Confidential

(Translation)

MINUTES*

OF THE 237th MEETING OF THE COMMITTEE OF GOVERNORS
OF THE CENTRAL BANKS OF THE MEMBER STATES
OF THE EUROPEAN ECONOMIC COMMUNITY
HELD IN BASLE ON TUESDAY, 11th JULY 1989 AT 9.30 a.m.

Those present at the meeting were: the Governor of the Bank of Greece and Chairman of the Committee, Mr. Chalikias, accompanied by Mr. Papademos, Mr. Karamouzis and Mr. Brissimis; the Governor of the Banque Nationale de Belgique, Mr. Verplaetse, 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 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. Boot; the Governor of the Banco de Portugal, Mr. Tavares Moreira, accompanied by Mr. Pêgo Marques and Mr. Amorim; Mr. Crockett, Executive Director of the Bank of England, accompanied by Mr. Price; the President of the Commission of the European Communities, Mr. Delors, accompanied by Mr. Carré and Mr. Dixon; the Director General of the Luxembourg Monetary Institute, Mr. Jaans; Mr. Kees, Secretary of the Monetary Committee. Also present at the meeting were Mr. Dalgaard and Mr. Raymond, 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.

---

* Final text approved at the meeting on 12th September 1989, which incorporates some drafting changes.

The Chairman opened the meeting by welcoming Mr. Verplaetse, the new Governor of the Banque Nationale de Belgique. The Governors were familiar with the important role which Mr. Verplaetse had been playing for many years in shaping Belgium's economic policy and they looked forward to benefiting from his wide experience.

It was also fitting to welcome the peseta into the EMS exchange rate mechanism. In taking this decision, Spain was aiming to achieve low inflation and promote stability and was therefore contributing towards strengthening the co-ordination and convergence of monetary policies within the Community.

Mr. Rubio thanked the Governors for their co-operation which had made the peseta's entry into the exchange rate mechanism possible. Despite the doubts that might have existed regarding the procedure to be followed, the operation had in fact been executed with the necessary speed and efficiency. The Spanish decision might have appeared somewhat rash, given the rate of inflation in Spain, but on the one hand it had been prompted by those who, particularly on the "Delors Committee", had argued in favour of action, not just words, and on the other it reflected the authorities' conviction that this was the best way of securing economic stability and disinflation. In this context, a few days after the European Council meeting in Madrid, the Government had announced a tough budget for 1990. The policy mix, which had hitherto been somewhat problematic in that monetary policy had been bearing most of the burden, should therefore improve. The Government had already taken fiscal measures on 7th July aimed at reducing domestic demand by approximately 1% of GDP. On the same date the Banco de España had adopted measures to siphon off liquidity by raising its money market intervention rate by 0.75% to 14.5% and increasing the minimum reserve requirement from 18 to 19%. The Spanish authorities were aware of the need to reduce inflation as quickly as possible in order to avoid creating problems within the EMS.

VI. Exchange of views on the follow-up to the European Council

The Chairman proposed that the agenda be re-arranged to begin with item VI, "Exchange of views on the follow-up to the European Council", for, at the ECOFIN Council meeting held on 10th July, an extremely tight timetable had been agreed for the preparatory work required for the first stage of economic and monetary union, which meant that, if the Committee of

Governors intended to play an active role in this work, the Governors should agree on a programme as quickly as possible. The Commission was to present the Presidency of the Council with a working paper by the end of July. A preliminary discussion was to be held at the informal Council meeting scheduled for 9th and 10th September. The Commission would then present its proposals, including the legal texts, on which the Committee should express its views by the end of October at the latest. If the Committee accepted these suggestions, it could first hear what the President of the Commission, Mr. Delors, had to say about the decisions adopted by the European Council in Madrid, and then discuss the work programme. A few words could, however, be said beforehand regarding yesterday's ECOFIN Council meeting. This restricted session had been devoted to a discussion of economic and monetary policies and their convergence, in other words to a multilateral surveillance exercise. In his capacity as Chairman of the Committee of Governors, Mr. Chalikias had been invited to take part in this meeting by Mr. Bérégovoy, the President of the Council; a copy of the letter containing the invitation was being given to the Governors here. As he had indicated in his letter, Mr. Bérégovoy had confirmed at the meeting that he intended to invite all the Governors to participate in the next surveillance exercise, which could be held some time in the autumn, again in restricted session. The Chairman had not reacted to this proposal, so as to give the Governors the opportunity of discussing it here first.

