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Confidential

Final

MINUTES

OF THE 268th MEETING OF THE COMMITTEE OF GOVERNORS

OF THE CENTRAL BANKS OF THE MEMBER STATES

OF THE EUROPEAN ECONOMIC COMMUNITY

HELD IN BASLE ON TUESDAY, 14TH JULY 1992 AT 9.30 a.m.

Table of contents

I. Approval of the minutes of the 267th meeting

The Committee approved the minutes of the 267th meeting.

II. Adoption of the Committee's report to the EEC Ministers of Finance on developments in the foreign exchange markets of the nineteen countries participating in the concertation procedure during June 1992 and the first few days of July

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

III. Preparatory work for the move to the final stage of EMU:

1. Mandate for the Working Group on EC Payment Systems

Mr. Rey explained that, following the Deutsche Bundesbank's request for a shorter mandate than the one initially presented to the Governors, a revised version had been prepared. At the request of the representative of the European Commission, it was added to the mandate that the Working Group shall, where necessary, perform its tasks in consultation with any other competent parties inside the Community.

Mr. Schlesinger asked to which authorities did this reference apply.

Mr. Rey clarified that the Commission had taken an initiative to undertake work on retail payment systems and thus the authorisation would be for the Working Group to liaise with such bodies set up by the Commission, where needed.

The Committee approved the mandate.

2. Work programme of the Working Group on Printing and Issuing a European Bank-Note

Mr. Rey reported that there was agreement among the Alternates on the work programme received from Mr. Jarvis, Chairman of the Working Group. However, concern had been expressed that the chairmen of the working groups should not establish permanent sub-groups on their own authority. While they should have some leeway in the organisation of the work of their respective groups, the Alternates felt that it was important to avoid a proliferation of sub-groups.

The Chairman suggested that the working groups should not establish sub-groups which incurred additional costs for the Committee of Governors without receiving the prior authorisation of the Committee.

Mr. Christodoulou referred to the last page of the work programme which suggested that the Committee should make it clear in a public statement that the Working Group was the only competent body to which the Committee had delegated authority to consider the question of a future European bank-note. He did not think that the Governors should be so categoric as to exclude any type of relation with outside initiatives.

Mr. Rey said that the Alternates had felt that a statement could be counterproductive since it would probably give more publicity to the Graphic ECU Competition. Rather, if central banks were asked about it, they should deny any involvement with the competition.

The Chairman suggested that, if asked by journalists, the Governors should underline that the issue of the ECU bank-notes was the responsibility of the central banks, although anyone was at liberty to participate in making suggestions in this regard. A communiqué should not be issued.

Mr. Leigh-Pemberton agreed with the Chairman but felt that they did not need to go so far as to welcome suggestions.

The Committee approved this course of action.

Mr. Rey said that the Alternates agreed with the Working Group's suggestion that the Governors should make contact with the Finance Ministers in order to encourage them to give official status to the ad hoc grouping of the Mint Directors' Conference, which was considering issues relating to the design, denomination and issue of ECU coins, also with a view to establishing an official basis for contacts between the Working Group and the Mint Directors. This question could most appropriately be dealt with within the Monetary Committee.

The Committee endorsed the Alternates' suggestion with regard to the Mint Directors.

IV. Monetary co-operation with third countries

1. Report of the Foreign Exchange Policy Sub-Committee No. 9 entitled "Monetary Co-operation with Third Countries"

The Chairman said that he had informed the Finance Ministers at the previous day's ECOFIN meeting that a report had been produced on monetary co-operation but that this had not yet been discussed by the Committee. He had also indicated to the Ministers that the Governors might not reach a clear conclusion. He had undertaken to revert to this issue at the forthcoming informal ECOFIN meeting in September.

1.1. Statement by Mr. Saccomanni, Chairman, Foreign Exchange Policy Sub-Committee

The Sub-Committee had examined the possible elements which could be a part of monetary co-operation with third countries, namely the exchange rate link; financing facilities; and the consultation procedures. Two broad Community interests had to be taken into account: firstly, the desire to broaden the zone of exchange rate stability; and, secondly, to protect the smooth functioning of the EMS in this delicate phase of transition to EMU. The Sub-Committee recognised that the two Community interests might occasionally be in conflict and that there was also a need to reconcile them with the interests of third countries. To minimise such conflicts, a standardised approach should be adopted offering co-operation only to those countries which pursued stability-oriented policies and had close economic links with the Community. The report presented, for illustrative purposes, two possible arrangements and indicated how the various elements could be combined in a technically viable and internally consistent system. These were neither rigid schemes - variations could be introduced to meet different requirements - nor were they the only formulae that could be constructed. The two illustrations both implied the acceptance of the Basle/Nyborg principles, particularly with regard to the conduct of interventions and the principle of prior agreement by the issuing central bank in the event of intramarginal interventions. One formula was closer to full participation in the EMS although significant variations were possible, particularly regarding the methods of financing interventions at the margins. The second formula was a variation of the model that was already in place for Norway with some significant improvements, particularly concerning consultation and financing. The Sub-Committee had not been able to agree on which of the two formulae was preferable, although it concluded that they were not mutually exclusive; in theory, both could be implemented with different countries although it would remain to be decided which variant could be offered to which country.

