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(Translation)

MINUTES*

OF THE 229th 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 NOVEMBER AT 10 a.m.

Those present at the meeting were: the Governor of the Banque Nationale de Belgique and Chairman of the Committee, Mr. Godeaux, accompanied by Mr. Rey and Mr. Michielsen; the Governor of Danmarks Nationalbank, Mr. Hoffmeyer, accompanied by Mr. Mikkelsen; the President of the Deutsche Bundesbank, Mr. Pöhl, accompanied by Mr. Gleske and Mr. Rieke; the Governor of the Bank of Greece, Mr. Chalikias, accompanied by Mr. Papademos and Mr. Karamouzis; the Governor of the Banco de España, Mr. Rubio, accompanied by Mr. Linde and Mr. Durán; the Governor of the Banque de France, Mr. de Larosière, accompanied by Mr. Waitzenegger and Mr. Cappanera; the Governor of the Central Bank of Ireland, Mr. Doyle, accompanied by Mr. O'Grady Walshe and Mr. Reynolds; the Governor of the Banca d'Italia, Mr. Ciampi, accompanied by Mr. Dini and Mr. Santini; the President of De Nederlandsche Bank, Mr. Duisenberg, accompanied by Mr. Szász and Mr. Brockmeijer; the Governor of the Banco de Portugal, Mr. Tavares Moreira, accompanied by Mr. Pêgo Marques and Mr. Amorim; the Governor of the Bank of England, Mr. Leigh-Pemberton, accompanied by Mr. Loehnis and Mr. Price; the President of the Commission of the European Communities, Mr. Delors, accompanied by Mr. Costa, Mr. Mingasson and Mr. Dixon; the Director General of the Luxembourg Monetary Institute, Mr. Jaans; the Secretary of the Monetary Committee, Mr. Kees. Also present at the meeting were Mr. Raymond and Mr. Dalgaard, Chairmen of the Groups of Experts. The Secretary General of the Committee, Mr. Morelli, his Deputy, Mr. Bascoul, Mr. Scheller and Mr. Giles, and Mr. Bockelmann and Mr. Dagassan also attended.

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* Final text approved at the meeting on 13th December 1988, which incorporates some drafting changes.

I. Approval of the minutes of the 228th meeting.

The Committee unanimously approved the minutes of the 228th meeting, on the understanding that the editorial amendments suggested would be incorporated in the final text.

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

- Preparation by the "Dalgaard Group" and discussion by the Committee of Alternates;
- Statistical charts and tables.

A. Statement by Mr. Dalgaard

Mr. Dalgaard began by pointing out that the basic "monitoring" documentation (tables and statistical charts) was now drawn up by the Secretariat of the Committee.

During the two months which had passed since the September meeting there had been no acute tensions on the exchange markets but there had been a number of important developments.

The position of the dollar had changed markedly. Since the low reached at the end of 1987 and until September 1988 the dollar had firmed or remained stable. Intervention sales had totalled approximately $25 billion in the three months July, August and September. In October/early November the dollar had weakened by about 3% against the Deutsche Mark and intervention purchases had been made for a total of some $3 billion. This reversal of trend appeared to be connected with the fact that US growth seemed to be less vigorous and that, as a result, interest rates were unlikely to rise as had been expected. Moreover, the external imbalance was provoking renewed concern. However, the weakening of the dollar against the European currencies had not been very pronounced; its level vis-à-vis the Deutsche Mark in early November, for example, was the same as in January-October 1987 and more than 10% higher than its end-1987 level.

The weakening of the dollar had been more pronounced vis-à-vis the yen, whose current level was about the same as that recorded at the end of 1987. Concerted interventions had been undertaken by the Federal Reserve and the Bank of Japan to check the fall of the dollar, the latter intervening for the first time after a long period. The yen had thus strengthened against the Deutsche Mark, its appreciation amounting to approximately 10% since the beginning of the year.

The outlook for the dollar was even more uncertain than usual owing to the US elections, but a further decline following the elections was widely anticipated.

Within the EMS, the situation was currently remarkably calm. There had been two periods of tensions: in early September, in connection with rumours of a realignment, and in mid-October, when the French franc had been subject to some pressure. The tensions had never been acute and the narrow fluctuation band had not been utilised to the full at any time.

After a relatively weak performance until September, the Deutsche Mark had firmed again markedly within the EMS in October, while German interest rates, particularly long-term rates, had fallen and sales of Deutsche Mark had been undertaken. This development was to be seen against the background of the weakening of the dollar and the improvement in economic growth in Germany. Mention should also be made of the change in the repo tender technique in combination with an increase in rediscount quotas. These changes had been aimed at making the existing instruments more flexible without modifying the basic stance of monetary policy.

The French franc had experienced two bouts of weakness. Firstly in early September with the rumours of a realignment. The Banque de France had responded with intervention sales, by allowing the franc to weaken somewhat within the band and by raising short-term interest rates slightly. This had rapidly restored calm to the markets and the exchange rate and interest rates had returned to normal. Subsequently, towards mid-October, labour disputes and poor August foreign trade figures, combined with the fall of the dollar, had caused the franc to weaken again. Once more the Banque de France had responded with the three instruments. In addition, the French and German authorities had issued very clear statements opposing any realignment. The markets had again been calmed and the interventions had ceased. The situation in early November was that the franc was the weakest currency within the narrow band, quite close to its lower limit, that the real interest rate differential vis-à-vis the Deutsche Mark was wider than in the summer but smaller than it had been in 1987, and that there had been no return flows of capital following intervention sales totalling approximately $4 billion.

The Italian lira had also been affected by the rumours of a realignment in early September; the Banca d'Italia had then allowed the exchange rate to ease slightly; it had raised interest rates and carried out interventions. The tensions had disappeared. Since then the lira had firmed and purchases of foreign exchange had been made for approximately $2 billion. The reasons for this turn-round were: the high level of interest rates needed to finance the government budget, the good performance of fundamentals such as economic growth and the trade balance, and the good reception accorded the 1989 budget. The announcement of capital liberalisation measures had possibly contributed to the weakness of the lira in September but there had been no repercussions when the measures had entered into force on 1st October 1988.

The Danish krone had weakened slightly and had slipped below the middle of the band; since this level was considered perfectly acceptable, no intervention had been undertaken. The full liberalisation of capital movements as from 1st October 1988 had had no effect on the market.

The Irish pound had been strong for most of the period; it had weakened slightly, however, towards the end of October. Interest rates had increased somewhat, possibly in connection with the announcement of the full liberalisation of securities transactions at the end of the year.

The Belgian franc had been a little weak at the end of August/beginning of September, apparently because interest rate differentials had narrowed too far. Interest rates had been raised slightly and since then the situation had been calm.

The Dutch guilder had also been rather weak in August and early September; a number of intervention sales had been made. The interest rate differential vis-à-vis the Deutsche Mark had been increased to 3/4% and this had been sufficient to reverse the flows of capital. As a result the guilder had stabilised at a level close to bilateral parity with the Deutsche Mark, interventions had ceased and the interest rate differential vis-à-vis the Deutsche Mark had narrowed to less than 0.5%.

All in all, the general situation as far as the exchange rate mechanism was concerned was satisfactory, insofar as the flexible use of the three instruments had proved effective and the liberalisation of capital movements in Italy and Denmark had not had any negative effects on the exchange markets.

Sterling had remained stable vis-à-vis the other EEC currencies: there had been no significant intervention or interest rate changes. This reflected an equilibrium of a sort between the overheating of the economy, the large current-account deficit and the high level of UK interest rates.

The peseta had firmed following a substantial increase in interest rates by the Banco de España in response to the sharp rise in prices (+1% in September) caused by the overheating of the economy.

The Bank of Greece had pursued its policy of contributing to the aim of general stability by allowing the effective exchange rate of the Greek drachma to fall by less than inflation differentials. Since the beginning of 1988 the effective exchange rate had depreciated by 5.3%, with a figure of 7% expected for the year as a whole. Overall, the drachma should record a real appreciation of 3 to 4% in 1988.

In Portugal, the policy of gradually bringing down the effective exchange rate of the escudo had been continued, in progressively smaller steps.

Finally, several points should be made.

The recent interventions by the Banca d'Italia had included purchases of French francs totalling more than $400 million.

As could be seen from the tables submitted to the Governors, the central banks' holdings of private ECUs had grown substantially in 1988, from 4 to 8 billion, and had recorded sizable movements. Danmarks Nationalbank, for example, had reduced its holdings by 250 million in connection with repurchases of official ECUs; the Banca d'Italia had done likewise for a total of 670 million in October as part of a redistribution of exchange reserves. By contrast, the Bank of England had increased its holdings by more than 900 million following the issue of ECU Treasury bills.

