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(Translation)

MINUTES *

OF THE 228th MEETING OF THE COMMITTEE OF GOVERNORS

OF THE CENTRAL BANKS OF THE MEMBER STATES

OF THE EUROPEAN ECONOMIC COMMUNITY

HELD IN BASLE ON TUESDAY, 13th SEPTEMBER 1988 AT 10 a.m.

Those present at the meeting were: the Governor of the Banque Nationale de Belgique and Chairman of the Committee, Mr. Godeaux, accompanied by Mr. Janson, Mr. Rey and Mr. Michielsen; the Governor of Danmarks Nationalbank, Mr. Hoffmeyer, accompanied by Mr. Mikkelsen; the President of the Deutsche Bundesbank, Mr. Pöhl, accompanied by Mr. Gleske and Mr. Rieke; the Governor of the Bank of Greece, Mr. Chalikias, accompanied by Mr. Papademos and Mr. Karamouzis; the Governor of the Banco de España, Mr. Rubio, accompanied by Mr. Linde and Mr. Durán; the Governor of the Banque de France, Mr. de Larosière, accompanied by Mr. Waitzenegger and Mr. Cappanera; the Governor of the Central Bank of Ireland, Mr. Doyle, accompanied by Mr. O'Grady Walshe and Mr. Reynolds; the Governor of the Banca d'Italia, Mr. Ciampi, accompanied by Mr. Dini and Mr. Masera; the President of De Nederlandsche Bank, Mr. Duisenberg, accompanied by Mr. Szász and Mr. Boot; the Governor of the Banco de Portugal, Mr. Tavares Moreira, accompanied by Mr. Pêgo Marques and Mr. da Costa Pinto; the Governor of the Bank of England, Mr. Leigh-Pemberton, accompanied by Mr. Loehnis and Mr. Price; the President of the Commission of the European Communities, Mr. Delors, accompanied by Mr. Mingasson and Mr. Dixon; the Director General of the Luxembourg Monetary Institute, Mr. Jaans. Also present at the meeting were Mr. Raymond and Mr. Dalgaard, Chairmen of the Groups of Experts. The Secretary General of the Committee, Mr. Morelli, his Deputy, Mr. Bascoul, Mr. Scheller and Mr. Cook, and Mr. Bockelmann and Mr. Dagassan also attended.

The Chairman opened the meeting by announcing that the meeting of the Committee chaired by Mr. Delors would begin in the afternoon at 2 p.m. as planned; the time of the meeting could not be brought forward, but it should end at 5.30 p.m. to enable the participants to depart as planned.

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* Final text approved at the meeting on 8th November 1988, which incorporates some drafting changes.

I. Approval of the minutes of the 227th meeting.

The Committee unanimously approved the minutes of the 227th meeting, on the understanding that the editorial amendments suggested would be incorporated in the final text.

II. Monitoring of economic and monetary developments and policies in the EEC based on:

- Preparation by the "Dalgaard Group" and discussion by the Committee of Alternates;
- Statistical charts and tables.

A. Statement by Mr. Dalgaard

The firming of the dollar which had started in May had continued until mid-August. This appreciation had been due, as before, to strong economic growth in the United States, leading in particular to a rise in interest rates and some improvement in the trade balance.

The Deutsche Bundesbank had attempted to check this movement by selling dollars, firstly alone, and subsequently together with other central banks, including the Federal Reserve. These sales had been very considerable: over $20 billion in the three months June, July and August. At the same time, interest rates had been raised in Germany and elsewhere. This had taken the German three-month money market rate from below 3.5% to 4.5%. In spite of these moves the Deutsche Mark had remained weak, even within the EMS, owing to large outflows of long-term capital.

August had seen a change of sentiment towards the dollar, doubtless as a result of the cumulative effect of the very heavy intervention, the rise in interest rates in many countries and some indications of a slackening of growth in the United States. The Deutsche Mark had firmed against the dollar and within the EMS. Money market rates in Germany had, in fact, begun to fall when the discount rate was raised. It had no longer been necessary to support the Deutsche Mark with interventions and, indeed, some central banks had actually begun selling Deutsche Mark in early September.

The yen had moved through different phases, from weakness to stability and, more recently, firmness.

The situation within the EMS had been calm as long as the dollar had remained firm. At the end of August/beginning of September some tensions had surfaced in connection with the firming of the Deutsche Mark, rumours of a realignment linked with the informal meeting of the ECOFIN Council, and a number of special factors in certain countries. The tensions had been most marked in France and in Italy. In France the interest rate differential vis-à-vis the Deutsche Mark had narrowed from 4 points in early June to 2 points at the end of July. Pressure on the French franc had led to an increase in interest rates, a slipping of the exchange rate within the band and substantial interventions, totalling approximately $2 billion, around the end of August/beginning of September.

In Italy the deterioration in the balance of payments had added to downward pressure on the lira and the Banca d'Italia had also made use of the three instruments: the fluctuation band, interest rates and interventions. The interventions had been comparable to those undertaken by the French authorities, totalling $2 billion. The important capital liberalisation and deregulation measures scheduled for October did not seem to have contributed to the pressure on the lira.

Other participants in the EMS exchange rate mechanism had also been affected by these movements. The Belgian franc had been subject to the same influences as the French franc and the Italian lira, but in addition had suffered the repercussions of the Société Générale affair, i.e. capital outflows following the inflows of early 1988. The Banque Nationale de Belgique had raised its interest rates and had intervened regularly from mid-June onwards, for a total of approximately $2 billion.

The Dutch guilder had been less robust than during the first half of 1988. The exchange rate had weakened, interest rates had been raised and fairly regular support interventions had been undertaken for a total amount of over $2 billion. The interest rate differential vis-à-vis Germany had returned to its normal level of 0.5 points.

In Denmark capital inflows had been much smaller and the Danish krone had weakened slightly. The announcement of the abolition of the last exchange controls as from 1st October 1988 had had no effect on the market.

The Irish pound had remained firm even though there had been a slight narrowing of the interest rate differential vis-à-vis other countries.

In all, the tensions which had surfaced recently within the EMS appeared to be linked to the fact that interest rate differentials had been reduced further than the market considered appropriate. The central banks concerned had coped with these tensions by making use of the three traditional instruments and had obtained satisfactory results. There were, however, more fundamental differences between the EMS countries, in particular in current-account positions, and these could be a factor in keeping certain tensions alive.

The performance of those currencies not participating in the exchange rate mechanism had varied. In the United Kingdom interest rates had been raised chiefly for domestic reasons, and the announcement of a record trade deficit had caused some nervousness in regard to sterling. Its rate of exchange had fluctuated somewhat, but it should be noted that since March it had remained within a fairly limited range of between DM 3.10 and 3.22.

The Spanish peseta had been stable, but since the beginning of the year it had recorded an 8% appreciation vis-à-vis the Deutsche Mark in spite of intervention purchases in excess of $20 billion. At the end of August, however, the peseta had weakened in connection with the pressures on the French franc and the Italian lira, the deterioration in the trade balance and the narrowing of interest rate differentials vis-à-vis other countries, and the Banco de España had carried out intervention sales.

The Greek drachma and the Portuguese escudo had continued to depreciate slightly in effective terms.

B. Statement by Mr. Janson

The Alternates' discussion had focused on the following main points:

1. How were recent developments on the markets, which reflected a certain nervousness but which could not be called major tensions, to be interpreted?
2. What could be done to strengthen market confidence in the stability of exchange rate relations between EMS currencies and thus confirm the recent important and concurring statements by the German and French authorities?
3. How were the particular developments observed in the case of the pound sterling and the Spanish peseta to be evaluated?

1. Market nervousness

Recent conditions on the exchange markets had to be placed in the context of developments in the fundamentals.

