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FINAL

MINUTES
OF THE 279TH MEETING OF THE COMMITTEE OF GOVERNORS OF THE CENTRAL BANKS OF THE MEMBER STATES OF THE EUROPEAN COMMUNITY

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The *Chairman* said that, in accordance with Article 9.6 of the EMI Statute, the Committee, in a restricted meeting, had appointed Mr. Verplaetse, the Rt. Hon. Lord Kingsdown and Mr. Clappier as three of the six members of a Committee which was to be formed to make proposals for the terms and conditions of employment of the President of the EMI. The Governors' decision would be communicated to the President of the Council of Ministers who would be reminded that the Council should take similar action.

I Approval of the minutes of the 278th Meeting

The *Committee* approved the minutes of the 278th meeting.

II Monthly monitoring of economic and monetary developments and policies in the Community and questions relating to the European Monetary System

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

The Monitoring Group had concentrated on the implications of the EMS crisis which had culminated in the decision on 2nd August 1993 to widen the ERM fluctuation bands to ±15%. There had also been some discussion as to whether the interest-rate policies pursued by those countries whose currencies had come under pressure could be regarded as a main factor in triggering the crisis. Different views had been expressed. On the one hand, short-term interest-rate differentials vis-à-vis Germany had declined in June and early July, and had become negative in the case of France. On the other hand, the lowering of interest rates had been consistent with the market sentiment prevailing at the time and had been reversed as soon as the first signs of tension had appeared. The pressure had intensified after the Bundesbank Council's decision on 29th July not to lower the German discount rate, which had been contrary to market expectations particularly in the light of the reduction in the German repo rate on 28th July 1993.

The Monitoring Group had also reviewed the situation of exchange rates and interest rates after the crisis. The widening of the fluctuation bands had led to a reduction in liquidity in the foreign exchange markets and in larger spreads, which had resulted in increased volatility of exchange rates. The expectation that the greater degree of freedom afforded by the wider bands would be used to lower interest rates significantly throughout the ERM countries had contributed to the uncertainty. However, at times, currencies had strengthened in the wake of interest rate cuts whereas high-yielding currencies had remained under pressure. This seemed to imply that, in assessing the outlook for currencies, markets attached a greater weight to growth prospects than to the anti-inflationary stance of policies. Monetary policy in the new circumstances had to remain cautious, especially in countries where the exchange rate target had been a crucial element in the strategy towards achieving price stability. However, yields in the bond markets had broadly declined, particularly in those countries in which official rates had been lowered; this indicated that the markets were not anticipating a revival of inflation. Further declines in interest rates had probably been discounted already in the current exchange rate levels and the more accommodating monetary stance would not result in further exchange rate pressures.

Finally, the Group had considered the situation of some individual countries. The pressure on the Belgian franc had resulted in intervention amounting to nearly US$ 10 billion since the beginning of July. It had abated somewhat after the reduction of official interest rates in Germany; this had allowed the Belgian central bank to reverse in part the previous official interest-rate increases. Despite the weakness in the economy, the maintenance of a firm monetary policy stance was required to forestall a revival of inflation. The tension affecting the Greek drachma had been associated entirely with political developments in the country as the economic situation, particularly in respect of the balance of payments, was improving. The Greek authorities had responded by inducing an increase in money market rates to 29% and by foreign exchange intervention, while allowing some downward movement in the exchange rate.

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

The Alternates had discussed extensively the issues relating to the temporary widening of the ERM band. Their discussion could be summarised under four headings: firstly, the reasons for the summer 1993 crisis and the rationale for the decision to widen the fluctuation band; secondly, the current policy stance in the new circumstances; thirdly, the conditions for a return to narrower margins; and fourthly, the main lessons to be drawn and the message which might be sent to the political authorities.

With regard to the first issue, there had been broad agreement that the crisis had not been caused by an "Anglo-Saxon conspiracy". Rather, it had been due to the failure of the system to deliver, in a timely and orderly fashion, the nominal exchange rate changes which had been warranted by underlying fundamentals, and a growing perception of conflict between internal and external monetary policy objectives in a situation in which the credibility of the system as a whole had been undermined. Although there had been similar elements in the other crises since the summer of 1992, the latest tensions had been to some extent of a different nature and therefore needed a different policy response. No parity changes had been required given the underlying fundamentals, but the damage which had been done to the system's credibility, the depth of the recession and clear divergences in policy priorities had made it impossible to withstand the exchange markets' pressure. The decision had thus been taken to widen temporarily the margins of fluctuation, primarily to restore a two-way risk in the markets. It had not been an option in favour of a floating exchange rate regime, nor had it been intended to open up the margins of manoeuvre for monetary policy to the full extent of the 15% band.

