12th January 1993 Confidential

<u>Final</u>

MINUTES OF THE 271ST 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 DECEMBER 1992

TABLE OF CONTENTS

	Page
Ι	Approval of the minutes of the 270th meeting
II	Adoption of the Committee's report to the EEC Ministers of Finance on developments on the foreign exchange markets of the nineteen countries participating in the concertation procedure during November 1992 and the first few days of December
III	Extension of the EMS revolving swap mechanism1
IV	Renewal of the swap agreements with Norges Bank
v	Bilateral agreements between Community banking supervisors on the implementation of the Second Banking Co-ordination Directive
VI	 Monitoring of economic and monetary developments and policies in the Community: monthly monitoring of short-term develoments; ex-ante exercise devoted to the examination of monetary policy objectives for 1993 in the common framework for the monitoring of monetary policies; annual review of devlepments in the European Monetary System 1) Statement by Mr. Saccomanni, Chairman, Foreign Exchange Policy Sub-Committee (Monitoring)
VII	Preparatory work for the move to the final stage of EMU14
VIII	Other matters falling within the competence of the Committee 1. Exchange of personnel between Community central banks 2. Recruitment of a telecommunications expert 15 3. Forthcoming annual report of the Committee of Governors 15 4. Liaison between the Working Group on EC Payment Systems and the European Committee for Banking Standards, created under the aegis of the three European banking federation 15 5. Presentation of the Committee of Governors' first Annual Report to the plenary session of the European Parliament
IX	Date and place of next meeting

List of participants attached

Before turning to the agenda, the <u>Chairman</u> said that at their <u>restricted meeting</u>, which had been held prior to the current meeting, the Governors had agreed to appoint Mr. Duisenberg as Chairman of the Committee for a term of one calendar year from 1st January 1993. The Chairman would make it clear to journalists, if asked, that there was no presumption that Mr. Duisenberg's appointment had any implication for the recommendation which the Committee would in the future make regarding the nomination of a President of the EMI. Furthermore, since Mr. Lagayette had relinquished his position as Deputy Governor of the Banque de France and was thus no longer its representative on the Committee of Alternates, the Chairman asked that the Governor's appreciation of Mr. Lagayette's contribution to the work of the Alternates be conveyed to him.

Mr. Duisenberg thanked his colleagues for the confidence which they had expressed in appointing him.

- I <u>Approval of the minutes of the 270th meeting</u> The <u>Committee</u> approved the minutes of the 270th meeting.
- II Adoption of the Committee's report to the EEC Ministers of Finance on developments on the foreign exchange markets of the nineteen countries participating in the concertation procedure during November 1992 and the first few days of December.

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

III Extension of the EMS revolving swap mechanism

In order to ensure the continuation of the revolving swap mechanism of the EMS beyond 13th March 1993, the expiry date stipulated in the Governors' decision of 11th December 1990, the <u>Governors</u> decided, in pursuance of Article 20.1 of the Agreement of 13th March 1979 between the EEC central banks laying down the operating procedures for the EMS (hereafter "EMS Agreement"), as amended by the Instruments dated 10th June 1985 and 10th November 1987, respectively, that:

- the swaps referred to in Article 17.3 and 18a.4 of the EMS Agreement shall not be unwound on 13th March 1993; and,

- the swap mechanism shall be extended for a further two-year period, at the end of which, save in the event of a unanimous decision to the contrary, the said swaps will be unwound. During the said period (that is until 13th March 1995) the swap mechanism will remain subject to the same provisions of the EMS Agreement, it being understood, however, that the Governors may, by a unanimous decision, shorten this period and modify the mechanism in the event that institutional changes in the monetary area other than those provided for in the Treaty on European Union take place before 13th March 1995.

Furthermore, the Committee requested the Chairman to inform the President of the ECOFIN Council of the Governors' decision by a letter, the draft of which had been circulated by the Secretariat.

IV Renewal of the swap agreements with Norges Bank

Mr. Rey said that at their meeting on the previous day, the Alternates had been informed that the swap agreement of the Norges Bank with the Deutsche Bundesbank had been activated on 20th November 1992 for the total amount of DM I billion. This had not been known to the Foreign Exchange Policy Sub-Committee when it had recommended the renewal of the bilateral swap agreements for a further one year period in accordance with the current terms and conditions. Nevertheless, the Alternates had suggested following the recommendation of the Foreign Exchange Policy Sub-Committee. However, it had been mentioned that the intervention policy of Norges Bank should be clarified. The Alternates had taken note that the annual meeting with Governor Skanland would provide an opportunity to discuss the matter.

The <u>Committee</u> adopted the Alternates' proposal.

