability culture" exhibited by the various member states of the European Union. The insertion of the "convergence conditions" might then be seen as something of a "rite of passage" by which countries proved their ability to take the kinds of decisions required to produce monetary stability with the general support of the government as well as the general populace. The Bundesbank is not so naive to believe that it can operate monetary policy successfully, simply by setting monetary targets or by taking over EU monetary policy. It requires the support and cooperation of government fiscal policy and the acceptance by the general population that monetary stability is an economic policy priority to which individual behaviour can also contribute. It is thus not the specific figures in the convergence conditions which are important, but rather the economic policy culture which produces the economic aggregates.

Chapter 4 of the Treaty deals with "Transitional Provisions" and under Section 2(a) requires members to engage in "multiannual programmes intended to ensure the lasting convergence necessary for the achievement of economic and monetary union, in particular with regard to price stability and public finances". No country seems to have formally introduced such plans, but clearly they were included in order to provide a test of a country's intentions to participate. And clearly, they should be judged as any other contract in terms of the ability of the contracting party to satisfy the conditions. Any contract which set conditions which could not have been met by the parties involved is usually considered void. In the case of many countries, meeting the formal conditions must be considered as impossible. But, we may judge countries on the possible.

For example, if we take the third stage convergence conditions as a test of the will of a government to reduce inflation, the Italian government has more than fulfilled these conditions in its policies to bring down the Italian inflation rate to levels which for a period at the end of the '80s were below German inflation. That Italy clearly

has made substantial moves towards introducing a "stability culture" may also be seen in the contained increase in the inflation rate which has followed on what was by any standards a massive devaluation of the lira. The change may also be seen in the changes in the bargaining behaviour of the trade unions and their acceptance of broad incomes policies. It seems that only Italian industry has been able to maintain, and in some cases increase, their margins in this period.

Further, if one considers the part of the budget over which the government has direct control, that is excluding the impact of monetary policy on the interest burden of the outstanding debt, the government has produced primary surpluses which have in some years reached levels above 3% of GDP. The inability of Italy to meet the deficit and debt targets is representative of the absence of a "stability culture" in the past. But, what should be of importance is the performance since the adoption of the Treaty. In this respect, Italy would fully meet the conditions of "stability culture".

Obviously, the same sort of considerations would apply to France, Belgium, Denmark, Sweden, Spain and even the UK, were it so disposed to accept membership in the EMU. Using the convergence conditions defined in this way would allow the number of countries which would be required to make EMU a workable proposition.

But, this would not meet the formal numbers of the conditions. Would this be important? Only if the existence of a large outstanding public debt created difficulties for the continuation of a "stability culture" or the active implementation and operation of a policy of monetary stability by the ECB. There is no clear answer to this question. History suggests that economies can experience monetary stability with very large ratios of debt to GDP. Even the US in the post-war period provides an example. On the other hand, it is appropriate to remember that although the Belgian debt is a very large proportion of Belgian GDP, it is a very small proportion of EU GDP. The same applies for Italy. The size and maturity structure of the Italian debt may create difficulties for the operation of Italian monetary policy, but these problems should be diminished once Italy joins a monetary union.

There are no reasons to change the convergence conditions, but there may be very good reasons to reinterpret their intention, for they currently do not measure what they were set out to assess. Further, as even Germany is discovering, their strict interpretation has a perverse

impact on economic performance which may produce conditions in which only Luxembourg participates in the third stage, or the conditions have to be changed in a way which runs the risk that the conditions no longer represent what they are supposed to measure – the viability of an EU monetary policy.

Finally, it is important to recall that the decision concerning whether a country satisfies the convergence conditions ultimately rests on the decision of a qualified majority of the European Council meeting in the composition of heads of State or of Government acting on the recommendations contained in independent reports of the Commission and the EMI. There is mention of the possibility of a conflict of opinion in these recommendations, but the Treaty also requires the opinion of the European Parliament, which might be used to resolve a conflict of opinion.[2]

4. The problem of bank supervision

There is an associated problem, linked to the successful operation of EU monetary policy. Once the automatic introduction of the third stage takes place, another community institution will have to be created. Following the insistence of the Bundesbank, prudential supervision of banks has been excluded from the initial functions attributed to the ECB. Article 3, Section 3.3 of the ECB Statute refers to the ESCB contribution "to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system", and the Treaty contains virtually the same language in Article 105 Section 5. Section 6 provides for the ECB to be assigned "specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions". However, the Treaty appears to make no direct provision for any EU institution which might act as the competent authority. The Treaty might be interpreted as invoking the principle of subsidiarity, and allowing the national systems of prudential supervision to prevail. This seems unworkable, first because national systems differ as to whether prudential supervision is carried out by the central bank or by an independent authority. It is generally presumed that the policy independence of the central bank depends on its being free from prudential and lending of last resort concerns. This is basically because it is believed that there may be a conflict between the goals of monetary stability and the stability of the financial system. If the ECB is to be truly independent in carrying out its monetary policy to produce price stability, then it cannot be concerned for the stability or survival of particular financial institutions as a result of this policy. There is a certain symmetry between the problems created by large accumulated public debts of member states and the potential of bank failures for member states which have had large state participation in the banking system.