(a) Growth was strong in most European countries, including Germany, where it had recently accelerated. Since it was considerably stronger still in a number of other European countries, this was reflected both in the development of current-account balances within Europe and in Germany's bilateral trade relations with its partners. From the point of view of the EMS there was no call for particular concern. Where a current-account deficit existed, as in France or Italy, it remained at a level which gave no great cause for concern in itself, particularly as price and cost developments did not seem to be in any danger of getting out of control.

(b) On the price front, some Alternates observed that the climate was in the process of changing slightly. The concern to avoid any depreciation of the Deutsche Mark was to be seen in this light and in the light of furthering the adjustment process. The action taken by the German authorities to this end had been followed by the other EMS member countries, which had made use of the various mechanisms put in place by the Basle/Nyborg Agreement.

(c) This combined action had somewhat influenced expectations of stable exchange rates which, together with appropriate interest rate differentials, had encouraged long-term capital movements and thereby helped to finance the current payments imbalances. It had been emphasised that, in some cases, these movements were adequately financing the varying rates of investment growth in different regions of the Community and augured well for the positive effects of the liberalisation of capital movements. However, when there was a resurgence of rumours about exchange rate relationships between major currencies, simply re-establishing interest differentials was not necessarily enough to calm market expectations. Moreover, some Alternates were concerned about the levels interest rates had reached, and saw limits to any realistic scope for further upward adjustments.

2. The policies to be followed

(a) Some Alternates had expressed the fear that speculative pressures on the markets could grow. With the rise of the Deutsche Mark to the top of the EMS and the slight decline of the French franc, market operators were reminded of the long history of realignments between these two important EMS currencies in particular. It was therefore essential to give the markets a clear and convincing signal to quell realignment rumours.

(b) These rumours should be quelled for a number of other reasons: price-competitiveness relationships were little changed. The trade-account imbalances in Europe largely reflected the structural advantage of the German economy, in an upward phase of the cycle, in exports of capital goods. Moreover, it was important not to shake confidence in the declared intention to continue efforts towards closer convergence in domestic and external stability. It was essential, particularly during the present period of international meetings, that any official statements should help strengthen confidence in the stability of exchange rate relationships.

(c) In an attempt to give concrete shape to the signals of cohesion judged desirable, the following ideas had been put forward on the basis of assumptions regarding the dollar. It had been noted that US economic fundamentals continued to hold out a real threat of dollar depreciation. If the dollar were to decline, co-ordinated action to preserve stability in the EMS and recover room for manoeuvre should take the form of a signal in the direction of a relaxation of interest rates, initiated by Germany.

Any upward trend shown by the dollar should be countered not by a further increase in interest rates but by co-ordinated interventions in dollars only.

3. <u>Sterling and the Spanish peseta</u>

(a) Sterling

The size of the UK trade deficit in August reflected the strength of domestic demand in that country. In the view of the UK Alternate this had justified the policy of progressively tightening interest rates. He acknowledged that sterling was vulnerable at its present level and hoped that further increases in interest rates could be avoided.

(b) The Spanish peseta

The weakening of the peseta had to be seen in the context of a rate of inflation higher than the 3% target, the sharp deterioration on current account and the cut in interest rates. The depreciation only partially offset the considerable appreciation of the peseta vis-à-vis the Deutsche Mark (of the order of 8% since the beginning of the year) in real terms. The decline of the peseta primarily reflected short-term capital movements, in particular under the contagious influence of pressures on the French franc and the Italian lira.

C. Discussion by the Committee

Mr. Hoffmeyer added a few comments on the abolition of the last exchange controls in Denmark to which Mr. Dalgaard had referred. This would end fifty-five years of controls and would enter into force on 1st October. From that date capital movements would be free of restrictions, save for two rules: firstly, a rule on financial institutions' external positions, which was liberal and was intended to ensure that the financial intermediaries did not speculate against the Danish krone, and secondly a tax provision whose principle was that Danish residents had to ensure that the Danish tax authorities received the same information about their deposits abroad as about deposits in Denmark. Danish residents were themselves responsible for supplying this information, so that there would be no conflict with the national legislation of those countries in which the deposits were held.

As had already been mentioned, the announcement of the abolition of exchange controls as from 1st October 1988 had had no effect on the exchange market.

The Chairman noted that there were no further comments on the reports given by Mr. Dalgaard and Mr. Janson.

III. Adoption of the Committee's report to the EEC Ministers of Finance on developments on the foreign exchange markets of the nineteen countries participating in the concertation procedure during July, August and the first few days of September 1988.

The Chairman took note of the Committee's approval of the "concertation report", which would be submitted as usual to the EEC Ministers of Finance.

IV. Exchange of views on recent developments in public finance and policy implications.

The Chairman pointed out that the Committee had not been able to hold this exchange of views at its previous meeting. Although Mr. Raymond had already introduced the note on public finance in July, he might now wish to repeat one or two points or perhaps bring his introduction up to date.

A. Statement by Mr. Raymond

There was no need to bring the introduction given in July up to date, since the note on public finance basically dealt with 1987, but the substance of what he had said in July and of the note itself could be summarised again.

The evolution of public finance in 1987 could be characterised by three welcome developments and three that gave cause for concern. The welcome developments highlighted in the note were:

- a slight overall contraction, as a proportion of GNP, in expenditure and in the aggregate budget deficit for the Community as a whole;
- a slight improvement in convergence among member countries;
- a lessening of the conflicts between fiscal and monetary policies, primarily as a result of a sharp reduction in direct monetary financing of the budget deficits.

The three areas of concern were:

- the progress that had been made was very limited;
- no significant, lasting progress had been made in those countries whose positions were the least favourable, i.e. those in which the budget deficit or the public debt ratio was highest; this was particularly true after adjustment for cyclical factors in these countries, such as a temporary rise in revenue associated with higher-than-expected growth, or the decline in nominal interest rates, which had not continued in 1988;
- in those countries whose budgetary positions were favourable, on the other hand, the authorities saw little scope for using the fiscal instrument to stimulate economic activity.

B. Statement by Mr. Janson

1. Broadly speaking, the Alternates agreed with the conclusion of the report presented by Mr. Raymond. While conflicts between fiscal and monetary policy had lessened in 1987, budgetary developments were only in part satisfactory. Wide differences remained in budgetary positions, which in several cases still seemed unsustainable in the medium term.

2. The Alternates noted that in some countries interest service on public debt had a major impact on budgetary balances. This made it harder

to reduce the deficits as adjustment efforts had to focus on non-interest expenditure, which could be difficult to trim.

It had also been noted, on reading Table 10, that in some countries substantial differences existed between gross interest payments (column a) and these same payments after deduction, on the one hand, of revenue from taxes on interest income (see column e) and, on the other hand, of the interest received by the authorities on their own financial assets (see column h). This demonstrated the importance of the fiscal implications of the liberalisation of capital movements for some countries and might, in the opinion of one of the Alternates, be a useful subject for study by the "Raymond Group".

3. The German Alternate had commented on the factors underlying the growth of the German budget deficit and on its consequences for interest rates. He had noted that the Bundesbank would closely monitor the price effects of the increase in a number of taxes on consumption planned for next year.

The Italian Alternate had stated that his Government intended transforming the budget deficit excluding interest payments - at present 3.4% of GNP - into a small surplus by 1992, which represented an adjustment of some 4% of GNP. Interest payments were currently equivalent to 8% of GNP. If this objective were achieved it should make it possible to stabilise the debt ratio in terms of GNP in 1992. This obviously depended on interest rate developments.

4. The Alternates had also noted that the public sector deficits were financed less and less by base money creation, i.e. by direct central bank financing or, indirectly, through government borrowing abroad. Financing government deficits on the domestic financial markets had in effect become a widely followed practice in the EEC countries.

