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MINUTES

.

OF THE 250th MEETING OF THE COMMITTEE OF GOVERNORS OF THE CENTRAL BANKS OF THE MEMBER STATES OF THE EUROPEAN ECONOMIC COMMUNITY

HELD IN BASLE ON TUESDAY, 11th DECEMBER 1990 AT 9.30 a.m.

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#### I. Approval of the minutes of the 249th meeting

The Committee approved the minutes of the 249th meeting.

## II. <u>Mandates of the Monetary Policy Sub-Committee</u>, the Foreign Exchange Policy Sub-Committee and the Committee on Financial Matters

<u>Mr. Rey</u> said that the Committee of Alternates had slightly amended the draft mandates of the Monetary Policy and Foreign Exchange Policy Sub-Committees prepared by the Secretariat and recommended adoption of the revised mandates.

With regard to the establishment of a Committee on Financial Matters, the Alternates were in agreement with the proposals of the Secretariat. The draft mandate had been slightly revised with respect to two aspects. Firstly, the Alternates had recommended that the amount of non-recurrent expenditure not provided for in the annual projections which the Chairman of the Committee of Governors would be able to authorise without consulting the Committee on Financial Matters should be fixed at the equivalent of ecu 20,000. Secondly, a reference to Article 10.2 of the Rules of Procedure had been inserted in the text which would provide for annual projections of expected expenditure for the account of the Committee of Governors.

The Alternates had noted that the Committee on Financial Matters would comprise three members of the Committee of Governors. In view of the fact that Governors would, in general, be under considerable time pressure, the Alternates had recommended adoption of the Decision on the understanding that it would be left to the members of the Committee on Financial Matters to decide how their work would be supported by their respective Alternates.

The <u>Committee</u> adopted:

- the mandates of the Monetary Policy and Foreign Exchange Policy Sub-Committees (see annexes);
- the Decision relating to financial matters (see attached).

In respect of the composition of the newly established Financial Committee, the <u>Committee</u> endorsed the Chairman's suggestion that, in order to avoid any conflict of interest, the three Governors should not be members of the Board of the Bank for International Settlements and that Governors Rubio, Hoffmeyer and Doyle should be appointed to the Committee for a period of three years commencing 1st January 1991 (see annex).

#### III. Exchange rate arrangements with third countries

<u>Mr. Rey</u> said that the Foreign Exchange Policy Sub-Committee had produced an excellent report (FXP/90/03 final); this had been the third report in twelve months produced by the Sub-Committee on the issue of links with third countries. The Alternates had been in broad agreement with the proposals and had recommended that they be adopted, subject to some minor amendments to the draft joint press release. In addition, the Alternates had suggested that:

- all Community central banks would be prepared to participate in extending bilateral co-operation with Norges Bank;
- the aggregate amount of the bilateral swap should amount to ecu 2 billion;
- the aggregate amount might be shared out amongst Community central banks in accordance with a key which would be based on the average between ecu weights and the short-term monetary support quotas;
- the agreement with Norges Bank should be concluded on 1st January 1991.

The draft model of a swap agreement with Norges Bank and draft joint press release had been agreed by the representative of Norges Bank.

<u>Mr. de Larosière</u> said that the report proposed a good, pragmatic arrangement, which combined a unilateral decision by Norway to shadow the EMS coupled with bilateral swap agreements between individual central banks in a multilateral framework. The solution avoided too many complicated political issues.

The <u>Chairman</u> also welcomed the arrangement, which he felt might open the door to others interested in a unilateral exchange rate links with the EMS.

The <u>Governors</u> agreed that they would proceed in the manner described by Mr. Rey (see above). The <u>Committee</u> endorsed the proposals made by the Foreign Exchange Policy Sub-Committee in respect of:

- the common understanding about the co-ordinated management of the swap agreements and in particular the procedure to be followed in case of their activation (see Chapter III, section 4b of Report FXP/90/03);
- the rules for consultations with Norges Bank (see Chapter IV, section 1 of Report FXP/90/03);
- the provision by the Secretariat of regular statistical information on Norway (see Chapter IV, section 1 of Report FXP/90/03). The Secretariat was requested to make the necessary arrangements with Norges Bank for regular reporting of such data. The <u>Committee asked the Chairman</u> to:
- agree with Norges about the procedure for and the date for publishing the press release;
- inform the President of the ECOFIN Council of the Governors' decisions.

#### IV. Issues relating to the EMS agreement

## 1. <u>Principles concerning prior agreement on interventions in</u> <u>Community currencies</u>

<u>Mr. Rey</u> said that the Alternates had been unable to reach agreement on the draft Statement of Principles. In May 1990, the text had been agreed by all Alternates, with the exception of that from the Banco de España. However, the previous day's meeting of the Alternates had revealed that, following the experience of the last few months, the Banque de France and the Banca d'Italia also had reservations about the proposed text. Consequently, the Alternates proposed to discuss the matter again at their meeting in January and had asked the Foreign Exchange Policy Sub-Committee to prepare the discussion. In the absence of an understanding on the principles of intervention in Community currencies, the formal abolition of the acceptance limit for official ecus in intra-Community settlements should be postponed.

The <u>Chairman</u> said that he was disappointed that an understanding had not been reached, especially since it was in the spirit of the Basle/Nyborg Agreement. He said that a solution had to be found in order to facilitate and strengthen the co-ordination process. He was content for the matter to be reviewed by the Foreign Exchange Policy Sub-Committee.

<u>Mr. Ciampi</u> said that he would be keen to see the full implementation of the Basle/Nyborg Agreement. He urged the Foreign Exchange Policy Sub-Committee to reach an understanding and emphasised that it would be in everyone's interests to find a solution. <u>Mr. Rubio</u> said that the Foreign Exchange Policy Sub-Committee should take into account the new role of the Deutsche Mark in the EMS. <u>Mr. de Larosière</u> said that recent experiences had necessitated a review of the situation and that it was now essential to reconsider the fundamental issues. It was imperative to have the necessary degree of flexibility to ensure the smooth running of the daily operation of the System.

