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(Translation)

MINUTES*

OF THE 223rd MEETING OF THE COMMITTEE OF GOVERNORS

OF THE CENTRAL BANKS OF THE MEMBER STATES

OF THE EUROPEAN ECONOMIC COMMUNITY

HELD IN BASLE ON TUESDAY, 8th MARCH 1988 AT 10.00 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. 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, Mr. Masera and Mr. Saccomanni; the President of De Nederlandsche Bank, Mr. Duisenberg, accompanied by Mr. Szász and Mr. Brockmeijer; the Governor of the Banco de Portugal, Mr. Tavares Moreira, accompanied by Mr. Pêgo Marques; the Governor of the Bank of England, Mr. Leigh-Pemberton, accompanied by Mr. Loehnis and Mr. Kirby; the President of the Commission of the European Communities, Mr. Delors, accompanied by Mr. Costa, Mr. Mingasson and Mr. Dixon; the Director General of the Luxembourg Monetary Institute, Mr. Jaans. Also present at the meeting was Mr. Dalgaard, Chairman of the Group 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.

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*Final text approved at the meeting on 12th April 1988, which incorporates some drafting changes.

I. Approval of the minutes of the 222nd meeting

The Committee unanimously approved the minutes of the 222nd 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 main feature in February and the beginning of March had been the remarkable stability on the foreign exchange markets: the dollar and the yen had been stable and there had been no tensions within the EMS. On the whole there had been only slight fluctuations in both exchange rates and interest rates, and interventions, too, had been on a small scale. There was one small difference, however: whereas in January most of the countries with comparatively weak currencies had been able to lower their interest rates and purchase foreign exchange, this had occurred to a very much smaller degree in February.

The stability of the dollar seemed to have been linked to the improvement in the trade balance of the United States and to the feeling that the US authorities considered the dollar to be low enough. This stability had been achieved without significant support interventions since net dollar purchases had totalled approximately 2 billion in February, compared with 7.5 billion in January and a monthly average of the order of 10 billion in December, November and October 1987. There was nothing to guarantee, however, that the situation would last. In fact, the US trade balance was healthier owing to essentially seasonal factors and could deteriorate again; moreover, a tightening was highly unlikely for monetary policy and virtually out of the question for fiscal policy.

Within the EMS, currency fluctuations had been very limited. The Belgian franc had firmed slightly, enabling interest rates to be lowered and purchases of foreign exchange to be made. The French franc had weakened slightly against the Deutsche Mark, but this was a very minor change in view of the growing internationalisation of the French currency and the resultant increase in capital movements. A similar increase had, moreover, been registered in most of the EMS countries, and it was satisfying to see that it had been possible to meet it by means of minor adjustments to the currencies within the band and to interest rates and with the aid of modest interventions.

Outside the exchange rate mechanism sterling had been subjected to strong pressure. For several months in 1987 its exchange rate had been maintained within a narrow band, just below the DM 3 threshold, solely by means of substantial interventions. Following a slight weakening in December/January a rise had been recorded in February despite a slight slipping of long-term interest rates, the drop in oil prices and a poor trade balance. However, as the British economy was experiencing strong growth and public finances were in an excellent state, investments in sterling were attractive and free of risk because the market felt that any fall in the exchange rate would be offset by a rise in interest rates. At the beginning of March it had been possible to maintain the DM 3 exchange rate only by means of substantial interventions made, for the most part, in Community currencies, Deutsche Mark, French francs and ECUs.

The Spanish peseta had been firm at the beginning of February, and sizable interventions had been made. As from 10th February the tightening of the swap arrangements offered to banks had resulted in a marked weakening of the exchange rate and halted interventions.

B. Statement by Mr. Janson

The analysis carried out by the Alternates had dealt with:

- the behaviour of the dollar in recent weeks and its prospective development in the months to come;
- the specific development of certain European currencies within the EMS exchange rate mechanism or outside it.

The Alternates had placed their analysis in a broader context, taking into account not only developments in the foreign exchange markets but also macro-economic developments (summarised in the Secretariat's monthly publication) and prospects for the immediate future.

The Alternates had expressed their satisfaction at the stability which the dollar had exhibited in the preceding weeks. This stability had shown itself not only in the very small fluctuations in the dollar exchange rate but also in a sharp reduction in the volume of interventions in support of the dollar (which seemed to indicate that the US current account had been financed by spontaneous flows during the preceding weeks). It seemed that the steadiness of the dollar was due both to underlying and to technical factors. However, the situation was still delicate. The adjustment of current-account disequilibria could only be a slow process (given the size of the disequilibria) and, in view of the marked extent to which the trade balance of the United States was affected by seasonal factors, it could not be ruled out that the figures in this respect would, in nominal terms, be less favourable in the coming months. This could have repercussions on the standing of the dollar, and the authorities might be faced with choosing between accommodating the downward pressure and supporting the dollar by means of interventions and/or an adjustment of monetary policies. Conversely, a tendency to appreciate might also create problems. The German Alternate pointed out in this respect that in that case the downward trend of yields on long-term securities in Germany might be halted or even reversed. This would be a situation analogous to that observed in the summer of 1987.

Within the EMS the Belgian franc had benefited from a quite substantial current-account surplus and from inflows of funds in connection with the events centred on the "Société Générale de Belgique" and the increase in share prices on the Brussels Stock Exchange. However, these inflows had been offset, to a large extent, by outflows of funds as Belgian residents had sought high-yielding foreign bonds. The proceeds of the interventions effected by the Banque Nationale de Belgique were not reflected in an increase in foreign exchange reserves but were used by the Treasury to reduce external indebtedness.