5. The discussion had shown that the impact of the public finances on monetary policy could not be judged either from the size or from the method of financing of the budget deficits.

A number of Alternates stressed the need to consider countries' overall domestic saving, within which public sector dissaving could be absorbed by a high level of private sector saving. This did not mean that the budget deficit did not require correction in the medium term, but for the immediate future it was more difficult to see it as a source of macroeconomic disturbance.

Similarly, one Alternate noted that the fact that there was no direct central bank financing of the budget deficit was not sufficient to place a real constraint on the management of the public finances, as the present situation in the Community demonstrated. This would have to be borne in mind in the study of the appropriate operational framework for a future European central bank, and other forms of budgetary discipline might have to be considered.

It had to be added that on 6th September the Monetary Committee had stated that it might soon address the question of government budget financing mechanisms in member countries. The staff of the Commission would be preparing a memorandum for this purpose. Mr. Loehnis had pointed out that for several years now the Committee of Governors had undertaken an annual review of developments in public finance on the basis of documents which were then forwarded to the Monetary Committee, and that the Monetary Committee should therefore take these documents into consideration in its proposed study.

C. Discussion by the Committee

Mr. Leigh-Pemberton noted that the experts' report presented the following conclusions: the public finance situation had been partially satisfactory in 1987 but prospects for closer convergence within the Community were uncertain. In the United Kingdom there had been further progress in reducing public expenditure and in the policy of reducing the public debt. The objective was to continue this policy over the medium term and to preserve a balanced budget. In fact, the budget surplus could considerably exceed the forecasts and reach 3% of GNP in 1988. Nonetheless, monetary expansion was very vigorous owing to the sharp increase in private sector borrowing. The economy was in fact very buoyant, domestic demand was very brisk and exceeded supply potential, hence the deterioration in the current account and the sharp expansion of credit. It should, however, be noted that there was an improvement in the area of supply, productivity and employment. This had led to an increase in real incomes, a rise in confidence within industry and among households and also an increase in private saving. These phenomena, which were more marked than in the other Community countries, accounted for the differences between the United Kingdom and other member countries in terms of monetary expansion and public finance.

Mr. Ciampi began by thanking the Group of Experts and its Chairman for the report, which gave a clear and full picture of developments in the different Community countries. Without doubt Italy had most difficulties in this area, given the size of the public sector borrowing requirement, the scale of the public debt and the links between budgetary performance and the other components of the economy and the monetary situation. Although the borrowing requirement was essentially financed by the market, it had effects on the economy and on the monetary situation. The efforts made in recent years had done no more than make it possible to avoid an increase in the borrowing requirment as a proportion of GNP. The need to tackle this problem decisively was recognised by all, and government circles and the population as a whole had become aware of it. The programme of budgetary adjustment was seen in the context of the European structure, of which Italy was very much in favour, but a certain contradiction between the profound desire for further integration and the disorder in the Italian public finances had to be recognised. Measures had been taken in the summer to hold down the budget deficit but the most important thing was to put in place a multi-year programme of successive cuts in the deficit and in the borrowing requirement. A proposal was to be presented to Parliament before the end of September; it would represent the first phase of a multi-year plan whose aim was to eliminate the non-interest deficit by 1992. This was to be achieved by raising taxes and reducing public expenditure.

The borrowing requirement, which amounted to approximately 11.5% of GNP, posed a difficult problem even if it was not financed by money creation or central bank intervention. For years the central bank had consistently pressed for financing on the market; this had made it possible to bring monetary expansion in Italy under control, but at the expense of high interest rates, which in turn added somewhat further to government costs. Only a few years ago, for example in 1982-83, great resistance had had to be overcome to convince everyone of the need to avoid monetary financing of the budget deficit. Today, thanks in particular to the persistence of the central bank, this need was recognised by all and had become a prime concern of the Government and of Parliament.

The Chairman pointed out that, in accordance with established tradition, the note on public finance would be sent to the Monetary Committee following a brief written procedure to enable the central banks to put forward any proposals they might have for changes to the text. That the note would be sent to the Monetary Committee might be considered additionally expedient in that it could be useful for the study which that Committee intended to undertake. It was also traditional to draw the note and the Governors' comments on it directly to the attention of Finance Ministers. Of course, the Governors would as usual receive a copy of the covering letter to the Ministers, which would set out the substance of the exchange of views the Committee had just had.

V. Exchange of views on the items on the agendas for the international meetings in Berlin.

The Chairman explained that this exchange of views was traditionally included in the agenda of the Committee's September meeting but that, almost equally traditionally, the Committee did not hold any discussion on this subject. In fact, the Governors had an opportunity to address these questions in other forums.

The Chairman noted that there were no further comments.

VI. Other matters falling within the competence of the Committee:

- Exchange of views on the decision by the British authorities to issue short-term Treasury bills in ECUs in the near future.

The Chairman noted that the Alternates had heard a brief report from their British colleague concerning the decision by the UK authorities to issue short-term Treasury bills in ECUs in the near future, and that Mr. Leigh-Pemberton would now say something to the Committee.

Mr. Leigh-Pemberton made the following comments on the British Government's ECU Treasury bill programme. The main objective of the programme was to have a short-term instrument available so as to secure greater flexibility in the management of the public debt, i.e. of official assets and liabilities in foreign currencies. The programme was also aimed at helping to promote the use of the ECU on the international markets and at strengthening London's role in transactions in ECUs. There was, in fact, a gap to be filled between the market in deposits and that in securities in ECUs, hence the need for short-term instruments which were government-guaranteed, actively traded and very liquid on a secondary market. Italy had been a pioneer in this field with its one-year Treasury bill programme; the United Kingdom had the shorter end of this market in mind, viz. maturities of one, three and six months.

Since the announcement of the programme in early August the final details had been worked out. The first tender would take place in October and this would probably be followed by a series of monthly operations, each involving about ECU 500 million, probably for maturities of one, three or six months. Initially, the programme could be expected to total some ECU 1 to 2 billion. The prospectus distributed to the Alternates the previous day would not be published for several days; it contained the details of the programme, which would be reviewed in March 1989 in the light of the experience of the first six auctions. These were planned as a continuous operation, i.e. the intention was not simply to borrow in ECUs but to develop a new liquid secondary market for bills in ECUs. Arrangements had been made with a group of banks and securities houses which would act as market-makers and would market the instruments among their customers. The prospectus listed the institutions which had agreed to play this role: they included the major British houses, but also banks from other Community countries, as well as a small number of institutions from outside the EEC which already conducted a substantial amount of business in ECUs.

So far the response of potential investors and of market-makers to the announcement of the programme had been very positive. The UK authorities were aware, however, that if they wished to build up a market their programme had to get off to a good start and other issuers had to enter the field; they hoped that interest would grow and that other issuers would extend the range of instruments available. It would be interesting to know whether plans along these lines existed in other EEC countries.

The Chairman thanked Mr. Leigh-Pemberton for his interesting remarks; he noted that there were no comments and wished the Bank of England and the British Treasury good luck in implementing their programme for the issue of short-term securities in ECUs.

- Departure of Mr. Janson.

The Chairman noted that, owing to the fact that he was due to retire shortly, Mr. Georges Janson was participating for the last time in the work of the Committee. He added that there was much he could say, having known Mr. Janson since university days, but that he would not inflict a long speech on him since over the past few days and in the days ahead he had had and would have the opportunity to attend or to chair meetings distinguished by the participation of Mr. Janson for the last time.

Going no further than the Committee of Governors, within which he had carried out extremely important work, Mr. Janson had established at least three records: the record for length of service, having been a member of the Committee for seventeen and a half years; the record for attendance, not having been absent for one of the 180 meetings held during this period, and, finally, the record for chairmanships, having chaired the Committee of Alternates for three separate terms: in 1974, in 1978 and in 1988. With such a track record, Mr. Janson could certainly look back with confidence and satisfaction. It was with these sentiments, together with their thanks and their best wishes, that the Governors were today taking leave of Mr. Janson.