#### 2. Extension of the EMS revolving swap mechanism

The <u>Committee</u> agreed to proceed in the manner proposed in the Secretariat's note dated 5th December 1990 and to enter the following text in the minutes of the meeting: "In order to ensure the continuation of the EMS revolving swap mechanism beyond 13th March 1991 and to extend the expiry date stipulated in the Governors' decision of 13th December 1988, the Governors decide, in pursuance of Article 20.1 of the Agreement of 13th March 1979 between the EEC central banks laying down the operating procedures for the EMS (hereinafter the "EMS Agreement"), as amended by the Instruments dated 10th June 1985 and 10th November 1987, respectively, and that:

- the swaps referred to in Article 17.3 and Article 18a.4 of the EMS Agreement should not be unwound on 13th March 1991:

- the swap mechanism should be extended for a further two-year period at the end of which, save in the event of a unanimous decision to the contrary, the swaps would be unwound. During the period in question (that is, until 13th March 1993) the swap mechanism would remain subject to the same provisions of the EMS Agreement, it being understood, however, that the Governors could, by unanimous decision, shorten this period and modify the mechanism if institutional changes in the monetary field were to take place before 13th March 1993."

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Furthermore, the Committee requested its Chairman to inform the President of the ECOFIN Council of the Governors' decision by a letter, the text of which was annexed to the above-mentioned note from the Secretariat.

#### 3. <u>Intervention hours</u>

<u>Mr. Dalgaard</u> explained that hitherto the ERM central banks had been conducting marginal interventions between 9.00 a.m. and 4.00 p.m. Brussels time. With the participation of pound sterling in the ERM, the Bank of England had pointed out that, owing to the time difference, it would be extremely early to close at 3.00 p.m.. The position of the United Kingdom had been accepted by all other participating central banks, and the Monitoring Group had agreed that the hours of intervention should be extended by one hour, which would mean closing at 5.00 p.m. Brussels time (4.00 p.m. in the United Kingdom, Ireland and Portugal). The new procedure would commence on 2nd January 1991.

This alteration would cause no major problems; it was agreed for practical reasons that the normal afternoon concertation would continue to take place at 4.00 p.m., but that there would be a special concertation at 5.00 p.m., should circumstances warrant. There would be some implications for the realignment procedure since, in accordance with the present rules, information should normally be given by the country requesting the realignment shortly after closing of official intervention. However, this was not seen as a serious problem.

Following the agreement of the <u>Committee</u> to the changes, <u>Mr. Leigh-Pemberton</u> expressed his appreciation and gratitude for the understanding shown.

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- V. <u>Monitoring of economic and monetary developments and policies in the</u> <u>EEC based on:</u>
  - <u>Preparation by the "Foreign Exchange Policy Sub-Committee and</u> <u>discussion by the Committee of Alternates;</u>
  - Statistical charts and tables

#### 1. <u>Statement by Mr. Dalgaard</u>

In November the decline of the US dollar which had taken place over the previous six months had come to an end. The situation had been influenced, in particular, by the Gulf crisis and by the weakening of the US economy, which had led to a reduction in interest rates, coupled with expectations of a further fall. These factors, together with what was seen as a weak budget compromise and problems with the financial system, would probably lead to a further weakening of the US dollar. If there was a peaceful solution in the Middle East, it was likely to have the immediate effect of weakening the US dollar because the safe haven effect would be lost. In the longer run, however, lower oil prices might help strengthen the US dollar exchange rate.

Since mid-October the Japanese yen had weakened by between 6% and 7% against both the US dollar and the Deutsche Mark, principally because of the decline in Japanese long-term interest rates.

Since the first quarter of 1990, the currencies of the ERM narrow band had fluctuated within a range of 1%, except the Italian lira, which had joined the other currencies in August. In September and October the fluctuation range had narrowed to less than 0.5\%. Since November it had widened to about 1.0% and had increased further in early December.

The principal reason for the narrowness of the actual fluctuation range before November 1990 was the weak Deutsche Mark in the wake of the reunification of Germany. During this period, other currencies had taken the opportunity to lower interest rates or to make intervention purchases when circumstances permitted.

The situation had changed at the beginning of November with the increase by 0.5 percentage point in the German Lombard rate. Although this was considered by the Deutsche Bundesbank as a technical adjustment, the market had taken it as a sign of a continued tight monetary policy. Consequently short-term money market rates had started to rise, with an expectation of further rises. The increase in German interest rates had had an important impact in other ERM countries; in several member states, official key interest rates were also raised. In some countries, the rise was stemmed through intervention sales. Nevertheless, the net result had been that all the other ERM currencies had weakened against the Deutsche Mark.

The conclusion that had been reached by the monitoring group was that the situation was now not quite so calm as had previously been the case, but that the tensions remained modest and that it was still recommended that a flexible policy be followed using all available instruments. Should interest rates in Germany continue to rise, other ERM countries would be faced with the choice of letting their interest rates move up, in a situation where the economy was already soft, of intervening heavily, of letting exchange rates fluctuate within the permitted limits.

In Germany, although short-term interest rates had risen by more than 0.5 percentage point since early November, long-term rates had declined slightly. Seasonal factors had contributed to the rise in the short-term rates but it seemed unlikely that German interest rates would be lowered in the near future. With the strong growth of the German economy and the new round of wage negotiations underway, it had been considered important to demonstrate to the negotiating parties that excessive wage claims could not be accommodated. The large budget deficit was also a factor but it was now no longer increasing and was expected to remain at the present monthly level during 1991 and fall in 1992.