V Bilateral agreements between Community banking supervisors on the implementation of the Second Banking Co-ordination Directive

Mr. Quinn said that the cover note which had been circulated with the proposed draft communiqué set out some of the background to the suggestion that the Governors should issue a communiqué. While the Second Banking Co-ordination Directive provided the legislative framework and governing principles, the Sub-Committee had seen a need to agree on the practical implementation of that legislation, particularly with respect to the supervision of branches of banks established in other Member States. A preliminary idea that a model bilateral agreement might be formulated which would apply to the relationships between all Community banking supervisors was not feasible given the differences in national legislation and the different preferences of the member countries. As a result, a series of bilateral agreements governing the relationships between home and host country supervisors concerning the implementation of the directive had had to be negotiated; this process was virtually complete. At its November meeting, the Sub-Committee had considered whether all of the bilateral agreements should be published. Some countries had wished to do so; one agreement had already been published with the mutual consent of both parties involved. Other countries had been less comfortable with this approach and had preferred to communicate the implications for supervision to their banks using other means. The Sub-Committee had adopted the view not to publish all of the bilateral agreements but to recommend to the Governors that they should issue a communiqué. The draft communiqué had two principal messages: firstly, to indicate to the banking community and the public that the process of preparing for the Single Market in banking services had been completed, both legislatively and administratively; and, secondly, to provide reassurance regarding the supervision of the operations of EC banks under the new regime.

Furthermore, since Sir Leon Brittan would be making a public statement during the course of the following week welcoming the implementation of the directive as a signal that the Single Market in this area was about to commence, the Sub-Committee had felt that a communiqué issued by the Governors along similar lines would complement and strengthen the message.

The <u>Committee</u> approved the draft communiqué and asked Mr. Quinn and the Secretariat to co-ordinate its release with the Commission.

<u>Mr. Ciampi</u> said that he hoped that in the future it would be possible to develop a standard, multilateral agreement to take the place of the network of bilateral agreements which had been negotiated.

- VI Monitoring of economic and monetary developments and policies in the Community:
- monthly monitoring of short-term developments;
- <u>ex-ante exercise devoted to the examination of monetary policy objectives for 1993 in the</u> common framework for the monitoring of monetary policies;
- <u>annual review of developments in the European Monetary System.</u>
- 1) <u>Statement by Mr. Saccomanni, Chairman, Foreign Exchange Policy Sub-Committee</u> (Monitoring)

The Monitoring Group had concentrated its attention on the situation in the EMS following a brief review of the outlook for the US dollar. The Group had noted that the long-awaited recovery of the US economy, of which there were now clear signs, had not been accompanied by the expected appreciation of the US dollar; profit-taking sales were limiting its upward momentum. Various reasons were cited to explain such developments, including: continuing tension in the EMS associated with the expectation of firmness in German interest rates; and uncertainties about the policies of the US government, particularly the prospect that the Clinton administration might be cautious in proposing a major programme of deficit spending. Those factors had contributed to keeping US interest rates stable. However, as economic activity in the period ahead was likely to grow faster in the US than in the rest of the industrial world, a stronger dollar might just be a matter of time.

The ERM had remained under tension even after the realignment of the Spanish and Portuguese currencies on 22nd November. Market participants still appeared to still expect further parity adjustments, even in countries with good fundamentals, and were likely to retain such expectations in the current situation of slow growth and high levels of interest rates required to fight currency speculation. The markets had taken note of events in Sweden where the resolve to use interest rates aggressively had been eroded because of its domestic repercussions.

Against this general background, the Group had examined the situation of the individual currencies. In both Spain and Portugal, markets had been quiet after the realignment: there had been little movement in market interest rates and the parity change had been regarded as adequate. In Spain, the removal of measures penalising speculation had been well received and the policy mix

adopted by the Spanish authorities had been considered more balanced. In Portugal, the escudo, which had been allowed to slide shortly before the realignment, had subsequently remained stable near the top of the new wide ERM band. This had been achieved through interventions in the money and foreign exchange markets aimed at penalising speculators and maintaining an anti-inflationary policy stance. Following the realignment, tensions had concentrated on the Irish pound, the Danish krone and the French franc. Some tension had derived mainly from the reduced credibility of the ERM and the impact of the floating of the Swedish krona, although domestic factors had also played a role. In particular, in France, uncertainties had arisen as the policy of the "franc fort" had been questioned by some politicians in the debates taking place ahead of next March's legislative elections. The rise in the number of unemployed above three million and the French position on the GATT negotiations were also sources of tension. The discussion about the outlook for monetary co-operation in the ERM was also contributing to uncertainty and the prospect that a new narrower band could be established between the French franc and the Deutsche Mark had led the market to test the supposed new limit of FRF 3.40 to the Deutsche Mark. Tensions had been contained by using all of the Basle/Nyborg market instruments to varying degrees, with interest rate rises playing a relatively larger role in Ireland and Denmark, and interventions a larger role in France.

The situation of the stronger currency countries had also been reviewed. With regard to Germany, the Deutsche Bundesbank did not see any room for manoeuvre in the management of monetary policy given the persistent overshooting of monetary aggregates and a disappointing evolution of price trends, despite a slowdown in economic activity. A cautious approach to monetary management was also regarded as necessary in view of the uncertainties concerning the impact on inflation of next January's planned VAT increase, the forthcoming round of wage negotiations and the outcome of the budgetary process in Germany. Markets had ceased to expect official interest rates to be lowered at the next Bundesbank Council meeting and short-term market rates had firmed, partly anticipating a traditional year-end upward movement. Such trends had, to a lesser extent, also been recorded in Belgium and the Netherlands, despite a small cut in the rate of advances introduced by the two central banks in mid-November.