The strong position of the Dutch guilder was attributable to a combination of structural and temporary factors. The latter included expectations of a further lowering of key rates in the Netherlands. The expectations were fuelled by the frequency of the reductions decided on during recent months; a further cut in interest rates would, however, carry the risk of the level of interest rates in the Netherlands falling too far and subsequently necessitating an adjustment in the opposite direction.

The upward pressure on the pound sterling posed serious problems for the British authorities. The upward trend of domestic prices, the sustained growth rate of domestic demand, the risk of the economy overheating and the prospect of a significant current-account deficit were all reasons for maintaining and perhaps even raising the current high level of interest rates. If sterling persisted in its tendency to appreciate as a result of inflows of funds, the authorities would be faced with the choice of either allowing the pound to appreciate beyond the DM 3 threshold, which they had just done the day before, or to continue their diversified interventions in ECUs and certain EMS currencies, or to combine both approaches to some extent. The British Alternate pointed out in this connection that the Bank of England would ensure that the interventions were made in close co-operation with the central banks of the currencies concerned and with due attention to the cohesion of the EMS currencies.

The Alternates also noted that the Banco de España had not intervened for almost a month. This development reflected, on the one hand, the fall in interest rates in Spain and, on the other, the new foreign exchange policy being applied by the Spanish central bank (which was no longer present in the market on a permanent basis) and the effect of the limits imposed on Spanish banks' spot positions in foreign currencies.

Finally, the Alternates stressed the importance of not restricting the discussion to an analysis of developments on the foreign exchange markets but of taking into consideration also the data on the real economy and the possible repercussions on the behaviour of the foreign exchange and financial markets. In their view, such an approach would meet the objective of the strengthened monitoring procedure, viz. the detection of risks which might affect the cohesion of the EMS.

C. Discussion by the Committee

Mr. Leigh-Pemberton pointed out that, after the sterling exchange rate had been kept below DM 3 for almost a year, the upward pressure in the early days of March had been such that it had become impossible to carry on and the threshold had been crossed. Basically, however, the exchange rate policy remained the same, i.e. its aim was to ensure the stability of the exchange rate as far as was possible in the context of general monetary policy. This exchange rate policy had been put into effect in 1987, with allowance for certain adjustments to the sterling exchange rate from time to time. The pound was to be prevented from appreciating too much, but also from depreciating too much to stop the "accommodation" of the increase in domestic prices. On Monday, 7th March, the Bank of England had had to intervene again, taking up fairly large amounts of Deutsche Mark, French francs and ECUs, and it was grateful to its partners for their understanding and co-operation, in particular during the past few weeks; it understood the problems to which such interventions could give rise, and these interventions had been carried out specifically with a view to ensuring that the EMS parity grid was not disturbed. The interventions in ECUs had again given rise to problems. The Treasury had wished to have greater recourse to this type of intervention, believing such an approach to be more Community-spirited and, moreover, that it would enable certain difficulties encountered with interventions in specific currencies to be avoided. But the composition of the ECU was such that in purchasing ECUs, it was inevitable that more than 40% of the purchase would consist of strong currencies and the remainder comprise weaker currencies. That raised in any case the issue of the use of the ECU as a valid intervention instrument within the EMS.

Mr. de Larosière thanked Mr. Leigh-Pemberton for having done the utmost to ensure that the interventions by the Bank of England were carried out smoothly and did not disturb the relative positions of the currencies within the narrow band, and for the co-operative attitude shown over the past few days. However, that was not the only problem. The United Kingdom's intervention to purchase currencies such as the Deutsche Mark, the French franc or the component currencies of the ECU posed a fundamental problem for relations between the European countries and for operating practices within a fragile international monetary system. There was a general agreement to stabilise the dollar, but it needed to be appreciated that the equilibrium was extremely delicate: the US current-account deficit was substantial and would continue for a long time to come, while economic adjustment in the United States had made a modest start and was likely to be unconvincing when the foreign trade figures were published every month. Given the situation of unstable equilibrium, the purchase by the central bank of a major country of substantial amounts of non-US currencies, but particularly EEC currencies, constituted a further threat of dollar weakening (it had, incidentally, fallen slightly on Monday, 7th March). It might be asked whether it was sensible to risk rocking the entire international monetary system by making purchases of already strong currencies when a country reached, or thought it was reaching, certain limits. In this respect one could only applaud the fact that the United Kingdom had abandoned the DM 3 limit, but the movements which were taking shape on the foreign exchange market as a result of this action were worrying.

Mr. Pöhl pointed out that it was precisely upward pressure that the Deutsche Mark was being subjected to that day (8th March) and asked Mr. Leigh-Pemberton why, if he considered sterling to be too strong, he purchased European currencies, even via the ECU, but not dollars, which would have more or less the same effect.

Mr. Leigh-Pemberton, in reply, pointed out that intervening directly in Deutsche Mark had a greater impact on the pound sterling/Deutsche Mark rate than purchasing dollars. It was true, as Mr. de Larosière had said, that world monetary equilibrium was fragile, but it should not be forgotten that the Bank of England had made dollar purchases totalling nearly 25 billion in 1987. In January 1988, as had already been mentioned, the UK authorities had been of the opinion that in order to influence the pound sterling/Deutsche Mark rate and also because of the vast quantity of dollars accumulated, a diversification of reserves was desirable. To understand this attitude, it had to be borne in mind that the United Kingdom had already contributed substantially to the stability of the international monetary system.