As regards the policies adopted in the new circumstances, the Alternates had confirmed that exchange rate stability remained a major objective. This was now defined in more qualitative terms and its pursuit was not seen as being incompatible with a prudent and gradual decline in interest rates in line with the aim of price stability. The leeway which central banks had to reduce official interest rates varied, but there was a strong consensus that monetary policy must remain credible and that exchange rate stability was an essential foundation of the internal market.

However, the new fluctuation band did not provide the kind of disciplinary framework which formerly had been instrumental in promoting nominal convergence. While the exchange rate would remain an important policy objective in most Community countries, the credible commitment of the authorities to both internal and external monetary stability might become more difficult to

convey than through an explicit exchange rate target. One Alternate had expressed the view that an explicit inflation target would provide a good anchor for policy. Other Alternates had said that money, price and interest-rate indicators, and in particular the behaviour of long-term interest rates, would as usual supplement the exchange rate in assessing the monetary policy stance. However, to the extent that the role of exchange rate constraints in the formulation of national monetary policies had been reduced, the framework for policy co-ordination might have to be reassessed. One Alternate had stressed the widely-shared view that the spirit of co-operation among central banks should be urgently revived.

On the third issue, the Alternates had unanimously rejected the idea of establishing a timetable for the narrowing of the fluctuation margins. There had also been general agreement that any narrowing should be subject to: a better cyclical situation; progress towards broadly-based convergence; and the restoration of the credibility of the policies of the Member States. A better cyclical situation would reduce the likelihood of policy dilemmas and conflicts between the domestic and external requirements of monetary policy and increase the acceptability and scope for stability-oriented policies. It had been noted, however, that the system should be sufficiently robust in order to be able to cope with cyclical divergence which might still occur despite further progress in the field of convergence. Convergence itself should be broadly based and focus not only on stability-oriented monetary policies and better control of public finances, but also on the reduction of structural and institutional differences between member countries, including the status of central banks. Furthermore, an essential precondition for reducing the margins was that this should be done under conditions which would ensure the restoration of the system's credibility. A cautious approach would have to be adopted with, for instance, a de facto stabilisation of exchange rates before the margins were formally narrowed.

Some Alternates had also seen a need to revise some technical features of the system before returning to narrower bands. The German Alternate had recalled his previous request for a procedure allowing for the suspension of intervention obligations once the authorities concerned had concluded that the prevailing situation was not sustainable. The French Alternate had reiterated his strong reservations on this point and had warned against any proposal which might be interpreted as a further blow to the system.

While some Alternates had envisaged a gradual narrowing of the margins, doubts had been expressed about the appropriateness of moving towards economic and monetary union via a restoration of a 2.25% fluctuation band. According to some Alternates, the effective management of a system with narrow margins would require a greater emphasis on the role of interest rates to prevent the build-up of speculative capital movements. However, this raised fundamental issues. A paper prepared by the Economic Unit had highlighted the structural differences among Community countries which explained the varying economic impacts of interest-rate changes. The attitudes of national authorities differed correspondingly towards the role of interest rates and exchange rates in managing the economy.

Fourthly, the Alternates had felt that it might be useful to convey a message to the political authorities to help them draw the proper lessons from the decision they had taken to widen

the fluctuation bands. Firstly, it might be stressed that the restoration of the system's credibility was fundamentally dependent on the credibility of the policies pursued. Some Alternates had warned against a reliance on the EMI as an institutional answer to the present policy problems; the creation of false expectations with regard to the EMI should be avoided. Secondly, maintaining the credibility of the medium-term strategy of fiscal consolidation was vital. The rapid deterioration in the fiscal situation of those countries with a good record in the recent past deserved as much attention as the difficulties faced by countries to bring down their high deficits in an unfavourable cyclical situation. Thirdly, the convergence process had to be broadened so as to encompass structural problems which could not be solved by increased exchange rate flexibility and monetary policy.

The Alternates had also briefly reviewed two outstanding mandates: the denomination and remuneration of outstanding VSTF balances; and the procedural issues relating to the suspension of ERM intervention obligations. Although the likelihood of intervention at the limit had become more remote, the Alternates had suggested inviting the Foreign Exchange Policy Sub-Committee to finalise its report taking into account the decision to widen the fluctuation bands. Future intervention at the limit could not be excluded; if it occurred, the financial consequences would possibly be more severe given the scope for larger movements of the ECU. The procedural issues relating to the suspension of ERM intervention obligations, although now less urgent, would remain on the Alternates' agenda.