Among the floating currencies, the renewed tensions had negatively affected the Italian lira despite the fall of the inflation rate to below 5%, and the improvement on the trade balance which had recorded a small surplus in October vis-à-vis a large deficit in October 1991. The Greek drachma had been affected to a limited extent and, as the market had stabilised, the restriction on forward operations of banks had been removed. The appreciation of the pound sterling reflected profit-taking following its depreciation in September; inflows of funds from Hong Kong; and the improved economic outlook in the United Kingdom.

2) <u>Statement by Mr. Borges, Chairman, Monetary Policy Sub-Committee</u>

In the current context of market turbulence and unprecedented instability in the EMS, the ex-ante exercise must assume a more qualitative character; although precise forecasts had been developed, the high level of uncertainty in any scenario recommended caution in dealing with the

figures. The background to the ex-ante exercise was dominated by the persistently poor growth performance and the disappointing progress on inflation. During 1992, the economic outlook outside of the Community had remained weak while the Community's domestic demand had become more depressed. The persistence of the slowdown had generated a serious problem of confidence, especially in countries where high levels of public or private debt might prevent or delay a return to normal spending patterns. The progress on inflation remained limited due to strong wage growth in some countries, or tax increases - or other fiscal factors - in others. Monetary developments had reflected strong contrasts with slow money growth in countries where activity and inflation were low and rapid growth elsewhere. In Germany, excessive monetary growth had remained stubborn in spite of high short-term interest rates.

The policy dilemmas generated by the fight against inflation in the context of deteriorating activity levels had been at the heart of the ERM crisis of the previous three months. The uncertainties surrounding the ratification of the Maastricht Treaty had undermined confidence in the determination of countries to converge to price stability; this had been compounded by a lack of cohesion behind the anchor country's priority to fight inflation. A realignment had become inevitable in the eyes of market participants. The change in parities had taken place in an atmosphere of tension and might have led to even worse problems of confidence since the credibility of policies had been badly shaken; because massive interventions had taken place, the difficulties of monetary control had become more intractable. The ERM crisis had highlighted the importance of timely and, if necessary, substantial increases in interest rates as the most effective way of defending a currency under pressure. However, the ability or willingness to raise interest rates differed from country to country. The degree of central bank independence was an important factor in this respect, but economic and financial factors often created additional constraints on interest rates, in particular in countries with very high levels of debt; if money market interest-rate changes were quickly transmitted to all or most financial instruments, the defence of currencies through interest-rate policy might not be credible.

When realignments become unavoidable, they should be undertaken as early as possible although frequent realignments had drawbacks. Moreover, realignments would be ineffective and even counterproductive if they were not accompanied by adequate measures to restore stability. As a consequence of the crisis, monetary conditions had diverged considerably; only the re-establishment of confidence in the parity grid could restore interest-rate convergence.

The outlook for 1993 remained gloomy. Growth would continue to be weak and, partly as a consequence, fiscal deficits would widen considerably in several countries. Inflation was expected to remain high, well above the levels of 1986 to 1988 and far from price stability. There were promising signs of wage moderation but further increases in indirect taxes, as well as the appreciation of the US dollar, would push up prices. The Sub-Committee had emphasised that monetary policies must remain geared to the achievement and maintenance of price stability; however, this was not incompatible with non-inflationary growth. A medium-term oriented monetary policy should allow for some recovery in growth during 1993. In fact, in the event of a significant slowdown in nominal growth, monetary targeting normally implied that interest rates would fall. Monetary activism, consisting of attempts to fine-tune the economy, was counterproductive and should be avoided. The continuity of the monetary policy stance in the Community was desirable but monetary targeting should take account of increased economic and monetary uncertainties. In Germany, monetary growth must slow down. The setting of the target for 1993 would be particularly difficult given the current year's overshooting and the persistence of some special factors. The Sub-Committee had noted the possible advantages of a widening of the target range. In the low-inflation countries, whose currencies were under pressure, the restoration of exchange rate credibility should be the first priority; that would bring considerable gains through lower interest-rate differentials. The economies of Spain and Portugal were slowing down, but inflation remained a problem. Tight policies, especially on the fiscal side, would be required to contain the inflationary consequences of the recent realignment. The countries outside of the ERM had a more autonomous monetary policy; all would rely on monetary targets. In Italy and the United Kingdom, the sharp depreciation of the currencies had considerable potential inflationary effects which called for caution in monetary policy.

The mutual compatibility of the Community's monetary policies was difficult to assess. The recent realignments might have restored lost competitiveness, thereby eliminating a possible source of tension; monetary and other policies must now prevent a further deterioration of competitiveness. The willingness of the narrow band countries to use interest rates to defend their currencies suggested that compatibility problems might be avoided in the future; however, policy tensions linked to the most serious cases of weak economic activity might re-emerge. The policies of those countries outside of the ERM could not be regarded as indifferent to the stability of the ERM countries and therefore should be firmly directed to long-term price stability; this would lead to exchange-rate stability and a successful re-entry into the ERM.