Dutch interest rates and the guilder had mirrored events in Germany. In Belgium the exchange rate had declined somewhat, despite some intervention and increases in short-term interest rates. In France short-term interest rates during November had remained stable while long-term rates had continued to decline. As a result, interest rate differentials vis-à-vis the Deutsche Mark had narrowed to 1.0 percentage point, and this had led to a slight decline in the exchange rate. Recently, however, short-term interest rates had been rising. The Italian lira had come under some pressure in November, but this had been counteracted by interventions and a rise in short-term interest rates. There had been a considerable increase in the interest rate differential vis-à-vis the Deutsche Mark. The lira had weakened in early December which again reflected the strength of the Deutsche Mark.

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The pound sterling had fluctuated relatively sharply, reflecting the political situation. Without ERM membership, the fluctuation would probably have been more significant. An interesting feature had been the parallel movement between sterling and the peseta. This could be attributed to the fact that both were high interest rate currencies and, therefore, to some extent, would be influenced by similar factors in the international capital markets. The Portuguese escudo's effective exchange rate had appreciated by more than 1.5 percentage point during the last two months, instead of the normally administered depreciation of about 0.5 percentage point. There had been no interventions for some time, but from late November intervention purchases had been resumed to limit the escudo's appreciation.

#### 2. Statement by Mr. Rey

The highly unpredictable outlook for the US dollar had been emphasised by the Alternates. On the one hand, the weakness in the US economy and the general financial fragility pointed to possible further interest rate cuts, which would widen the negative interest rate differential against the Deutsche Mark and could undermine the value of the US dollar in exchange markets. On the other hand, it had been argued that, given the other substantial problems still facing the US authorities, the room for additional interest rate cuts was limited and short-term pressures on the US dollar could be counteracted by longer-term expectations of dollar appreciation. Furthermore, the impact on the US dollar of events in the Gulf and developments in oil prices, in themselves unpredictable, had been extremely difficult to evaluate and had added to the uncertainty surrounding the US dollar's outlook. There had been some fear that once the year-end window-dressing operations had unwound, renewed downward pressure would again be experienced. Some Alternates had felt that this risk called for a review of the process of co-ordination of economic policies. Other Alternates had expressed doubts that such a process would be constructive in the present circumstances. The situation had to be very carefully monitored.

The ERM was now more visibly affected by the growing divergence in economic activity between Community countries. While domestic demand was booming in Germany, under the impact of unification, a slowdown was

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increasingly perceptible in other countries. The Alternates had discussed the implications of this trend for prospects within the ERM and for the appropriate mix of policies. It had generally been felt that the recent increase in short-term interest rates, although influenced by seasonal factors, was unlikely to be reversed. Nor would it be desirable, in the present circumstances, for the Deutsche Bundesbank to soften its non-accommodating policy stance. It had been noted that in 1991 the target range for  $M_3$  would possibly be set at 4 to 6Z, i.e. a range which would signal the Deutsche Bundesbank's intention to continue its present monetary policy stance. It had been stated that France's present monetary policy stance was also likely to be maintained.

The rise in German interest rates had presented other Community countries with the difficult choice of whether to tighten monetary policy, in spite of slower or sluggish domestic demand, or to let the exchange rate drift downwards within the ERM band. While there had been some recent movement within the band, it had been underlined that it would be dangerous to use the band's full width, since this might lead to undesirable expectations. On the other hand, the strengthening of the Deutsche Mark had been desirable in that it would facilitate the necessary current-account adjustment in Germany, as well as enable other countries to benefit from the surge in demand as a result of German reunification.

Although there was no simple way to avoid possible tensions, two important points had been made. Firstly, it was important to abstain from behaviour that would publicise conflicting priorities in the member states; after all, stability-oriented policies were to remain a common goal. Secondly, it was important to review the appropriateness of the policy mix, particularly in respect of fiscal policies, and it had been widely stressed that it was of the utmost importance for the new German Government to be seen to be taking steps towards reining back the budget deficit, thereby relieving monetary policy of an otherwise increased burden.

The Alternates had also discussed briefly the position of the lira and the pound sterling in the ERM. The Italian Alternate had expressed satisfaction with the present position of the lira, which had now stabilised following heavy interventions and a very significant rise in short-term interest rates. The United Kingdom Alternate had been encouraged by the behaviour of the pound, which had ridden out recent political events reasonably well, probably better than it would have in the absence of ERM

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membership. The UK economy now showed signs of significant weakening but price indices would look better in the coming weeks. This might increase pressures to lower interest rates but any decision to this effect would have to take account of the position of sterling in the ERM.

The Portuguese Alternate had commented upon the accord between the banks, the government and the central bank which aimed at mopping up excess liquidity in the banking system and at removing all direct credit ceilings. He had stressed the increased difficulty of liberalising capital inflows but, in this respect, had noted that measures in this field were to be expected in due course.

The Greek delegate had presented his country's monetary policy guidelines for 1991, against the background of the very ambitious fiscal stabilisation plan currently being discussed by the Greek Parliament.

#### 3. <u>Discussion by the Committee</u>

The Chairman said that there appeared to be a policy dilemma. Interest rates in Germany would remain fairly high for reasons already well known. He said that the recent increase in short-term interest rates was largely due to seasonal factors, which would be unwound in January. However, monetary policy needed to be firm and at the present juncture, there was little room for manoeuvre with respect to interest rates. This might give rise to two problems. Firstly, the interest rate differential between the US dollar and the Deutsche Mark was widening, and in this context, the US dollar/DM exchange rate could weaken further. There was also the question of co-ordination in the framework of the G-7. However, the question to be decided was what precisely should be co-ordinated. The situation currently differed considerably in the individual G-7 countries and he felt that the present widening of interest rate differentials would have to be tolerated. One possibility would be intervention, but this had to be decided by the US authorities and so far they had abstained from any action. Secondly, there was the issue of the ERM. The stability that had been enjoyed over recent years should not be taken for granted. There were countries which - for good reasons - wished to lower interest rates; what would be the reaction of the markets to any consequential changes in exchange rates?