Mr. Janson recalled that he had joined the Committee of Governors under the chairmanship of Mr. Carli at the April 1971 meeting, just as preparations were being made to reduce the fluctuation band from 1.50% to 1.20%. In May 1971, the following month, the whole plan fell apart when the Deutsche Mark and the Dutch guilder were floated. The Belgians and the Dutch had then worked to set up a fixed link between their currencies, called the "worm", which subsequently slipped into the "snake" to be finally swallowed up - but not before having been the precursor of the Community exchange rate systems. Now, seventeen or eighteen years later, the Governors were themselves being called on to study the question of a European central bank, and he wished them greater success than in some earlier projects.

Mr. Janson thanked the Governors for having listened to him for so many years; he was aware that very often he said what he thought, which could be rather irritating but was probably the best way of being understood. He also thanked the interpreters who had had to adjust to his volubility and speed of delivery, which was all the faster since he frequently departed from the draft texts of his statements.

The Chairman added that Mr. Janson's departure was unfortunately not the only one. Mr. Masera was leaving the Banca d'Italia to take up the office of Director General of the IMI as from 1st October. The Chairman thanked Mr. Masera for his valuable contribution to the work of the Committee over a number of years and, on behalf of the Governors, wished him every success in his new responsibilities.

VII. Date and place of the next meeting.

The next meeting would take place in Basle on Monday, 8th November 1988, beginning at 10 a.m.

Committee of Governors of the
Central Banks of the Member States
of the European Economic Community

13th September 1988

Confidential

BRIEF REPORT ON DEVELOPMENTS ON THE FOREIGN EXCHANGE MARKETS OF THE COUNTRIES WHOSE CENTRAL BANKS PARTICIPATE IN THE CONCERTATION PROCEDURE

JULY AND AUGUST 1988

This report summarises developments on the exchange markets of the countries whose central banks participate in the concertation procedure[1] and briefly describes their interventions during July, August and the first few days of September 1988.

I. EXCHANGE RATE DEVELOPMENTS

The main features of the foreign exchange markets in July and August 1988 were:

- a further strengthening of the US dollar against most currencies in July and early August followed by a certain decline in late August against European currencies;
- increased, concerted intervention sales of dollars mainly against Deutsche Mark;
- good demand for sterling and yen which stayed in a relatively narrow range against the US dollar up to the end of August when they weakened against most currencies;
- increases of official interest rates in many countries.

The US dollar continued to move higher against most foreign currencies during July and August. Throughout the period the dollar benefited from signs of strength in the US economy which were thought likely to

1 The central banks of the EEC, Norway, Sweden, Finland, Switzerland, Austria, Japan, Canada and the United States.

lead to a tighter monetary policy and thus to higher dollar interest rates. The Federal Reserve's commitment to containing inflationary pressures was evident in the early August decision to increase its discount rate by 0.5 percentage point to 6.5%. Market participants were also encouraged by the belief that the international adjustment process was proceeding, a belief reinforced by the release of better-than-expected US trade statistics for May and not dispelled by less favourable trade statistics for June. On various occasions during the two months the US authorities intervened to limit the dollar's rise, operating at times aggressively in co-operation with other central banks. Late in August the dollar moved slightly downwards against European currencies. The dollar closed the period 2.3% higher against the yen and 3.2% higher against the Deutsche Mark.

Having been stable in July the EMS experienced some movements in August. The Irish pound and the Deutsche Mark moved to the top of the EMS band while the Danish krone, the French franc and the Italian lira weakened somewhat.

The Deutsche Mark continued to weaken sharply in July and the first few days of August. Despite sometimes substantial intervention, it lost considerable ground against the US dollar in particular. This weakness was caused by capital outflows from the Federal Republic, for the most part induced by higher interest rates on most foreign markets. From the second third of August onwards the Deutsche Mark recovered appreciably vis-à-vis the US dollar and all other currencies. As a result, it moved to the top of the EMS exchange rate band. On 25th August the Central Bank Council of the Deutsche Bundesbank raised the official discount rate from 3% to 3 1/2% per annum, thereby consolidating the increase in DM interest rates on the money markets in recent weeks in the wake of the rise in US dollar interest rates.

The further 1/4 point cut in the intervention rate of the Banque de France at the beginning of July had no effect on the strong position of the French franc throughout July and the first few days of August. The general rise in interest rates that followed, first in the United States and subsequently in Europe, was reflected in particular in a further narrowing of the differential between German and French market rates, which this time resulted in arbitrage in favour of the Deutsche Mark and some weakening of the position of the franc. These pressures abated in the last few days of August.

The Belgian franc weakened as a result of the tensions which developed at the beginning of the period under review. The policy of the Banque Nationale was, on the one hand, to support the currency with relatively substantial interventions and, on the other, to raise its discount and lombard rates by 1/4 percentage point. After some weeks of calm, the tensions re-emerged following the general upward movement in interest rates. The Banque Nationale thus made further sales of foreign currency and twice raised its discount and lombard rates by 1/4 percentage point to bring them to 7.5% and 7.75% respectively.

The Dutch guilder eased somewhat further against the Deutsche Mark, notwithstanding substantial sales of dollars by the Nederlandsche Bank and a recovery of the interest rate differential vis-à-vis the Mark after the marked fall that had taken place earlier. In view of the developments in interest rates abroad the Nederlandsche Bank increased its discount rate on 29th July and 26th August by 0.25 percentage point on each occasion to 4.0% and its interest rate on advances by 0.5 and 0.25 percentage point respectively to 4.75%.

The Danish krone declined from the upper end to the middle of the EMS band. Danmarks Nationalbank lowered its official lending and deposit rates by 1/4 percentage point to 7 3/4% and 8 1/2% respectively on 8th July. Market rates were almost unchanged, but interest rate differentials in favour of the krone narrowed.

Despite occasional fluctuations, the Irish pound was positioned at the top of the EMS band for most of the period.

Seasonal factors and short-term capital inflows supported the Italian lira throughout the summer leading to substantial intervention purchases by the Banca d'Italia. The situation changed in the second half of August following the Federal Reserve's discount rate hike as market uncertainties developed about the future evolution of interest rates in Europe. Such conditions have continued to prevail also in the aftermath of the 1/2 point discount rate increase to 12.5% by the Banca d'Italia on 25th August.

Underpinned by three 1/2 percentage point increases in UK base rates (from 9 1/2% at the beginning of July to 11% on 8th August) and the perception that interest rates would need to remain high in order to combat inflationary pressures, sterling saw periods of strong demand during July and the first half of August, recording significant gains against European currencies. However, sentiment turned against the pound on 22nd August amid growing unease about the direction of the UK economy, and the release of UK trade figures for July showing a record current account deficit caused sterling to fall abruptly. It was steadied by a full 1 percentage point increase (to 12%) in UK base rates on 25th August, but ended the month on a soft note. Over the period, sterling's trade-weighted index rose by 0.8% to 75.8.

The Greek drachma weakened by 3.8% and 0.7% against the US dollar and the ECU respectively. In effective terms the drachma depreciated by 1.2%.

The Spanish peseta remained firm during most of the period, weakening slightly at the end of August. The Banco de España's interventions were sporadic and, on the whole, much smaller than in any other period of the year. In nominal terms the peseta appreciated by 0.9% against the ECU and depreciated by 2.1% against the US dollar. The Banco de España raised its three-month repurchase agreement rate by 1/4 percentage point to 10.5%; at the same time a technical correction was introduced in the overnight rate which was reduced by 1/8 percentage point to 10 3/8%.