1.2. <u>Statement by Mr. Rey, Chairman, Committee of Alternates</u>

The Alternates had agreed with the approach adopted in the report which aimed to reconcile the desire of the Community to extend the zone of monetary stability with the need to minimise the risks for the smooth functioning of the exchange rate mechanism of the EMS. They had also agreed on the proposed criteria for assessing the eligibility of third countries for monetary co-operation. The Alternates had praised the analytical part of the report, which outlined different types of exchange rate links, financing facilities and consultation procedures. While the illustrative examples were also broadly endorsed, most Alternates felt that the options had been narrowed down too much. The scope for consensus on a standardised approach currently appeared limited; both formulae had attracted critical remarks. On the one hand, the ECU orientation of the second formula was considered by some undesirable; one Alternate had advocated replacing the third country's unilateral link to the ECU with a unilateral link to the ERM parity grid. On the other hand, a quasi-participation in the ERM, as suggested in the first formula, was seen by other Alternates as involving too many risks for exchange rate stability in the parity grid. The Alternates had concluded that it would not be desirable to transmit the report in its present form to the Finance Ministers. As a possible solution, some Alternates suggested deleting the last section of the report. Another possibility would be to widen the range of options; modifications to the features of both formulae could be considered so as to present a series of arrangements with a progressive intensity of commitment on the part of the Community. For example, the width of the fluctuation band and the terms of the financing facility could be modified in the first formula while, in the second, further options could stem from changes in the procedure for fixing the parity of third currencies. It was also suggested that a distinction should be drawn between formulae based on commitments involving both the central banks and the political authorities, and co-operative arrangements which could remain within the realm of central banks. The Alternates agreed that any attempt to amend the report would only be fruitful if clear guidance was given by the Governors. In considering how to proceed, it should be borne in mind that the September meeting of the informal ECOFIN was scheduled before the next meeting of the Committee of Governors.

1.3. Discussion by the Committee

Mr. Schlesinger said that, since only a small number of the currencies which comprised the ECU basket tended to be used by third countries for intervention purposes, it was not a convincing argument that the latter should have "to buy a whole basket if it was only interested in some of its components"; the solution would be to link third currencies to the parity grid.

Mr. de Larosière said that he would have strong objections if the possibility of linking to the ECU were to be discarded. That would run counter to the aim of the EMS to base a common currency on the unification of the monetary policies of Member States. While the Sub-Committee's report offered a good analysis of the spectrum of possibilities, its focus on two solutions might not provide the full answer. One formula was a proxy for virtual full membership of the EMS, which would create problems since a country could not join the EMS without being a member of the Community; the other solution, an upgraded "Norwegian arrangement", was not wanted by Sweden. More work should be carried out on intermediate solutions, although he was not sure that this would accommodate Sweden which strived for something close to participation in the EMS. Two principles should be kept in mind: firstly, a country which wanted to associate itself with the EMS, whatever the formula, should not be able to provoke a realignment of the ERM currencies' parities. Secondly, to show that there was a difference between being an associated member and a full EMS member, recourse to the mutual financing arrangements should not be unlimited for the former. The EMS countries had a duty to try and accommodate the countries which were looking at the EMS as a method of anchoring their currencies; this should not be discouraged although the integrity of the EMS should be preserved.

Mr. Leigh-Pemberton said that he did not feel that it was possible to prevent third countries from linking their currencies to the ECU, although it should be examined to what extent such a link might affect the ECU and, above all, the EMS and ERM. He agreed that the degree of financial support given to a third country could not be unlimited. He supported the view that the question of monetary co-operation should be kept open; it was consistent with the general philosophy of strengthening the EMS, by removing instability outside of it, and with the widening of the Community. He was sympathetic to the idea of a link to the ECU, but he was cautious about participation in the parity grid without full EEC membership.

Mr. Ciampi said that he was becoming convinced that there were few alternatives to the two formulae set out in the report. The Committee was confronted by two possibilities: the Norway-type solution which Sweden did not want; or a solution which would have a serious impact on the existing system. He was unable to accept solutions which ignored the ECU since this was at the core of the system. In view of the current tensions within the EMS, it would be in the best interests of all Member States to ensure that during the coming months, the risk of non-ratification of the Treaty on European Union was minimised. He suggested that it might be advisable to postpone a decision on the question of monetary co-operation until after ratification.

Mr. Duisenberg supported the proposal that the Sub-Committee should study further variants of a solution within the parity grid system, although ECU-based variants should not be discarded. It seemed odd to say to third countries that the ECU was at the heart of the EMS when the existing members ignored the ECU in practice; there was no link with the ECU and there was no role for it in the system. He shared Mr. de Larosière's views that the admission of a third country to the system should not give them the advantages enjoyed by the present members; he favoured limiting third countries access to financing, and an arrangement under which the settlement of accounts and interventions could only be done in the currency of the creditor country. The Sub-Committee should be asked to study further alternatives within the parity grid system for consideration by the Governors at their September or November meeting; the Committee should not wait until the Maastricht Treaty was ratified.