3. Discussion by the Committee

The ***Committee*** approved the Alternates' recommendation that the Foreign Exchange Policy Sub-Committee should finalise its report on the denomination and remuneration of outstanding VSTF balances and that the procedural issue relating to the suspension of ERM intervention obligations should remain on the Alternates' agenda.

Mr. Christophersen said that at the ECOFIN Council's meeting on the previous day most Ministers and the Commission had expressed concerns about the risks associated with the widening of the ERM fluctuations margins: exchange rates could drift away from their central rates; governments in Community countries might come under pressure to lower interest rates; central banks could experience difficulties in adhering to a firm monetary policy; and fiscal policies could be relaxed further. Such a scenario would have serious drawbacks for the functioning of the single market. There would also be increasing difficulties for the management of the common agricultural policy. Such difficulties had already arisen with respect to agricultural prices denominated in Deutsche Mark and Dutch guilders which would have to be revised downwards according to existing rules. He added that it was generally accepted that a quick return to narrow fluctuation margins would be unrealistic and dangerous because the problem was not just a technical one. It would be unwise to establish a firm timetable for a return to narrow bands as that would create unrealistic expectations. Some technical improvements could be made to the ERM, but a return to narrower bands would in the first instance have to be underpinned by firmer political commitments in respect of macro-economic policies. One precondition would be a strengthening of the convergence process; it was not sufficient that some Member States were converging in nominal terms. More emphasis must be laid on the policy mix. The markets had not believed that the convergence process based upon the existing policy mix was

sustainable in the medium term. It was important to see how fiscal policies could be strengthened so as to avoid overburdening monetary policies. Some Member States were considering whether social pacts between various interest groups could be achieved as part of an anti-inflationary strategy, but there also needed to be a better co-ordination of medium-term growth strategies. The discussion on these issues would be continued in the next few months on several occasions. The Commission would be presenting orally to the informal ECOFIN Council on 9th October first draft recommendations for the macro-economic guidelines in accordance with Article 103(2) of the Maastricht Treaty. Furthermore, pursuant to Article 109e(2) of the Treaty, the Commission would have to prepare its report on the state of convergence which would be presented to the ECOFIN Council in November. A general discussion on the overall economic situation could be conducted during the proposed extraordinary meeting of the European Council on 29th October. The European Council would not deal with the ERM. According to the intentions of the Belgian Presidency, an informal discussion among the ECOFIN Ministers would be held on the eve of the October meeting about the ERM and the experiences which could be drawn from the events of 2nd August.

Mr. Christodoulou said that the Greek foreign exchange market had been in turmoil the previous week following the resignation of the Greek government. The uncertainties created by this development concerning the future stance of economic policy in Greece had had a strong effect; over the past week the drachma had depreciated by about 1.25% in effective terms, and about 1.5% against the ECU, despite intervention by the Bank of Greece amounting to the equivalent of around US$ 500/600 million. Official interest rates in Greece had been increased from 20% to 29% in order to discourage speculation. The political crisis had come at a time when there were a number of positive economic developments: the inflation rate had been decelerating rapidly and was projected to reach 13% in September 1993 and about 12% by the year end; the current account had recorded a surplus in the first seven months of the year, for the first time for many years, compared with a deficit of about US$ 1.3 billion in the same period in 1992; foreign exchange reserves had reached a historical high of around US$ 8.5 billion as at the end of August; and money and credit growth had declined steadily to well within the 1993 target range despite the deterioration in public finances. The main unfavourable developments were that tax revenue was well below the budgeted figure and that the public sector deficit had increased as a result. Despite the fiscal pressures, the Bank of Greece had succeeded in reducing monetary expansion and in implementing a tight exchange rate policy, both of which were contributing to the slowdown in inflation. All of the political parties in Greece understood that a calm approach to economic matters was required. In the past, there had been a relaxation of fiscal policy in the run-up to general elections; it was therefore welcome that this time there was only a short period before the elections on 10th October, although both major parties had declared that the campaign should not undermine the state and the prospects of the economy. The Bank of Greece was prepared to use all available instruments to stabilise the markets.