Mr. Delors gave a brief account of the European Council's Madrid meeting. The Governors had been able to judge at S'Agaró what the position of each country had been: in particular, there had been either a certain hostility to the proposals contained in paragraph 39 of the report on economic and monetary union, or reservations or conditions posed by certain countries. From that point of view the situation had, between S'Agaró and Madrid, developed positively, enabling a consensus to be reached in a very good atmosphere which contrasted with the barbed comments exchanged following publication of the report. In view of the lack of agreement on taking paragraph 39 of the report as a basis and given the positive development in certain countries, three points, which were closely linked to the report, had been proposed in Mr. Delors' conclusion:

(1) the single process of creating economic and monetary union (EMU) was initiated by a clear single commitment contained in the conclusions of the European Council meeting;

(2) the European Council accepted paragraphs 64 to 66 of the report, which had been proposed by Mr. Duisenberg;

(3) the European Council accepted that the first stage would commence on 1st July 1990, coinciding with the completion of the liberalisation of capital movements.

The European Council had accepted these three conclusions and had thus confirmed its commitment and that of the twelve Member States to moving forward towards EMU. Since paragraph 39 had not been accepted, the report did not form the basis for the work that was going to be embarked upon but was a good basis for that work. In the Council's conclusions three important principles had been restated:

- the need for parallelism between economic and monetary union, this emphasis being particularly necessary since, between the publication of the report and the Madrid Council meeting, it had been argued by some that it was sufficient to establish monetary union and economic union would follow automatically; this argument had not been accepted by the Heads of State or Government, who had themselves placed the emphasis on parallelism;
- the principle of subsidiarity (some criticised the report for taking too centralised a view of EMU);
- allowance should be made for specific situations, i.e. the transitions that some countries would have to make.

The European Council had decided that the preparatory work should commence immediately, making a clear distinction between the first and subsequent stages.

With regard to the first stage, Mr. Delors had pointed out to the Ministers of Finance on 10th July, in the presence of the Chairman of the Committee of Governors, that it was for this Committee to deliberate and make proposals, in collaboration with the institutions of its choice, on how to improve or amend the Council Decision of 8th May 1964. Yesterday, the Ministers of Finance had laid down a timetable, but had left it to the Committee of Governors to consider how to apply the principles of the first stage. These principles, set out in the report, were as follows. At the economic level: achievement of the internal market and a strengthening of competition policy, the pursuit of policies aimed at greater economic and social cohesion, and the implementation of a new convergence procedure. At the monetary level: the realisation of the common market in financial services, enlargement of the exchange rate mechanism to include all the member countries, removal of the impediments to the private use of the ECU, and organisation of the Committee of Governors. It was on this basis, since the report had been accepted insofar as the first stage was concerned, that each institution concerned was to proceed.

Work would have to commence concurrently in respect of the subsequent stages, which did not mean stages two and three of the report, since those stages had not been unanimously agreed. It had appeared that, if the report's definitions of EMU were accepted, five main questions were open to discussion and debate and might be the subject of counter-proposals from certain Member States.

(1) To what extent was EMU to be centralised and, depending on what was decided in that regard, how was this to be reflected at the institutional level (creation of a European system of central banks, strengthening of existing economic institutions or the creation of a new institution). In this respect, the binding rules proposed in the report in the budgetary field had led in Madrid to fears that this would lead to a state with a federal structure. In fact, in a federal state 60 to 70% of public spending took place at federal level, while under EMU in the form proposed the proportion would be only 3 to 4%. This put the problem of centralisation into perspective and showed that governments would, via their fiscal policies, remain master of their policies to a large extent, for example in the areas of internal security, education, social security and health.