Mr. Beleza said that the strategy followed by the Sub-Committee of putting forward two consistent, yet different, formulations was appropriate. With regard to the proposal for bilateral agreements mentioned in the report, this could place considerable constraints, both on existing members and third countries, if such agreements were established between a third country and all EMS currencies. Furthermore, full participation by a third country in the parity grid would imply full participation in the multilateral surveillance exercises, which would be largely a matter for other fora in the Community. He agreed that the ECU option should not be rejected and suggested that the Sub-Committee examine some compromise solutions for consideration by the Governors.

Mr. Rubio did not agree that the two formulae of monetary co-operation presented alternatives between which the Committee could choose. The Committee did not have a clear answer to the Swedish request because some countries were against a solution which would offer an association with the EMS without being a member of the Community, and because such an association would imply a discussion of the third countries' policies and their representation on certain Committees.

Mr. Schlesinger clarified that until a single currency in its own right was established, the ECU was only a basket of currencies and, therefore, it did not play a large role as far as interventions were concerned. He could understand that, on the basis of a European philosophy, the ECU-link solution was being proposed. However, to keep the exchange rate of the currency of a third country in a relatively narrow band vis-à-vis the ECU, the question arose how this could be achieved if the former's currency came under pressure. In the case of Sweden, the level of its interventions were high for a country of its size. They were largely undertaken in Deutsche Mark and, to a lesser degree, US dollars and ECUs; the relevant central banks were informed only afterwards. In order to minimise such problems for the EMS currencies, the Deutsche Bundesbank favoured a parity grid solution.

Mr. Christophersen said that, although the Swedish request for associate membership of the EMS had originated from the central bank, the new Swedish government had made several political démarches both to the Commission and Member States. It was important to consider how to avoid damaging the credibility of the Swedish currency, and the political relationship between Sweden and the Community, if there was a further delay in the decision-making process. The Ministers were unlikely to express any opinion or to take any decision at the September informal ECOFIN meeting without a clear recommendation from the Governors; it would thus be better to tell the Chairman of the ECOFIN Council that further studies would have to be made. He agreed with Mr. de Larosière that there should not be a system which could provoke a realignment within the EMS. Whatever the form of arrangement, it should be accompanied by a proper surveillance procedure together with a binding commitment from the third country to follow similar guidelines for nominal convergence as those which applied to Community countries. Since it was the Commission's intention to give its opinion about the Swedish application for membership of the Community towards the end of July, and it was EC policy that new members would have to respect the application of convergence criteria, he suggested that the exercise of monetary co-operation with third countries could be presented more as a transitional arrangement for applicants before they became full EMS members than as a kind of permanent association.

The Chairman summarised the issues as follows. Firstly, the Committee had been asked by the Ministers to produce a report on this issue, although Mr. Ciampi's reservations about timing had been noted. Secondly, if third countries chose to link their currencies unilaterally to the ECU, that was a matter for them. Thirdly, if some form of monetary co-operation was to be entered into, there was no possibility that a third country could be granted full EMS membership. Finally, the Sub-Committee could take, as a basis, an extension of the Norwegian-type arrangement within which different forms of co-operation could be established. Given that so many of the Governors had spoken in favour of exploring the possibility of ECU-linked arrangements, this should be examined by the Sub-Committee in a revised report together with a parity-grid arrangement. If this item appeared on the agenda of the informal ECOFIN meeting in September, he would remind the ECOFIN Council that he had forewarned them that a report might not be available for that meeting although one was being prepared.

2. Request by Suomen Pankki

The Committee approved the communiqué which had been agreed by the Alternates concerning the bilateral swap agreements to be concluded between the central banks of the Member States and Suomen Pankki.

Mr. Rubio noted that nothing was mentioned in the communiqué regarding the ECU.

Mr. Rey pointed out that the Suomen Pankki had agreed to the text.

The Chairman said that the communiqué would not be published until 16th July to allow time for the Committee's decision on the Finnish request to be reported to the Finnish Government.

V. Principles governing prior agreement on interventions in Community currencies

With reference to the note by the Foreign Exchange Policy Sub-Committee dated 3rd July 1992, the Chairman said that, on 9th April 1991, the Committee had adopted the principles governing the prior agreement on intervention in Community countries which had since been applied on a trial basis. The Sub-Committee recommended that the arrangements should be continued on a permanent basis; this had been endorsed by the Alternates.

The Committee approved the Sub-Committee's recommendation. Furthermore, the Secretariat would prepare a single document, for approval by the Governors at their meeting in September, which brought together the rules governing the arrangements which were currently set out in several documents. The Secretariat would also prepare a draft instrument which would amend Article 16.1 of the EMS Agreement so as to formalise the extended use of official ECUs in intra-Community settlements.

VI. Conditions governing the entry into the EMS exchange rate mechanism and the move to the narrow band

Mr. Rey said that the note by the Alternates dated 13th July entitled "Prior consultation among EC Central Banks in the event of a currency's entry into the ERM or its move to the narrow band" reflected their unanimous view of the issues involved. The Committee's attention was drawn to paragraph 4 which stated that the Alternates had reached a consensus on the desirability of holding informal, confidential discussions on prospective decisions relating to a currency's entry into the ERM or its move to the narrow band. He added that the Alternates had had a consultation at a breakfast meeting that morning, the outcome of which they would each report to their respective Governor.