Finally, in trying to identify the key risks in the outlook for 1993, the Sub-Committee had focused on the possibility of a more pronounced economic slowdown in the Community which would intensify existing policy dilemmas. In such a case, a medium-term oriented monetary policy would normally generate the appropriate fall of interest rates although a serious problem would arise if monetary growth, perhaps fuelled by persistent inflation, remained strong. A premature easing of monetary policy, or a too-loose fiscal stance, also could not be dismissed; the consequences for the medium-term inflation outlook in the Community would be very serious. There was also a considerable chance of continued exchange rate tensions in the ERM since even currencies with strong fundamentals remained vulnerable. The Sub-Committee had underscored the beneficial effects of all measures that would strengthen exchange rate credibility. However, the recent sharp depreciation of some currencies would generate inflationary pressures; even if they were only felt in the medium run, monetary policy should remain cautious.

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

Monetary policy had been confronted with serious challenges in the past year; 1993 was unlikely to be any easier as the short-term outlook for growth in the Community was deteriorating without any significant reduction of inflation prospects in the anchor country. The Alternates had been briefed by the Commission representative on the contemplated growth initiative, the purpose of which was to promote confidence while acknowledging fully the limited room for manoeuvre which Member States currently enjoyed. Against this background, the Alternates had endorsed one of the conclusions of the ex-ante report, namely, that the temptations to fine-tune monetary policy should be firmly resisted. The view was widely shared that, in order to restore confidence in the ERM, monetary policies should be firmly maintained in a medium-term perspective of price stability; any departure from this stance could be counterproductive and lead to further exchange-rate instability.

Five main points had emerged from the Alternates' discussion. Firstly, most Alternates had agreed that, given the outlook for inflation in Germany, there was little choice for the broad orientation of monetary policy in Germany; it would be the task of the Deutsche Bundesbank Council to translate this into the appropriate monetary target. Technical questions were raised on the reliability of the present M3 aggregate as an indicator for German monetary policy and it was stressed that the behaviour of prices would ultimately be most important. It was not disputed that a premature easing of monetary conditions would not be appropriate as long as inflation remained resilient. Secondly, there was wide agreement that, in countries where currencies had come under downward pressure, the interest rate defences which had been put in place should not be unwound too early, at least completely; interest-rate differentials would probably have to remain rather high for the foreseeable future, even in countries with strong fundamentals but with a fragile currency position. Thirdly, monetary policy was likely to be challenged in countries where interest rates were kept high in relation to the sluggishness of activity and the level of unemployment. The priorities should be clearly stated in such circumstances; if there was a risk that they would appear inconsistent with ERM stability, the appropriate conclusions should be drawn at an early stage before market pressures dictated the outcome. Fourthly, where governments were determined to maintain a stable exchange rate, and to use interest rates to that end, they should refrain from sending messages to the market which indirectly undermined their own credibility. Repeated calls for a general lowering of interest rates, or for that to occur in other countries, merely served to raise doubts about the sustainability of the interest-rate level in their own country. Several Alternates had endorsed a message in the ex-ante report that the independence of central banks could have a strong impact on the credibility of monetary policy. Fifthly, in countries which had suspended participation in the ERM, appropriate ways must be found to minimise the inflationary risks linked to currency depreciation; this would be pursued in the United Kingdom by adopting an inflation target and, in Italy, by giving pre-eminence to the monetary aggregates. In Greece, significant progress was being achieved in the underlying rate of inflation and greater emphasis would henceforth be placed on the exchange rate now that progress was being made in the fiscal policy area.

The Alternates had concluded that, given the uncertainties which surrounded the present ex-ante exercise, very vigilant monitoring of the monetary policies in the Member States would have to be carried out during 1993.

4) Discussion by the Committee

Mr. Schlesinger said that the ex-ante report presented by Mr. Borges described very well the current situation and the problems that had arisen during the course of the year; the approach suggested for 1993 deserved to be supported. Price stability should continue to be the prime objective; this was not in contradiction with the need to encourage economic growth and medium-term policies should not be abandoned. Those objectives were correct but would not be easy to achieve. The views expressed by the Monitoring Group, the Monetary Policy Sub-Committee and the Alternates would be of help to the Deutsche Bundesbank Council when it met two days later to fix the monetary aggregate growth target for 1993 and to consider whether any changes in monetary policy should be made.

Mr. de Larosière said that he agreed with most of what had been reported to the Committee. However, without changing the overall objective of medium-term price stability, with which he agreed, he wished that Mr. Borges' report had shown a little more understanding of the economic reality in some countries in which greater unemployment was being observed and would be experienced in 1993. In France, there were no inflationary pressures but growing concern about the low level of economic activity. The rate of inflation was currently 2.5% on an annualised basis and would probably be 2% by the year end. French monetary policy in 1993 would be geared to mediumterm stability which would not hamper a pick-up in economic activity. This in turn would have a beneficial impact on price and cost developments as it would help to implement a sound fiscal policy and reduce cost pressures resulting from the low degree of capacity utilisation. The target rate of growth of M3 in France for 1993 would be similar to that for 1992. Furthermore, if one emphasised too much the danger of a premature relaxation of policies, this could trigger counterproductive results. The constant repetition that interest rates must continue to remain high would do nothing for the morale of industrial managers. Interest rates in France were sufficiently high to ensure that the exchange rate would remain stable. The French authorities had not hesitated to use the interest rate weapon during the tension in September, and there had been no hesitation in increasing interest rates, particularly at the shorter maturities, when the French franc had come under renewed attack. At his forthcoming annual press conference on monetary policy, he would stress that monetary policy in France was aimed at reducing the rate of inflation but that it would endeavour to encourage economic growth.