The Portuguese escudo decreased vis-à-vis the US dollar by 3.6%. As from 1st August the weights of the currencies on which the effective exchange rate index is based were updated and in line with the objectives defined by the authorities the escudo depreciated by 0.25% in effective terms.

Up towards the end of August the Swiss franc continuously weakened vis-à-vis all important currencies. This was caused by marked interest rate increases for investments in other currencies. During that period the export-weighted value of the franc dropped by 2.7%. It was only in the last days of August when the franc managed to break away from its year's low. Effective 26th August, the official discount and lombard rates were raised by 1/2 percentage point each to 3% and 5% respectively.

The Austrian schilling weakened by 2.9% against the US dollar in July and August, with a monthly spread of 4.1% and 3.0% respectively. Against the Deutsche Mark the schilling fluctuated in both months within a range of 0.24%. With effect from 4th and 20th July and 3rd August the money market rate for short-term open market operations was raised in steps of 1/4 percentage point to 4 5/8%. Banks eligible for refinancing were given additional liquidity assistance with an offer of special open market operations from 22nd to 29th July at 6 1/2%, after a temporary undesired liquidity shortage had arisen as a result of large interest rate induced capital outflows. In line with the measures taken by other central banks, the discount rate was raised by 1/2 percentage point to 4% with effect from 26th August. The lombard rate remained unchanged at 5%.

The Norwegian krone continued to weaken during the period and the currency index moved from 110.7 to 112.6. Despite some positive indications of reduced pressure in the domestic economy, uncertainty in the market concerning the future stance of fiscal policy and the effect of reduced interest rate differentials led to some outflow of foreign exchange. On balance, however, the interest rate differential against the basket currencies remained as high as 5 percentage points.

The Swedish krona weakened somewhat from the middle of July. This was partly due to smaller interest rate differentials vis-à-vis foreign currencies and a leads and lags effect after the heavy inflow in May. The Riksbank intervened by selling currencies but allowed at the same time the currency index to rise by 1 percentage point to 131.7. From the second part of August the market has been balanced.

In effective terms the Finnish markka remained quite stable. It was supported, however, by relatively large sales by the central bank. Domestic market interest rates increased by over 100 basis points.

The Japanese yen declined by 2.2% against the US dollar during July and August. Despite the overall bullish sentiment towards the US dollar that prevailed overseas, the yen stayed within a relatively narrow range of Yen 132 to Yen 135 under the persistent dollar-selling pressure from Japanese exporters and institutional investors in the forward market. Toward the end of August, however, the rumour concerning a new Japanese tax on equity-related capital gains triggered an abrupt fall of the yen, which dropped to a nine-month low of Yen 136.85 in the New York market on 31st August. Vis-à-vis the European currencies the yen appreciated by 0.9%. In particular, the yen reached a new high of Yen 69.96 against the Deutsche Mark on 18th August.

After moving to a 6 1/2 year high of US$ 0.8373 in late July, the Canadian dollar weakened throughout the remainder of the period ending the month of August near the US$ 0.8075 level - its weakest level since May. This represents a decline of 2.1% since June. Lending support to the currency in July was the good performance of the Canadian economy, firm commodity prices, and the positive spread between Canadian and US short-term interest rate differentials which, in turn, encouraged foreign investor interest in Canadian dollar denominated securities. In August, however, against the background of the US dollar's strength against the major overseas currencies, the Canadian dollar was undermined by political uncertainties regarding the passage of the pending US/Canada free trade legislation by parliament and the outcome of a possible federal election this fall.

II. INTERVENTIONS

A. Interventions in US dollars

Net sales of US dollars in July and August amounted to US$ 21.5 billion, compared with sales of US$ 0.2 billion in June. They consisted of gross purchases of US$ 1.8 billion and gross sales of US$ 23.3 billion. Major purchases were undertaken by the Banco de Portugal and in July the Bank of Canada. Large sales of dollars were undertaken by a number of central banks with the Deutsche Bundesbank, the Federal Reserve Bank of New York and, in August, the Bank of Canada being the major sellers. A number of central banks participated also on some occasions in concerted interventions by selling US dollars against Deutsche Mark.

B. Interventions in Community currencies and in private ECUs

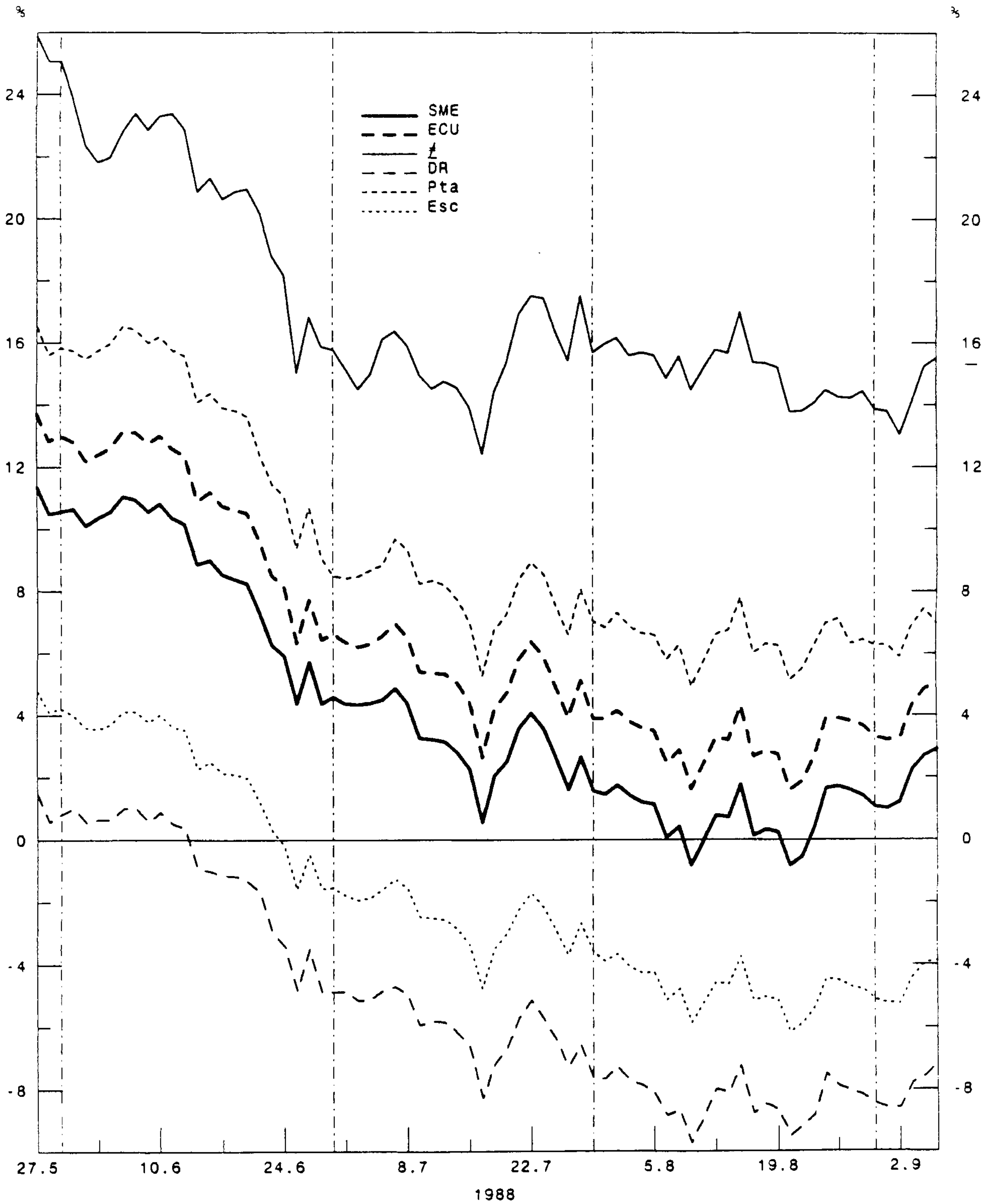
Interventions in EMS currencies and ECUs by Community central banks amounted to the equivalent of US$ 5.7 billion compared with US$ 2.6 billion in June. The interventions consisted mainly of purchases of Deutsche Mark with the Banca d'Italia and the Banco de España as the main buyers.