The Committee expressed agreement with the Alternates' note dated 13th July.

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

- Preparation by the Foreign Exchange Policy Sub-Committee (Monitoring)
- Statistical charts and tables prepared by the Secretariat
- Two reports by the Monetary Policy Sub-Committee entitled "Review of monetary policies in the Community in 1992" and "Recent developments in public finance and their policy implications"
- A note by the Economic Unit entitled "Review of monetary policies in the Community in 1992

1. Outcome of ECOFIN meeting

The Chairman said that he had made the following points at the ECOFIN meeting which had taken place the previous day. Firstly, convergence was not proceeding at a satisfactory rate; inflation was not falling despite the sluggishness of the Member States' economies. Studies prepared by the Monetary Policy Sub-Committee on the traded goods and sheltered goods sectors showed that it was the former which had been most affected by the tight monetary policy. Secondly, the Committee was concerned about Germany's anchor role and, finally, fiscal policy in many countries was inappropriate. The Committee was concerned that unrest in the exchange markets had reappeared which had led to the conclusion that the credibility of the ERM was not as unconditional as it had been previously. The Dutch Minister subsequently stressed that any measures which were taken in Germany for internal reasons had repercussions throughout the EMS which were not wholly satisfactory. The German representative reacted sharply and pointed out that there were so many tensions in the German economic system, such as the growth of money supply, credit expansion and the difficulties with the Eastern Länder, that he could not exclude a tightening of monetary policy. The rest of the discussion had concentrated on monetary developments with little discussion on fiscal policy in the Community. The Chairman said that he had also reported on the preparatory work towards EMU being undertaken by the Committee.

2. Statement by Mr. Saccomanni, Chairman, Foreign Exchange Policy Sub-Committee (Monitoring)

The Monitoring Group had expressed concern about the evolution of the US dollar and the Japanese yen. The downward trend of the dollar was gaining momentum following the discount rate cut by the Federal Reserve in early July and the lack of supporting action from the G-7 countries, which the markets had expected. The trend was likely to continue given the size of the interest- rate differential between the dollar and the EMS currencies, and the disappointing level of economic activity in the US. With regard to the Japanese yen, it was stronger vis-à-vis the dollar but weaker against the European currencies, despite Japan's large current account surplus. The Bank of Japan was intervening to support the yen but pressure to lower official interest rates was again mounting in view of the weakness of both the domestic economy and the Japanese stock market.

The tensions in the EMS, which had emerged since the Danish referendum on the Maastricht Treaty, had abated after the Irish referendum result but had since resurfaced in a number of countries. The Italian lira had remained under pressure because of the domestic imbalances and the political situation in Italy; this had occasionally become acute on rumours of a devaluation of the lira and possible action by the Bank of Italy to restrict activity on the foreign exchange market. As a result of increases in Italian official interest rates in early June and early July, and supporting interventions, the Italian currency had remained within a narrow range vis-à-vis the Deutsche Mark. The objective of exchange rate stability had been strongly endorsed by the new Italian government; the budget measures and structural reforms, which had been approved on 4th July, should contribute to stabilising market expectations. In the United Kingdom, the weakness of the pound sterling had originated from the persistent recession which was leading to pressure for a reduction in official interest rates and for a depreciation of the currency. The political debate on EMU had reopened following the Danish referendum, which, together with consideration of domestic economic policies, was fuelling market uncertainty. The tensions had increased since late June when the exchange rate of the pound sterling was allowed to fall outside of the narrow ERM band range; some supporting intervention had been conducted in the past week and official statements in support of the existing exchange rate policy had also been made. Occasional tensions had also emerged in Spain, Ireland and France requiring supporting intervention by the respective central banks, while some intervention sales of the Portuguese escudo had also been made by the Bank of Portugal, which had also lowered the rate of remuneration on commercial banks' obligatory deposits. It was noted that German M3 continued to grow at an annualised rate close to 9% while there was no sign of a decline in underlying domestic inflation. The factors affecting the growth of the German monetary aggregates had been reviewed, particularly the portfolio shifts into money market investments; the expectation that the Deutsche Bundesbank might take measures to maintain the credibility of its tight monetary policy stance was a factor of uncertainty and tension in the ERM.

3. Statement by Mr. Borges, Chairman, Monetary Policy Sub-Committee

The performance of the Community's economies was disappointing with the recovery much weaker than had been expected. Although external developments had contributed to this, domestic private sector spending had been affected by subdued business and consumer confidence. However, inflation remained resilient; the best estimate for Community-wide inflation in 1992 had been revised to 4.5%, which was a very small improvement relative to 1991 yet far from the objective of price stability. The resilience was attributed to domestic factors, since external inflationary pressures had been less strong than expected; wage pressures remained strong in many countries, and fiscal policy developments had not helped to bring down inflation. A significant source of price rises was the increase in indirect taxes and administered prices which, in many countries, was more pronounced than expected. Inflationary pressures had remained strong in the sheltered sectors of most Community countries, and low inflation in the tradeable sector seemed to have been achieved at the cost of squeezed profit margins, which indicated that it might not be sustainable. A lack of flexibility, in particular in labour markets, and non-competitive practices in the sheltered sector, were reducing the effectiveness of anti-inflation policies.