Mr. Pöhl observed that the Bank of England had purchased US$25 billion in 1987 but had resold some of this as the official reserves had increased by less. It was understandable that nobody wanted to invest in a currency that was depreciating. However, the G-7 agreements could not function if one country, like the United Kingdom, expected other countries to purchase more dollars while it diversified its reserves, i.e. sold dollars and purchased Deutsche Mark in exchange.

Mr. Leigh-Pemberton acknowledged that 5 to 6 billion dollars had been converted into other currencies, which nonetheless left a net increase in dollar reserves of approximately 19 billion, far more than was the case in a number of other countries. The objective now was not to let the pound rise too high and too quickly. The interventions on Monday, 7th March were intended precisely to control the market and avoid excesses. It was hoped that the pound would quite quickly reach a level at which interventions would no longer be necessary and which would not be too much higher than the previous exchange rate of DM 3.

Mr. Pöhl emphasised that the Deutsche Bundesbank was not prepared to purchase dollars while other banks were selling them or purchasing Deutsche Mark.

Mr. Hoffmeyer recalled that in an initial report on a common policy in respect of the dollar the Governors had already agreed in 1975 that in the event of dollar weakness vis-à-vis the EMS the central banks should not intervene in the system's strong currencies. But even purchases of ECUs represented interventions of which approximately 50 per cent. was in strong currencies, not 40 per cent., since sterling was one of the strong ECU currencies, which meant, moreover, that the Bank of England was purchasing its own currency.

Mr. de Larosière thought that a large part of the Bank of England's dollar purchases was not so much an intervention aimed at supporting the US currency as a move to rebuild UK official reserves, which had previously diminished. If this interpretation was correct, it should be taken into account. In any case, when a country, for reasons of its own based on the elements of its overall economic policy (growth, interest rates, monetary policy, etc.), considered that it had to prevent its currency from appreciating too much vis-à-vis the dollar or another currency, it was obvious, under the prevailing circumstances and in the context of the Louvre Accords, that its interventions should not involve the strongest currencies. If this was not the case, the very logic of any move to stabilise the dollar would be destroyed. The Governors should give this matter serious thought and also take note of Mr. Pöhl's comments.

Mr. Janson expressed his satisfaction at the Governors' discussion, the outcome of which should be a clear exchange rate policy for the central banks, in particular with regard to their action in the framework of concertation. Thus, if there was a consensus that further falls in the dollar should be avoided, this meant that central banks with strong currencies which had to purchase foreign currencies should acquire dollars, and that those with weak currencies should not sell dollars. The problem for the latter was, therefore, to know which currencies they could use to support their own currencies.

Mr. de Larosière pointed out that central banks with weak currencies should sell strong currencies, for example Deutsche Mark, to the extent that they had any, for one could not demand the impossible.

Mr. Doyle recalled the problem of interventions in ECUs at times of simultaneous sterling and Deutsche Mark strength.

Mr. Janson considered that it was very important that the Governors' agreement on this principle concerning intervention - viz. dollar purchases by those central banks with strong currencies and Deutsche Mark sales for those with weak currencies - should become a clear brief for central bank exchange dealers until there was a complete reversal in the foreign exchange market.

Mr. Duisenberg said that he shared Mr. de Larosière's concern. The action on the pound was a sort of unilateral realignment; it illustrated very clearly that one should not try to cope with such a situation using only interventions and realignments. Interest rates should also be used, as the participants in the EMS exchange rate mechanism had agreed, supplemented, if necessary, by budgetary instruments.

The Chairman thanked Mr. Leigh-Pemberton for having opened a very interesting debate which demonstrated the extent of the co-ordination of central bank policies and the means which could be employed to achieve the desired convergence. The observations which had been made contained the seeds for an improvement in the methods of co-operation.

Mr. Dalgaard said that the monitoring group would take account of the views and comments of the Governors.

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 February and the first few days of March 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. Continuation of the discussion on the Commission's proposals concerning the full liberalisation of capital movements on the basis of Report No. 63 prepared by a group of experts under the chairmanship of Mr. Dalgaard

The Chairman recalled that the oral report on this question which he had presented to the ECOFIN Council on 9th February 1988 had been amended to take account of the comments made by a number of Governors at the meeting on 9th February 1988. A text had accordingly been drawn up after that meeting and distributed to the Governors.

Mr. Dalgaard briefly presented Report No. 63, drawn up by a group of experts under his chairmanship, noting that it had been an unusually difficult report to prepare owing to the fact that capital movements raised many complex issues, particularly for exchange rate policy and monetary policy; moreover, even though the experts had met on three occasions, the report did not contain a consensus on all the issues addressed.

A. Statement by Mr. Janson

The Alternates had found the concluding remarks of Report No. 63 of the "Dalgaard Group" to be a useful basis for drawing up the final opinion of the Committee of Governors.

1. The Alternates had noted that the conclusions of Report No. 63 reiterated certain principles that had already been stressed in the oral report by the Chairman of the Committee of Governors to the ECOFIN Council in February:

- the aim of liberalisation in itself met with unanimous support;
- in order to ensure that liberalisation did not jeopardise the achievements of the EMS with regard to internal and external stability, it was necessary to follow policies which would foster stability of prices and costs and eliminate excessive external imbalances;
- the participation of all Community currencies in the exchange rate mechanism on equal terms remained a highly desirable objective even if, in conjunction with the liberalisation of capital movements, it could make the management of the EMS more difficult;
- some of the countries in which liberalisation was less advanced stressed the importance they attached to the adoption of adequate measures to improve economic and social cohesion within the Community.