III. DEVELOPMENTS IN THE CURRENT MONTH, UP TO 9TH SEPTEMBER

After the release of various statistics indicating slower economic growth the dollar lost some ground.

Within the EMS the French franc and the Italian lira experienced some pressure which abated somewhat by the end of the week.

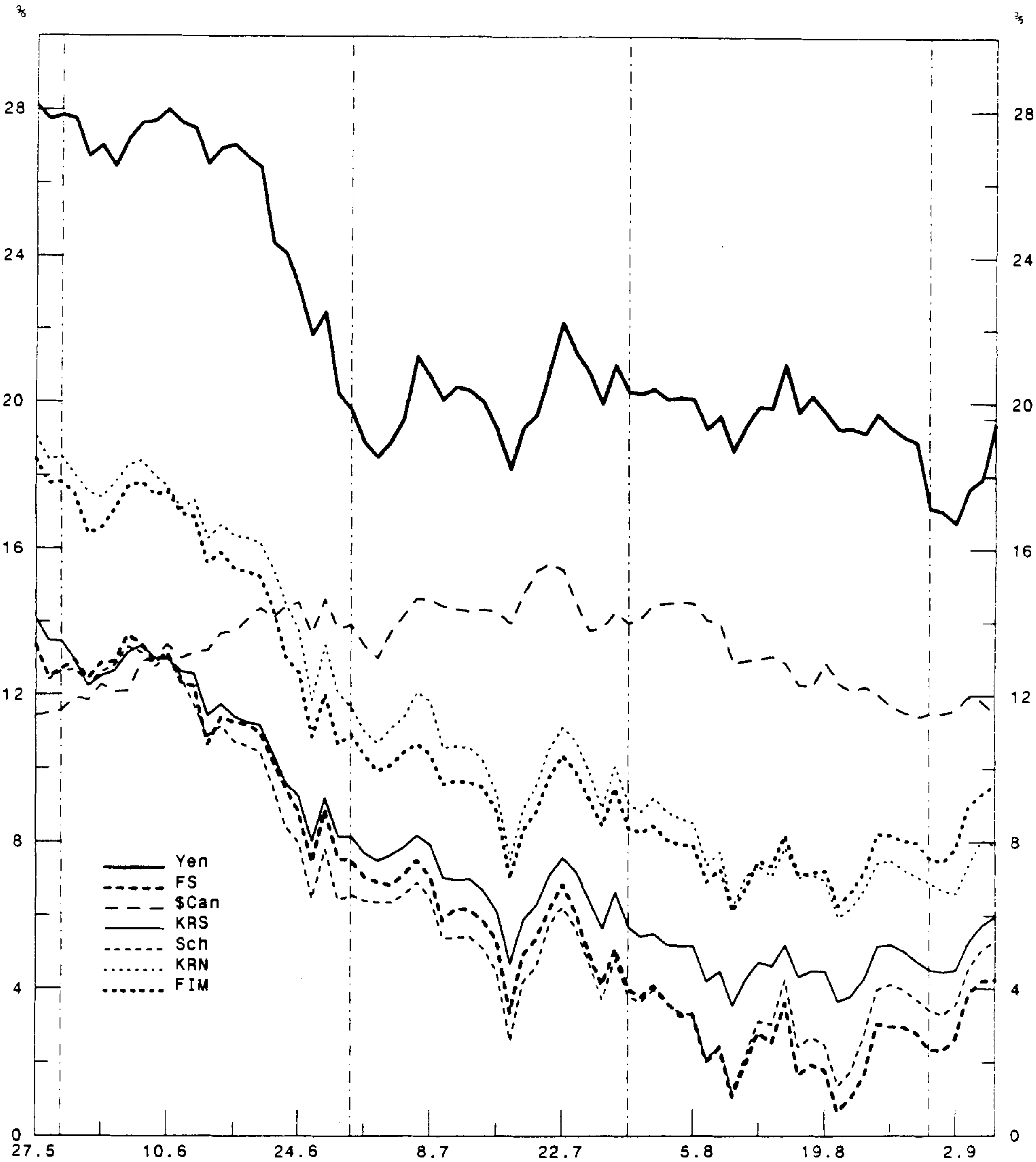
EVOLUTION DE L'ECU, DU COURS MEDIAN DES MONNAIES PARTICIPANT AU MECANISME DE CHANGE DU SME ET DES MONNAIES DES BANQUES CENTRALES DE LA CEE NE PARTICIPANT PAS A CE MECANISME, SUR LA BASE DES COURS RELEVES LE 31 DECEMBRE 1986 VIS-A-VIS DU $EU*



* Voir page suivante.

9.9.1988

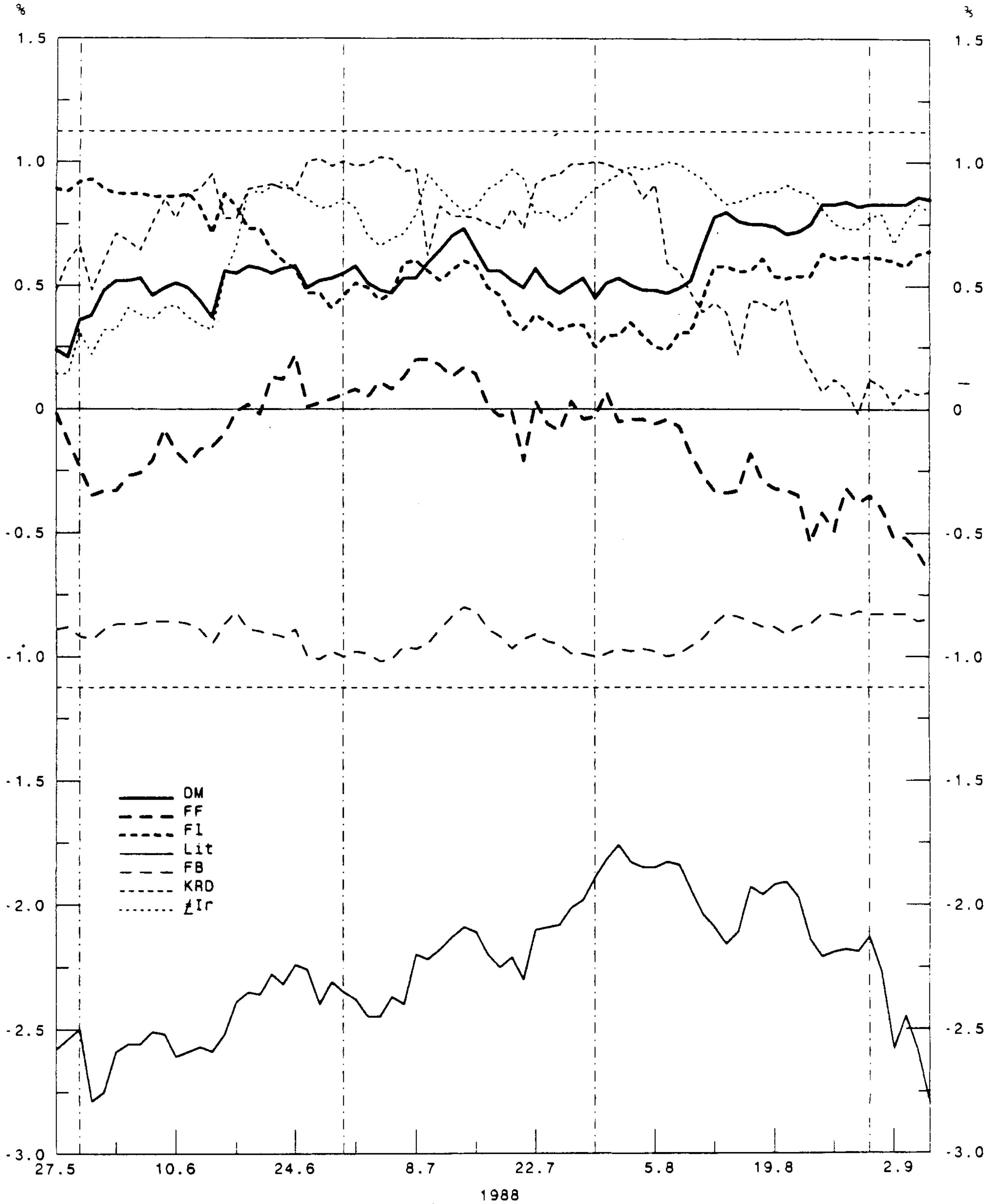
EVOLUTION DES MONNAIES DES BANQUES CENTRALES HORS CEE PARTICIPANT A LA CONCERTATION, SUR LA BASE DES COURS RELEVES LE 31 DECEMBRE 1986 VIS-A-VIS DU $EU*