As an example of policy conflict, consider the use by the US Federal Reserve of a long period of low interest rates at the beginning of the 1990s in order to restore stability of the financial system. The Bundesbank would argue that this represents the subordination of monetary policy to the preservation of stability of financial institutions. Such action suggests multiple policy goals and thus reduces the credibility of the central bank to act consistently to carry out policies to control inflation, irrespective of their impact on the political, real or financial sectors. Thus, the Article 109e(5) regulation which says that all countries must start the process leading to "independence of its central bank" implies that either all countries must create independent supervisory agencies if they do not have them, or what is more probable, that prudential supervision will be undertaken by an as yet to be designed and created EU Supervisory institution,

[2] A qualified majority is 62 votes out of the 87 votes assigned proportionally as follows: Germany, France, UK, Italy, 10; Spain, 8; Belgium, Netherlands, Greece, Portugal, 5; Austria, Sweden, 4; Denmark, Finland, Ireland, 3, Luxembourg, 2. On the assumption that France, Italy, Spain, Portugal, Belgium, Netherlands, Austria, Sweden, Ireland, and Luxembourg consider that they have met the "rite of passage" convergence conditions suggested above, this gives 56 votes in Council. The balance is then with Germany and the UK. The UK has an exemption from participation (as Denmark), while the German Constitutional Court has ruled that the German Bundestag has the authority to determine Germany's vote in Council and should interpret the convergence conditions strictly. This raises the possibility that the UK votes in favour and exercises its opt out, placing Germany in the difficult position of being solely responsible for the success of EMU. Thus, despite the convergence conditions it seems clear that the final decision will be determined by Germany and the UK. Germany has an election in 1998, and the UK is likely to have an election before the end of 1997. Since the Labour Party is considered to be more favourable to Europe than the current Major government (or any future Conservative government), should the Bundestag defeat the Kohl government and vote no, the UK would be in a position to negotiate further concessions in order to persuade the British government to approve Monetary Union. This would allow Germany to avoid the responsibility for unilaterally postponing the third stage. All this suggests that the convergence criteria are not the most important aspect of the third stage decision.

independent of the ESCB and the ECB. Little has been done so far to bring about the creation of this institution, although a great deal has been done to provide harmonisation of community-wide prudential regulations through the various banking, insurance and securities directives. In relation to banks, the major provisions relate to capital adequacy standards, which had in any case already been agreed for banks operating internationally under the auspices of the Bank for International Settlements.

It is clear that once the third stage starts, each national central bank of the "countries concerned" will be issuing the euro-ecu on behalf of the ECB through the ECB. At this stage it is no longer certain that the provisions for home-country licensing and prudential supervision can continue to apply. Already, most countries have adopted their domestic banking legislation to allow for the introduction of German style "universal" banking. However they have not yet introduced German style prudential regulations. It must be presumed that the European Bank Supervisory institution will in fact incorporate most of the German prudential regulations.

The nature of German prudential regulations is now well known (cf. Kregel 1992 and 1993). It is sufficient to note that they provide for a rough balance sheet matching of the long and short maturities of bank assets and liabilities. In addition there are a number of more traditional measures such as consolidated reporting and reserve requirements. The issue which is of importance to the problem of the transition to the third stage is the close relation between these prudential regulations and the German approach to the operation of monetary policy and the fact that this approach seems to be at contrast with the changes which are taking place in the international financial environment.

The first point can be seen clearly with respect to minimum reserve requirements. The Bundesbank has always regarded reserve requirements as important because of their role in controlling bank liquidity and thus bank lending to the private sector. They are not considered as part of prudential regulation of banks, acting as a buffer against liquidity risk. Rather, they are looked upon as a method for stabilising interest rates. Indeed, minimum reserves are probably the most frequently and consistently used policy tool in the Bundesbank's arsenal. The Bundesbank has thus strongly resisted the tendency towards the elimination of reserves as a result of competition among community financial systems after the introduction of the community

banking license. Recently, as a result of the advantages offered to German banks operating in international markets, it has been forced to reduce its minimum requirements to 5% on sight deposits and 2% on other tied deposits. The role of reserves has thus changed, and they are no longer actively used. However, the Bundesbank argues that they are still important as the lynch pin which causes the banks to react to changes in the money supply decided as part of the policy of targeting M3. The Bundesbank believes that without reserve requirements they would no longer be able to exercise control over bank lending. It should be noted that German reserve policy has always been more flexible than in the monetarist vision. Ratios must be met on a monthly basis and are in fact available for use as working balances by the banks. This means that the Bundesbank does not have to be consistently in the market to offset unforeseen changes in money market conditions. As long as required reserves are larger than banks' desired working balances, they will be seeking their additional liquidity needs from the Bundesbank. This is what gives the impact of monetary control over bank lending, as well as the stability of the long term demand for money in Germany which is the basis for this policy.