2. It was now agreed that the liberalisation of capital movements as such did not at present seem to necessitate any adjustment of the EMS operating mechanisms as strengthened in 1985 and 1987. This was not to say that

further strengthening might not be found necessary at a later stage once more experience had been gained with the technical improvements introduced recently.

3. The Governors should address the issues below with a view to arriving if possible at a common position to submit to the Ministers.

(a) While it was generally recognised that greater co-ordination of monetary policies was required in a context of full liberalisation of capital movements, there was disagreement on the appropriate means of achieving it. Some Alternates were in favour of establishing a framework for the ex ante co-ordination of monetary policy for the whole system at Community level and treating any deviations symmetrically. Under this approach a role might be played, for example, by commonly agreed targets for domestic credit expansion and a rule whereby the money creation effects of intra-EMS interventions were not offset by changes in credit to the domestic sector.
Other Alternates favoured a pragmatic approach, stressing that, firstly, too formal an analytical framework was not suited to the unforeseeable and complex nature of the problems associated with co-ordination and that, secondly, the existing procedures were a sufficient basis for improving the co-ordination of monetary policies.
The Alternates were of the opinion that, while noting these divergences of views at the present stage, the Committee of Governors could suggest to the ECOFIN that it pursue its work in this area. Specifically, the Governors could ask the "Raymond Group" to elucidate the proposals made concerning the establishment of a framework for the ex ante co-ordination of monetary policies.

(b) The Alternates were in agreement with the Commission in recommending that the conduct of monetary policy, which remained a national responsibility, should continue to be able to rely on instruments and markets designed or organised to ensure its effectiveness. However, the provisions proposed to this end - in effect Article 2 of the proposed Directive and the relevant recital - called for two sets of comments on the part of the Alternates.

The first concerned the room for manoeuvre left to the authorities to take measures, for monetary policy purposes, that might run counter to liberalisation and non-discrimination. A derogation limited to the two instruments mentioned in Article 2 did not adequately cater for the range of measures that might be adopted to meet monetary policy needs. In the view of the Alternates a more general formula should be adopted in order to leave room for the conduct of monetary policy.
Secondly, the Alternates shared the Commission's concern to ensure that monetary policy grounds could not be cited in order to introduce disguised restrictions on capital movements. Surveillance therefore had to be exercised in this connection, on the responsibility of the Monetary Committee and the Committee of Governors, in which the Commission was represented. The form taken by this surveillance must not, indeed, be such as to indirectly result in the conduct of monetary policies being placed under Community jurisdiction, as would be implied by the notification requirement under Article 2 and the reference to a "framework of appropriate Community procedures" in the preamble. The Commission representative had noted that it was at all events the responsibility of the Commission to ensure compliance with the obligations laid down in the Treaty and the secondary legislation.

(c) Diverging views had been expressed on the need for a <u>specific safeguard clause</u> as proposed in Article 3 of the Directive. Some felt that the safeguard provisions contained in the Treaty of Rome were sufficient to cover all conceivable eventualities and an additional clause would do more harm than good. Others, on the contrary, considered that such a clause should form part of the available arsenal of defensive measures and that its drawbacks could be limited by means of appropriate conditions: use only in exceptional circumstances, limited duration, and Community surveillance.

4. The Alternates retained their doubts as to the usefulness of extending the 1972 Directive on regulating international capital flows and neutralising their undesirable effects. The Commission representative had pointed out that, regardless of what became of the 1972 Directive, the real

question was that of finding the appropriate vehicle to give expression to the following three concerns: the economic and technical justification of the "erga omnes" principle of liberalisation, the possibility for the Community to revoke this principle if necessary, and the indispensability of Community procedures for monetary and exchange rate policies with a view to monetary union.

Mr. Janson concluded by saying that the Alternates could prepare a draft report for discussion and approval by the Governors on the basis of the experts' Report No. 63, the Alternates' discussions, the substance of which had just been outlined, and the Governors' subsequent deliberations.

B. The Committee's discussion

Mr. Ciampi noted that it was not surprising that the work carried out by the experts and the Alternates had not culminated in unanimous reports, given the differences of opinion which still existed; he paid tribute to the quality of this work and made the following remarks. The concern, already expressed in January, that the liberalisation of short-term capital movements might involve risks for the EMS found little support within the Committee, and it was to be hoped that events would prove this fear to be unfounded. All possible misunderstandings should be dispelled: as it has demonstrated in the past, the Banca d'Italia favours a further strengthening of the EMS and growing integration in Europe; its concern is that the proposals or measures which are currently being examined could lead to incoherencies or imbalances which might turn out to be dangerous in the future.

There had been a choice between progressing along the path leading to the liberalisation of capital movements and that leading to the enlargement of the exchange rate mechanism. The choice had fallen on a decisive advance along the former, which would necessarily mean a delay on the latter. The liberalisation of short-term capital movements will pose problems both for exchange rate stability and for the autonomy of national monetary policies.

With regard to the first issue, the Banca d'Italia was anxious to limit the risks of exchange rate instability in order to avoid unnecessary realignments. Two measures appeared to lend themselves to this purpose. Firstly, a recycling instrument which would not be a financing mechanism in the traditional style but which would be designed and managed in the general interests of the EMS. Secondly, a new safeguard clause whose existence, instead of undermining the credibility of the objective of liberalisation, would, on the contrary, serve this goal by making it possible to cope with difficult situations.