Mr. Schlesinger said with regard to the state of the German economy that the recession in western Germany now appeared to have bottomed out. Seasonally-adjusted GDP for the second quarter of 1993 indicated an increase of 0.5%, which had continued in July. The increase had, inter alia, been due to the fact that the slowdown in manufacturing production had stopped in June and had

turned upwards in July. Positive developments had also been observed in the building and services sectors. With regard to eastern Germany, GDP had been assessed as having risen during the first six months of 1993 by 6% compared with the same period in 1992. Current estimates for GDP growth in eastern Germany for 1993 as a whole had been revised upwards from 7% to 9%. Domestic production and the absorption of goods and services in eastern Germany amounted to 7% and 14%, respectively, of GDP in western Germany. The difference of 7% (twice as much as the transfer of resources caused by the two oil price shocks) was covered by transfers from public sector budgets (5%) and loans granted to the Treuhandanstalt and to the state railways. Germany's current account deficit would not exceed the deficit recorded for 1992 (around DM 40 billion; equivalent to 1.4% of GDP). The transfer of real resources from the rest of the world to Germany was relatively small. The cost of living for the year to August 1993 had risen by 4.2%, in part due to an increase in VAT; however, for the period March to August 1993 the annualised rate of increase was only 3.4%. While manufacturing costs were stable, agricultural costs had fallen by 10% compared with a year ago and had dampened the rise in prices. German M3 had grown by 9% in 1992 and had decelerated to an annualised rate of 7.4% as at the end of July. The liquidity created by the Bundesbank's intervention during the recent ERM crisis had been mopped up without too much difficulty and it was hoped that M3 growth would move closer to the upper end of the 4.5%-6.5% target range in the forthcoming months. Such circumstances did not warrant an expansionary monetary policy. Nevertheless, the Bundesbank had lowered interest rates significantly over the past year, although it had proceeded cautiously, particularly during the period from March 1993 to the beginning of July when the Deutsche Mark had depreciated against the US dollar and in the ERM. Money market rates on the basis of repo transactions to be completed the following day, were 3 percentage points lower than they had been a year earlier and the discount and Lombard rates were both 2.5 percentage points lower. Medium and long-term interest rates had also fallen considerably to a level of around 6%; they had only been lower for three short periods during the past 40 years and at times when prices had been rising by between 0% and 2%. The previously inverted yield curve had now become positive and extended from 5.75% for one-year paper to 6% for ten-year paper. The pressure which the Bundesbank had come under in July to reduce interest rates further had been fuelled by the media and reinforced by an international organisation. For their part, Bundesbank officials had not given credence to the expectations, but had publicly warned that such expectations could be dangerous if they were disappointed. While the repo and Lombard rates had been lowered during this period, any change in the domestically-important discount rate could not be contemplated under prevailing circumstances. In the meantime, the situation had changed; the depreciation of the Deutsche Mark in effective terms had been offset and the effective exchange rate index was now at the level of the beginning of 1993. This had enabled the Bundesbank to cut the Lombard and discount rates and, by a small amount, the repo rate on 9th September.

Mr. Verplaetse said that the Belgian economy was small and open and between 70% and 80% of the cost of Belgian products was influenced by import developments. This explained the importance attached by the authorities to the Belgian franc's exchange rate and the need for fixed exchange rates. Therefore, except for only the month after the collapse of the Bretton Woods system, the Belgian currency had always been anchored to another currency. The Belgian franc had not

suffered an exchange rate crisis since 1987 and, following the Belgian government's decision upon the central bank's advice towards the middle of 1990 to anchor the currency to the Deutsche Mark, no problems had been experienced until six weeks ago. Indeed, during the second half of 1992, the Belgian franc had for the first time become a "safe-haven". The pressure on the Belgian franc, which had occurred towards the end of July, and of which warnings had been received in January and April, had been caused by "extra-monetary" factors. With regard to the Belgian economy, the rate of inflation was currently a little over 3%, due to the impact of certain indirect taxes and the price of energy, and the current account surplus of the Belgian/Luxembourg union for 1993 was expected to increase to 4% of GDP. However, the public sector deficit, which was in the order of 6% - 7% of GDP, remained the weak point and would be difficult to compress in current circumstances. During the crisis, the Belgian authorities had decided that the Belgian franc should be defended and all available means had been used to do so. The movement against the Belgian franc had not been caused by residents but by non-residents, 80% of whose transactions had been in the forward market. The current aim of the Belgian central bank's monetary policy was to gain sufficient time to allow the political authorities to take decisions on the "social pact" which the capital markets were awaiting. Belgium had to achieve competitiveness by controlling wages and by creating once and for all the likelihood of redressing the public sector deficit situation.