Monetary policies were generally adequate and mutually consistent. The homogeneity of monetary conditions reflected the degree of nominal convergence that had been achieved. However, the primary objective of reducing inflation had become more difficult since strong price pressures existed in Germany. The Sub-Committee had reaffirmed that the restoration of price stability in Germany must be a high priority for the Community and necessitated a tight monetary policy. Monetary expansion in Germany remained strong; it was not possible to exclude a scenario of stubborn inflation in Germany. Much could be gained from an improved policy mix but monetary policy needed to remain firmly non-accommodating.

The Danish referendum result had generated considerable turbulence in financial markets; interest rate differentials had widened and supporting interventions had been necessary. The Sub-Committee had concluded that no change in the stance of monetary policies was called for; a decline in inflation in the remainder of 1992 should take place given the expected progress of inflation prospects in Germany in parallel with a decline in monetary growth. However, there was a risk that persistent strong inflationary pressures in Germany would force the authorities to tighten monetary policy further. A weaker than expected economic recovery in the Community could be an additional source of tension. The Sub-Committee felt that the commitment to the ERM parity grid would preclude any easing of monetary policies; however, fiscal policies were already reflecting the impact of low levels of economic activity and might possibly become more expansionary. The EMU Treaty ratification process would also remain a source of uncertainty; any events which shook the confidence of the markets would probably require adjustments in interest rates and exchange market interventions.

With regard to the review of public finance developments, the Sub-Committee had assessed progress in the light of the criteria set out in the EMU Treaty. The trend towards fiscal consolidation which had been achieved in the 1980s had reversed in 1990 and 1991. In spite of a reduction in some countries, the borrowing requirement for the Community as a whole had risen from 2.7% of GDP in 1989 to 4% in 1990, and 4.3% in 1991. Current projections indicated that a continuation of spending growth would push the general borrowing requirement to 4.8% of GDP for 1992. As a consequence, only four countries would achieve deficits below 3%, the reference rate of the Maastricht Treaty. A significant part of the widening of budget deficits was attributable to the impact of the economic cycle; however, the Sub-Committee felt that it was appropriate to let the automatic stabilisers take their course only in low-deficit countries. For the Community as a whole, public debt was projected to increase to a record high level of 63% of GDP in 1992, from 61% in 1991. Only six Community countries would have a debt/GDP ratio below 60%. The persistence of excessive budget deficits in the Community undermined the effectiveness of monetary policy in achieving price stability. Any large fiscal expansion led to higher long-term interest rates for the Community as a whole. Furthermore, if it took place in the anchor currency's country, and the maintenance of price stability required a consequent tightening of monetary policy, the resulting increase in short-term interest rates would affect all Community countries. In contrast, if ERM commitments did not allow a country to increase interest rates, it might be impossible to offset the inflationary impact of a fiscal expansion.

The Sub-Committee had considered the possible implications of a simultaneous move by many Community countries to reduce their budget deficits in order to meet the EMU criteria. A reduction of excessive deficits to the 3% maximum would imply a cut in general borrowing requirements of about 2 percentage points of Community GDP spread over a number of years. This might have limited short-term costs, compared with the magnitude of other shocks, but would bring long-term benefits, including strengthening the foundations for sustained non-inflationary growth.

4. Statement by Mr. Rey, Chairman, Committee of Alternates

The Alternates' discussion had focused on three issues. Firstly, the need to maintain the momentum towards economic convergence in the Community. The credibility of this process had been damaged by the result of the Danish referendum, which had apparently directed market perceptions towards the divergences in economic fundamentals that existed among Community countries. The most effective contribution which central banks could now make to enhancing market confidence would be to reaffirm their commitment to co-operate within the exchange rate mechanism and to accept its disciplinary effects. In addition, the announcement of measures such as the granting of legal independence to central banks would also boost credibility.

The second issue discussed had been the conclusion of the ex-post report that monetary policies in the Community were mutually compatible and also adequate to lead to a further decline in inflation in 1992. Particular attention had been devoted to the economic and monetary situation in Germany. Credit was expanding without a corresponding increase in long-term savings; this was leading to a significant overshooting of monetary targets. No Alternate disputed the importance of restoring price stability in Germany and it was noted that the forthcoming review of German monetary conditions offered an opportunity for central banks to express their support for a clear anti-inflationary strategy in the Community. Nevertheless, one Alternate challenged the view that the stance of national monetary policies, was now broadly appropriate. He pointed out that the risks, which according to the ex-post report could possibly upset the assessment of monetary policies, had already materialised.

Thirdly, with regard to public finances, the Alternates agreed with the Monetary Policy Sub-Committee's report that fiscal policies were a major factor contributing to the resilience of inflation in many Community countries. The convergence programmes had the potential to make an important contribution, but it was important that the targets were effectively implemented.