The liberalisation of capital movements would reduce the scope and autonomy of national monetary policies. As it was not reasonable to think that a single central bank would be able to determine monetary policy for the whole system, with the other member countries being content to follow suit, ex ante co-ordination had to be developed with a view, firstly, to defining and, secondly, to implementing a genuinely Community-wide monetary policy. In this respect the Alternates' proposal that the Raymond Group study the issue in depth could only be supported.

Article 2 of the draft Directive was directly concerned with the powers of the central banks, and the Governors should voice their opinion on this. The monetary authorities might be permitted to use instruments other than those listed under Article 2 subject to prior verification that the instruments complied with the spirit of the obligation of liberalisation.

The aim of monetary policy co-ordination could not be restricted to convergence towards low inflation rates; growth was absolutely essential to genuine and sound monetary stability. In addition, the elimination of persistent disequilibria in the trade balance and the balance of payments on current account could not rely on non-monetary policies alone. Finally, it was difficult to accept, as stated in Report No. 63 (page 14), that the co-ordination of monetary policies could work only if there was sufficient support from other policies. A co-ordination of the various policies was of course necessary, but if that argument had been put forward from the outset, the EMS and convergence would not have become what they were, aided, in part, by the action taken by the central banks.

Mr. Duisenberg began by pointing out that on Tuesday, 12th April, most of the Governors would have to leave the BIS very early (at 11 a.m.) to travel to Washington for the meeting of the Interim Committee, and that it would therefore be advisable to organise the times of the meetings so as to leave sufficient time for the Committee's discussions.

The Chairman said that arrangements would be made to take account of these exceptional circumstances.

Mr. Duisenberg addressed the fundamental issues raised by the liberalisation of capital movements, commenting on three points, namely the co-ordination of monetary policies, the instruments of monetary policy and the specific safeguard clause.

Regarding monetary policy co-ordination, the Governors had reached an important agreement in Basle and Nyborg in September 1987 which established, in particular, the principle of combining the utilisation of interest rate differentials and a flexible and full-scale use of the fluctuation margin, with a minimum of realignments. Of course, in time, the central banks would have to go beyond the terms of this agreement, but in a pragmatic way. On the other hand, it would not be sensible to start drawing up and adopting new rules straight away. The degree of pragmatism to be desired might be illustrated by the example of the Deutsche Bundesbank, which displayed great flexibility when in 1987, in the interests of exchange rate stability, it allowed an overshooting of its monetary targets for the second year running. It was very unlikely that the Deutsche Bundesbank would have agreed to this overshooting ex ante, even if it had been approved collectively within the Committee. As Mr. Ciampi had suggested, the group of experts under the chairmanship of Mr. Raymond could, nonetheless, analyse and clarify the issue of the methods or procedures of monetary policy co-ordination.

What monetary policy instruments were chosen had to remain the preserve of the relevant national authorities, and, consequently, those instruments likely to have an external impact should be excluded from the Directive. The Directive, in Article 2, provided for a derogation in favour of two instruments of this type, which had the disadvantage of making this provision seem like a permanent derogation from the obligation to liberalise capital movements. Article 2 of the Directive should limit itself to emphasising the competence of the national authorities, which, moreover, had already been recognised in the Treaty. In this connection the assertion contained in Report No. 63 (Section IV, 1(c)), that derogations other than those specified in Article 2 would only be possible under safeguard clauses, was unacceptable. However, in order to ensure that the liberalisation of capital movements was not thwarted by monetary measures introduced by individual countries, it was imperative that the Monetary Committee and the Committee of Governors examined the justification for these measures on a case-by-case basis. In this context it might be useful for both committees to be notified of certain measures taken by national authorities. The requirement of notification to the Commission should nonetheless be omitted from Article 2 of the Directive and the list of monetary policy instruments should not be restrictive. Moreover, the preamble should be amended accordingly; more precisely, in the second recital, the expression "Whereas Member States should be able to take, within the framework of appropriate Community procedures" might be replaced by "Within the framework of the restrictions imposed by their Community obligations".

The specific safeguard clause provided for in Article 3 of the Directive did not appear necessary, given the existence of general safeguard clauses in the Treaty. If exchange controls were abolished, the mere possibility of reintroducing them constituted a signal to the market that, in the event of tensions, restrictions would be imposed. This would lead to an outflow of funds from the countries concerned. A specific safeguard clause would thus have a counter-productive and negative effect, particularly if it had to be a permanent component of the provisions of the Directive.

Mr. Pöhl said that he very largely agreed with all of Mr. Duisenberg's remarks and, in particular, with those concerning monetary targets. The Commission's proposal for the full liberalisation of capital movements was one of the great advances made by the Community in recent years and a very significant step towards a monetary union and closer monetary co-operation. At the same time liberalisation was no more than the fulfilment of commitments undertaken in the Treaty. Mr. Duisenberg's comments on the specific safeguard clause had to be taken very seriously. In fact, if it was intended to demonstrate the intention of progressing resolutely towards a single integrated capital market, there should be no suggestion of any mental reservation or of leaving any loophole for backpedalling. The elimination of existing controls had to be carried out without hesitation and in such a way as to convince the markets that it was irreversible. An integrated capital market was as important for the future of Europe as the goods and services market, since, in reality, funds only moved to wherever they would be employed most profitably.