<u>Mr. de Larosière</u> said that the crux of the issue was the need to obtain a successful policy mix which would lead to greater stability within the ERM. Recent developments with regard to anti-inflationary policies had already enhanced the credibility of the ERM and had enabled some narrowing of interest rate differentials. However, short-term developments could be at variance with the fundamental principles and therefore care should be taken not to allow excessive movements which might unbalance overall longer-term stability. Furthermore, if too much emphasis was placed on monetary policy to combat inflation in the face of large fiscal deficits there would be an automatic bias towards the use of interest rates. In the present situation, where there existed a contrasting conjunctural situation - with the German economy booming but other European countries' economies slowing down - a further rise in German interest rates would greatly complicate the situation, even with declining inflation. He would therefore urge the new German Government to comprehend and take into consideration fully the inter-relationships, especially in the context of Germany's large fiscal deficit. Were a monetary union to be established, the question of the overall policy mix and the macro-economic setting of the Community should be addressed as a global issue. The question of the policy mix between Germany and the rest of the Community, the USA and Japan was of fundamental importance.

Mr. Leigh-Pemberton supported the comments of Mr. de Larosière. The economy of the United Kingdom was slowing sharply and there was strong pressure to reduce nominal interest rates in order to save the real economy from dangerous contraction. If the United Kingdom had not been bound by other constraints, the authorities would have wished to see interest rates lowered in order to assist the real economy. The other consideration was high inflation, which would fall soon and was therefore less cogent than hitherto. Sterling, however, had weakened in the wide band of the ERM. Its position could be explained, firstly, as a result of pressure from the real economy and the presumption that the authorities would lower interest rates, which had led to discounting of the exchange rate. Secondly, there was a tiresome undertone within the London markets that the Government was not fully committed to the ERM and would be prepared to re-align in order to accommodate a more relaxed domestic monetary policy. Mr. Leigh-Pemberton did not think that this was at all likely. The dilemma was that with the position of sterling within the ERM, the opportunities for lowering nominal

interest rates were restricted. There was concern that strains from elsewhere in the ERM would make it increasingly difficult to lower interest rates at a time when otherwise they ought probably to be reduced. The United Kingdom's position was similar to that of France.

Mr. Ciampi said that the relaxation of monetary policy in the United States was likely to cause a further weakening of the dollar even if the markets concluded that the dollar was at present undervalued from a commercial point of view. In the context of the Deutsche Mark it was necessary for the markets to be aware that the Deutsche Bundesbank had no intention of increasing interest rates. Any increase in the dollar/Deutsche Mark interest rate differential would probably cause additional tensions within the ERM and, in this context, he noted the Chairman's comments that the present increases could be partly attributed to seasonal influences, which would unwind at the beginning of next year. The situation was extremely fragile; for example, the knowledge of a forthcoming Deutsche Bundesbank press conference had been sufficient to generate tensions, especially in Italy. All this would have to be discussed were the G-7 to meet in the not-too-distant future. In Italy the outcome of the Gulf crisis would be a critical factor, given the country's dependence on oil. Furthermore, Italy had recently come under increasing foreign exchange pressure; during the first twenty days of November outflows had amounted to US\$ 5 billion. The immediate impact on domestic liquidity had resulted in a rise in short-term interest rates, which had subsequently eased tensions. Tensions had risen again at the beginning of December because of the strong Deutsche Mark. The situation in Italy would remain delicately poised until the new finance bill was approved by Parliament. He hoped that the bill would be passed by the end of the year; its adoption would be a step towards reducing the budget deficit. Another issue was wage negotiations and, in this respect, the unions had just announced a strike scheduled for 20th December; in this situation it would be imperative to maintain exchange rate stability during this period, as a necessary point of reference.

<u>Mr. Hoffmeyer</u> said that Denmark was in a similar position to France and the United Kingdom. The increase in the German interest rates had not been followed. The interest rate differential had been halved to around 1 percentage point; however, it was felt unlikely that the margin could be narrowed further. Thus, any further rise in German interest rates

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would probably have to be followed in Denmark and this would be uncomfortable.

<u>Mr. Doyle</u> expressed similar views to Mr. Hoffmeyer. He felt that the markets had become accustomed to and the Community central banks too complacent about the recent trends towards convergence and that any apparent change to the contrary could result in an exaggerated adverse market reaction. He said that, at this juncture, it would be difficult to contemplate full use of the band within the ERM as it would be misinterpreted by the markets. In addition, given the high rate of unemployment in Ireland, any rise in interest rates would not be welcome. Even more worrying, specifically from a trade point of view, was the present downward trend of sterling, especially given its wide room for manoeuvre within the ERM.

<u>Mr. Rubio</u> said that the peseta had also weakened during the past few weeks but this was not specifically linked to the rise in German interest rates. The downward trend would be likely to continue in the immediate future and certainly whilst the current restrictions on deposits by non-residents were in place. It was expected that a number of these restrictions would be lifted around the turn of the year, at which time the peseta might move in a more positive direction. The present aim was to maintain the peseta in the upper half of the ERM band as a contribution to the anti-inflationary policy. The economic situation had worsened and there might come a time when interest rates would have to be lowered in order to stimulate the economy. The round of wage negotiations in the spring would be very important and have a direct impact on the economy; it was hoped that settlements would be in the region of 6 to 7%.

<u>Mr. Duisenberg</u> said that he echoed the comments of previous speakers. He asked whether the end-season rise in interest rates in Germany was similar to that of previous years and whether there were any technical measures available to the Deutsche Bundesbank to limit such effects?