Mr. de Larosière said that French monetary policy was geared to the medium-term objective of price stability; the annual rate of inflation was currently about 2%. The setting of the intermediate target for M3 was part of the medium-term strategy. As in Belgium, exchange rate stability was also regarded as essential in France since it was through the exchange rate that external inflationary pressures were felt. He had no doubt that his successor, who was devoted to the stability of the French currency, would pursue the same overall policy. With regard to France's economic performance, there were indications that the recession was bottoming out. Firstly, the decline of domestic demand seemed to have decelerated. Secondly, exports were developing well as France's competitiveness had improved considerably since 1987. Thirdly, inflationary expectations in France were practically nil, as demonstrated by the evolution of medium and long-term interest rates. Ten-year public debt in France currently yielded 6.15%, which was comparable to the rate applicable to similar instruments in Germany. In a recent public opinion poll in France, the question had been posed whether the French authorities should use the room for manoeuvre resulting from the widening of the ERM fluctuation bands on 2nd August to lower interest rates and thereby encourage an economic pick-up. Only 20% had supported that course of action, while 50% had been against such a move believing that it would have a negative influence on the exchange rate. This result indicated the population's awareness of the importance of a policy aimed at monetary stability. With regard to the EMS, his interpretation of the decision taken on 2nd August was that there had not been a realignment of the ERM currencies. Had a relatively small increase in the margin of fluctuation been agreed, market operators might quickly have tested the new margins. Furthermore, it had not been decided on 2nd August to let the currencies float. In their management of monetary policy, the French authorities had shown caution. For example, he had refused to reduce the official tender rate in France a few days previously on the basis that the monetary situation should be allowed to consolidate before interest

rates were cut further. He agreed with Mr. Schlesinger that the EMS had been given a breathing space, although this should be used with care so as not to give the impression that the exchange rate was no longer regarded as important. If irresponsible interest-rate policies were to be pursued, exchange rates would slide within the ERM band and competitive devaluations would result. These dangers were seen and the ERM members were co-operating. The system had survived. He hoped that moves could be made towards narrower margins once justified by the convergence factors. He agreed with the emphasis which Mr. Christophersen had placed on convergence. The need for the policy mix and economic structures to converge better was one lesson which could be drawn from recent events. He suggested that, in future, more attention should be paid to structural issues and to the situation of economic cycles when assessing convergence. He hoped that the Committee would continue its efforts towards monetary co-operation and, ultimately, to monetary union.

Mr. Beleza said that he agreed with Mr. Rey's analysis. Although exchange rates were not floating, the present situation could be regarded as being close to that position. He shared Mr. Christophersen's concerns about the implicit dangers for the single market and for the move towards the final stage of EMU and hoped that the determination of governments in Community countries to take action, particularly in the fiscal area, was realised. He also shared the view that it would be impossible to return to a "normal" ERM in the immediate future, but he would not be satisfied if the members resigned themselves to a quasi-floating system. Both for domestic and Community reasons, the Portuguese authorities regarded the ERM as an essential instrument towards achieving: lower inflation; conditions for stable growth; credibility; and fiscal consolidation. The ERM could lose its power as an instrument for fostering convergence if the authorities in the Member States waited until all of these problems had been solved. He hoped that the system would be kept alive and that the spirit of co-operation would not fade. A good deal of Mr. Verplaetse's analysis of Belgium could be adapted to Portugal, which was also a small country with an open economy for which exchange rate stability was essential. If possible, the Portuguese authorities intended conducting their policies as if the ERM bands had not been widened. A prudent and gradual downward adjustment of Portuguese interest rates had been made since the beginning of August; market interest rates were now almost back to their mid-July levels although official rates were still somewhat higher. The annual rate of inflation (5.8% as at the end of August) - albeit still too high - had been reduced from double figures. However, the slowdown in economic activity in Portugal, where the recession had arrived late, and the state of public finances gave rise to concern.

Mr. Hoffmeyer made three points. Firstly, when analysing the impact of short-term interest rates on the recent crisis, a different picture would be obtained if the summer of 1992 was taken as the reference period. There was also a need to distinguish between the evolution of market interest rates and that of official rates. He recalled that some members of the Committee had welcomed the decline in short-term rates in the spring of 1993. Secondly, most of the foreign exchange transactions recorded during the exchange crisis had been of a hedging nature and had no direct relationship with the money supply since the balances would not be used for expenditure purposes. That being the case, the ERM had been loosened for the wrong reasons. The members had been afraid that there would otherwise have been an adverse impact on monetary policy in the various

countries; that could not have been the case. Mr. Schlesinger's remark that German money supply had actually not been affected much during the recent crisis illustrated the point. Thirdly, with regard to returning to narrow fluctuation margins, it had to be decided what was the objective. The authorities in France and Germany had stated on several occasions that there was no reason to change the parities as the fundamentals were in order, whereas Mr. Christophersen and others seemed to feel that the fundamentals should be improved further. He wondered how the markets could be persuaded of the credibility of such a policy if it had not been successful before. As had generally been agreed in the past, a policy of fine-tuning economic performance could not be successful since there were no instruments available to achieve it. The pursuit of policies in that direction would lead to further disappointment.