* ECU 0,93425; £ 0,6773; DR 138,7601; PTA 131,8700; ESC 146,0995; FIM 4,7925; $Can 1,3805; FS 1,6215; Yen 159,7993; KRS 6,7750; KRN 7,3975; Sch 13,6520; cours médian des monnaies participant au SME 0,92913. Le cours médian des monnaies participant au SME représente la moyenne journalière des cours des deux monnaies à marge de fluctuation de 2,25% qui se sont éloignés le plus de leurs cours-pivots bilatéraux actuels.

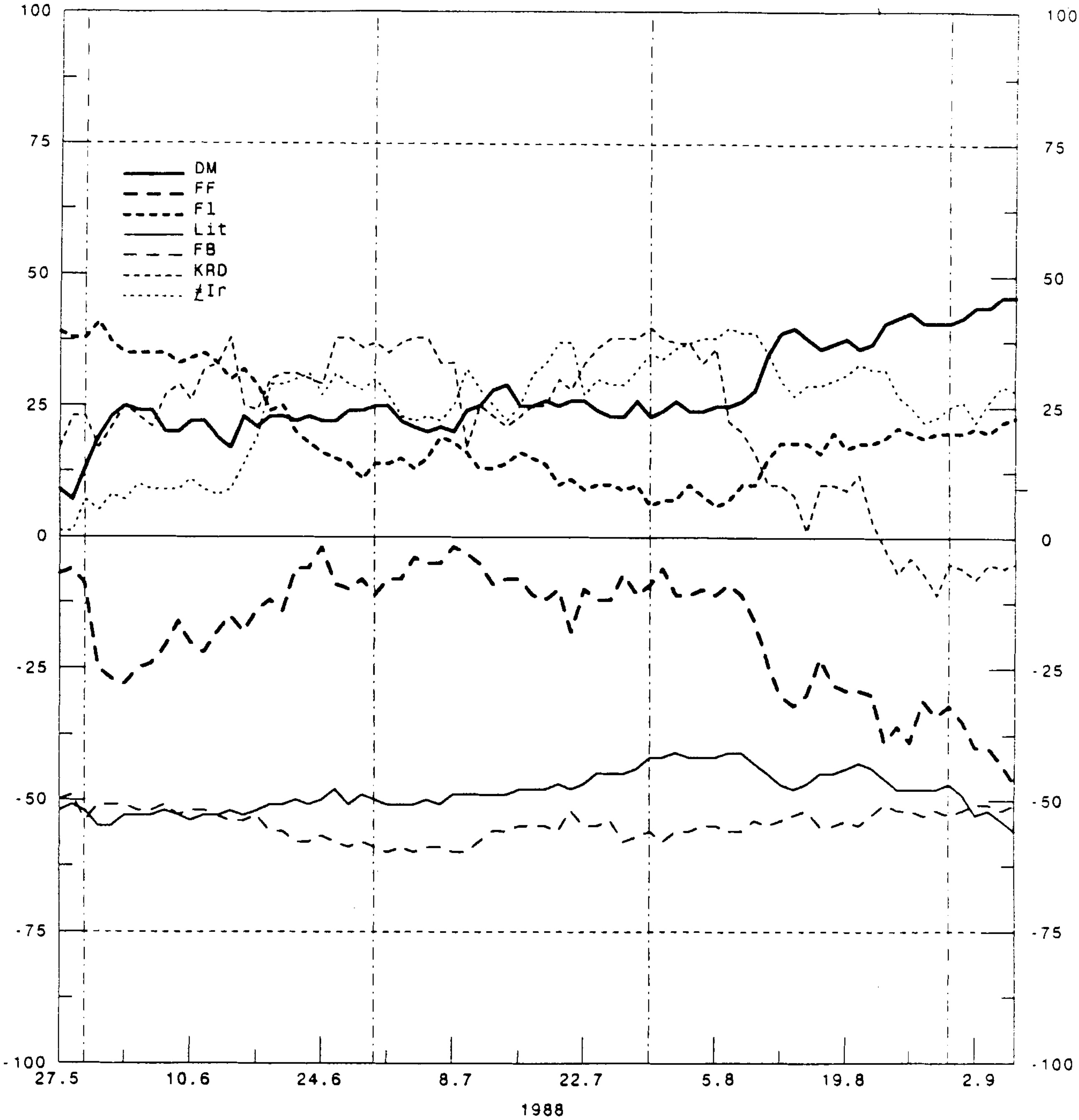
9.9.1988

MOUVEMENTS A L'INTERIEUR DE LA GRILLE DE PARITES DU SME CALCULES SUR LA BASE DES COURS DE L'ECU DANS LES DIFFERENTES MONNAIES PARTICIPANTES