<u>Mr. Tavares Moreira</u> said that the escudo had appreciated in effective terms in recent months. The Portuguese economy was still extremely strong and was in its sixth year of growth, the annual average being 4.5% of GDP. Inflation was clearly the main problem facing the economy but it was seen by politicians as part of a trade-off for economic growth. The new exchange rate policy had, notwithstanding, received clear support from the favourable position of the current account which,

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according to the most recent revision, had shown a small surplus in 1989 (0.1% of GDP) and was expected to show a deficit much smaller than initially expected in 1990 (around 1% of GDP). As in the case of Spain, the imposition of controls on short-term capital flows had been necessary in order to protect the economy against large capital inflows. In conjunction with the Treasury and the domestic banks, the Banco de Portugal had recently removed approximately US\$ 8 billion from the market through an issue of public debt. Three-quarters of the proceeds would be used to prepay all public debt held by the central bank and the remainder would be used to prepay public sector foreign debt. This would reduce the volume of liquidity held by banks and would make monetary policy more effective. In January 1991 a new system of indirect monetary control would be implemented.

<u>Mr. Verplaetse</u> said that the situation in Belgium was relatively satisfactory. Agreements for the next two years indicated that wages would rise by only 0.3% in real terms. The current account for the Benelux area would show a surplus of 2% of GDP. He mentioned that the authorities had failed to respond appropriately to the recent increases in German interest rates owing to confusion between technical and seasonal phenomena.

Mr. Chalikias said that the monetary objectives of the Bank of Greece had been announced two months earlier than on previous occasions in order to provide markets with an early signal and to underscore the consistency of monetary policy with fiscal and income policies. The monetary and credit targets for 1991 were consistent with the Government's objective of reducing inflation by the end of 1991 to an annual rate of below 17%, compared with an estimated 23% for 1990. The M<sub>2</sub> growth rate had been set at 14-16% compared with an estimated outturn of 17% in 1990. Domestic credit expansion for the private sector would grow at 142; overall domestic credit expansion would be expected to decelerate substantially to 12.5-13.5% compared with an estimated 18% in the twelve-month period to November 1990. The PSBR was forecast to decline by 5 percentage points to 13.5% of GDP and nominal wage increases in the public sector would be less than 10%; this implied a sharp fall in the real wages of public sector employees. Nominal wage increases in the private sector would not be expected to deviate significantly from those of the public sector. The stance of monetary and exchange rate policies would contribute to such an outcome. Thus, a substantial reduction in overall inflation was feasible

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for 1991 as a result of the tighter fiscal policy and also the favourable development of labour costs. Monetary targets had also taken into account the effects of demand on broad money, of new financial instruments which had been introduced to finance the Government's deficit and of increased financial disintermediation. Mr. Chalikias announced that the Greek government had applied for a Community loan to support the balance of payments; this loan was necessary to bolster the credibility of the three-year stabilisation and adjustment programme.

The Chairman said that the situation with regard to fiscal policy in Germany was becoming a problem for Germany as well as the EMS. He felt that it was necessary for the German political authorities to be fully aware of what effect such a significant deficit (57 of GDP) would have on Germany's partners and the functioning of the System. Such observations should also be made at both ECOFIN and G-7 meetings. The major components of the increased deficit were current payments in respect of unemployment compensation, pensions etc. and expenditure on the infrastructure in eastern Germany. Imports to Germany were rising, which would be helpful for the other Community countries, but if it were allowed to continue, the significant increase in the deficit could change the overall economy of Germany. Another factor was wage settlements, and claims were reaching 10%. This had to be seen in the light of the transfer of real resources to eastern Germany, where wages were rising by 20 to 30%, although from a low level.

The growth of monetary aggregates was also accelerating. The planned increase in money supply as a result of unification was about 10%, but in reality it had been nearer 15%. In spite of this, inflation was still low; if the oil factor was excluded the increase would be in the region of 2.5%; this had been partly helped by the decline in import prices. In spite of the overall situation, long-term interest rates had eased slightly recently as markets appeared to remain confident about the authorities' resolve to fight inflation. The primary reason for the rise in market short-term interest rates could be attributed to the banks' window-dressing of their end-year accounts, which had caused trouble and misunderstandings in previous years. However, there was also the influence of the Deutsche Bundesbank, which had no choice but to pursue a restrictive monetary policy.

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If it was assumed that economic growth in all other countries of the EMS was slowing and all other central banks had good reasons for wanting to lower interest rates, then there was a real dilemma. The narrowing of the interest rate differential was justified if it was assumed that there would be no change in the exchange rate. In this case, he did not exclude the possibility of interest rates elsewhere in the Community being lower than those in Germany, especially given the size of the fiscal deficit. However, the market's attitude regarding the possibility of a realignment could change.

# VI. 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 November and the first few days of December 1990

The Committee adopted this report, which would be sent to the EEC Ministers of Finance in the usual way.

#### VII. Common framework for the monitoring of monetary policies

#### 1. <u>Statement by Mr. Raymond</u>

<u>Mr. Raymond</u> said that this was the first ex ante co-ordination exercise. The task had been undertaken by the Monetary Policy Sub-Committee on the basis of conclusions contained in the Special Report of the Group of Experts of May 1990 on a "Common Framework For the Monitoring of Monetary Policies" and also on the basis of conclusions contained in a note produced by the Economic Unit to the Committee of Governors in September 1990. He emphasised that the report was the first example of co-operation between the Sub-Committee and the Economic Unit, and it had demonstrated how the two bodies complemented one another.