Mr. George said that he understood the concerns that had been expressed about the risks of excessive exchange rate volatility within the context of the 15% margins and also how important it was that those countries in the ERM should not give a shock to domestic inflationary expectations. The adjustment which had been made to UK monetary policy in the autumn of 1992 had undoubtedly given a major shock to inflationary expectations and industrial confidence. Although it had not lasted for long, it had been an important factor behind the weakness of the UK economy in the fourth quarter of 1992. He understood the caution that had been adopted since 2nd August and the difficulties faced by the smaller countries, where the importance of an external anchor was greater than for the larger countries. The recent crisis had not been related to competitiveness or problems affecting individual countries, nor could it be explained by a weakness of the fundamentals in the way that the 1992 crisis could; rather it had been caused by tension in the system itself. There was a tension between the domestic policy needs in Germany to cope with reunification and those of other countries with very soft economic performance. That tension could be eased if the inflationary pressures in Germany abated and German monetary growth moderated but, if that did not happen rapidly enough, the factors which had created the problem in July would remain. There was a need, both nationally and in the Community as a whole, for sustainable growth to the extent that it was consistent with price stability. In that regard, he agreed with Mr. Christophersen about the importance of medium-term credibility. However, the current situation with 15% fluctuation margins did not give clear guidance, either to the way in which national monetary policies should be conducted, or to the appropriate behaviour in the collective interest. As Mr. Rey had suggested, it was important to develop more a complete policy specification, the essence of which was to be found in the convergence criteria set out in the Maastricht Treaty. There had been suggestions that criteria needed to be developed to take account of structural factors and that a wider range of indicators needed to be considered; such matters should be considered collectively through a procedure which monitored progress towards convergence. A tighter exchange rate arrangement was not an immediate prospect; therefore time should be devoted to studying what procedures and indicators should be monitored during the period of wide fluctuation margins.

Mr. Fazio said that Mr. Rey's report was well-founded and realistic. The concept of fundamentals dated back to the Bretton Woods era when the emphasis had been on current account payments; attention had thus continued to be focused on prices and competitiveness. He shared

Mr. de Larosière's view that this concept should be enlarged and he agreed with Mr. George that structural factors such as the state of the economy and the prospects for growth needed to be taken into account. The performance of price competitiveness in the short term, while being relevant to trade, was not relevant to financial transactions which accounted for the bulk of foreign exchange market activity. The volatility of the foreign exchange markets, which was probably inferior only to that of the stock markets, also warranted some reflection. Turning to Italy's economic situation, he said that the official discount rate had been lowered by 0.5 percentage point on 9th September, the fourth reduction in four months, and, overall, it had been reduced from 15% to 8.5% since October 1992. The present level was the lowest since before the first oil crisis. The decline in market interest rates - both short and long term - had even been greater than the discount rate reduction. The ten-year bond yield was currently 8%, a level not seen since the 1960s. The Banca d'Italia had thus followed the market's trend and had accommodated the expectation that medium and long-term interest rates would decline. The rate of broad money growth was currently 6%; domestic credit demand was growing at a much slower pace reflecting the weakness of the Italian economy. The Italian central bank was not increasing its official reserves; the amounts it had bought had come from short-term repurchase agreements. However, the Italian banking system had halved its net foreign indebtedness, in constant US dollar terms, from approximately US$ 130 billion to US$ 70 billion in less than a year.

Mr. Rojo said that the effect of German unification could only in part explain the ERM's recent difficulties; the basic source of the problem had been the conjunction of the German unification with the deep recession which all Community countries had been suffering. It would be impossible to re-establish stability in the system if the source of its instability could not be overcome. The widening of the ERM fluctuation bands had offered member countries the opportunity to tackle the problems which afflicted them. On the one hand, it had provided Germany with the possibility of maintaining its disinflationary monetary policy while, on the other hand, other countries were no longer bound by excessive external constraints in the management of interest rate policies. The margin to reduce interest rates in the latter countries differed from country to country depending on the evolution of wages and their respective fiscal positions. That margin had so far been used with extreme prudence, an approach which should be maintained. However, if the authorities in the various countries were too cautious in their management of interest rates, further disturbances in the exchange markets might occur. Although the difficulties faced by each country were different, co-operation was necessary to determine what margins for manoeuvre were available to allow interest rates to be reduced.

Mr. Doyle said that the decision to adopt wider fluctuation margins had only been taken after other options had been ruled out. The recent crisis had revealed that the achievement of a fixed exchange rate system would not be realised without collectively addressing the issue of how such a system could operate in a situation in which members' economies were diverging. That issue had not been addressed in the discussions about how to arrive at economic and monetary union. He agreed with Mr. George that new procedures were necessary. The ERM had benefited Ireland by imposing an external discipline which was lacking internally. Ireland had an open economy with exports plus imports accounting for about 120% of GNP and could not simply insulate itself from outside price effects through the exchange rate. Following the crisis in July, the differential between Irish and

German interest rates, which had become negative following the devaluation of the Irish pound in January 1993, had returned to a more rational level. The Irish economy did not face problems in the immediate future since inflationary expectations were subdued but the management of the exchange rate would become more difficult.