9.9.1988

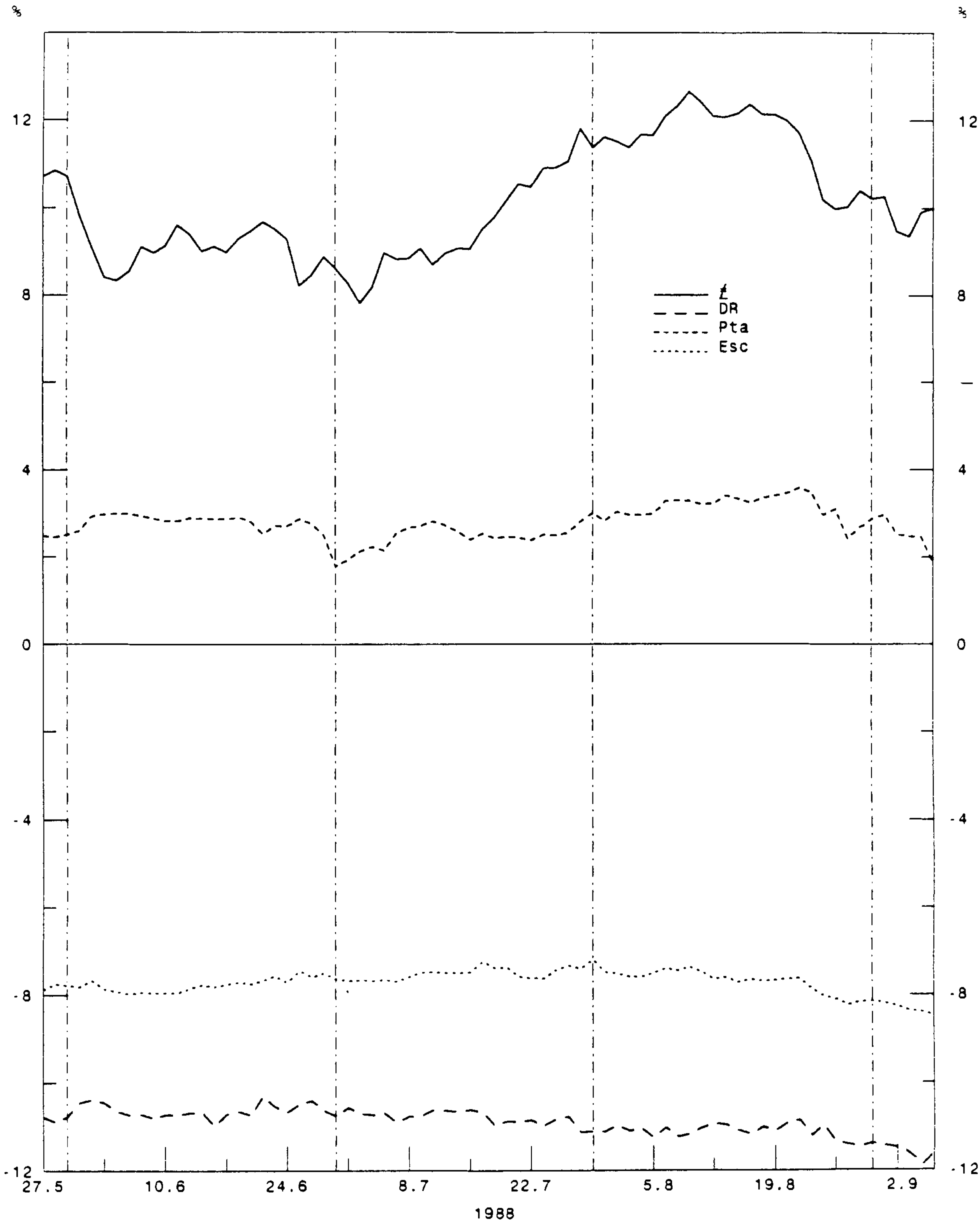
EVOLUTION DE L'INDICATEUR DE DIVERGENCE*



* L'indicateur de divergence a pour but de mesurer, sur une base comparable pour toutes les monnaies participant au mécanisme de change européen, la position d'une monnaie vis-à-vis de son cours-pivot ECU. L'écart maximal de divergence est le pourcentage maximal par lequel le cours de marché de l'ECU dans chaque monnaie peut s'apprécier ou se déprécier par rapport à son cours-pivot ECU; il est exprimé par ± 100, le seuil de divergence étant ± 75. Les données qui ont servi de base à l'établissement de ce graphique sont les cours de l'ECU exprimés en termes de diverses monnaies, cours qui sont toutefois corrigés des effets des fluctuations de la lire italienne, de la livre sterling et de la drachme grecque au-delà de la marge de 2,25% vis-à-vis des autres monnaies participant au SME.

9.9.1988

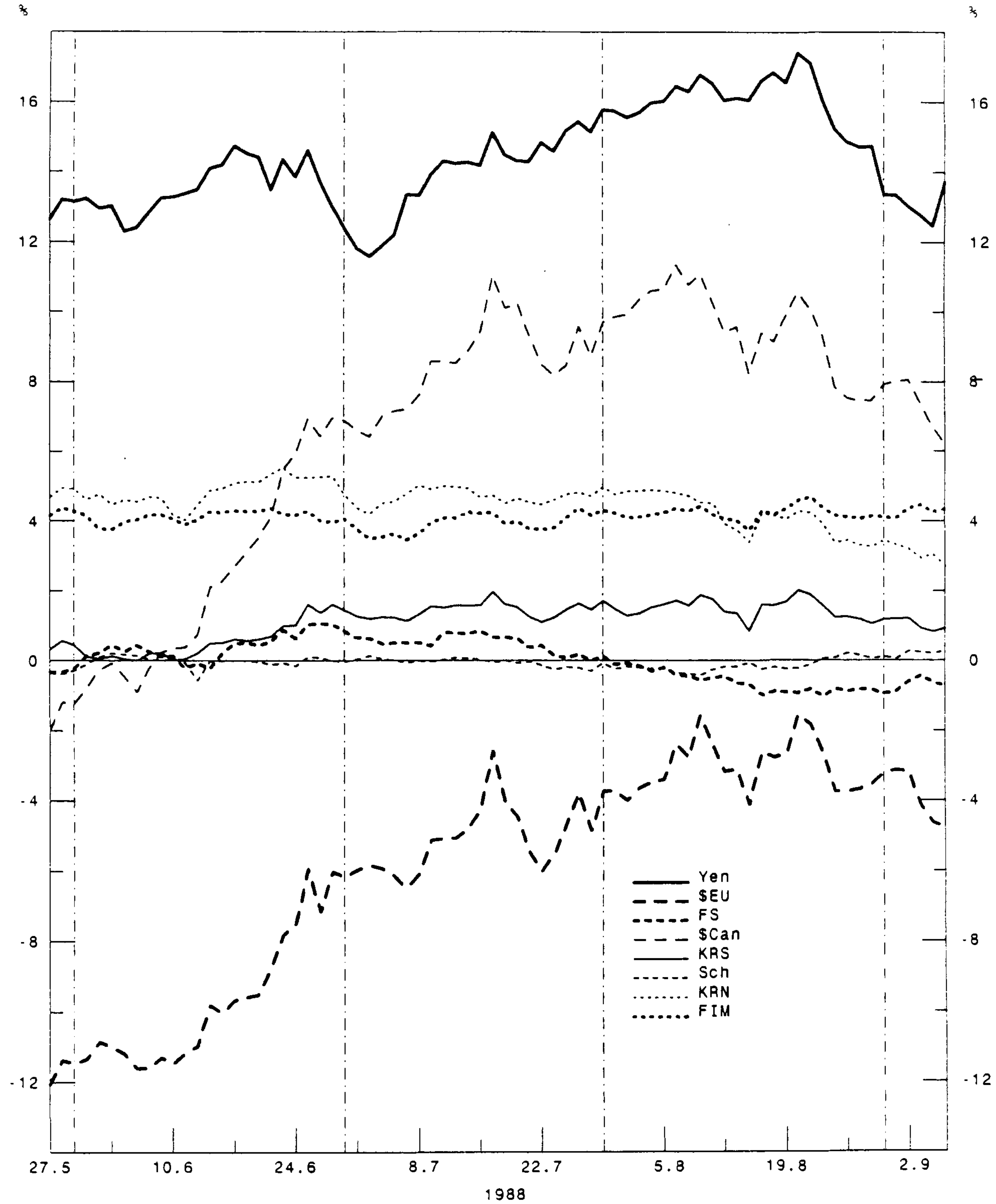
EVOLUTION DE LA LIVRE STERLING, DE LA DRACHME, DE LA PESETA ET DE L'ESCUDO PAR PAPPORT A L'ECU SUR LA BASE DES COURS DU MARCHE RELEVES LE 31 DECEMBRE 1986*



* £ 0,724942; DR 148,526; PTA 141,151; ESC 156,382.

9.9.1988

EVOLUTION DES MONNAIES DES BANQUES HORS CEE PARTICIPANT A LA CONCERTATION PAR RAPPORT A L'ECU SUR LA BASE DES COURS DU MARCHE RELEVES LE 31 DECEMBRE 1986*



* $EU 1,07038; $Can 1,47766; FS 1,73562; Yen 171,046; KRS 7,25181; KRN 7,91812; Sch 14,6128; FIM 5,12978.

9.9.1988