At a meeting of central bank experts held on Sunday evening in Basle it had been decided to make a study of the volume of transactions on the exchange markets. For this purpose a survey would be made in April 1989 by among the majority of the EEC central banks along the lines of the surveys already carried out in the past by the Bank of England and the Bank of Japan.

B. Statement by Mr. Rey

The Alternates' exchange of views could be summarised in two keywords: satisfaction, but a need for vigilance. This dual impression could be illustrated from four different angles.

1. There was every reason to show satisfaction with the measures taken to liberalise capital movements in Denmark and Italy and with those very recently announced in Ireland. These measures had, moreover, been on balance favourably received in the markets.

Vigilance was recommended in this area by the Alternates of the countries concerned; the Irish and Italian Alternates, in particular, had cautioned against any euphoria. In Ireland there had been a certain firming of long-term interest rates in connection with the announcement of the liberalisation measures. In Italy there was no lack of factors apart from the relaxation of exchange controls to explain the recent firmness of the lira; the improvement in the trade balance in particular had played a significant part in the strong performance of the currency.

2. The EMS also gave grounds for satisfaction. The stability of exchange rates within the EMS could not be said to have been seriously impaired during the period under review. Some tensions had emerged, and rumours of a realignment had been heard, but they had been well controlled. In particular, the downward pressure on the French franc had been successfully countered in accordance with both the letter and the spirit of the Basle/Nyborg Agreement: with interventions, a weakening within the exchange rate band and action on interest rates.

The need for vigilance lay in the size of the current-account imbalances between countries participating in the EMS exchange rate mechanism. These disequilibria could not be expected to disappear in the near future under the effect of differentiated demand policies. In the short term, therefore, they would have to be financed in one way or another. It was very widely felt that the necessary capital flows should continue to be a spontaneous response to market stimuli, which meant maintaining appropriate interest rate differentials. From this point of view, it would be as well to be cautious before contemplating unilateral action that would lead to a narrowing of the French franc/Deutsche Mark interest rate differential.

3. The Alternates' attention had been drawn to the situation in Spain, where the continued very fast growth of economic activity was accompanied by an acceleration of inflation and widening trade and budget deficits. The

authorities had found it necessary to tighten monetary policy in order to counteract this development.

4. Finally, it was satisfying that the fall of the dollar had taken place in an orderly manner, bringing the US currency back to a level judged to be more in keeping with the requirements of the international adjustment process. There were, however, obvious uncertainties surrounding the development of the dollar in the near term. Some Alternates thought that the dollar had stored up potential for a fall that might be released following the elections, but it could also be that the market had already anticipated the fall and was adopting a wait-and-see attitude until such time as the intentions of the new Administration became clear. It might even be desirable, at the dollar's present level, if some stabilisation were encouraged.

C. Discussion by the Committee

Mr. de Larosière thanked Mr. Rey for his statement, which had been extremely clear and concise.

Mr. Ciampi noted that the Banca d'Italia was delighted that the liberalisation of cross-border capital movements was now a reality after more than fifteen years of controls. The experience of just over a month had been without hitches, and it was not to be forgotten that the last realignment had taken place almost two years ago. A tribute should be paid to those in Italy who for so many years had tenaciously worked for progress along the path of liberalisation without its giving rise to imbalances. However, problems persisted for Italy and the EMS. The inflows of funds in October had followed upon September's outflows in connection with the rumours of a realignment. Interest rates were on average higher in Italy than in the other member countries, in both nominal and real terms. This situation had at the same time a cyclical component (the very strong growth of bank lending necessitating a policy of high interest rates) and a structural component (the government having to offer attractive rates of interest in order to raise the resources needed to finance a very large budget deficit). Two other factors had favoured the implementation of the latest stage in the liberalisation of capital movements: firstly, the good performance of the Italian balance of payments in response to buoyant world demand and the fall in oil prices; and, secondly, the greater confidence of Italian operators in the authorities' statements and commitments regarding the reform of the public finances. This store of confidence now had to be reinforced through concrete action.

Mr. Rubio confirmed that inflation was accelerating in Spain and that this had been the reason for the one-point increase in interest rates. The objective for 1989 was to bring inflation down to 3%, which would require a - possibly substantial - tightening of monetary policy. The budget deficit was in the process of being cut, and a further reduction ought to be achieved in 1989. This was due to the very sharp increase in revenue; overall, however, fiscal policy was not restrictive and could even be expansionary.

III. Adoption of the Committee's report to the EEC Ministers of Finance on developments on the foreign exchange markets of the nineteen countries participating in the concertation procedure during September, October and the first few days of November 1988.

The Chairman noted that the Committee approved the "concertation report", which would be sent to the EEC Ministers of Finance in the usual way.

IV. Examination of current monetary policies in EEC countries based on Report No. 33 of the group of experts chaired by Mr. Raymond.

The Chairman drew attention to the fact that Report No. 33 was the first reflecting the supplementary mandate which the Governors had given to the "Raymond Group" in May 1988 with a view to improving the co-ordination of monetary policies between the EEC member countries and supplementing the monthly monitoring procedure established as a result of the Basle/Nyborg Agreement of September 1987. In addition, the drafting of this autumn report had been brought forward one month to enable the Governors to discuss it in November, as December had appeared a little late given the various monetary decisions that had to be taken in the EEC countries.

A. Statement by Mr. Raymond

Report No. 33 differed from preceding semi-annual reports by the Group of Experts at least in terms of its aims. These aims had been set by the new mandate given by the Governors in May 1988. The Group had been asked to provide the Community central banks with the information necessary for developing a co-ordinated monetary policy approach in 1989. For this purpose it had been called upon to focus on an analysis of divergences and of the steps to be taken to reduce them.

The experts had taken note of the unforeseen acceleration in growth in 1988, with a slowdown to be expected in 1989. They had noted that although price movements had become less favourable than in the preceding two years, they had remained moderate and the situation should stabilise. This was true in general as well as in Europe.

It was primarily the balance-of-payments adjustment process that claimed attention. It had seemed to be marking time for some months between the United States, Japan and the Federal Republic of Germany. While the EEC surplus had narrowed in 1988 to no more than 0.5% of aggregate GNP, divergences had widened between member countries. Germany's surplus was still equivalent to 4% of its GNP and 1% of that of the Community. Surpluses persisted in the Benelux countries and Ireland.

On the other hand, current balances were worsening or in deficit in those countries where they were already weaker, except in Denmark. These results, which were disappointing in convergence terms, could be attributed to several factors:

- domestic demand was stronger in the less developed member countries and in those which were experiencing some overheating than in the surplus countries;
- exchange rates had worked against adjustment for much of the year; and,
- finally, the rapid pace of growth had intensified the effects of industrial specialisation, with Germany in particular demonstrating its capacity to meet the strong demand for capital goods on the part of its partners.

The divergences with regard to prices and budgetary positions had narrowed slightly, but not enough to bring real convergence.

In sum, in 1989 the Community countries would still for the most part be split into two groups: those with moderate inflation and an appreciable current-account surplus (Germany, the Netherlands, Belgium, Luxembourg and Ireland) and those with an inflation level higher than the Community average and current-account deficits or deteriorating external positions (the

United Kingdom, Italy, Spain, Portugal and Greece). France and Denmark lay somewhere in between.

The above analysis appeared to point to two conclusions for the co-ordination of member countries' monetary policies in 1989.

Firstly, the general stance of these policies: two contradictory observations led the experts not to recommend that it should be modified in one direction or the other. Monetary policies, which had been eased immediately following the stock market crash in October 1987, had been tightened again at different times in the various countries as from the second quarter of 1988. This re-appraisal, well received by the markets, appeared to have calmed inflationary expectations and therefore seemed to suffice for the moment. On the other hand, the buoyancy of lending and the high liquidity of the economy in many countries suggested that the reins should not be loosened, a move which could only be contemplated in 1989, in the view of most experts, if a significant slowdown in growth occurred.

Secondly, the differentiation between monetary policies: this was in theory necessary in order to bring closer together the two groups of countries set in rather dramatic contrast. In the long term the persistence of different inflation rates and contrasting balance-of-payments positions could only put exchange rate stability at risk, especially within the exchange rate mechanism (but the Group's mandate was not confined to that mechanism).

It had first been stressed that the balance of payments on current account might give an excessively pessimistic impression of the risks being run. It was true that in 1988 large outflows of capital from Germany had helped to limit tensions. Nevertheless, one could not rely entirely on such phenomena: capital flows other than direct investment could move against exchange market equilibrium, in flight from the deficit countries to a safe haven in the surplus countries under the influence of exchange rate expectations. This risk was greater today, in a deregulated Europe. It called for stronger and swifter responses from the central banks on interest rates.

Structural policies were certainly indispensable, but their impact on supply would be too slow to resolve the difficulties of 1989.