#### (a) Difficulties in preparing the ex ante exercise

The Sub-Committee had experienced two difficulties in preparing the report. Firstly, there had been a number of exceptional uncertainties. The unification of Germany had led to doubts about growth,

balance-of-payments developments and continued price stability in 1991. There had been the shock to the global economy following the crisis in the Gulf and the recent rise in oil prices. There were also uncertainties surrounding the interpretation of monetary aggregates. In several countries (e.g. France and Spain) the definition and contents of monetary aggregates were being reformed. To prepare forecasts for 1991 had proved more difficult than had been envisaged. Secondly, the Sub-Committee had noted a number of methodological imperfections. These were principally caused by the attitude of the Community central banks, which had acted somewhat independently, and this had resulted in the heterogeneous information. On the other hand, the participants had not delved sufficiently deeply into the basis of the information available from their central bank colleagues. For example, there were a number of non-co-ordinated hypotheses with regard to developments outside the Community. These shortcomings should be rectified and, to this end, Mr. Raymond recommended that there should be a technical meeting in the autumn of next year at which a set of working hypotheses should be agreed. Furthermore, he suggested that each central bank should take into consideration the expected rate of growth and inflation in neighbouring countries when preparing their forecasts.

#### (b) Strategies for 1991

With regard to the analysis of strategies for 1991, central banks had been very conscientious with regard to their monetary policy intentions. No central bank was considering relaxing its monetary strategy in 1991. There would be no accommodation of the oil price shock or, for example, in Germany, of the cost of unification. Furthermore, there was also growing awareness of the risks associated with large fiscal deficits. Mr. Raymond recalled that it was the intention to redress the situation that had occurred in 1989/90 in certain countries, such as Greece. Italy and Portugal. Spain had already made considerable efforts in this direction. On the other hand, there was now a considerably larger fiscal deficit in Germany, to which the Deutsche Bundesbank had responded in a very orthodox manner. Nonetheless, as far as the global result of monetary policy was concerned there would be improvements in some countries and a worsening situation in others. The Sub-Committee felt that the pressure of

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fiscal deficits in the Community as a whole would be the same in 1991 as it had been in 1990.

Indications were that there would be better convergence in 1991 than there had been in 1990, which was a reversal of the trend. Greater convergence would promote greater exchange rate stability. However, the situation was delicately poised. In those countries where the inflation rate was high, a lowering of the rate depended on an expected correction of fiscal policy. Furthermore, those countries would be more sensitive to oil price shocks, especially to the extent that there existed indexing agreements.

The targets which had been announced in the four major continental economies appeared to be consistent with improved convergence in the field of price levels and exchange rate stability.

Mr. Raymond said that in 1991 there would be progress in lowering the overall level of inflation in the Community, largely because there would be a fall in high-inflation countries. However, a great deal remained to be done before real convergence was achieved. In those countries with a low rate of inflation, there would probably be a worsening in 1991 compared with 1990. The overall lowering of the inflation rate took into consideration the unwinding of the increases in the mortgage rates in the United Kingdom in 1990. An additional factor was whether the ambitious targets set by the high-inflation countries for 1991 would in fact be achieved.

(c) <u>Conclusion</u>

Mr. Raymond drew the following conclusions:

- The Sub-Committee wished to improve its methodology and technique; in this respect, there should be greater co-operation with the Economic Unit.

- In the four major economies, work was presently underway to improve the quality of quantitative indicators. This had also been the subject of a note recently circulated by the Economic Unit. The Economic Unit and a small number of experts from the Sub-Committee should work on this issue in the spring.

- With regard to the implementation of monetary policy, there was a risk that not all countries would achieve their objectives. There were a

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number of uncertainties, such as the oil price, German unification and fiscal policies. The report had recommended that it would be necessary to carry out ex post assessments several times in the course of the year.

Furthermore, Mr. Raymond enquired whether the Governors were considering publishing a statement or communiqué as proposed in the Special Report.

#### 2. <u>Statement by Mr. Rey</u>

Mr. Rey said that the Alternates had thanked Mr. Raymond and the Sub-Committee for the high-quality report, which had been produced in a difficult and highly uncertain global environment; this reinforced the need for regular ex post reviews of the objectives and implementation of policy. The Alternates had favoured ex post assessments on either a quarterly or a four-monthly basis.

The recommendation for a non-accommodating monetary policy stance had been endorsed by all Alternates. It had been encouraging that the report assumed a reduction in the average inflation rate in the Community in 1991 and held out the prospect of greater convergence in this field, despite the oil shock. Caution was, however, justified on three grounds:

- Convergence of inflation rates was due to the combination of better performance in the high-inflation countries and a slight and, it was to be hoped, transitory deterioration in the performance of lower-inflation countries.
- The predicted convergence was heavily dependent on the high-inflation countries showing the appropriate degree of fiscal restraint. The importance of implementing the ambitious fiscal plans announced in these countries was stressed.
- Even if the forecasts for 1991 were achieved, it was important to emphasise that a considerable spread between inflation rates would remain in the Community, and this had to be reduced further if rapid progress towards EMU was to be contemplated.

Some Alternates had suggested that the report was too optimistic on the prospects for growth in the Community in 1991, and the updates provided by some since early November had indeed pointed to a lowering of real GDP growth. This would apply particularly if the US economy was very weak and there could be expected to be pressure on central banks in such

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circumstances to ease monetary policy. It was also noted that growth differentials within the Community could diverge further, with Germany continuing to grow rapidly, whilst prospects elsewhere were rather less bright.

With respect to methodology, the Alternates had taken note of the deficiencies which had been identified by the Sub-Committee, such as the widely different oil price assumptions used in national forecasts. The methodological improvements recommended in the report for next year's exercise had been endorsed. Work by central banks and the Economic Unit on improving and harmonising monetary aggregates had been welcomed, and the need for supporting analytical and econometric research, taking into account continuing financial innovation, had also been highlighted. One Alternate had stressed that, in a world of semi-fixed exchange rates and free capital movements, the monetary aggregates should be looked at as indicators rather than targets. It had also been underlined that the the counterparts of liquidity creation held analysis of important informational value. The Economic Unit was studying these topics: a paper on the harmonisation of broad monetary aggregates was now available, and a paper on the role of counterparts was expected soon. The Alternates would deal with the follow-up to this material at their next meeting.