With regard to the situation in Italy, <u>Mr. Ciampi</u> said that the Banca d'Italia's policies were aimed at containing the inflationary effects of devaluation; the results so far had been positive. The downward trend of the rate of inflation in Italy had not been broken by the devaluation; inflation, as measured by the consumer prices index, was currently less than 5% per annum. The target for inflation for 1993 was 4.5% on average; this was more than the original objective but was still ambitious when taking into account the extent of the devaluation that the Italian lira had undergone. Several factors should reduce the effect on prices and costs from the devaluation of the lira. Firstly, the devaluation of the lira had occurred at a time when demand was weak and had further discouraged spending on consumer goods. Secondly, the long period of exchange rate stability before the recent

tensions had enabled the employers and unions in Italy to reach the important agreement to abandon the scala mobile. Thirdly, Italy's monetary policy was very strict; target rates of growth for M2 were between 5% and 7% with current growth at around 5%. The existing monetary policy stance would continue although it was recognised that interest rates were still too high. Since production in Italy was slowing down, and there was growing unused capacity, he agreed with Mr. de Larosière that in such circumstances inflation could be fought through an economic pick-up and an increase in production. With regard to the ERM, it would not be easy to recover the credibility which had been lost. It was in the interests of those currencies which had come under attack, and of the system as a whole, if such pressures could be withstood. The credibility of the system could be regained only by demonstrating a better cohesion among the authorities of the Member States. When a currency came under attack, all members of the system should respond in its support, either through co-ordinated interventions or co-ordinated moves on the interest-rate front. Member countries should have strict monetary policies with well-defined objectives but, when necessary, interest rates should be appropriately raised or lowered without abandoning the overall stance of monetary policy as a response to attacks against currencies.

The <u>Chairman</u> invited Mr. Christophersen to outline the Commission's 1993 forecast for growth in the Community.

Mr. Christophersen commented briefly on the discussion paper which had been prepared by the Commission for the UK Presidency with a view to the Edinburgh Summit. The Commission expected growth to be between 1% and 1.5% in 1993 although, personally, he felt that it would be closer to 1% or even less. Furthermore, the unemployment rate, which was a cause for concern in many Member States, would exceed 11%; by the end of 1993 it might become the highest since the Second World War with the utilisation of industrial capacity falling to 79% or lower. A distinction had been drawn in the Commission's paper between what the individual Member States, and what the Community, could do. With regard to the Member States, the ground should be prepared for a reduction of interest rates although the underlying risks of inflation were still evident. The level of wage increases would be a crucial factor in a number of Member States since it would affect inflationary expectations. The reduction in wage demands in Germany over the past year was an encouraging factor. As far as fiscal policy was concerned, there did not seem to be much room for manoeuvre. Where countries had room, this was already being used by letting the automatic stabilisers work, at least on the revenue side, as was the case in France. In other countries, the deficit had increased such that the room for manoeuvre had become non-existent. The Commission's paper recommended that the Member States should consider how they could re-orientate public spending towards investment, although this would be difficult since it would mean putting a ceiling on current spending such as social transfers, public salaries and state aid which would raise political and social questions. However, the only option was to restructure the use of available resources; this should be done in a co-ordinated fashion. A number of countries had introduced programmes aimed at improving competitiveness, privatisation of state-owned enterprises and removing labour market rigidities; some were being implemented successfully whilst others were being done in a less convincing way. As far as the Community was concerned, the main need was to focus on structural adjustments. A lot could be achieved by speeding up the implementation of the internal market and the Community could re-orientate its own expenditure by way of bringing some research expenditures closer to the market place and spending more on training. In addition, the Commission had been working on an agreement with a number of private banks and the European Investment Bank to create a special investment fund to provide credit guarantees to help finance small and medium-sized companies and investments in high-tech projects. Guarantees of ECU 6 million over two or three years would be available, the size of which would not have a direct impact on growth rates but would be of psychological importance. The Commission was also considering an idea of the President of the Commission that the Community could raise credits of ECU 5 billion in the market to help finance infrastructure projects in eastern and central Europe. It would be more advantageous for Member States to finance projects using Community-guaranteed credits not least because of the Community's triple A rating. It was important that the discussions at the forthcoming Edinburgh Summit avoid building up unrealistic expectations, rather they must be seen as part of an ongoing process. In addition, the Community should establish close contact as soon as possible with the new administration in the United States; initial analysis had suggested that the Clinton administration's policies could generate up to 0.5% of extra growth in the Community, although there were many uncertainties such as the future direction of the dollar and how US monetary policy would be conducted if there was to be a more expansionary fiscal policy. Finally, the process of multilateral surveillance needed to be conducted in a more frank manner.