There remained cyclical demand management. None of the countries with a current-account surplus saw any scope for stimulating domestic demand further. Domestic demand was considered satisfactory in Germany to the extent that it was broadly in line with the growth of productive capacity and thus did not threaten medium-term price stability. The other surplus countries attached priority to the stability of their exchange rates vis-à-vis

Germany, from which they therefore did not wish to diverge; these countries could not stimulate their economies through fiscal measures as their public finances on the contrary needed adjustment. Under these conditions closer convergence could only come from demand restraint in the second group of countries with higher inflation and a weak balance of payments.

Most experts had regretted the timing of the fiscal measures adopted in 1988 in the United Kingdom, or planned for 1989 in Germany, which, albeit warranted on a long-term view, could work against short-term adjustment.

From all this it could be concluded that closer convergence would depend largely on the development of interest rates and their differentiation, which was mainly the task of the second group of countries; the result would undoubtedly be an overall tightening in the Community. At the same time, interest rate differentials alone could not be expected to reduce the external imbalances rapidly, given their size.

Different views had also emerged regarding responses to possible fluctuations in the dollar. The representatives of the second group of countries (higher inflation, weaker balance of payments) feared that a fall in the dollar would not bring a fall in interest rates in the first group, or that a dollar appreciation would lead to further increases in interest rates in those countries.

Many experts thought that it would be useful if any announcement of targets for 1989 contained a reference to joint preparatory work - even though the experts were well aware that they had not yet reached complete agreement.

B. <u>Statement by Mr. Rey</u>

The Alternates had attempted to answer the following four questions:

- did the redrafted version of the report constitute an appropriate response to the mandate given by the Committee of Governors last May?
- could the analysis of macro-economic and monetary developments be shared?
- was it possible to reduce the differences of opinion that had emerged between experts on the subject of the desirable monetary policy approach in the Community?

- should one follow the recommendation made by the majority of experts to announce publicly that the monetary targets set for 1989 in the various countries had been the subject of a joint preliminary discussion within the Committee of Governors?

With regard to the first question, which concerned the execution of the mandate, the Alternates had been unanimous in their appreciation of the quality of the report, which lucidly set out the problems involved in the co-ordinated conduct of monetary policies. If there were disagreements as to some of the options to be taken, it was the experts' role to highlight them, and that had been done. It was for the Alternates and the Governors to assess to what extent these points of view could be reconciled.

As regards the analysis of recent developments, the Alternates were very largely in agreement with the experts. There were three comments to be made in connection with growth, inflation and the current-account imbalances.

Growth, which had been sustained in the Community in 1988, had exceeded the most optimistic forecasts. This was particularly true in Germany, where aggregate demand was growing significantly more quickly than estimated productive capacity. In this respect a slowdown in the rate of demand growth in 1989 would not be undesirable and would not be enough to warrant a relaxation of monetary discipline. The observation had been made that the rapid growth of investment should contribute to enlarging productive capacity; without denying the validity of this argument, the German Alternate had pointed out that this process required time and meanwhile was being thwarted by the reduction of the working week.

With respect to inflation it was remarkable that economic growth had accelerated in the countries participating in the EMS exchange rate mechanism, without any appreciable sacrifice of internal stability. Outside the mechanism, however, some countries were facing relatively strong inflationary pressures.

The Alternates were of the opinion that the current-account imbalances within the EEC were at present the main cause for concern. The forecasts hardly held out hope of any appreciable reduction of these imbalances in 1989. This fact was particularly important for the choice of monetary policy stances.

As regards the third question examined by the Alternates, they had first of all noted that the possible contribution of fiscal policies to greater convergence, in particular at the balance-of-payments level, would be very limited. The criticisms voiced in the report by the majority of experts regarding the fiscal measures taken in two member countries had been countered by the Alternates concerned. For the German Alternate, the raising of indirect taxes in 1989 could not be divorced from the cut in direct taxes planned for the following year. The British Alternate had emphasised that the strong growth of domestic demand in the United Kingdom was wrongly being attributed to fiscal policy (it should be remembered that the budget showed a comfortable surplus); rather, it reflected the easing of monetary policy in the last few months of 1987 and early 1988, for well-known reasons. The tightening of monetary policy, as subsequently observed, had therefore been an appropriate response.

The report thus proposed a differentiation of monetary policies between countries participating in the EMS exchange rate mechanism according to their balance-of-payments positions and suggested a differentiated response depending on whether the dollar moved up or down. The discussion held by the Alternates had not enabled them to reconcile the diverging views expressed on this subject by the experts. In particular, the German Alternate had suggested that in the event of a rise in the dollar an increase in German interest rates might be the appropriate response, whereas if the dollar fell one should hardly expect a lowering of rates but rather interventions, to the extent that their impact on domestic liquidity could be neutralised by other means. Other Alternates had remarked that the situation in their countries, and in the EEC as a whole, would not justify a tightening of monetary policy.

Being unable to agree in advance on a co-ordinated monetary policy strategy, the Alternates recognised the need to respond flexibly to developments and consequently to ensure a certain continuity in the joint monitoring of monetary policies. It had also been pointed out that the Bundesbank should be more attentive not only to the risks of liquidity expansion but also to the counterparts of any such expansion. If it were to occur, for example, as a result of capital inflows, it would be inappropriate to respond with a policy of raising interest rates.

As for the proposal that an announcement affect should be aimed for when the monetary targets for 1989 were published by referring to the work carried out by the Committee of Governors, the Alternates were not greatly in favour of it under the present circumstances. Apart from the institutional difficulties which this proposal could create in certain countries, the Alternates thought that it would lack credibility in a situation in which it had not been possible to eliminate significant differences of opinion as to the appropriate approaches. The Alternates did not, however, rule out for the future the idea of a joint public announcement of approaches on which the monetary authorities had reached a genuine consensus.

C. Discussion by the Committee

Mr. Duisenberg agreed with the Alternates in their assessment of Report No. 33, which provided a very balanced analysis of economic and monetary developments within the Community and the problems arising. The report usefully focused on the co-ordination of monetary policies and the lack of convergence, but perhaps devoted too much attention to the past and not enough to the future. The Group should be more forward-looking and suggest some options for suitable corrective measures; it might indicate how monetary policies could contribute within the member countries to the process of disinflation and the restoration of external equilibrium. The experts could, for example, discuss desirable monetary targets for 1989, including that for the growth of domestic lending which formed part of the mandate.

The report stressed that monetary growth had been vigorous in the majority of the EEC countries, above all in the last few months, and that this was chiefly due to the strong growth in bank lending to the private sector in the context of very buoyant domestic demand. Moreover, the average rate of inflation within the Community had increased, reaching 5% in August. Determination was therefore required with regard to monetary targets, but greater attention needed to be given to the internal and external counterparts of money creation.

At a more general level, a few points were worth making. In 1989 economic growth would remain strong in some countries, while in others there would be an appreciable rise in wages. There would thus be an obvious risk of new inflationary pressure which policies should combat as quickly as possible so that productive capacities were not exhausted and so as to reduce excess liquidity. Finally, a sharp depreciation of the dollar leading to tensions within the EMS could not be ruled out; rapid action would then have to be taken on interest rates and differentials suitably widened.

Mr. Ciampi endorsed the opinions expressed about the quality of the study submitted by the "Raymond Group". The process of liberalisation of capital movements in which the Community was engaged involved risks unless simultaneous progress was made in the conduct of monetary policy, which, moreover, could no longer be seen in a narrow national context but had to take account of the situation of the other member countries. It was clear that the studies should not be confined to retrospective observations, commenting on the past, but should look to the future. Such an approach, which had already been advocated by Italy, should be followed by everybody, independently from the stage reached in the liberalisation of capital movements. The "Raymond Group" should go further in the direction desired by Mr. Duisenberg, i.e. it should provide pointers and options for co-ordination for the future.

At the procedural level, Mr. Ciampi proposed that the new mandate given to the "Raymond Group" should be confirmed and if possible that part of it which was forward-looking and prepared the ground for the future should be reinforced.

Mr. Pöhl thought that Report No. 33 represented an excellent analysis of the situation and the problems arising. The experts appeared to be a little pessimistic in saying that the adjustment process had been marking time, especially as far as the United States was concerned. Actually, the US representatives thought that the reduction of their country's deficit would continue, albeit perhaps at a slower pace. In fact, the bilateral relations between the United States and Germany had seen a decrease in German exports of around 13% and an increase in German imports of roughly the same order of magnitude since the beginning of 1988. The problem obviously arose within the EEC: since the beginning of 1988 exports from Germany to its partners, notably Italy and France, had risen much more rapidly than German imports from the other member countries. The problem was thus tending to worsen, and gave all the more cause for concern in that the scope for expanding domestic demand in Germany was limited.

