

5th April 1993

**Strictly confidential**

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**SUMMARY RECORD OF THE RESTRICTED MEETING OF THE  
COMMITTEE OF GOVERNORS ON 9th MARCH 1993**

The main purpose of the meeting was to have an exchange of views on the possibility of the lira returning into the ERM and the width of the band the Italian authorities might consider when making this step. In addition, **the Chairman** suggested discussing briefly the recent developments of the Spanish peseta.

**Governor Ciampi** emphasised that profound changes were presently taking place in Italy's political life and society. The budget for 1993 aimed at revising past trends and was designed to yield a primary surplus of 3% of GDP; a review would take place in March in order to ascertain whether budgetary developments were on track. Cost and price developments were favourable, with annual inflation running at 4.5%. This was attributable to the recessionary forces, moderate monetary growth and also to the effects of the July 1992 labour agreement, which had resulted in modest wage settlements. Unit labour costs were currently rising at only 2 to 3%. Nonetheless, the lira had sharply depreciated (by 19% vis-à-vis the ERM currencies), far in excess of cost and price differentials. Following a very difficult situation at end-September 1992, when there were problems with financing the budget, confidence was gradually being restored. Interest rates had declined and Treasury paper yields had fallen to the level of 1991-92. Following the floating of the lira the Banca d'Italia had engineered a gradual interest rate decline. However, it was clear that the foreign exchange market needed a frame of reference and that the floating of the lira was temporary. The authorities therefore wished to rejoin the ERM, also to avoid the danger of competitive losses being imposed on other EC countries. But there was a danger that markets would test the willingness and the ability of the authorities to maintain a new lira parity and that implied that the return to the ERM needed to be managed in a co-ordinated action. Governor Ciampi stressed that he was firmly in favour of the lira's re-entry and added that in his opinion current changes in economic and political conditions (especially in view of the upcoming referendum in April 1993) were steps in the right direction. The width of the band was a secondary issue and a decision in this respect should be taken only together with the decision on the parity. However, a larger band might give the impression of uncertainty about the appropriateness of the parity. Governor Ciampi believed that the lira would appreciate after the return to the ERM, since it was presently undervalued by 6 to 8%. He emphasised that re-entry should take place before inflation picked up and expressed concern that the depreciation might feed through to the domestic price level rather soon .

Following an observation by **the Chairman** that a wide band would offer scope for an appreciation of the lira, **Governor de Larosière** and **President Schlesinger** both expressed support for the idea of a wide band for the lira. **President Schlesinger** added that a new parity was difficult to determine under present circumstances and that it might be wise to postpone the re-entry into the ERM until there had been a period of stable floating without intervention but guided by monetary policy. **Mr. Jaans** and **Governor Leigh-Pemberton** both emphasised that the re-entry should be considered only after very careful analysis, taking into account not only the developments in Italy but also those in all other Community countries (including political developments). **Governor Beleza** noted that it was very difficult to re-enter the ERM at a rate far from the market rate but that there was also an element of competitive devaluation. **Governor Ciampi** agreed that all Community countries must endorse the decision on the parity at which the lira would return.

**Governor Leigh-Pemberton** reaffirmed that the UK authorities had the intention of bringing the pound back into the ERM but only under certain conditions. The divergence of cyclical positions between the United Kingdom and Germany would have to be eliminated and there was also a question of the correct re-entry parity. The present exchange rate of DM 2.40 against the pound looked like a "floating central rate" but this was seen by the Bank of England as too low in the longer run.

**Governor Christodoulou** said that recent events have led the Bank of Greece to reconsider the view of bringing the drachma into the ERM in the course of 1993. This seemed no longer likely although the Government was still maintaining its position.

**Governor Rojo** said that there had been a strong attack on the peseta during the previous three weeks. When on 18th February 1993 the markets' mood suddenly changed, the Banco de España had raised short-term interest rates to 18-19% and also tried to let the exchange rate slide downwards in the band. However, this apparently alarmed markets and triggered enormous hedging activity. The Banco de España therefore decided to keep the peseta in the middle of the band and to prevent a further fall; intervention was used heavily, amounting to DM 10 billion. The pressures had eased in the previous week but resurfaced on Thursday. However, when the Deutsche Bundesbank's decision on money market interest rates became clear there was a strong upward movement of the peseta.

The background to the exchange market developments in Spain were pressures for lower interest rates and a softer fiscal policy. The Government had rejected calls for a fiscal easing and had announced a (largely cosmetic) programme to fight unemployment. Given the discussions inside Spain, Mr. Delors' remark that high unemployment might make it difficult for a country to go to EMU had been interpreted as support for fiscal relaxation (and lower interest rates). Mr. Delors' remark together with the systematic spreading of rumours by US investment funds had nourished speculation and triggered the attack on the peseta. **Governor Rojo** added that in his view interest rates should stay high (as he had also explained to Parliament). In the light of a decline in the inflation rate, an improvement in the trade balance, the limitation of the fiscal deficit to 4% of GDP in 1993 and taking into account the recent devaluations of the peseta, **Governor Rojo** felt that the present parity of the peseta was sustainable.