In response to Mr Christophersen's comment about multilateral surveillance, Mr. Christodoulou said that the real economy should be the paramount element in the discussions. Attention had tended to concentrate on monetary, fiscal and financial issues without taking into account sufficiently their impact on the real economy. With regard to the economic prospects and policies in Greece, he mentioned that progress had been made towards reducing inflation and fiscal imbalances. Inflation was declining steadily albeit slowly. It was projected to fall to 15% by the year end from 18% in December 1991. The slow pace of disinflation reflected the introduction of substantial indirect taxes, mainly on fuel, to help combat the fiscal deficit, which was estimated to have added 4 percentage points to price increases. The inflation rate was projected to fall to below 10% by the end of 1993 with the help of moderate public sector wage increases and a tightening of fiscal policy. The Greek government's budget, which had been submitted to parliament the previous week, projected a primary surplus of 5% of GDP and an overall borrowing requirement of 8% of GDP. Weak economic activity would also contribute to the slowdown in inflation. Economic growth in Greece in 1993 was likely to be lower than forecast in the ex-ante report as a result of restrictive domestic economic policies and weaker external demand than previously expected. The persistence of low growth and rising unemployment in the Community were of concern since their effects were multiplied in an economy such that as in Greece. Monetary policy in 1992 had remained restrictive as

indicated by rising real interest rates and moderate domestic credit expansion. On the other hand, broad money growth had accelerated to an annualised rate of nearly 19% in August, well above the target of 9% to 12%, as a result of a substantial improvement in the current account, sizable capital inflows during the first half of 1992, and a narrowing of the differential between interest rates on bank deposits and government securities. Over the last few months, however, money growth had declined as a result of: a rise in interest rates on Treasury bills; adverse developments in foreign exchange markets; and continued interventions by the Bank of Greece in the domestic money market. Monetary policy in 1993 would continue to aim at disinflation; a broad money growth target of about 10% would be set. At the same time, more reliance would be placed on exchange rate policy as a means of fighting inflation. Real interest rates would need to be maintained at high levels in 1993. However, the expected improvement in the policy mix should result in a gradual decline of inflation-adjusted interest rates from the recent record levels. The economic and monetary policies which were in place were consistent with the realisation of the targets of the Greek convergence programme for 1993. The achievement of the medium-term targets for Greece and other Community countries would, however, depend to a large extent on internal and external political developments.

Mr. Beleza said that the stance of policies in Portugal was in accordance with its convergence programme. The budget deficit was expected to be reduced by over 1 percentage point of GDP to close to 3%; it was hoped that the Portuguese government's emphasis would be on restraint of current spending. The ratio of debt to GDP was now close to 60% and would continue to decline. A crucial element would be the wage negotiations with the civil service, not least because it would set the general tone for wage bargaining in the forthcoming round of negotiations. It was essential that the counter-inflationary stance of monetary policy and the policy of exchange rate stability be maintained. This would mean an acceptance of the consequences for interest rates although it was hoped that differentials would decline in the near future. Portugal would continue to abide by the Basle/Nyborg agreements and felt that that was the best contribution it could make to sustaining the credibility of the ERM. Finally, the previously announced removal of the last remaining capital controls would occur as planned; this should not give rise to apprehension.

Mr. Duisenberg said that the Netherlands, like other countries, was moving into a phase of very slow growth. GDP was expected to grow in the current year by about 1.25% to 1.5%, and by not more than 1.5% in 1993. However, the government's deficit in the twelve months to November had fallen to 2.8% of GDP for the first time in twenty years. The rate of inflation as at the middle of October was 3%, partly due to the fact that the government had brought forward a cut in VAT from 1st January 1993 to 1st October 1992; the effects of that cut, together with the effective appreciation of the Dutch guilder, was expected to lead to a fall in inflation to below 3%. With long-term interest rates at 7.5% and short-term rates marginally below those in Germany, it was not expected that these would inhibit the resumption of economic growth. The most important contribution that could be made in the monetary field towards the resumption of economic activity would be to restore made in the monetary field towards the resumption of economic activity would be to restore confidence in the parity grid and the EMU process; there was a danger that inflation rates in the Community would diverge rather than converge, particularly in the medium-term. Taking into account the resilience of inflation in most countries despite the economic slowdown and the fiscal slippage that many countries had experienced, there was reason for caution in changing the stance of monetary policy; in particular, the interest-rate policy in the anchor country should continue to be targeted to the objective of price stability. The ex-ante report correctly stressed that timely and, if necessary, substantial increases in interest-rate differentials were the most effective means of countering market pressures on exchange rates. However, the ability to do this had been diminished by repeated public criticisms of interest-rate policies, particularly of those in Germany. That criticism was counterproductive because the markets had begun to doubt the ability and willingness of the authorities to increase their own domestic interest rates and to maintain high interest-rate cifferentia's when necessary to counter market pressures. It could be useful to convey that message to the Ministers in advance of their discussions at the Edinburgh Summit.