The question was, therefore, how these imbalances might be corrected, bearing in mind that exchange rate adjustments should only be a last resort and could in any case only be modest. Hitherto the growth in the German trade surplus had not caused any problems, since it had been offset by capital movements. It was possible that, with different exchange rate expectations, capital flows would be reversed, as had been the case for some time.

Were such a trend to persist or to intensify, tensions would be bound to emerge within the EMS. A widening of interest rate differentials risked being insufficient, and so it would be better to bring about capital exports from Germany to those countries with relatively weak currencies. These countries had, in fact, to adopt policies conducive to attracting capital. Italy provided a convincing example in this regard: the liberalisation of capital movements there had given rise not to outflows but, on the contrary, to inflows of capital, which were a sign of confidence. This kind of policy designed to make the country more attractive to foreign capital was the only way of achieving progress, given that the cohesion attained now ruled out any major parity changes.

Mr. Pöhl noted that the EEC countries with the highest inflation rates and the largest current-account deficits did not participate in the EMS exchange rate mechanism. Membership of the exchange rate mechanism had a disciplinary effect that appeared to be conducive to closer convergence. This was a situation which might merit examination in greater depth.

Mr. de Larosière offered a few remarks and a suggestion as regards method. The size of the current-account imbalances was currently a major factor. The existence of surpluses or deficits within a regional grouping such as the Community was not abnormal, but the size of these imbalances, for example a surplus equal to 4% of GNP, and their persistence year after year posed a problem. The monetary policies of the EEC countries could not fail to be influenced by this basic fact. The countries with large surpluses and low inflation should not therefore envisage any tightening of their monetary policy but should rather consider a slight relaxation, especially if the dollar weakened. Moreover, the restrictive stance of fiscal policy in Germany in 1989 was to be regretted. The structural reasons for raising indirect taxes were understandable, but the decision was wholly out of line with the cyclical situation.

The risks of inflation in the second group of countries, as described by Mr. Raymond, should lead them to exercise very strict vigilance in their demand management policies. This applied both to fiscal policy and to monetary policy and meant, for example, that interest rates had to be maintained at relatively high levels. In France the narrow monetary aggregates were developing along fairly satisfactory lines, but the growth in lending, of the order of 11%, was too strong and demanded the continuation of a vigilant and rigorous monetary policy.

With regard to the dollar, close attention had to be paid to the international aspects of its development. As long as US fiscal policy failed to bring about a significant easing of domestic demand pressures, a sharp decline in the dollar, in the current context of very high capacity utilisation in the United States, would only serve to heighten inflationary pressures in that country and would not improve the balance of payments. Moreover, interest rates would have to be raised in the United States, and this, which would doubtless take place in a context of stagflation, would have adverse consequences for the Third World and the international monetary system as a whole. A rapid fall in the dollar might also cause disturbances within the EMS. All these reasons gave grounds for thinking that it was the central bank Governors' responsibility rather to seek dollar stability.

With regard to a suggested method, Mr. de Larosière noted first of all that the "Raymond Group" had produced a very remarkable study. As Mr. Duisenberg and Mr. Ciampi had mentioned, the experts should be encouraged to be even more precise in their recommendations and their analysis concerning monetary policies and their co-ordination. The more forward-looking and precise the picture presented (perhaps by setting out different monetary policy scenarios in the various countries), the better the Governors would be assisted in making their own authorities or boards aware of aspects of interaction at the European level.

The schedule of work for the Group could be modified with this in mind. The November report introduced this year was perfectly appropriate, since it enabled the Governors to draw on the experts' analysis in preparing their monetary policy decisions. On the other hand, the May report was a little late for an examination of the preceding year, which was known by March, and a little early to offer a sound view of the first half-year. A possibility would therefore be to have, firstly, a fairly brief report in March, or possibly in April, concerned essentially with taking stock of the previous year's results and, secondly, a report in July for purposes of examining the situation half-way through the year. If Mr. Raymond agreed, one meeting of the experts might be sufficient for the March report, instead of two as at present for the May report, so that the total number of meetings could perhaps remain the same.

Mr. Rubio referred to Mr. Pöhl's remark on the current improvement in adjustment between the United States and Germany. If this development continued, the current-account deficits would increase in several EEC countries. However, offsetting such a deterioration by increasing capital inflows was certainly not a good solution and could lead to more serious problems in the future. It was possible to conduct a monetary policy capable of attracting sufficient capital, but this could not be made a permanent process. As soon as the current-account surpluses of certain countries became structural, its deficit partners would have to maintain a restrictive policy and therefore high interest rates for such a long time that at some point the markets would come to feel that the only solution was a substantial change in parities and would exert pressure accordingly.

Mr. Raymond thanked the Governors for their compliments, which he would pass on to his colleagues and which he directed more especially to the Secretariat of the Committee, which carried out a considerable amount of work in drafting the reports.

The Governors' request that the experts be more precise in their proposals for the future was an entirely desirable development in the Group's work; it obviously presupposed that the experts would comment very clearly on the situation in their own countries and on that in the other member countries; one could soon hope to have more concrete mutual criticisms. As far as the schedule was concerned, bearing in mind both the emphasis on the future and the Governors' desire to take more frequent stock of monetary strategy outside the monthly monitoring procedure, Mr. de Larosière's proposal might be followed up. In March, when figures for the past year were known, a report would to some extent update the November report, which only gave reliable forecasts concerning the current year. The March report could, in addition, include the data on which the central banks had based their objectives for 1989, their assumptions regarding lending, the various monetary aggregates and interest rates. This would lay the foundation for taking up the examination again on a forward-looking basis in November 1989, since it was true that in November 1988 the experts said nothing about the development of the monetary and credit aggregates in 1989 in the member countries. Such an approach presupposed that the Governors would instruct their experts to be as frank and precise as possible.

In July a report could indeed take stock of the situation half-way through the current year, whereas in May there would only be the first quarter to cover; experience had shown, particularly in July 1988, that the situation and assessments at that point had been very different from those in November 1987.

Mr. Raymond added that the Governors' various projects did not present any problems for the work of the Group of Experts; he would, however, like to be given the leeway of five working meetings, as it would perhaps be difficult to make do with only four.

Mr. Duisenberg reverted to the problem of the current-account imbalances. Monetary policy could help correct these imbalances but it could not do everything, and capital movements could not offset them indefinitely. Fiscal policy also had to play an important role. In addition, another factor contributed to maintaining these imbalances, namely the various subsidies or assistance schemes which existed in the EEC countries to promote national exports. There was no uniformity in this area, and the Commission should look into this.

Mr. Leigh-Pemberton remarked that in most of the EEC countries growth was strong, particularly with regard to investment, which had contributed a good deal to the German current-account surplus. The slowdown predicted for 1989 in Europe and worldwide should bring some correction of the current-account imbalances, and one should therefore perhaps avoid being overly pessimistic.

With regard to the programme of work for the "Raymond Group", Mr. Leigh-Pemberton agreed with the drafting of three reports a year; he noted that even though April was the better month for the United Kingdom - as the budget was then established - March seemed preferable to him, given that in April the Governors were often under pressure owing to ECOFIN Council and IMF meetings.

The Chairman brought the discussion to a close by noting the Committee's agreement with the proposals put forward concerning the focus of future "Raymond Group" reports and the programme of three reports a year.

V. Other matters falling within the competence of the Committee.

There was no other business.

VI. Date and place of the next meeting.

The next meeting would take place in Basle on Tuesday, 13th December 1988, beginning at 10 a.m.

Committee of Governors of the
Central Banks of the Member States
of the European Economic Community

Annex

8th November 1988

Confidential

BRIEF REPORT ON
DEVELOPMENTS ON THE FOREIGN EXCHANGE MARKETS OF THE COUNTRIES
WHOSE CENTRAL BANKS PARTICIPATE IN THE CONCERTATION PROCEDURE

SEPTEMBER AND OCTOBER 1988

This report summarises developments on the exchange markets of the countries whose central banks participate in the concertation procedure[1] and briefly describes their interventions during September, October and the first few days of November 1988.

I. EXCHANGE RATE DEVELOPMENTS

The main features of the foreign exchange markets in September and October 1988 were:

- a sharp decline of the US dollar during October, the depreciation being more pronounced with respect to the Japanese yen;
- a short period of nervousness in the EMS at the beginning of September, which did not give rise to major tensions.

After an initial weakening in early September, the US dollar moved higher against most major currencies during the rest of the month. The dollar benefited from the release of US trade statistics for July, as well as from expectations that any emerging signs of economic overheating would lead to higher US interest rates. Also, the Berlin summit communiqué and subsequent official commentary were interpreted by some as suggesting that the G-7 monetary authorities would tolerate a further rise in the

1 The central banks of the EEC, Norway, Sweden, Finland, Switzerland, Austria, Japan, Canada and the United States.

dollar. Towards the end of the month, the US authorities sold dollars against Deutsche Mark in concerted intervention that restored the view that monetary authorities would resist a further dollar rise. From late September, the dollar has declined in a move prompted by various indications that US economic activity was not expanding as vigorously as had been thought, suggesting that upward pressure on dollar interest rates might subside. Market sentiment towards the dollar became increasingly negative as concerns about the pace of external adjustment resurfaced. As the dollar came under strong selling pressure at the end of October, the US authorities bought dollars against yen to limit the dollar's decline. The dollar closed the two-month period under review down 5% on average against European currencies and 8.6% lower against the Japanese yen.