5. Statement by Mr. Ciampi

Mr. Ciampi recalled the points he had made in the June meeting of the Committee and, in particular, the reasons that had led the Bank of Italy to raise the rate on its fixed-term advances by half a percentage point on 5th June. Since then, however, the Italian foreign exchange and financial markets had repeatedly come under pressure owing to: the budget and balance-of-payments deficits; and the political difficulties engendered by the Italian elections on 5th April, with the result that the process of electing a new President of the Republic and forming a new government had only been completed in early July.

The Bank of Italy had countered the heavy pressure on the Italian lira by: intervening in the foreign exchange market; tightening liquidity conditions; and, on 5th July, raising the official discount rate from 12% to 13%, and the rate on fixed-term advances from 13% to 14.5%. Immediately after the vote of confidence by the Italian parliament on 4th July, the government, which Mr. Ciampi had kept constantly informed of developments in the foreign exchange and financial markets, had taken steps to implement its economic programme. On 11th July, the government had acted on three fronts: firstly, budget measures equivalent to about 2% of GNP were adopted with the aim of curbing the budget deficit for 1992, for which the government had not yet set a target but which Mr. Ciampi reckoned should be close to that for 1991. Secondly, the Italian parliament was asked to authorise the government to approve rules for the reform of the pension and health-care systems, local government finances and public employment. The planned measures would only have a limited effect in 1992, but they involved a major change in the four main areas of public expenditure. Thirdly, a Decree Law was issued to speed up the process of privatisation by transforming state-owned enterprises into joint-stock companies.

The reforms of the pension system and public employment were intended to provide support for an incomes policy based on the planned rate of inflation. Mr. Ciampi pointed out that the policy might result in a small decline in real incomes, since the target rate of inflation for 1992 was 4.5% while the current rate was around 5%. While Mr. Ciampi's overall assessment of the government package was positive, he made a number of observations: on the fiscal front, he would have preferred measures increasing revenues beyond 1992 instead of the one-off tax on bank deposits; with regard to pensions, more rigorous criteria would have been desirable; and on privatisation, no decision had yet been taken on the elimination of the rules which prevented the private sector from taking control of state-owned enterprises.

The reaction of the market was still uncertain. The explanation, he believed, was to be found in the market's intention of testing the strength of the Italian government, in the weakness of the US dollar and in the expectation that the Deutsche Bundesbank Council would raise German rates further. In such conditions, public declarations regarding the appropriateness of a realignment within the EMS should be carefully avoided.

The stability of the Italian lira within its present band was crucial to the success of the incomes policy and the drive to bring down the rate of inflation. The pivotal role of the exchange rate had been strongly reaffirmed by the Prime Minister, Mr. Amato, in public declarations and private communications; the Bank of Italy was acting accordingly.

6. Discussion by the Committee

Mr. Duisenberg asked Mr. Ciampi whether the privatisation decree also applied to companies, particularly banks, that were partly government-owned. On a separate point, he asked whether Mr. Schlesinger could give an indication of the extent to which the growth in German M3 could be explained by both the accumulation of interventions and the autonomous import of short and long-term capital to Germany.

Mr. Ciampi replied that the Bank of Italy's policy for a number of years had been to allow publicly-owned banks to be opened up to private capital. It had encouraged the Italian government to pass a law which stipulated that publicly-owned banks could become joint stock companies. Since the enactment of the so-called Amato-Carli Law three years previously, approximately half of the publicly-owned banks had become joint stock companies. However, a restriction, which was still in force, had been introduced by the Italian parliament which prohibited private investors from acquiring a majority participation in such banks without the government's specific authorisation. He added that the Ministry of State Participations, which was responsible for managing the publicly-owned companies, was to be abolished.

Mr. Schlesinger said that he was in favour of making public the Monetary Policy Sub-Committee's reports, particularly that relating to public finances; support from the Committee in respect of the various Member States' convergence programmes would help to obtain greater backing from public opinion. He felt that Germany's monetary target was correct but that the development was not. The money supply growth was largely caused by the strong credit expansion in Germany; credit to companies and private households had grown at an annualised rate of 12% as at the end of May; however, monetary capital formation was decreasing allowing credit growth to be near-fully reflected in the growth of M3. The strong M3 growth was thus not simply a consequence of investments being diverted from bonds and long-term savings deposits into M3 components; the strong increase in time deposits was mainly caused by a movement of funds from short-term savings deposits, both of which were in M3. Other factors were not significant. Germany had experienced some large long-term capital outflows, although no outflow had occurred in May. The current account deficit was not financed using the reserves but by imports of short-term capital inflows, which were largely invested in the liabilities of the German banking system and which did not form a part of the money supply. The modest changes in Germany's reserves in May and June had been mainly caused by the Deutsche Bundesbank's transactions in US dollars and those of the US authorities in Deutsche Mark. The principal focus of the Deutsche Bundesbank Council's forthcoming discussion was likely to be the strong credit expansion in Germany but the problems which could be created for other EMS countries by any increase in German interest rates would also be considered. He shared the view of the other EMS countries that exchange rates should be kept stable and said that he had never made any reference about devaluing any of the EMS currencies.