(2) Democratic accountability, i.e. the question of who was accountable to whom. This question was very important, particularly to the United Kingdom, and simply to say that the powers of the European Parliament would be strengthened was no answer. It was more complicated than that, since the national parliaments had to be involved in this process, given the present conception of Europe.

(3) The role of supporting policies. This question had been dealt with in the report, in which the various criteria determining the location of investment and economic activity had been set out. However, it was as 1992 approached that one would know whether the structural policies introduced with the European Council's Decision of February 1988 had produced the anticipated positive effects.

(4) The content of the compulsory economic and monetary rules. Two governments were somewhat alarmed by the scope of the obligations arising from EMU as conceived in the report, judging it to be excessive insofar as they were concerned.

(5) The common currency. Was one necessary and would it be the ECU? This too was a controversial question.

These questions, which had emerged more clearly in Madrid than in S'Agaró, were inherent in the definitions of EMU given in the report. It seemed that one country at least, namely the United Kingdom, was going to make counter-proposals which would call these definitions into question. There could be other approaches to EMU, entailing a redefinition of the concept. It was therefore necessary to distinguish between the controversial questions inherent in the definitions given in the report and the questions which might be raised by another general approach to EMU.

In Madrid the future of the construction of Europe had also been discussed in connection with EMU. Some would have liked a more binding timetable, because they wanted to go further in the construction of Europe and for them EMU was a necessary step in that direction.

Mr. Delors said that he was at the Governors' disposal if they wanted further details of the European Council's discussions and that the Commission was at the Committee's disposal to assist in the review of the Decision of May 1964. Of course, as had been said to the Ministers, it was for the Committee to take the initiatives required in this area. They would all be working under the constraint arising from the decision of the Ministers of Finance to devote the whole of the next informal ECOFIN Council meeting, to be held in Antibes on 9th and 10th September, to discussion of these questions. The political objective was that at the European Council meeting in December in Strasbourg the Heads of State or Government should be able to note that the preparatory work for the first stage had been completed and that the new texts would be adopted before the end of 1989.

The Chairman thanked Mr. Delors for the very interesting information he had presented and proposed that they commence discussion of the work programme. First of all, it should be stressed that the Committee should participate in all phases of the preparations for the implementation of the first stage of EMU, which meant that the Committee should examine and give its opinion on the Commission working paper and the draft legal texts, particularly regarding the monetary aspects, before they were referred to the Council Presidency. On this point, the remarks made by Mr. Delors had been reassuring. The new Decision that was to replace the May 1964 Decision defining the mandate of the Committee of Governors should formalise the Committee's present functions and organisation, while at the same time securing its status and strengthening its authority and autonomy. It would also be desirable for the new Decision to contain only general rules or guidelines, in order to provide the flexibility and adaptability needed for the Committee to function and carry out its work. Furthermore, it would appear necessary to strengthen the Committee's present Secretariat by recruiting, or seconding to Basle from central banks, a small number of highly qualified, experienced economists, who would be able to assess monetary conditions and assist the Governors in formulating monetary policy for the Community as a whole. It would be especially necessary to strengthen the Secretariat if the Committee extended its activities to embrace new sectors, as had been proposed in the report on EMU. Lastly, the three sub-committees referred to in the report would have to be set up, the aim being that their work should be policy-oriented and forward-looking.

In view of the very tight timetable, it seemed advisable to call upon the Alternates to begin work on preparing the first stage and present an interim report at the beginning of September. The Governors would discuss that report before the informal ECOFIN Council meeting to be held on 9th and 10th September. The date and venue for these discussions could be fixed later, after consultation. It seemed clear that priority should be given to the technical and legal aspects of the questions relating to the Committee's activities in the first stage and to ways of ensuring parallelism between the economic and monetary aspects. Later, the Alternates could draw up a list of questions to be examined in connection with the preparations for the inter-governmental conference.