At the beginning of September and for the second time this year, some nervousness appeared in the EMS, although the pressures abated easily. Subsequently, there was some movement in currencies' relative positions, mainly the strengthening of the Deutsche Mark to the top of the band and the weakening of the French franc to the bottom of the narrow band.

The Deutsche Mark continued to firm against almost all currencies, appreciating most strongly - by 5.7% - against the US dollar. During the second half of September this development was temporarily interrupted when the decline of the dollar gave way to an upswing. Late in September this rise was, however, halted by concerted intervention, and in October the Deutsche Mark firmed strongly. In the second half of October the weighted index of the Deutsche Mark vis-à-vis the EMS currencies reached the highest levels yet recorded; overall (vis-à-vis fourteen major industrial countries), however, the Deutsche Mark's index was still approximately 3% below the peak values recorded at the beginning of the year.

In the period under review the French franc was subject to certain pressures. At the beginning of September, as a result of rumours of a realignment associated with the dismantling of Italian exchange controls, the franc weakened against the Deutsche Mark, but the decline was checked by the statements made by the French and German monetary authorities ruling out the necessity of a parity readjustment. The announcement at the end of September of a substantial August trade deficit (of Fr.fr. 9 billion), followed at the beginning of October by social disputes, gave rise to new pressures on the franc, in particular by inducing French residents to cover forward their commercial operations. The firming of the Deutsche Mark exchange rate, accompanied by an increase in French short-term interest rates, subsequently made the taking of positions more costly and dissipated these pressures. Thereafter the resolution of the social disputes and the announcement of a Fr.fr. 0.4 billion trade surplus in September gave an incentive to purchases of francs by non-residents.

The Belgian franc remained relatively stable. The Banque Nationale intervened occasionally in the market, above all in the form of sales in the first fortnight of September. On four occasions it was able to reduce the rate for three-month Treasury bills, which currently stands at 7.25%, corresponding to a reduction of 0.35% over the last two months.

The Dutch guilder firmed slightly against the Deutsche Mark in September, due to a somewhat larger short-term interest rate differential. It subsequently rose further within the EMS as it followed the strengthening Deutsche Mark.

The Danish krone weakened slightly to a level just below the middle of the EMS band. The abolition of the remaining capital controls in Denmark as from 1st October had no effect on the foreign exchange market.

The Irish pound was relatively stable at the top of the EMS band during September, with continuous small net inflows of currency. However, during October, the Irish pound weakened slightly within the band, in response to currency outflows, resulting in intervention sales. Towards the end of the month, it was announced that investment in medium and long-term securities would be fully liberalised with effect from 1989.

During the first half of September the Italian lira was weakened by substantial short-term capital outflows, fuelled by expectations of an EMS realignment, necessitating the Banca d'Italia to intervene with sizable sales of foreign currencies. Since mid-September and throughout October the stabilisation of exchange rate expectations induced substantial capital inflows and made possible a replenishment of official reserves while the lira appreciated slightly in the EMS.

Helped by modest intervention, sterling recovered from an uneasy start to September and enjoyed a period of stability until suffering from nervousness about the UK trade figures for August. In the event, the figures (published on 27th September) were not as bad as feared and sterling advanced strongly in their wake. With the Chancellor ruling out an early fall in UK interest rates, the pound displayed a firm tone during October until balance of payments concerns again resurfaced ahead of the UK trade figures for September. Once again, the figures (a current account deficit of

£560 million) were better than anticipated and sterling recovered well to end the period on a steady note. Over the two months, sterling appreciated vis-à-vis the US dollar but remained stable vis-à-vis the other European currencies. Sterling's trade-weighted index rose by 0.8% to 76.4 (1975=100).

The Greek drachma appreciated by 4.0% against the US dollar and depreciated by 1.8% against the ECU. In effective terms the drachma depreciated by 0.4% in September and by 1.0% in October.

During the first few days of September the Spanish peseta depreciated sharply, which led to intervention sales by the Banco de España. However, for the rest of the period it appreciated smoothly, driven by the increased positive interest rate differential. In all, the peseta ended 0.1% higher with respect to the ECU and 6.0% higher with respect to the dollar. On 23rd September the Banco de España raised by 1 percentage point its intervention rate for overnight funds, and on 26th September the three-month repurchase agreement rate.

The Portuguese escudo depreciated by 0.45% in effective terms during the two months - 0.25% in September and 0.2% in October - in line with the objectives defined by the authorities. Against the US dollar the escudo rose by 5.5%.

Vis-à-vis the US dollar the Swiss franc strengthened by 5.75%. On an export-weighted basis its value rose by just under 1%. Against all other currencies the franc's weakness, which had persisted for months, continued up to the end of October. On some days the Deutsche Mark/Swiss franc rate temporarily increased to the level of 85.- francs. In the last week of October a break in the trend appeared and the franc became stronger in relation to most currencies.

The Austrian schilling firmed against the US dollar by just under 6% in October. Vis-à-vis the Deutsche Mark it fluctuated by a mere 0.01%. Speculative short-term capital inflows were countered by interventions.

The Norwegian krone continued to weaken during the first days of September, but this trend was reversed later in the month. In October the krone was fairly stable despite fluctuating oil prices. The relative stability of the krone, together with a moderate expansion of domestic credit and reduced inflation, gave room for a further 0.4 percentage point reduction, to 12.4%, in Norges Bank's overnight lending rate with effect from 24th October. The interest rate differential versus the basket currencies has, during the period, been reduced by more than 100 basis points to less than 4 percentage points. In effective terms the krone weakened by 0.3%.

The Swedish krona strengthened in mid-September by about 1 percentage point as a result of the election. At the same time, short-term interest rates tended to decline and the Riksbank was forced to intervene in both foreign exchange and money markets. In October, the krona remained fairly stable, unaffected by a sharp fall in long-term money market rates as it was speculated that Sweden might be close to a further liberalisation of the foreign exchange regulations.

The Finnish markka continued to fluctuate, in effective terms, within a narrow range around the currency index level of 102. Domestic short-term interest rates rose by about 1%.

After recording the year-low of 136.80 yen per dollar (on a Tokyo-market basis) on 1st September, the Japanese yen appreciated by 8.0%, reaching Yen 125.00 on 31st October. The yen's sharp appreciation, which started in early September and continued throughout October, was attributable largely to a surge in the bullish sentiment towards the currency, reflecting lower oil prices and the various economic indicators, including unemployment statistics, suggesting a possible slowdown in the US economy. The yen appreciated by 3.3% against the ECU.

The Canadian dollar rose through September and most of October to above the US$ 0.8325 level, but has since fallen markedly to about US$ 0.8150. Underpinning the currency throughout its rise were investment-related inflows from abroad, related in part to new euro-Canadian issues, a firming of Canadian interest rates in response to domestic inflationary pressures and a widening of short-term interest rate spreads vis-à-vis the United States. Over the last week, public opinion polls have indicated that the official opposition was gaining strongly in popularity ahead of the 21st November election. This has cast some doubt over the final passage of the US/Canada free trade agreement which has, in turn, exerted considerable downward pressure on the Canadian dollar.

II. INTERVENTIONS

A. Interventions in US dollars

Net sales of US dollars by central banks in September amounted to US$ 3.9 billion, whereas in October there were net purchases of

US$ 2.6 billion. This compares with with net sales of US$ 21.5 billion in July and August. Gross purchases for September and October taken together amounted to US$ 5.7 billion, the main buyers being the Bank of Canada, the Banca d'Italia and, to a lesser extent, the Banco de Portugal. Gross sales amounted to US$ 6.9 billion, the main sellers being the Banque de France and, in September, the Banca d'Italia and, to a lesser extent, the Banco de España. In late September, a number of central banks participated also in concerted intervention sales of US dollars.