Mr. de Larosière noted that the ex-post report concluded that the monetary policies of the Community countries were on the whole appropriate, although this assessment would have to be reviewed if the following risks appeared: inflationary prospects in Germany; the possibility of a weaker than expected economic recovery; the persistence of the wrong type of policy mix in Community countries; or the remaining uncertainties surrounding the ratification of the EMU Treaty. He said these risks were to some extent materialising. He suggested that the Monetary Policy Sub-Committee's next report should analyse the following: firstly, would a tightening of monetary policies in a country improve its inflationary situation to a degree that would not be more than offset by adverse consequences for other countries? Secondly, were monetary policies always able to offset the effects of inflationary fiscal policies or wage developments? Thirdly, to what extent would the effect of very high interest rates reintroduce inflationary tensions in a country such as France where inflation was low, the growth of monetary aggregates was moderate, and there was spare capacity in the economy. He welcomed Mr. Schlesinger's comments that he was aware of the consequences of any decision to be taken by the Deutsche Bundesbank on its EC partners; it would be a problem for some countries to have to tighten their monetary policies in order to avoid exchange rate difficulties. He added that he did not understand the sentence at the beginning of paragraph six on page 16 of the ex-post report which said, "Germany's traditional anchor role in the ERM may make it difficult for other countries - in spite of weaker domestic economic growth - to achieve and maintain a rate of inflation much below Germany's". With regard to the changes in the composition of the German M3, Mr. de Larosière felt that, notwithstanding the shifts from sight deposits into term deposits, the resource allocation of banks in Germany might be helping to fuel the growth of the monetary aggregate. Finally, the strains in some countries that could be created by certain anti-inflationary policies in Germany should not be underestimated.

Mr. Leigh-Pemberton said that the situation in the United Kingdom was currently difficult. The government was determined to adhere to counter-inflationary policies based on membership of the ERM, which was gradually producing some success; the headline rate of inflation had fallen to below 4% for the first time in a number of years. Nevertheless, it was being criticised because of the effect of those policies on the real economy; recovery was seen to be elusive and critics were increasingly discussing devaluation, realignment and even secession of the pound sterling from the ERM. Even though the Prime Minister and the Chancellor of the Exchequer had each made strong statements the previous weekend, they had done little to strengthen the pound sterling judging by the markets' reaction. He also welcomed Mr. Schlesinger's understanding approach to the difficulties of Germany's ERM partners, although the situation was made more difficult when the media reported on statements which appeared to have been made by the Deutsche Bundesbank concerning a realignment of the ERM currencies.

Mr. Verplaetse said that he understood Germany's position, and added that all Member States were interested in price stability. He noted that price increases were reducing in Germany, although he would prefer more faith to be placed in some kind of incomes policy. However, given that Germany had to take action for domestic reasons, he hoped that monetary policy might be tightened in Germany using measures other than changing official interest rates.

Mr. Beleza said that the Committee should not stray too far towards consideration of fiscal policies as they were not within its terms of reference. With regard to the points made in the report concerning the impact of indirect taxes and the difference between the tradeable and sheltered sectors vis-à-vis measured inflation, this might suggest that the measurement of the variables might not represent true inflation.

Mr. Schlesinger said that he agreed with most of what had been said concerning Germany's situation; there could be a danger in a country over-using monetary policy and not having the right combination of different economic policy instruments. On a number of occasions, he had expressed his concern about the high level of interest rate subsidies in Germany, especially those in favour of the new Länder; this had also been pointed out in the Deutsche Bundesbank's monthly reports. However, the German central bank's priority was the stability of the price level. In response to a question from Mr. de Larosière, he said that he felt that any change in minimum reserve requirements would influence market interest rates. The minimum reserve requirements in Germany were already the highest among industrial countries and it was not sure that any further increase would act as a brake to the current credit expansion. In reply to a question from the Chairman, he said that the weakening of economic activity in the second quarter of 1992 was expected given the strong growth in the German economy in the first quarter. Inflationary developments were still disappointing, with a substantial increase in prices taking place in eastern Germany.

Mr. Christophersen said that the Finance Ministers were concerned that the convergence programmes of the Member States were based on two main assumptions, both of which were becoming increasingly unrealistic: namely, comfortable growth rates over the next two years; and an easing of monetary policies resulting in lower interest rates. The Ministers felt that the pressure they were putting on expenditure control was yielding results in a number of countries, however, the automatic stabilisers were tending to have a partly offsetting effect; this could further erode the credibility of a number of convergence programmes and exchange rate policies.

Mr. Doyle suggested that the Monetary Policy Sub-Committee should analyse the present conjuncture of economic events by projecting a situation in which a single monetary policy in the Community existed and assess what policy variations would be possible to cope with a situation where one or more countries' economic situations was out of step with the rest. Furthermore, while tensions in the markets had formerly tended to arise as a function of the economic fundamentals in Member States, those which had arisen since the Danish referendum result could be ascribed largely to a general institutional vagueness.