The second part of this policy is the balance sheet matching. If interest rate changes feed through to the money market, tightening at the short end of the maturity spectrum will usually cause a rise in short deposits demand and a fall off in the demand for short lending. Because of the universal banking and the maturity matching conditions, the rise in short rates should then drive demand into the medium to long term market, which means banks have to raise funds in securities markets to provide the match. Thus, the rise in interest rates is spread through the market and causes a shift towards monetary capital assets, causing measured M3 to fall.

And this is where the problem arises. No other community country shows the same stability in money demand as observed in Germany. From what has been argued here, much of that stability is in fact due to the prudential regulations applied to the universal bank structure. This is also the reason for the proposition that if the ECB is going to operate its policy in the same way as the Bundesbank, it will require a Supervisory Authority and prudential regulation similar to that which applies in Germany.

The second point is whether this can be successfully applied in the rest of the community, and more importantly, whether it can be applied in the present international financial environment. Even if

there is a group of countries with a predominantly German type banking system (Austria, Netherlands, Belgium, Luxembourg) their regulatory systems are rather different (e.g. Belgium does not apply a required reserve) and some of them, such as Luxembourg are unlikely to be willing to adapt completely for competitive considerations. Even if German prudential regulations were introduced community wide, it is unlikely that the same stability in monetary demand would result. The basis for the ECB operation of monetary policy along German lines is thus undermined.

More importantly, the whole basis of German regulation is that the banking system depends on the central bank for its liquidity and thus for its lending. On the other hand the Capital and Liquidity principles organise assets and liabilities, and thus bank risk according to maturity. The role of long-term securities, in particular bank bonds, is particularly important.

However, modern bank management differs substantially from this model. Banks are more and more limited in their activities by their ability to borrow outside the central bank, in international markets. As reserve requirements fall, the likelihood that that will exceed a bank's working balances declines. This eliminates one of the elements of the operation of German monetary policy.

In addition, banks no longer manage their balance sheets according to maturity considerations. All assets and liabilities are broken down into their constituent risk components. A long-term bond issued at a fixed interest rate may have been converted into a floating rate instrument through a swap. It thus has a price behaviour similar to a short-term asset. Likewise, positions in long-term assets may be created by purchasing futures contracts. We need not go into the full range of financial engineering to note that regulation of banks on maturity management lines, when they operate on risk management lines, will create inefficiencies – or, alternatively, will create advantages for banks which are regulated on risk-management basis. This is precisely what has occurred in the BIS committee dealing with the regulation of price or market risk in international banks. The banks appear to have won the fight to be regulated on the basis of risk-management techniques. Clearly, if banks operating within the Community are required to operate under maturity management supervision, they will be at a competitive disadvantage. The decision of German banks to move most of their international operations outside Germany by buying British banks and leaving them to operate

in London exemplifies the problem. This is the response to the policy of the Bundesbank which has always acted to restrain innovations which might threaten their ability to operate monetary policy by weakening the money demand relation. The recent delays over the creation of money market funds is a case in point.

Of course, this also means that it will not be possible to reconstruct the monetary demand stability which has been present in Germany in the rest of the community, if community banks follow risk management principles. There is no basis of experience concerning the impact of monetary control on the lending behaviour of banks which operate on risk management principles.

Thus, the constitution of the institution to manage prudential regulation in the community has yet to be undertaken. It seems clear that it should be in place if the third stage is to begin on 1 January 1999. It also seems likely that it will attempt to replicate the German system of prudential regulation and supervision of financial institutions. However, despite the fact that the German system is one which is relatively free of restrictions on bank activities, it is based on what is an increasingly outmoded method of evaluating the risks faced by banks. It seems clear that it has been maintained because it supports the stability of the money demand function which the Bundesbank uses as a basis for its policy of money targets.

Should the Bundesbank succeed, it would introduce an outmoded structure which would be operationally inefficient, would not guarantee monetary control and place European banks at a substantial disadvantage relative to banks operating according to more modern principles in international markets. The discussions on prudential regulation of bank market risk currently underway under the auspices of the BIS should also be taking place in the community. Not only will they be important for the regulations applied by the new Supervisory institutions in the community, they will have important implications for the operation of the monetary policy of the new ECB. For this reason they must be ready by 1999. In all likelihood, they will not be the same as those applied in Germany.

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