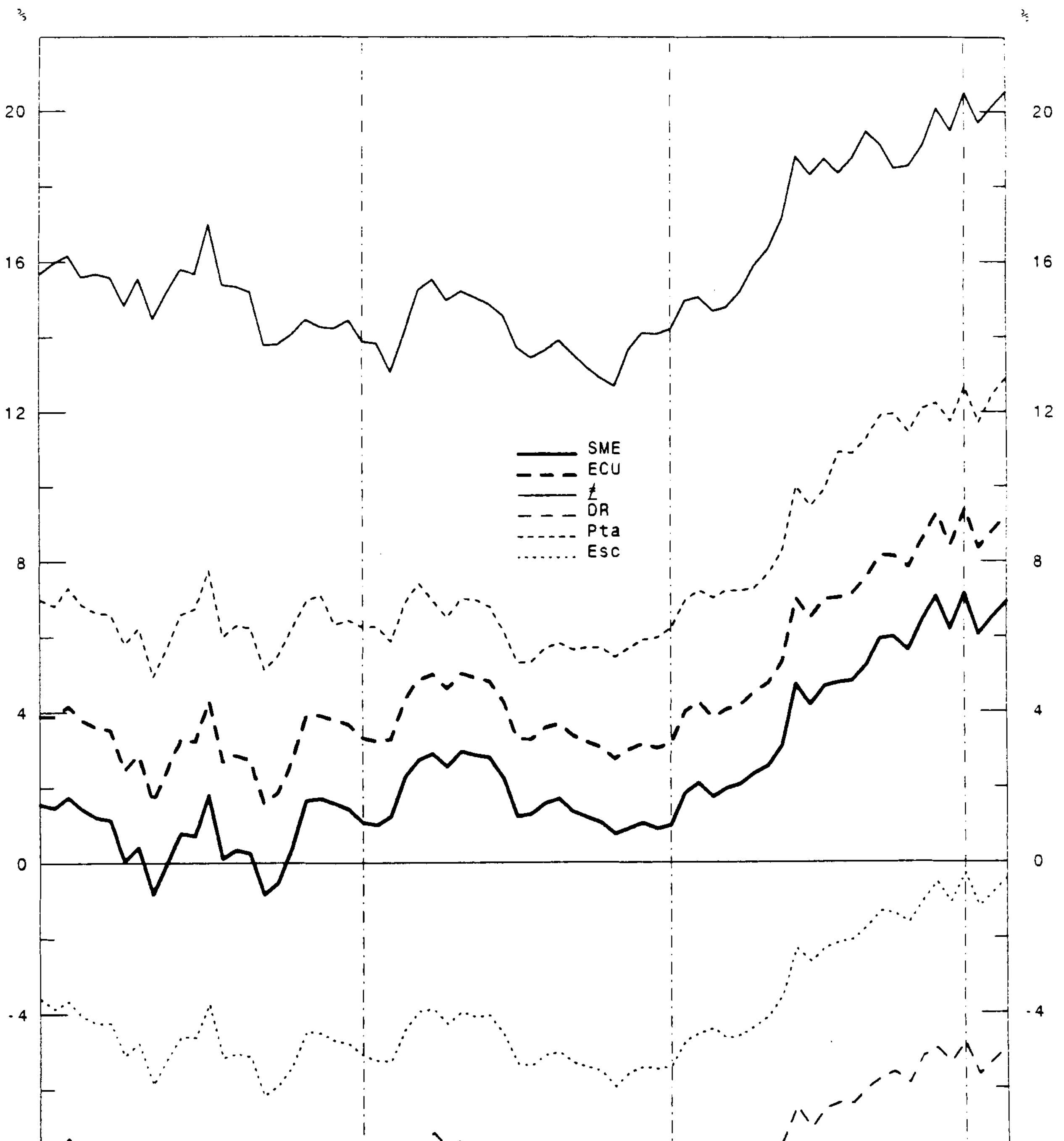
B. Interventions in Community currencies and in private ECUs

Interventions in EMS currencies and ECUs by Community central banks amounted in September and October to the equivalent of US$ 5.0 billion, compared with US$ 5.7 billion in July and August. The interventions consisted of sales of Deutsche Mark by the Banca d'Italia in the early part of September which were reversed later in the month, and of sales of Deutsche Mark by the Banque de France in October.

III. DEVELOPMENTS IN THE CURRENT MONTH, UP TO 4TH NOVEMBER

The downward pressure on the US dollar chiefly against the Japanese yen continued, which prompted intervention purchases of dollars both by the Federal Reserve and by the Bank of Japan. The release in the United States of the employment data for October has eased these pressures.

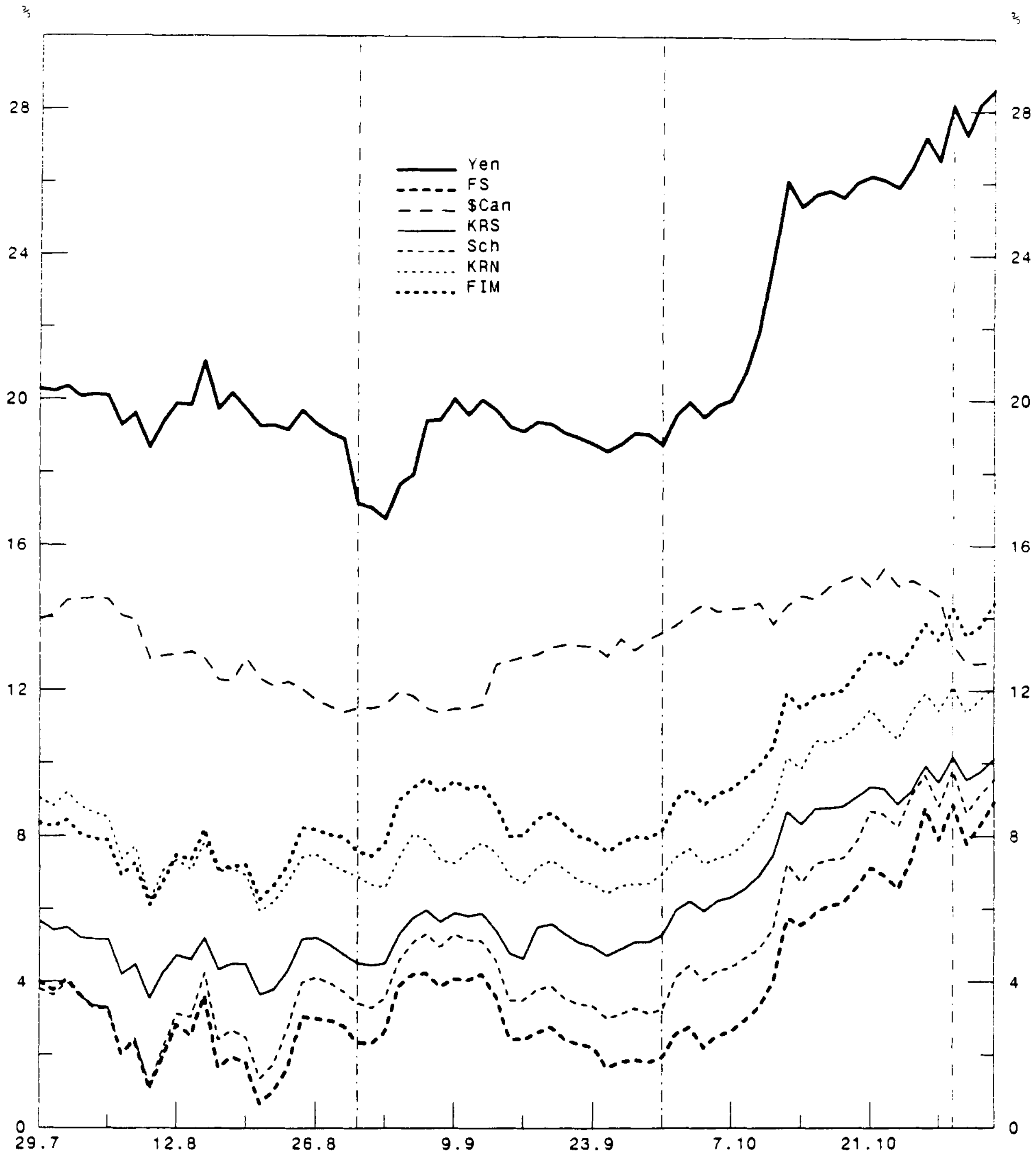
EVOLUTION DE L'ECU, DU COURS MEDIAN DES MONNAIES PARTICIPANT AU MECANISME DE CHANGE DU SME ET DES MONNAIES DES BANQUES CENTRALES DE LA CEE NE PARTICIPANT PAS A CE MECANISME, SUR LA BASE DES COURS RELEVES LE 31 DECEMBRE 1986 VIS-A-VIS DU $EU*



* Voir page suivante.