The ***Chairman*** suggested that he would make an oral report of the views expressed by the Committee to the informal ECOFIN meeting at the beginning of October. He would prepare a draft report which, drawing on Mr. Rey's statement, would highlight that the crisis in July 1993 had been different in character from that in the autumn of 1992. In the recent crisis, the credibility of the system had been eroded and, partly as a consequence, currencies had come under downward pressure despite sound fundamentals. All Governors had expressed the need for stability-oriented policies, including exchange rate stability, so as not to jeopardise the move towards further European economic and monetary integration. The two-way risk that had been introduced by widening the ERM bands should be helpful in striving towards exchange rate stability, but the need to pursue sound domestic policies had assumed greater importance. The fact that the "excessive deficit procedure" would become operational on 1st January 1994, at a time when eleven out of the twelve Community countries had an excessive deficit, underlined the need for fiscal consolidation to have top priority. There was strong support among the Governors for the maintenance of the EMS and a common desire to return to narrower margins. At the same time, there was a realisation that this aim could not be achieved in the short term. For a return to narrow margins to be sustainable, certain conditions would have to be fulfilled: a favourable economic climate; a movement of national economies in the same direction; better economic convergence, particularly in the fiscal field; and agreement on the policy instruments to be used in the defence of exchange rates.

III Adoption of the Committee's report to the EC Ministers of Finance on developments on the foreign exchange markets of the nineteen countries participating in the concertation procedure during July and August 1993 and the first few days of September 1993

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

IV Insolvency procedures in the Community - concerns for supervisors

The ***Committee*** endorsed the concerns expressed in the note dated 2nd September 1993 by the Banking Supervisory Sub-Committee and agreed to communicate these concerns to the Council of Ministers in the proposed letter from the Chairman to the President of the Council of the European Community.

V Preparatory work for the move to Stages Two and Three of EMU

(a) Issues arising from prudential developments and the co-ordination of prudential policy in Stage Two

The *Committee* noted the views expressed by the Banking Supervisory Sub-Committee in its report dated 2nd September 1993 and agreed that it be released to the EFTA central banks.

(b) Minimum common features for domestic payment systems

Mr. Padoa-Schioppa said that the report by the Working Group on EC Payment Systems was the follow-up to one of the four recommendations of the report that had been submitted to the Governors by the ad hoc Working Group on EC Payment Systems in the spring of 1992. This had stated that certain minimum common features for domestic payment systems should be defined. He added that the origin of the current report lay more against the background of the problems caused by the Single Market than by the process of moving towards Stages Two and Three of EMU. According to the Second Banking Co-ordination Directive, commercial banks were now able to provide cross-border payment services and to become affiliated to the payment systems of other EC countries. The report, which focused on large-value payments, set out a number of policy principles covering access conditions, risk reduction measures, legal and technical aspects, pricing policies and operating hours. These principles were in line with the activities undertaken by national central banks and had been developed with the help of some contact with the banking community. The Working Group suggested that an edited version of the report be made available to representatives of the banking community.

Mr. Rey said that the Alternates had expressed their appreciation for the report and had been in agreement with its principles and suggestions.

The *Committee* endorsed the report and agreed that it be released to the EFTA central banks. It approved the suggestion that an edited version of the report be made available to the banking community.

c) Detail, frequency and timeliness of available country data

The *Committee* agreed with the analysis and suggestions made by the Working Group on Statistics in its interim report, dated 6th September, as well as with the two practical proposals. It noted that projects for new statistics needed to be assessed with regard to cost considerations and authorised the release of the report to the EFTA central banks as well as to the Committee on Monetary, Financial and Balance-of-Payments Statistics.