<u>Mr. Schlesinger</u> noted that, by stressing the need for the stability of the anchor currency, the resultant monetary policy consequences had to be accepted. The situation in the last year and a half had been complicated by the constant expectation of a lowering of German interest rates which the Deutsche Bundesbank had not been able to fulfil except for a one percentage point fall last September. With reference to the sentence in the ex-ante report, which said "when realignments become unavoidable, they should be undertaken as early as possible to avoid the build-up of tensions with significant costs for countries under downward, as well as upward, exchange rate pressure", he wondered whether this responsibility had been carried out well enough. He agreed with Mr. Ciampi that the credibility of the EMS had to be restored but wondered what "symmetric measures" meant in this context. If the anchor currency was to be stable in terms of money growth and the price level, the anchor country should not lower interest rates for the sake of the "credibility of the ERM". German M3, which had been growing at an annual rate of nearly 8.5% in the first eight months of 1992, was currently 10% higher than one year ago. The acceleration of M3 growth was to a large extent the consequence of the heavy obligatory interventions which had an expansionary impact not only on bank liquidity, which could be offset, but also on the amount of money held by non-banks. While some of the Alternates had questioned the reliability of M3 as an indicator, all other indicators also showed that monetary expansion was too strong in Germany. This would still hold if allowance was made for special factors, for instance the fact that currency in circulation was currently growing at a rate of 12.5%, a development probably linked to private sector capital outflows as a consequence of the introduction of a withholding tax on interest receipts. Even without this special factor, monetary growth would still overshoot significantly its target for 1992 of 3.5% to 5.5%. The interest rate instrument was partly blunted since a sizable share of the credit expansion in Germany benefited from interest-rate subsidies. The monetary target for 1993 would have to be formulated taking into account various factors: the growth potential (around 3%); the acceptable medium-term price increase (2%);

the liquidity overhang from the current year; the change in the velocity of money as a consequence of the greater demand for money in eastern relative to western Germany, and possibly the price increases resulting from the increase in VAT. Under current circumstances, care was therefore necessary in lowering interest rates so as not to provide an additional incentive for monetary expansion. The situation as far as wages and prices were concerned was also not ideal: the rate of inflation, which was currently below 4%, would rise to a little over 4% by February 1993; wages were likely to increase effectively by around 4%. Overall, it would be helpful to the Deutsche Bundesbank if it could make decisions about the possible lowering of interest rates without being under such strong pressure from other central banks and politicians.

Mr. Ciampi said that, against the background of the three recent realignments, he was concerned that a further realignment might cause the system to collapse; everything must be done to ensure this would not happen. Once the parities in the system were felt to be appropriate, it was the responsibility of all of the members of the system to defend them. Better cohesion would reduce the need for intervention since, if the markets understood that the parity grid was considered to be appropriate by all of the members that were prepared to defend it, there would be fewer attacks against the member currencies. Interventions undertaken to defend the parity grid by several countries, and not just by a single country, were more credible and would reduce the total amount of interventions that would be necessary for exchange-rate stabilisation. Furthermore, changes in short-term interest rates should be co-ordinated. Increases in weak currency countries should be accompanied by reductions in strong currency countries.

Mr. Verplaetse said that the operation of the automatic stabilisers had tended to push up the budget deficit in Belgium in 1992; despite this, Standard and Poors had upgraded the Kingdom of Belgium to triple A for the first time. The incomes policy had played an important role in Belgium and such a policy should be assigned a more important role in Germany. The compulsory interventions of the Belgian central bank had amounted to 47% of the monetary base in Belgium. This had complicated monetary management and, in addition, resulted in considerable exchange losses. When discussing the difficulties of the EMS, it should not be forgotten that creditor countries encountered difficulties as well.

Mr. Christophersen said that members could not be prevented from discussing interest rates but he agreed with Mr. Schlesinger that it would be wrong for politicians simply to draw the conclusion that interest rates had to be lowered. They should focus on the contribution they could make for preparing the conditions for lowering interest rates; that had been included in the Commission's paper to Chancellor Lamont. Furthermore, the lowering of interest rates was a precondition, but no longer a sufficient one, for higher investment since so many companies were concerned about reducing their indebtedness and industrial capacities in most Member States were under-utilised.

<u>Mr. Doyle</u> supported the comments made by Mr. de Larosière and Mr. Ciampi. If there was to be a system, every member had a responsibility towards it. He appreciated the difficulties that

Mr. Schlesinger faced when contemplating reductions in interest rates although it ought to be possible to devise a greater degree of symmetry in countering speculative attacks than merely to have one country increasing its interest rates substantially whilst other countries made no contribution in this respect. There ought to be some possibility of reducing the incentive to hold strong currencies for short-term speculative gains which would support the action being taken by countries with weak currencies. He added that there would be no cost to anybody in making concerted complementary statements in support of currencies which came under attack where the fundamentals had been deemed to be sound, instead of which statements had been made in September and October in a number of countries which had created immense damage in the Irish financial markets.

Mr. de Larosière said that, while he had not stated it publicly, the task of keeping inflation as low as possible would be facilitated by some decline in German interest rates. He had been pleased to see a downward movement in September but the impression should not be given that there would be no further reductions for a very long time. Without generating expectations as to timescale, the nope should not be killed that, with better wage performances and given the sluggishness of the German economy, there was some scope for lowering interest rates without endangering price stability. He agreed with Mr. Verplaetse that wage policies played an important role; the German authorities had in the past not been sufficiently concerned about wage developments. Other weaknesses in Germany were the stance of fiscal policy and the degree of subsidisation of credit by the Federal authorities. These ultimately had direct implications for other countries since, being an anchor currency, Germany determined the structure of interest rates in the system. It was therefore not sufficient to say that the central bank in an anchor country should keep its policies tight: it was the duty of other countries to point out that there were other elements of policies in such a country. The currency of a country with a mediocre policy mix might not be regarded by some as a proper anchor and the experience made in other systems suggested that such a situation would be difficult to sustain.