4.11.1988

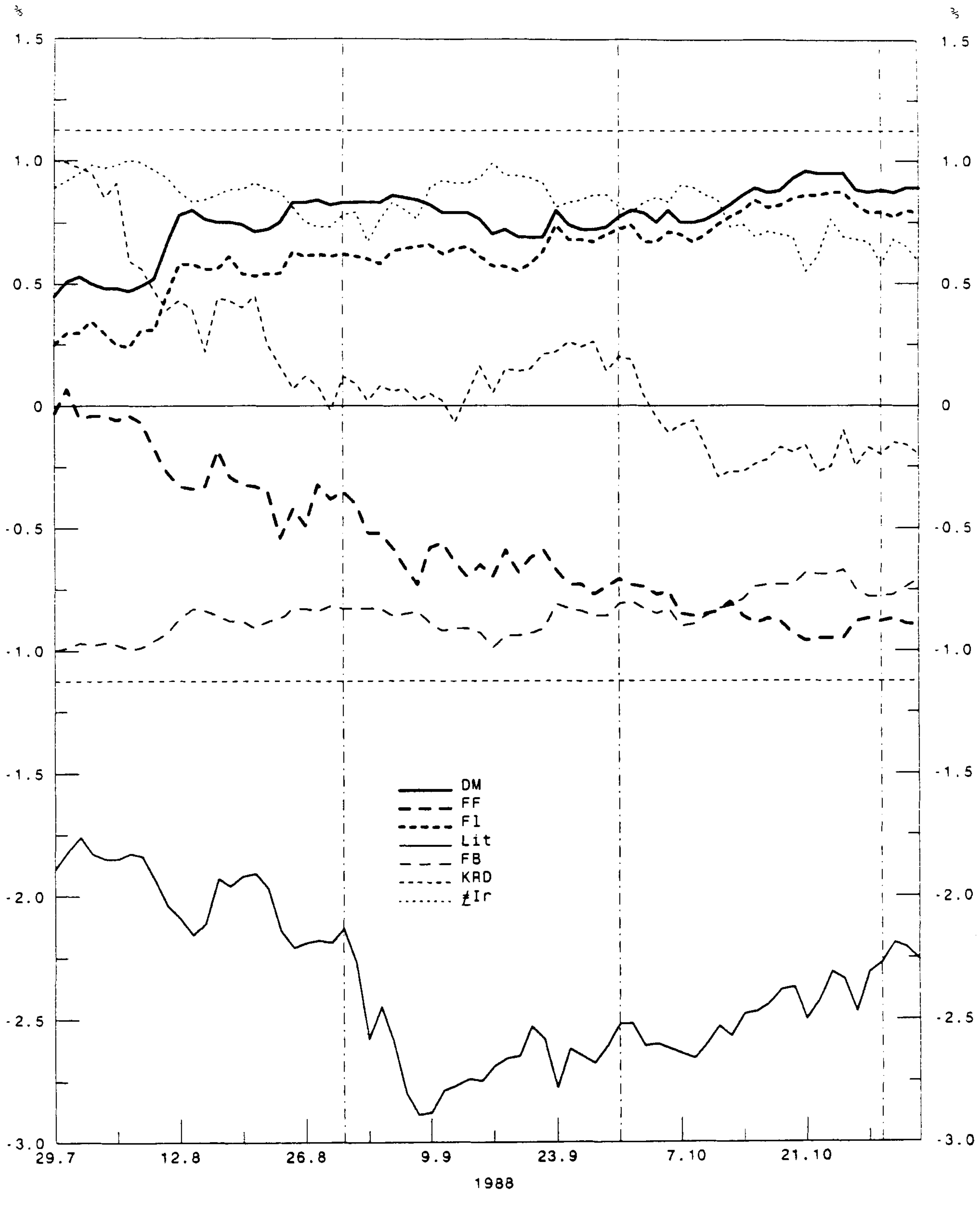
EVOLUTION DES MONNAIES DES BANQUES CENTRALES HORS CEE PARTICIPANT A LA CONCERTATION, SUR LA BASE DES COURS RELEVES LE 31 DECEMBRE 1986 VIS-A-VIS DU $EU*



* ECU 0,93425; £ 0,6773; DR 138,7601; PTA 131,8700; ESC 146,0995; FIM 4,7925; $Can 1,3805; FS 1,6215; Yen 159,7993; KRS 6,7750; KRN 7,3975; Sch 13,6520; cours médian des monnaies participant au SME 0,92913. Le cours médian des monnaies participant au SME représente la moyenne journalière des cours des deux monnaies à marge de fluctuation de 2,25% qui se sont éloignés le plus de leurs cours-pivots bilatéraux actuels.

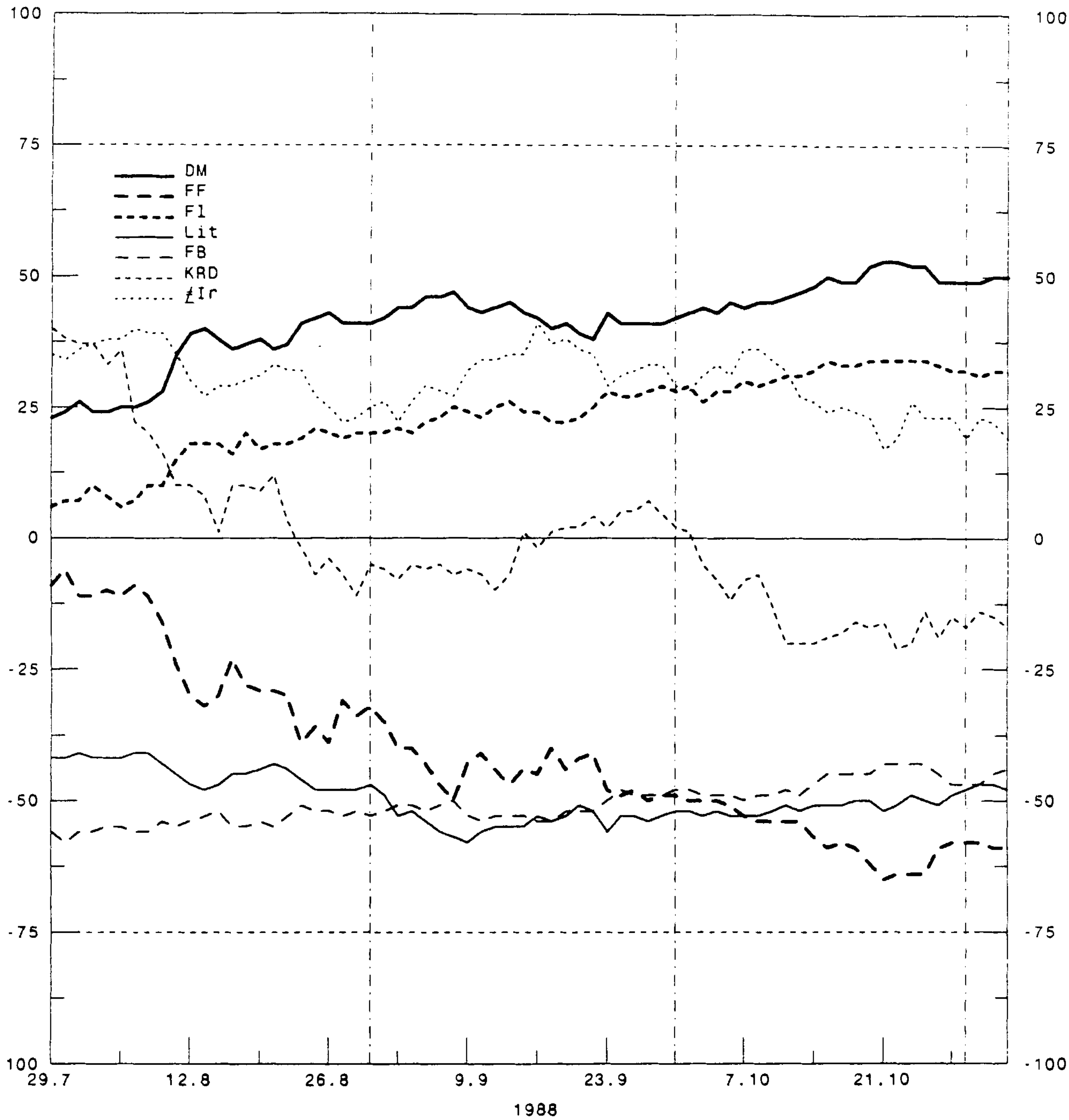
4.11.1988

MOUVEMENTS A L'INTERIEUR DE LA GRILLE DE PARITES DU SME CALCULES SUR LA BASE DES COURS DE L'ECU DANS LES DIFFERENTES MONNAIES PARTICIPANTES