Mr. de Larosière thanked the Chairman for having set out his views on the work to be done so clearly, views which he broadly shared, and the President of the Commission for his very clear and full statement on the Madrid European Council meeting and the questions which were now outstanding; he wished to highlight a few points. In the first place, the Committee had to play a bigger part in co-ordinating Member States' monetary policies, which meant giving the Committee a stronger, more tangible and more visible influence over monetary events than had characterised its work hitherto. This increased influence could be achieved in a number of ways.

First of all, the Committee must be seen as a real committee, with a profile and an independence that made it a very serious partner; all the Committee's actions should be guided by this principle. Secondly, the Committee must be equipped both intellectually and technically to play an active, forward-looking role in the co-ordination of monetary policies. To that end, as the Chairman had indicated, a real economic secretariat would be needed, not just a logistical secretariat, excellent though it was (and here tribute could be paid to Mr. Bascoul). Something more structured would be necessary, some highly talented economists seconded from the central banks who could advise the Governors on how to formulate a better European economic policy. It was not a matter of creating an administrative behemoth but of assembling a small number of first-class individuals, with a solid grasp of the issues and with whom the three sub-committees would have to conduct a dialogue in a forward-looking, action-oriented spirit. In this connection, the idea of asking the Alternates to prepare proposals for action on all these questions for September was an excellent one.

With regard to the drafting of the new Decision that was to replace the May 1964 Decision, the Governors had to be extremely vigilant, as this was a basic text, which was intended in particular to mark the strengthening of the Committee. The Governors should therefore examine this text carefully before it was submitted to any Community authority. In fact, the drafting of the text should not be particularly complicated, since the 1964 Decision was well drafted and little would be needed to update it. The experts could do that in a matter of days and, in conjunction with the Commission, propose a text which could be agreed to by the Governors.

Lastly, the parallelism between the economic and monetary aspects had to be fully respected. This was one of the fundamental elements of the report on EMU and, from that point of view, the multilateral surveillance exercise which the Ministers of Finance had just undertaken was very important. If progress was to be made on both fronts - economic and monetary - it was necessary for the Council of Ministers to take care of the Community's macro-economy and for the Committee of Governors to deal with monetary policy. The more these two bodies were strengthened, the better. The standard of the first multilateral surveillance exercise which had taken place at the ECOFIN Council meeting on 10th July was therefore gratifying, and it was to be hoped that the Ministers of Finance on the one hand and the Governors on the other would emulate one another to create two centres for economic and monetary action that would enable progress to be made.

Mr. Ciampi endorsed the Chairman's remarks and had noted with pleasure the information given by Mr. Delors. It was now necessary to work swiftly and in depth, in order to mark out the way ahead in accordance with the principles adopted in the report for the first stage of EMU. The Alternates therefore had an urgent job to do, the broad lines of which could already be laid down today, leaving further details until later. The Governors had to be well-prepared and ready for the next ECOFIN Council meeting and, to begin with, for the informal meeting on 9th and 10th September. If problems raised by the Alternates had to be resolved, the Governors could hold a teleconference, given the conclusive experience in connection with the entry of the peseta into the exchange rate mechanism. The consensus that existed on moving from ex post analysis to an ex ante approach could only be welcomed. The Banca d'Italia had long been strongly recommending this approach, which was necessary to make progress towards a common economic policy and, above all, a common monetary policy. It would also be necessary to take administrative measures and establish a nucleus of young and enthusiastic staff, which would support the office of the Chairman of the Committee of Governors and report directly to it. The three sub-committees would have to co-ordinate their activities with this general staff and would present their proposals, which the Governors could be called upon to adopt as the work proceeded.