In response to Mr. de Larosière's earlier comments, <u>Mr. Borges</u> said that the Monetary Policy Sub-Committee had tried to write a balanced report. It had not been the intention to give any bias against lower interest rates; in fact, the report had welcomed the lower interest rates in Germany which had occurred in September and had stated that, as the slowdown had become more pronounced, the appropriate easing of interest rates should take place. It was more a question of whether they should occur as a consequence of the long-term orientation of policy. The report had tried to make clear that the most effective way of reducing interest rates in the Community in the medium term was by restoring exchange rate credibility and that that objective was probably incompatible with too much emphasis on lowering interest rates in the short term.

VII <u>Preparatory work for the move to the final stage of EMU</u>

The <u>Committee</u> noted the Secretariat's first status report on the preparatory work.

- VIII Other matters falling within the competence of the Committee
- 1. Exchange of personnel between Community central banks

The <u>Committee</u> approved the proposal by the Heads of Personnel for a liability provision in the framework of the exchange programme for central bank staff.

2. <u>Recruitment of a telecommunications expert</u>

<u>Mr. Rey</u> reminded the Committee that the decision on this item had been postponed until the Chairman of the Working Group on Information Systems had clarified the need for the recruitment of a telecommunications expert to the Secretariat. In response, Mr. Barroux, the working group Chairman, had presented a convincing case. The Alternates therefore recommended that the Committee now approve the proposal made by the working group, extend for a few months the present arrangement for the Cebamail co-ordinator and request the Secretariat to take the measures necessary to fill the vacancy in the Secretariat.

The <u>Committee</u> endorsed the Alternates' recommendation.

3. Forthcoming annual report of the Committee of Governors

Mr. Rey said that the Alternates had had a short discussion on the contents of the forthcoming Annual Report as well as technical and financial issues relating to its production and distribution. With respect to the latter, the Alternates had agreed with the Secretariat that any major departure from last year's approach would raise a number of serious technical difficulties, was likely to be more costly and would involve risks for the timely completion and distribution of the report. Apart from the more practical consideration that the current year's annual report would be the last one prepared under the aegis of the Committee of Governors, much would, therefore, speak in favour of repeating the procedure established for the previous year's report, i.e. translation into the eight official Community languages other than English by the respective central banks, and the same presentation as the previous year with a centralised production of the report organised and supervised by the Secretariat. If that approach was to be adopted by the Governors, there would nevertheless be scope for improving the co-ordination of translation costs among the central banks. The Alternates would examine whether the translation costs should be determined on the basis of the present BIS tariff (Swiss francs 175 per page) or by a different formula.

The Committee approved the Alternates' recommendation.

4. <u>Liaison between the Working Group on EC Payment Systems and the European</u> <u>Committee for Banking Standards, created under the aegis of the three European banking</u> <u>federations</u>

<u>Mr. Rey</u> said that the Alternates were in agreement with the proposal made by Mr. Padoa-Schioppa in his letter dated 1st December 1992 to the Chairman of the Committee of Governors. The Alternates, however, had considered that the task of the European Committee for Banking Standards might also be of interest to other working groups. The Alternates had suggested centralising the liaison with the Committee in the Secretariat rather than selecting someone from the EC central banks.

The <u>Committee</u> approved the Alternates' recommendation.

5. <u>Presentation of the Committee of Governors' first Annual Report to the plenary session</u> of the European Parliament

The <u>Chairman</u> said that he had been invited to present the Committee's first Annual Report to the plenary session of the European Parliament on 15th December 1992.

IX Date and place of next meeting

The next meeting of the Committee of Governors will take place in Basle on Tuesday, 12th January 1993.

MINUTES

271ST MEETING OF THE COMMITTEE OF GOVERNORS

8th December 1992

Those present were:			
Chairman	Mr. Hoffmeyer		
Banque Nationale de Belgique	Mr. Verplaetse Mr. Rey ¹ 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. Rojo Mr. Linde Mr. Durán		
Banque de France	Mr. de Larosière Mr. Robert Mr. Redouin		
Central Bank of Ireland	Mr. Doyle Mr. Coffey Mr. Reynolds		
Banca d'Italia	Mr. Ciampi Mr. Dini Mr. Santini		
Institut Monétaire Luxembourgeois	Mr. Jaans		
Nederlandsche Bank	Mr. Duisenberg Mr. Szász Mr. Bakker		
Banco de Portugal	Mr. Beleza Mr. Borges ² Mr. Bento		
Bank of England	Mr. Leigh-Pemberton Mr. Crockett Mr. Foot		
Commission of the European Communities	Mr. Christophersen Mr. Pons		
Chairman of the Banking Supervisory Sub-Committee	Mr. Quinn		
Chairman of the Foreign Exchange Policy Sub-Committee	Mr. Saccomanni		
Secretariat of the Committee of Governors	Mr. Baer Mr. Scheller Mr. Viñals		

¹Chairman of the Committee of Alternates ²Chairman of the Monetary Policy Sub-Committee