The Alternates would seek advice from the Governors on the question of the communiqué mentioned by Mr. Raymond and on the continuation of the practice of transmitting the report to the EC Monetary Committee after discussion by Governors and amendments by central banks. As the first report on ex ante co-ordination, it had clearly placed additional emphasis on the judgement and assessment of prospects and had made the break with the past, more conjunctural reports of the previous Raymond Group and contained more sensitive material. It was noted that, on the one hand, removing confidential material from the report could excise much of the content whilst, on the other, not sending the report would be inconsistent with achieving a higher profile for the Committee of Governors. It was also suggested that the Committee of Governors might wish to send the report to ECOFIN rather than the Monetary Committee.

#### 3. The current work of the Economic Unit

<u>Mr. Baer</u> said that both Mr. Raymond and Mr. Rey had already referred to part of the work being undertaken by the Economic Unit. Before

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reporting on this, he outlined the relationship envisaged between the Sub-Committees and the Economic Unit. He felt that the Economic Unit should be considered as the analytical think-tank of the Committee of Governors and provide the analytical basis for work which might then be undertaken by the Sub-Committees. If this was applied to the ex ante co-ordination exercise, the role of the Economic Unit should be to establish the analytical framework. The individual central banks would provide the input and the report would be produced by the Monetary Policy Sub-Committee. The Economic Unit had already prepared a paper on the mutual compatibility of monetary policy, which was designed to facilitate the work of the Monetary Policy Sub-Committee in the context of the ex ante co-ordination. The point of the paper was to raise a number of questions in order to structure the discussion with a view to a forward-looking exercise. The paper had already been discussed by the Alternates who, although welcoming it, had suggested that more emphasis should be placed on harmonising monetary aggregates and analysing the counterparts of money supply. Recently a paper had been circulated to the Alternates on the harmonisation of monetary aggregates; the paper considered what was available, what were the differences and what could be done in order to make the aggregates more similar, provided of course that the economic characteristics were not severely negatively affected.

Mr. Baer drew to the attention of the Committee the conclusions of the paper and pointed out that it would be very helpful to the Economic Unit to establish closer contact with its counterparts in the central banks, given the fact that a great deal of work was already underway and taking into account the size and capacity of the Unit. A third paper which would soon be circulated looked at the role of counterparts to money supply and the process of policy co-ordination.

#### 4. <u>Discussion by the Governors</u>

The <u>Chairman</u> felt that the work so far undertaken by the Monetary Policy Sub-Committee and the Economic Unit had been extremely valuable. The whole question of ex ante co-ordination was highly relevant to Stage Two and he thanked all those who were associated with work in this field. The <u>Committee</u> thanked Mr. Raymond and the Monetary Policy Sub-Committee for the

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very good report, which had provided an excellent start to the ex ante exercise.

Mr. Ciampi said that he was extremely appreciative of the work done so far and welcomed the high degree of co-operation between the Economic Unit and the Monetary Policy Sub-Committee. He said that he would not wish to see the Economic Unit playing only an ancillary role, and he envisaged that the Unit should also prepare documents specifically for the Committee of Governors. With respect to the heterogeneous nature of the information available, he said that the central banks should instruct their competent departments to ensure that the situation improved, in order that full and consistent information was supplied. This would probably mean that some central banks would have to change and accelerate their internal procedures, and this should be achieved in readiness for the next ex post examination. With respect to the issue of a communiqué, Mr. Ciampi was in favour in principle and suggested that the statement might also include some reference to the underlying assumptions, especially with regard to fiscal and income policies. This would encourage the public to appreciate the need for consistency and convergence. Mr. Ciampi considered that the report of the Monetary Policy Sub-Committee should be sent to ECOFIN rather than the Monetary Committee.

<u>Mr. Rubio</u> agreed with Mr. Ciampi that a communiqué should be published at the beginning of next year. It was essential for the public as well as the central bank governors to have a statement which described the situation and indicated the problems of monetary policy and convergence in 1991. He considered that the report should be sent to ECOFIN - and not to the Monetary Committee - providing that this did not entail too many procedural difficulties.

<u>Mr. Hoffmeyer</u> said that, owing to considerable institutional differences, the Economic Unit should not concentrate too much on perfecting money supply data. However, it would be worthwhile to explain why targets or objectives had not been achieved. He also felt that the report should be sent to ECOFIN and considered that a communiqué to the general public would not be worthwhile.

<u>Mr. de Larosière</u> said that next year the Committee of Governors should be in a position to work on common hypotheses and assumptions. Also the Sub-Committee and the Economic Unit should continue their work on methodology and aggregates. Ex post examinations would be required but he

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was not in a position to determine their frequency. He considered that a communiqué should be published in January and also supported sending the report to ECOFIN, with an accompanying letter describing the general economic framework and the basis for the targets. The report should also go to the Monetary Committee. Mr. de Larosière said that the Committee of Governors should agree a single, common view of what monetary policy should be in order to meet the anti-inflation target.

Mr. Duisenberg said that he was less optimistic than the report regarding the prospects for inflation and exchange rate stability. Inflation had appeared to be on a rising trend in a number of countries, even before the oil price shock. There was also the question of wages and whether the degree of fiscal tightening in some countries would be sufficient to reduce inflationary pressures. He felt that inflation and its convergence could well continue to deteriorate in 1991, with possible consequences for exchange rate stability. If Germany's demand pressures continued and the policy mix remained unbalanced, the co-ordination of interest rate policy would come under severe pressure. With respect to the money targets for 1991, it was clear that interest rate levels necessary for the attainment of these targets would, in a number of countries, depend heavily on the actual development of the fiscal policy stance and this should be monitored closely. In the Netherlands, the underlying rate of monetary growth had slowed from 14% in 1989 to approximately 9% in the first nine months of 1990. However, during the same period, domestic money creation by banks had accelerated strongly from 4% in 1989 to 14% on an annual basis in the third quarter of 1990. This development was of concern and, if it were to continue, would undoubtedly lead to monetary outflows.