4.11.1988

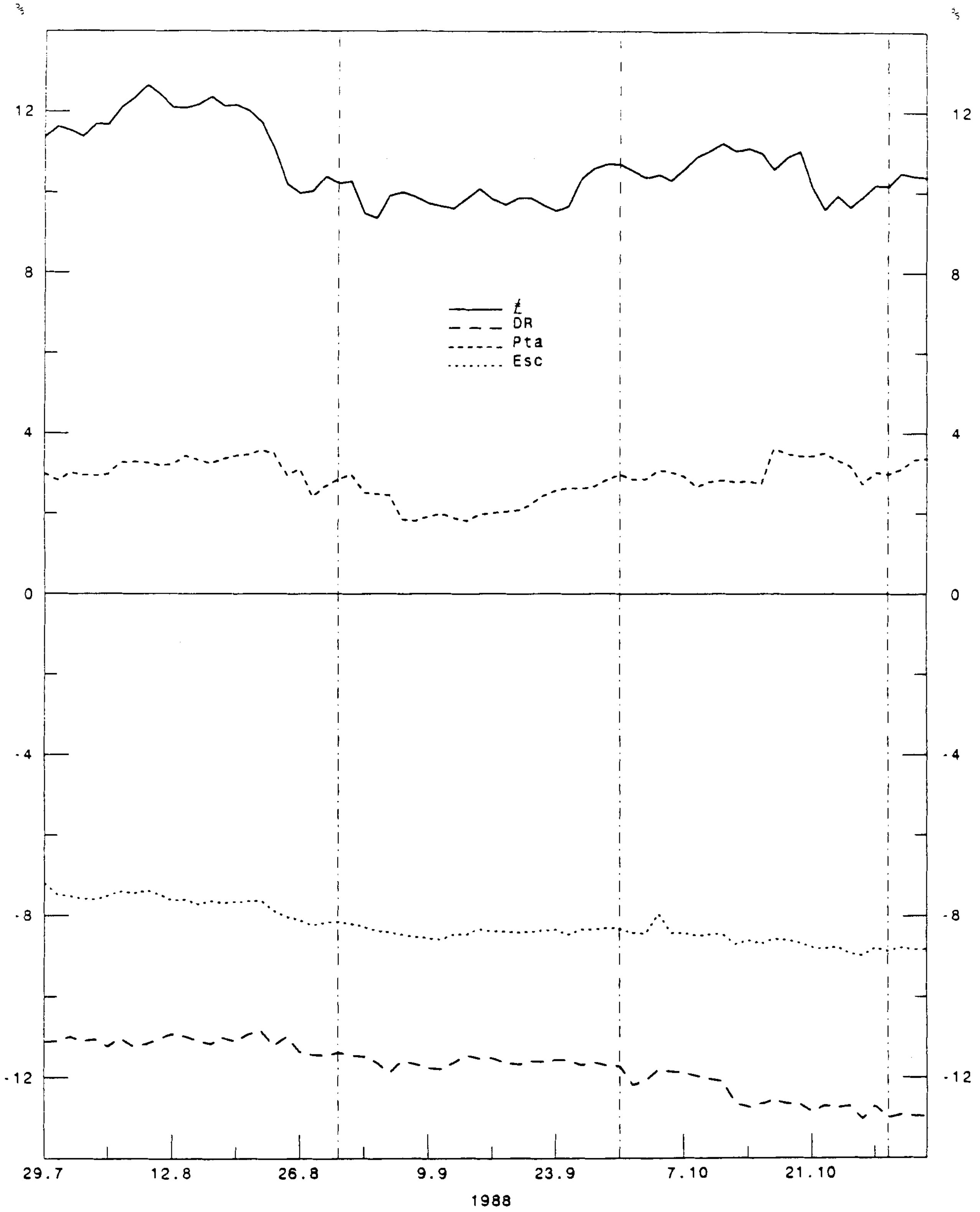
EVOLUTION DE L'INDICATEUR DE DIVERGENCE*



* L'indicateur de divergence a pour but de mesurer, sur une base comparable pour toutes les monnaies participant au mécanisme de change européen, la position d'une monnaie vis-à-vis de son cours-pivot ECU. L'écart maximal de divergence est le pourcentage maximal par lequel le cours de marché de l'ECU dans chaque monnaie peut s'apprécier ou se déprécier par rapport à son cours-pivot ECU; il est exprimé par +/-100, le seuil de divergence étant +/-75. Les données qui ont servi de base à l'établissement de ce graphique sont les cours de 'ECU exprimés en termes de diverses monnaies, cours qui sont toutefois corrigés des effets des fluctuations de la lire italienne, de la livre sterling et de la drachme grecque au-delà de la marge de 2,25% vis-à-vis des autres monnaies participant au SME.

4.11.1988

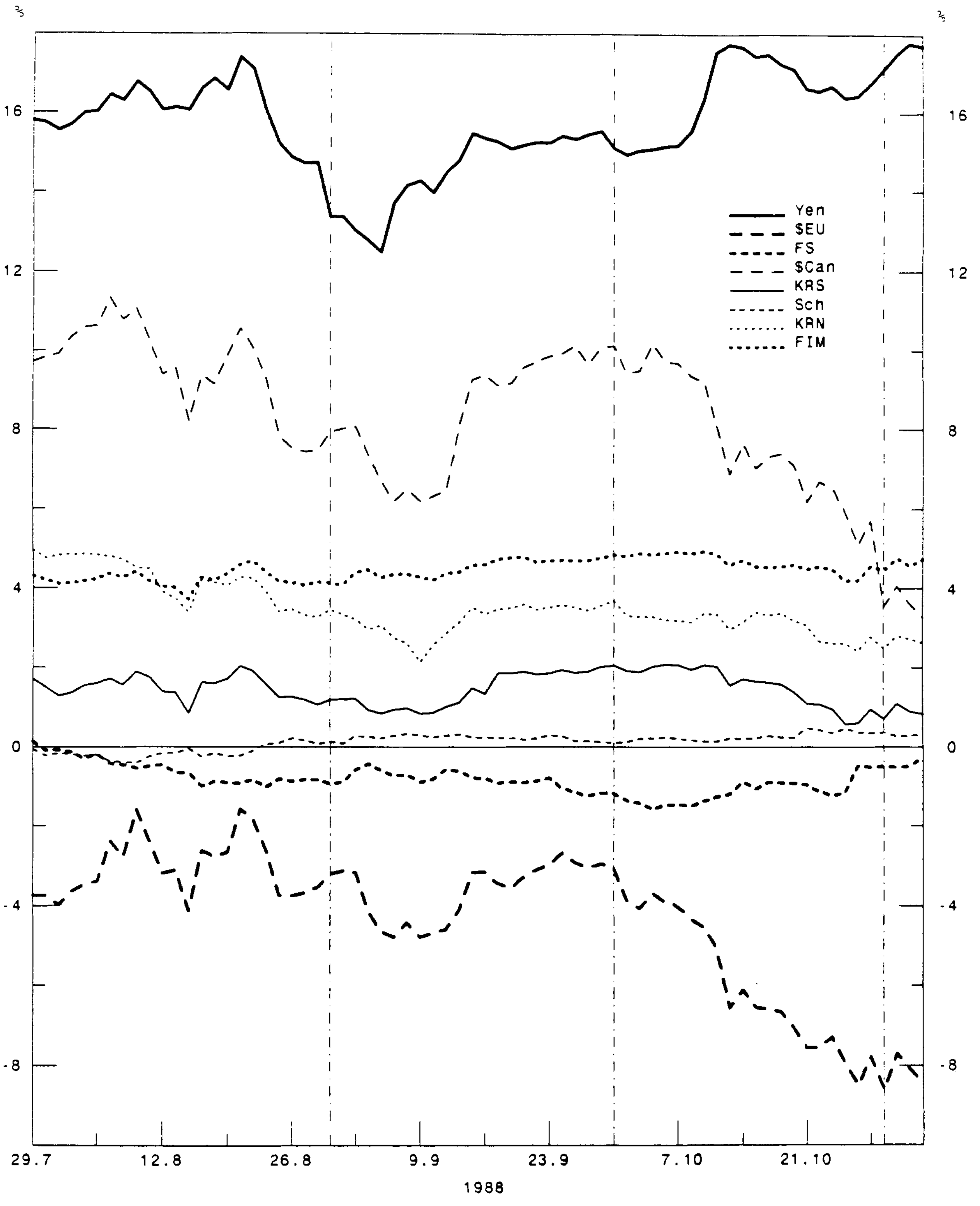
EVOLUTION DE LA LIVRE STERLING, DE LA DRACHME, DE LA PESETA ET DE L'ESCUDO PAR PAPPORT A L'ECU SUR LA BASE DES COURS DU MARCHE RELEVES LE 31 DECEMBRE 1986*



* £ 0,724942; DR 148,526; PTA 141,151; ESC 156,382.

4.11.1988

EVOLUTION DES MONNAIES DES BANQUES HORS CEE PARTICIPANT A LA CONCERTATION PAR RAPPORT A L'ECU SUR LA BASE DES COURS DU MARCHE RELEVES LE 31 DECEMBRE 1986*



* $EU 1,07038; $Can 1,47766; FS 1,73562; Yen 171,046; KRS 7,25181; KRN 7,91812; Sch 14,6128; FIM 5,12978.

4.11.1988