Mr. Duisenberg thanked the Chairman and the President of the Commission for the explanations they had given and agreed with Mr. de Larosière and Mr. Ciampi regarding the work to be done immediately. The timetable adopted by the Ministers of Finance was tight but it was necessary to adjust to it. The first job was to revise the Decision of 8th May 1964. This text already gave a very wide mandate to the Committee of Governors and would enable it to do virtually everything proposed in the report on EMU. However, paragraph 52 of the report provided for the replacement of the Decision of 8th May 1964. The new Decision should reaffirm the broad principles underlying the Committee's tasks and would have to be followed, as had been done in October 1964, by the adoption by the Committee of rules of procedure corresponding to the new framework.

Strengthening the Committee's role in the texts did not seem to present any difficulties, as the main points were already contained in the three indents of paragraph 52 of the report. The Alternates should begin immediately with the drafting in collaboration with the Commission, so that the Governors could come to an agreement before the informal ECOFIN Council meeting. The main aim was to strengthen the Committee; the procedures, the reinforcement of the Secretariat with a small number of additional staff were also necessary, but this had to be left to the Committee, which would decide when the time came.

Mr. Duisenberg turned to the letter from Mr. Bérégovoy to the Chairman of the Committee. He noted that the basic principle in the report on EMU was that a future European system of central banks should be autonomous and independent. In the Netherlands, for example, the independence of the central bank was highlighted by the fact that its President carefully refrained from participating in government meetings. If this national example was taken as a basis, it would be sufficient for the Committee to be represented at ECOFIN Council meetings by its Chairman, who would express the collective opinion of the Governors. Mr. Duisenberg indicated that he was not particularly in favour of participating in or being present at the Council's multilateral surveillance exercises and that he would consider himself to be fully represented by the Chairman. If the Committee agreed, a reply along these lines could be made to Mr. Bérégovoy.

The Chairman broadly shared Mr. Duisenberg's view on participation by the Governors in the multilateral surveillance exercises and wanted to know what the other Governors felt about this, so that he could reply to Mr. Bérégovoy. The amendments to be made to the Decision of 8th May 1964 could be fairly minor and, as in 1964, the Committee could determine the rules of procedure at a later date.

Mr. Pöhl thanked the Chairman and Mr. Delors for the very useful information they had given and agreed with most of what had been said around the table, except for the idea of urgency, however. There was no emergency at present and it was very important to discuss the consequences of the decisions to be taken by the Governors very carefully. The Council Decision concerning the Committee of Governors and how it should be strengthened was perhaps the only relatively urgent item; however, this was a legal text, which had to be prepared very seriously in view of the wide-ranging consequences it could have. It would be possible to do without a new text and accomplish what was proposed in the report on EMU with the Decision of 8th May 1964, but a new Decision might be of greater symbolic importance if the Council not only confirmed the content of the 1964 text but also clearly affirmed the objective of a Committee of Governors with a higher profile both in the eyes of the public and in the decision-making process in Europe, and if, moreover, it expressed the desire of the governments, particularly the Ministers of Finance, to strengthen the independence of the national central banks. This last aspect was also referred to in the report on EMU but had not been raised in the public discussions. And yet it was a very important point, as a more independent Committee of Governors, representing a kind of nucleus of the future European system of central banks, was not possible unless its members enjoyed sufficient independence in their own countries. This point was crucial and must be taken into account by the President of the Commission and all those responsible.

The main aspects of the new Decision had been described in the report on EMU and could be briefly summarised as follows: the Committee would be empowered to formulate opinions for the Ministers on those policies that might affect, in particular, the operation of the EMS; it would also formulate opinions on national monetary policies which, although not binding, would certainly carry moral weight. Finally, the Committee should be invited to draw up not a common monetary policy right away, but a convergent monetary policy. Domestic monetary policies would remain the responsibility of the individual central banks, but the Committee would satisfy itself that those policies were consistent, in particular with the basic objectives contained in the report, especially price stability. It would be useful for all these aspects to be formalised in the new Council Decision. Once it had been adopted, the Committee would be able to decide freely, without instructions from the Council, how to organise its work, i.e. what sub-committees should be set up and what staff would be needed. As had already been said, a kind of intellectual basis seemed necessary in order to prepare the groundwork for the formulation of convergent monetary policies. This could of course be done within the Committee itself, but it might be useful to have a small competent, independent group of, say, economic advisers, to prepare that formulation. Careful thought would have to be given to the status to be assigned to the staff in question. For example, should they be BIS officials or, preferably, have a rather more independent status? All these aspects would have to be discussed by the Alternates.