Improving monetary policy co-ordination was necessary if only because there would, ultimately, be total freedom of capital movements. Monetary policy objectives should not be unified but co-ordinated more closely, the aim being to keep the operating conditions of the markets as stable as possible. The countries which had achieved the greatest stability could clearly not back-pedal and aim for an average. On the contrary, it was necessary to continue along the path of maximum stability. On the other hand, monetary policy should not be entirely given over to the offsetting of capital movements or exchange rates. Monetary policy also had other aims; moreover, it could not be fully effective unless other elements of the policy mix were adequate. The co-ordination of monetary policies did not require new mechanisms or procedures. The necessary structures existed: the Committee of Governors with its Alternates and groups of experts operated effectively, and bilateral consultations also played a role. Embarking on more institutionalisation would not lead to any real progress; it was better to use and develop the existing infrastructure.

To achieve the objective of the EMS, i.e. fixed but adjustable exchange rates which should be adjusted only rarely, interest rates would have to be altered more than hitherto as long as fundamental divergences persisted between countries.

The requirement to notify the Commission provided for in Article 2 of the draft Directive posed certain legal problems in Germany. It was in fact felt that monetary decisions had to remain the prerogative of national institutions, the Deutsche Bundesbank in particular. This had been expressly confirmed at the time of the revision of the Treaty, and the Commission therefore had no specific competence in monetary affairs. A compromise could be reached by saying that notification could be made to the Committee of Governors, on which the Commission was represented.

Mr. de Larosière shared Mr. Pöhl's view that the liberalisation of capital movements within the Community was an essential goal, certainly a cornerstone of progress towards the single market. France considered this move to be irreversible; it had substantially reduced its regulations and was determined to bring the process to a conclusion. The impression should not be given that liberalisation was a secondary or uncertain objective. It was thus possible to be quite frank as regards the actual conditions of the specific safeguard clause, but the drafting of a clause should not be allowed to detract in any way from the credibility of the objective. Certainly, in the event of an overt balance-of-payments crisis or extreme volatility in the capital markets it would be necessary to let a country take corrective measures as long as monetary integration was not at a more advanced stage, but the safeguard clause should not give the impression that a sort of permanent and institutional loophole was being created. Ways and means might be found to cope with this concern, and it was possible that the provisions of the Treaty of Rome concerning the balance of payments and capital markets would suffice.

As a counterpart to a positive attitude towards the full liberalisation of capital movements, it was essential that more be done with regard to the co-ordination of economic and monetary policies, as desired by Mr. Ciampi. An ex ante discussion should be held on the objectives of economic policy and not just of monetary policy, the latter being only one element of the whole array of economic policy instruments. In addition to the convergence which was materialising in the combat against inflation, it was necessary to define the general aims of convergence towards which the Community should be working, a kind of optimum that would take into account the structural characteristics of the different countries. The equilibrium aimed for in this way would be based on objectives for prices, growth, employment and external trade and equilibrium, and would thus combine monetary variables and the real economy. Such an approach would make it possible to assess the degree of mutual compatibility existing between monetary policies, and its methods might vary. There was no question of setting up institutional procedures which would be likely to discourage or cause concern to some member countries, but it was imperative to work towards convergence in all the areas for which economic policy objectives were set if the aim was to bring about ex ante monetary policy co-ordination. The absence to date of such ex ante discussions bore testimony to the somewhat ad hoc nature of the monetary co-ordination which the Governors had achieved, and much further progress was required in this field.

Mr. Delors thanked the Governors, the Alternates and the group of experts under the chairmanship of Mr. Dalgaard for the work which they had undertaken. The Commission had of course proposed texts, but it had mainly raised questions concerning monetary and economic policy, appropriateness and legal issues; it would amend its texts on the basis of the remarks which had been made. The Commission had made a strategic choice in submitting, in 1987 already, a text for the full liberalisation of capital movements; it had considered that complete monetary and economic union could not be made a prerequisite for the liberalisation of capital movements. On the contrary, liberalisation would give impetus to achieving the common market in financial services and boost progress in monetary co-operation.

If the Directive on liberalisation were adopted swiftly, it would have a great psychological impact and be of great significance for the completion of the single market. One could envisage an application date being set for six or twelve months' hence, much sooner than could, for example, be foreseen for the convergence of indirect tax rates.

The Commission had also raised questions concerning the appropriateness and legal aspects of, in particular, Article 2 of the draft Directive (monetary policy instruments) and Article 3 (safeguard clause). The Governors were correct in saying that the wording of Article 2 was too restrictive, and it would consequently be revised. Article 155 of the Treaty of Rome made it obligatory for the Commission to ensure that it was notified of any derogations, even if only provisional, from the liberalisation of capital movements, but the Commission did not intend to bring its own power or expertise to bear. Once notified, it would consult the Committee of Governors and the Monetary Committee.

There was also a problem in connection with the appropriateness and legal aspects of Article 3. The clause applied to the case where a country experienced a speculative run on its market without any lasting impact on its balance of payments. Some said that such a clause undermined the credibility of the liberalisation of capital movements, but without it it was doubtful whether the Council would reach any agreement. In point of fact, the provisions of the Treaty concerned balance-of-payments disequilibrium and did not apply to this particular case.