Mr. Christodoulou said that inflation in Greece had declined to about 15% and was forecast to fall to around 13% by the end of 1992, and that tax revenues were increasing at a lower rate than that envisaged in the budget. The Greek government's deficit, excluding interest payments, had fallen by about 7% of GDP, from 10.5% in 1989 to around 3% in 1991; a small surplus should be achieved in 1992. Broad money growth had steadily accelerated and was currently well above the target range of 9% to 12% for 1992. However, this was not due to a strong demand for credit, rather it was the consequence of: the favourable evolution of the balance of payments and a larger than expected portfolio shift from government securities into bank deposits. The monetary policy stance had not eased. There were indications that monetary growth had peaked and had started to decelerate since June; the Greek central bank was trying to dampen growth by widening the differential between the yields on government securities and bank deposit rates. Finally, the Greek government, following a recommendation by the Bank of Greece, had introduced legislation prohibiting deficit financing by the latter after January 1994 and limiting it to half of the current level in 1993.

Mr. Borges said that the Community's inflation could not be attributed to monetary policy. However, the latter could not remain passive as it would quickly become accommodating. The Monetary Policy Sub-Committee had taken a Community-wide approach in its analyses to the extent possible. Even though the weakness in the French economy was attributed to a lack of confidence on the part of the business and private sectors, it might be possible to present a case in favour of a different monetary policy in that country, and perhaps in Denmark. In all other Community countries the problem of accommodating inflationary pressures was serious. Mr. de Larosière had pointed out that interest rates might not have sufficient impact to slow monetary growth. The question of whether monetary policy was appropriate depended on whether the current level of interest rates would be sufficient to slow down, perhaps with a lagged effect, the growth of money supply. If it did not, monetary policy might have to be tightened. The example of the United Kingdom in the late 1980s, and Spain in the past two years, showed how difficult it was to estimate how quickly monetary policy would have the desired impact on the monetary aggregates. With regard to Mr. de Larosière's question concerning the sentence on page 16 of the ex-post report, this should be read in the context that many Community members had argued that the discipline introduced traditionally by a low level of inflation in Germany was no longer present; the German inflation level had become a standard to the extent that, if a country fell below that level, the pressure to reduce inflation further might not be as strong. In response to Mr. Christophersen's reference to the impact of automatic stabilisers, the Public Finances Report had concluded that national budgets had become much more sensitive to the business cycle than had been the case in the past.

The Committee agreed that the Public Finances Report should be transmitted to the Finance Ministers in the usual way.

VIII Other matters falling within the competence of the Committee

1. Publication of the "Blue Book"

Mr. Rey recalled that the Committee had decided at its meeting in May to publish the Blue Book and had asked the Secretariat to consider the practical issues involved. Most Alternates were in favour of it being distributed without charge, mainly on the grounds that selling would involve additional administrative costs. One Alternate, however, had expressed strong reservations, particularly taking into account the fact that his central bank would have to bear the cost of translation, which it would wish to recoup, into his country's language. This issue raised a question of principle which had already been briefly discussed in connection with the Committee's Annual Report. At that time, it had been decided to revert to the matter before the next Annual Report was issued. The Alternates had concluded that the Committee should return to this matter during the autumn; the immediate issue should be settled on the basis of the majority view.

Mr. de Larosière said that he would abide by the majority view although he was not in favour of distribution being made without charge since the document was costly to produce and giving it away could lead to waste. Furthermore, there was a demand for the Blue Book to be translated into French. However, if the English version was to be free of charge, it would not be feasible to charge for the French edition. He did not wish this to be regarded as a precedent and agreed that the principles involved should be considered thoroughly.

The Committee agreed that no charge should be made for the Blue Book and that the general principle of producing different language versions of the Committee's publications should be returned to during the autumn.

2. Response to journalists

The Committee reaffirmed that, when responding to questions posed by journalists following the meeting, individual Governors could make reference to their own interventions although they should not report what other Committee members had said.

IX. Date and place of next meeting

The next meeting of the Committee of Governors will take place in Basle on Tuesday, 8th September 1992 starting at 9.30 a.m.

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Before closing the meeting, the Chairman, to mark the occasion of Mr. Rubio's last attendance at a Committee of Governors' meeting, praised him for the role he had played in the preparation of Spain's entry into the European Community, and to the liberalisation of the Spanish banking system, the improvements made to the efficiency of banking supervision and the more stable monetary system which had been achieved in Spain during his term of office.

268th MEETING OF THE COMMITTEE OF GOVERNORS

14th July 1992

Those present were:

Chairman of the Committee of Governors	Mr. Hoffmeyer
Banque Nationale de Belgique	Mr. Verplaetse Mr. Rey* Mr. Michielsen
Danmarks Nationalbank	Mrs. Andersen Mr. Hansen
Deutsche Bundesbank	Mr. Schlesinger Mr. Tietmeyer Mr. Rieke
Bank of Greece	Mr. Christodoulou Mr. Papademos Mr. Karamouzis
Banco de España	Mr. Rubio Mr. Rojo Mr. Linde
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 Mr. Saccomanni
Institut Monétaire Luxembourgeois	Mr. Jaans
Nederlandsche Bank	Mr. Duisenberg Mr. Szasz Mr. Bakker
Banco de Portugal	Mr. Beleza Mr. Borges Mr. Bento
Bank of England	Mr. Leigh-Pemberton Mr. Crockett Mr. Foot
Commission of the European Communities	Mr. Christophersen Mr. Pons
Secretariat of the Committee of Governors	Mr. Baer Mr. Scheller Mr. Guiomard

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* Chairman of the Committee of Alternates