With regard to the future reports of the Sub-Committee, Mr. Duisenberg felt that more consideration should be given to interest rate developments and particularly also to the development of the domestic and foreign sources of money supply growth. This would be a means of assessing the compatibility of the envisaged policies in greater depth. He welcomed the report of the Secretary General and said that the Secretariat should be encouraged to get in touch and co-operate with the research departments of the central banks. With respect to publication, the report should be sent to the Monetary Committee and to ECOFIN with an accompanying letter.

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Mr. Leigh-Pemberton said that the Committee should think carefully about the main objectives of its work and ensure that any publicity was consistent with that approach. In this respect, the Committee should also consider how best to influence governments. He felt that publicity should be divided into two categories. Firstly, to inform the public in general, thereby gaining public credibility for the future; in this context, the communiqué should stick to general principles. He would be against the public document going into quantitative detail. Secondly, if the Committee of Governors was seeking to influence fiscal authorities, he felt it would be more appropriate to tackle this privately, away from the public gaze. The report should not become a public document, but should go to ECOFIN and the Monetary Committee. The report should be a source of influence upon the Governors' respective governments.

The <u>Chairman</u> said that, from the point of view of the Deutsche Bundesbank, he felt that the report should be considered as a working document and therefore not be published. Indeed, it contained a number of details that he would not wish to see published, for example, the assumptions about oil prices and the forecasts for inflation in Germany. He could support making the report available on a confidential basis to the Monetary Committee and - with an accompanying letter - to ECOFIN. On the whole, however, he would be against such an approach for he felt that the report was not sufficiently mature. He would, therefore, suggest leaving it as an internal document this time and considering the issue again next year. If some sort of publication was necessary then it could be in the form of the annual report, this would be a more appropriate basis.

#### VIII. <u>Economic and Monetary Union</u>

# 1. Exchange of views on the British proposal for introducing the hard ecu

<u>Mr. Leigh-Pemberton</u> said that the Committee was fully aware of the proposal and he was content for work to be done on it by the Foreign Exchange Policy Sub-Committee in due course. He wished to ensure that there was an understanding that the proposal was on the table at the Intergovernmental Conference as a contribution to the transitional phase.

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The <u>Chairman</u> suggested that the hard ecu proposal should form an integral part of the discussion that the Governors should have on Stage Two, which could be discussed by the Committee at their January or February meeting.

#### 2. <u>The Intergovernmental Conference</u>

<u>Mr. Rey</u> reported that in the context of the follow-up to the informal ECOFIN meeting, the Alternates had identified three areas for discussion. The Committee of Governors:

- should complete the draft Statute pending further deliberation;

- should establish links with the IGC in order to be able to follow the work done and respond where necessary - although at present the information on the practical organisation of the Conference made it difficult to ascertain the proper way to proceed;
- should formulate their views at an early stage on the monetary aspects of Stage Two, given the importance and political emphasis being attached to the transitional phase.

Following comments by a number of Governors, the <u>Committee</u> agreed that it should be represented by the Secretariat which should attend the Intergovernmental Conference as an observer. A letter to that effect would be sent by the Chairman to the President of ECOFIN.

The <u>Chairman</u> agreed that at the next meeting the Governors should have a brainstorming session on Stage Two.

#### IX. Other matters falling within the competence of the Committee

1. Ecu clearing

The <u>Chairman</u> said that the Board of the Bank for International Settlements had authorised the BIS to conclude with the Ecu Banking Association a revised agreement. The main changes involved the establishment of an intermediation facility and changes in the criteria governing admission of new clearing banks.

# 2. <u>Annual Report of the Committee of Governors in accordance with</u> <u>Article 3 of Council Decision (90/142/EEC)</u>

The <u>Committee</u> agreed that a draft Report covering the eighteen month period since the start of Stage One of EMU was to be presented to the Committee by the Secretary General at the beginning of 1992. If, however, the situation in the EMS were to become critical, the Committee could send an ad hoc statement to ECOFIN. This statement might cover the question of the policy dilemma and include the essence of what could be included in the annual report.

#### X. Date and place of next meeting

The Committee's next regular meeting would be held in Basle on Tuesday, 8th January 1991 at 9.30 a.m.

# 250th MEETING OF THE COMMITTEE OF GOVERNORS 11TH DECEMBER 1990

### Those present were:

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Chairman of the Committee of Governors	Mr. Pöhl
Banque Nationale de Belgique	Mr. Verplaetse Mr. Rey Mr. Michielsen
Danmarks Nationalbank	Mr. Hoffmeyer Mrs. Andersen
Deutsche Bundesbank	Mr. Tietmeyer Mr. Rieke
Bank of Greece	Mr. Chalikias Mr. Papademos Mr. Karamouzis
Banco de España	Mr. Rubio Mr. Linde Mr. Durán
Banque de France	Mr. de Larosière Mr. Lagayette Mr. Cappanera
Central Bank of Ireland	Mr. Doyle Mr. Coffey Mr. Reynolds
Banca d'Italia	Mr. Ciampi Mr. Dini Mr. Santini
Institut Monétaire Luxembourgeois	Mr. Jaans
Nederlandsche Bank	Mr. Duisenberg Mr. Szász Mr. Boot
Banco de Portugal	Mr. Tavares Moreira Mr. Borges Mr. Amorim
Bank of England	Mr. Leigh-Pemberton Mr. Crockett Mr. Foot
Commission of the European Communities	Mr. Pons
Chairman of the Monetary Policy Sub-Committee	Mr. Raymond
Chairman of the Foreign Exchange Sub-Committee	Mr. Dalgaard
Secretariat of the Committee of Governors	Mr. Baer Mr. Scheller Mr. Jenkinson