d) Secondary Community legislation for Stage Two

Mr. Rey said that the Alternates had shared the Secretariat's view that the draft proposals prepared by the Commission for Community legislation on the prohibition of central bank credit to the public sector, and on the statistical data for the establishment of the EMI key, took into account virtually all of the Committee's substantive points which had been communicated in letters from the Chairman to President Delors. In some parts, the draft proposals should be clarified and made more precise. That had already been done for the EMI key in the context of informal consultations at expert level in the Working Group EMU of the Council. Furthermore, the Alternates had noted that in the draft proposal for the legislation on prohibition of central bank credit, the wording of Article 2, while fully mirroring the recommendations made by the Committee, might be too restrictive. The present

text explicitly permitted purchases of government securities solely for the purpose of implementing monetary policy and might, therefore, be seen to prevent central banks from concluding transactions in government securities under repurchase agreements in the management of payment systems, and from investing their own funds in government securities purchased on the secondary market. It was suggested that these issues should be raised by the respective country representatives in the Council's Working Group which was due to discuss issues relating to Article 104 on 17th September 1993. The Alternates had felt that, at this stage, it was not necessary to respond to the Commission's draft proposals in writing nor to send a letter to the ECOFIN Council. Instead, they recommended that the member of the Secretariat who would attend the Working Group's meeting be authorised to present the Governors' views as they had been expressed in the earlier letter to President Delors.

The *Committee* approved the Alternates' recommendation.

e) Fiscal aspects of the ECU/US dollar swaps with the EMI

The *Committee* agreed with the approach which had been proposed by the Secretariat, after consultation with the Foreign Exchange Policy Sub-Committee, in its note dated 3rd September. It was important to get assurance from the US authorities that the present tax ruling would continue to apply when the EMI took over the functions of the EMCF. The dispatch of the proposed letter to the President of the Federal Reserve Bank of New York was authorised by the Committee.

f) Future work of the Working Group on Printing and Issuing a European Bank-note

Mr. Rey said that the Alternates were in full agreement with the list of proposed topics set out in the letter dated 7th September 1993 from the Chairman of the Working Group on Printing and Issuing a European Bank-note to the Committee's Chairman; these were fully in line with the Governors' preference for a low-key and technical approach. The Alternates had recommended that the Committee requests the Working Group to continue its work on these topics.

The *Committee* endorsed the Alternates' recommendation.

g) Status of preparatory work

The *Committee* took note of the status report which had been prepared by the Secretariat.

VI Other matters falling within the competence of the Committee

Expenses of the Committee of Governors in the second quarter of 1993

Mr. Doyle said that, as in the first quarter of 1993, expenditure had fallen short of the projections. The cumulative undershooting for the first half of the year had amounted to almost SFr. 1 million, up to a quarter of which reflected delays in recruiting and training staff and bills not yet received from the BIS. About two-thirds of the undershooting represented shortfalls in operating expenditure largely because fewer meetings of Sub-Committees and Working Groups than had been expected had been held. Overall, expenditure for 1993 as a whole would remain within the Committee's projections although expenditure in the third quarter would be boosted by an unexpectedly large bill which the BIS was likely to present in respect of CEBAMAIL usage in the past.

The *Committee* took note of Mr. Doyle's report.

VII Date and place of next meeting

The next meeting of the Committee would take place at the BIS in Basle on Tuesday, 9th November 1993.

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To mark the occasion of Mr. Schlesinger's retirement and Mr. de Larosière's move to the European Bank for Reconstruction and Development, the Chairman thanked both men for the great contribution which they had made to the work of the Committee. He also expressed his thanks to Mr. Viñals who would be leaving the Economic Unit at the end of September to take up a senior position at the Banco de España.

279TH MEETING OF THE COMMITTEE OF GOVERNORS
14th September 1993

Chairman	Mr. Duisenberg
Banque Nationale de Belgique	Mr. Verplaetse Mr. Rey[1] Mr. Michielsen
Danmarks Nationalbank	Mr. Hoffmeyer Mrs. Andersen Mr. Hansen
Deutsche Bundesbank	Mr. Schlesinger Mr. Tietmeyer Mr. Rieke
Bank of Greece	Mr. Christodoulou Mr. Papademos Mr. Stournaras
Banco de España	Mr. Rojo Mr. Linde Mr. Durán
Banque de France	Mr. de Larosière Mr. Hannoun Mr. Robert
Central Bank of Ireland	Mr. Doyle Mr. Coffey Mr. Reynolds
Banca d'Italia	Mr. Fazio Mr. Dini Mr. Santini
Institut Monétaire Luxembourgeois	Mr. Jaans
Nederlandsche Bank	Mr. Szász Mr. Boot Mr. Bakker
Banco de Portugal	Mr. Beleza Mr. Costa Pinto Mr. Gaspar
Bank of England	Mr. George Mr. Crockett Mr. Clark
Commission of the European Communities	Mr. Christophersen Mr. Pons
Chairman of the Working Group on Payment Systems	Mr. Padoa-Schioppa
Chairman of the Foreign Exchange Policy Sub-Committee	Mr. Saccomanni
Secretariat of the Committee of Governors	Mr. Baer Mr. Scheller Mr. Viñals

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[1] Chairman of the Committee of Alternates