There were still two other difficult problems worth mentioning. The first was related to taxation and comprised two elements. On the one hand, concerning the taxation of share dividends, one might propose a convergence of corporate taxation, which should be fairly easy to accept in view of the national laws governing the assessment of corporation tax, tax credit and deductions at source. On the other hand, there was the very difficult matter of interest on bank deposits and bonds since national arrangements varied very greatly, ranging from absence of declaration to declaration and from non-taxation to taxation with or without deduction at source. The second problem concerned fair competition within a common financial area in which certain currencies could only fluctuate within narrow margins of 2.25 per cent. while others were able to float. For countries which would implement fully the liberalisation of capital movements there was a magic triangle consisting of the freedom of these movements, monetary policy co-operation and common exchange rate constraints.

The Chairman drew three conclusions as regarded procedure at the end of the Committee's discussion:

- the time of the Committee's next meeting, on 12th April, could be altered to take into account the Governors' departure at 11 a.m. and to leave a little more time for the discussions;
- a document would be drawn up by the office of the Chairman and the Secretariat aimed at combining and reconciling the points contained in the excellent Report No. 63 and the comments made by the Alternates and the Governors; this document would serve as a basis for the discussions to be held on 12th April and for the report to be submitted to the Ministers of Finance for the meeting of the ECOFIN Council on 18th April 1988;
- there was still disagreement on the important issue of what methods to use to improve co-ordination of monetary policies; as the Alternates had suggested, the Governors could point out in their report to the Ministers that they were continuing their work in this area, and the Raymond Group could be requested to clarify some of the suggestions which had been made.

V. Exchange of views on the manner in which the Committee could examine the memorandum by Minister Balladur following the mandate given by the the ECOFIN Council

The Chairman recalled that, during their ECOFIN Council lunch on 9th February 1988, the Finance Ministers had invited the Governors to examine the proposals and ideas formulated by Mr. Balladur in a memorandum published in January; the Chairman had notified the Committee of the terms in which the mandate had been given in a message dated 12th February 1988.

A. Statement by Mr. Janson

The Alternates had briefly broached the question of the organisation of the work to comply with the mandate from the ECOFIN Council to examine the Balladur memorandum. They had noted first of all that the French Minister's memorandum comprised two main sections: the first dealt in large part with subjects which the Governors had already examined or were in the process of examining, for example the liberalisation of capital movements and the strengthening of monetary policy co-ordination; the second section focused more on the longer-term aspects, in particular the creation of a single currency area and a European central bank.

The Alternates suggested discussing the matter in depth at their April meeting on the basis of a preparatory working document by the office of the Chairman. It had been agreed that the work should not be limited to an examination of the French memorandum but should also take into consideration the notes presented by other official figures, such as Minister Amato, as well as any contributions from other countries or central banks.

As far as the timetable of work was concerned, the Alternates had started from the premise that a preliminary report should be presented to the June session of the ECOFIN Council (probably on 6th June) and that to that end the Governors should discuss the matter in depth in May.

B. Discussion by the Committee

Mr. de Larosière agreed with the suggestions made by Mr. Janson on behalf of the Alternates. Mr. Balladur's memorandum in effect contained two rather different sets of ideas. The first set comprised reflections on the operation of the EMS, on the desirability of extending it to other participants and on certain improvements to the operation of the mechanisms. At the end of the memorandum questions were asked regarding the future of a European central monetary institution; questions were raised rather than positions adopted. The work should focus on both these sets of ideas and the consideration of the future of a European central bank should not be allowed to obscure the importance of examining the first set. The greater the convergence along the path leading to monetary stability, the more questions should be asked about the purpose of economic policy objectives and their consistency, and about optimum growth within overall stability. It was in that spirit that the comments contained in Mr. Balladur's memorandum concerning the symmetry of interventions and of adjustment efforts needed to be interpreted. Forecasts for the more distant future and concerned rather with the institutional aspects should not overshadow the importance of progress towards greater European monetary integration within the framework of the existing system. On the other hand, as Mr. Janson had pointed out, it was important to begin thinking now about the profusion of ideas for the creation of a European central bank, as contained for example in Mr. Genscher's memorandum. To that end, it would be useful to set up a think tank within the Committee, even were it only to be called at some future date, if at all.

Mr. Pöhl recalled that a number of the topics addressed in the papers by Mr. Balladur and Mr. Amato had been discussed at length up to September 1987 and had led to the Basle-Nyborg Agreement. Everyone was aware that the Agreement was a compromise in which the Deutsche Bundesbank had gone as far as it could; it had even been harshly criticised by highly respected circles in Germany, whose opinion it was that discipline within the EMS would be weakened by the Agreement, in particular by the increase in the already generous credit facilities. The new facilities had since been used and had contributed to the stability of the system.

Several of Mr. Balladur's and Mr. Amato's proposals, in particular those relating to symmetry and asymmetry, had been discussed ever since the inception of the EMS and had invariably provoked differences of opinion. The endless repetition of such proposals did not contribute to the stability of the system. Neither did statements such as that by Mr. Amato, who, according to an Italian newspaper, had claimed that the Deutsche Mark was structurally undervalued, implying that the other currencies were overvalued and that a realignment was in the offing, perhaps even inevitable. It was necessary to avoid making this sort of pronouncement in public and also to avoid announcing regularly that the EMS needed to be improved, which only gave the impression that the system was unsound and unable to function effectively.

Mr. Pöhl said that he was, however, prepared to discuss the ideas put forward in the memoranda circulated: in particular, the question of how the convergence and the co-ordination of both economic and monetary policies could be improved, given that it was impossible to isolate the one from the other. As Mr. de Larosière had suggested, the countries participating fully in the exchange rate mechanism should set themselves common ex ante targets. For the time being, and because the Ministers had submitted a request to the Governors, the Alternates could study these issues in depth by taking into consideration the memoranda by Mr. Balladur and Mr. Amato, but not Mr. Genscher's note, which was a personal opinion and not a German Government paper.

Mr. Duisenberg was also of the opinion that discussion of these issues, which were so high on the agenda elsewhere, could not be avoided and that, as Mr. Janson had said, the Committee should not be caught off guard. It was not easy, however, to decide what should be discussed and what could be disregarded. For a start, in addition to Mr. Balladur's memorandum was Mr. Amato's paper to be taken into consideration and that of Mr. Genscher which, although representing personal views, did come from the German Minister of Foreign Affairs? As for Mr. Balladur, should his interview with the Wall Street Journal also be taken into account? If so, it should be noted that this article put the accent on promoting currencies' internal and external stability, whereas in his paper on the monetary structure of Europe Mr. Balladur emphasised the sharing of the burden within the EMS, which it might not always be possible to reconcile completely with the commitment to internal and external stability.

The Chairman emphasised that the Governors should turn their attention to these issues because, for one thing, they had been given a mandate by the ECOFIN Council and, for another, they could not remain silent on subjects which involved them and which had been generating various ideas for some time, even if, among themselves, they had differing views as to the practicability of some of the ideas and the timetable of possible implementation. It therefore seemed useful to start the discussion off within the Committee of Alternates, rather than create a new group of experts. With a view to these discussions, the Chairman's office would draw up a document indicating the various questions which should be raised.

Asked by Mr. Janson if the French side wished to add anything with regard to Mr. Balladur's memorandum, Mr. de Larosière said that, to his mind, monetary stability was a pivotal objective for every central bank and it received top priority at the Banque de France, as at its partner central banks. It was, however, not forbidden to reflect on the consequences for the cohesion of the EMS of the existence of balance-of-payments disequilibria in certain countries, which could reflect a debatable choice of policy mix. It if was valid, in periods of divergent rates of inflation, to be compelled under the exchange rate mechanism to exercise greater rigour, it was valid to wonder whether, whatever the circumstances and whatever the policy mix of the country with the strongest currency, the whole Community should be guided by that particular policy mix. Thus there had to be a discussion about economic policy objectives, otherwise there would be tensions within the EMS. It was in that light that the debate about greater symmetry should be seen, and the French side might submit some detailed ideas at a later stage.

Mr. Pöhl expressed his agreement with Mr. de Larosière's analysis and acknowledged that imbalances in economic performances and balance-of-payments disequilibria were two of the problems currently besetting Europe. The situation was not, however, as extreme as that described by Mr. Dini when he said that a single central bank should not set the pace of monetary growth for all the others, whose duty was only to follow. In any event, even if it was true, it would apply only to those which participated in the exchange rate mechanism, and with a greater margin for manoeuvre for Italy, thanks to the wider fluctuation band.

If these subjects could be examined initially by the Alternates, it would be useful to define the mandate a little more closely. In fact, the memoranda by Mr. Balladur and Mr. Amato touched on a number of problems, some of which, such as policy in regard to the dollar and the European central bank, were eminently political. The Governors should concentrate on monetary policy, but realise that monetary policy was not capable of correcting the errors introduced by other policies and was not able, for example, to redress balance-of-payments current-account disequilibria.

The issue of symmetrical interventions had been raised repeatedly during the past ten years; the Deutsche Bundesbank had sound reasons for opposing it and was not prepared to revise its opinion. Was it, therefore, of any use to bring up the topic yet again, knowing a reconciliation to be impossible given that such interventions would mean an end to autonomous monetary policy for the Bundesbank and would rapidly lead to a splitting-up of the EMS?

Other issues, such as the enlargement of the system or the co-ordination of budgetary policy objectives, were either not really within the competence of the Governors, or had already been discussed in the Committee's report presented at Nyborg. It seemed important, therefore, to clarify the mandate and to draw up a list of the questions requiring answers on the basis of the document to which the Chair had referred.

The Chairman pointed out that the object of the document to be produced by the Chairman's office was precisely to determine which issues were to be examined and which were to be ignored either as being outside the competence of the Governors or because the Governors did not plan to consider them.

VI. Exchange of views on the relationships between the EEC and the four newly industrialised Asian countries on the basis of a short presentation by Mr. Bockelmann

The Chairman noted that, owing to the advanced hour, it appeared that he would have to postpone the presentation Mr. Bockelmann had planned to give until a subsequent meeting. He thanked Mr. Bockelmann for the statistical tables and charts he had prepared for the Governors and for the distribution of the text of his presentation, to be arranged in the very near future.

VII. Other matters falling within the competence of the Committee

Reappointment of Mr. Dalgaard as Chairman of the Group of Experts on foreign exchange policy

The Chairman recalled that Mr. Dalgaard's three-year term of office was due to expire on 31st March 1988. He proposed that Mr. Dalgaard be reappointed for a further three years, i.e. until 31st March 1991. Mr. Dalgaard was completing his second three-year term of office and, since March 1982, had been a highly competent and extremely efficient Chairman of the Group of Experts.

The Chairman noted that the Committee approved his proposal and expressed to Mr. Dalgaard the congratulations and thanks of the Committee.

VIII. Date and place of the next meeting

The next meeting would be held in Basle on Tuesday, 12th April 1988, but given that most of the Governors would be leaving for Washington in the course of the morning, the time would very probably be brought forward.