It would be very important to find ways of expressing in an appropriate manner the views of the Governors, both at ECOFIN Council meetings and publicly. If the Governors never appeared in public but left that to the Ministers, they could not expect to be known or to be perceived as being involved in the development of a European system of central banks. This aspect perhaps reflected more the experience in Germany but it was important; for example, if the Governors obtained the support of public opinion in formulating a prudent monetary policy geared to stability, governments could not ignore it.

From that point of view, Mr. Bérégovoy's letter was not an appropriate approach and was at odds with the report's proposals for a more independent Committee of Governors in the process leading to economic and monetary union. The participation of all the Governors in these ECOFIN Council meetings would weaken the Committee. The reply to Mr. Bérégovoy should therefore indicate that at least some of the Governors felt that they were quite satisfactorily represented by the Chairman of the Committee. It could also be pointed out that the Governors met the Ministers twice a year at the informal ECOFIN Council meetings. Furthermore, a question of principle arose: it was not acceptable that the multilateral surveillance exercises undertaken by the Ministers of Finance and prepared by the Commission should include monetary policies. In Germany, it would be totally inconceivable that monetary policy should be subject to surveillance by the Minister of Finance, and the same should apply in Europe.

Mr. Pöhl concluded by saying that he agreed that the Alternates should begin their discussions on the organisation of the Committee's work but that, in the immediate future, the most important thing was to prepare the new Council Decision replacing that of May 1964 in the right spirit of co-operation emphasised by Mr. Delors, taking into account the points already described and approved by the Governors.

The Chairman suggested that the Governors should hold a meeting, in conjunction with the informal Antibes meeting, perhaps on Friday, 8th September, in order to review all the subjects, but this suggestion would have to be looked at again, as certain Governors were not sure whether they would be free to attend.

Mr. Hoffmeyer shared Mr. Duisenberg's view that they should confine themselves to amending the Decision of 8th May 1964 by incorporating the three indents of paragraph 52 of the report. He would like to know whether the Commission also shared this view and whether it was necessary or expedient to inform the ECOFIN Council that the other points contained in paragraph 52 would be taken into account at a later stage, when the Committee revised its rules of procedure.

Mr. Crockett expressed Mr. Leigh-Pemberton's regret at being unable to attend and thanked the Chairman and the President of the Commission for their very illuminating statements. The United Kingdom was prepared to proceed in accordance with the set timetable, tight though it was. However, as Mr. Pöhl had pointed out, there was no need to rush the decisions on procedures, structures and organisation. Building for the future should not be done hastily but on the contrary time should be taken to do a meticulous, responsible job. The Alternates should therefore deal with the questions, even if this meant holding meetings in the summer in order to make progress according to schedule.

With regard to participation by the Governors in the ECOFIN Council meetings, Mr. Crockett understood the reasons put forward by certain members against such participation, but he wished to reserve the Governor's position on this point and would therefore prefer a qualified response to Mr. Bérégovoy's letter.

Mr. de Larosière came back to this question of participation by the Governors in ECOFIN Council meetings. Mr. Pöhl's and Mr. Duisenberg's remarks were quite understandable, but it would nevertheless be useful to carry out a multilateral surveillance exercise, for example, at the informal ECOFIN Council meetings, where Ministers and Governors were together. The Governors participated in this type of exercise within the Group of Seven and the idea of taking part in a macro-economic co-ordination exercise at Community level should not be rejected. It was understandable that some Governors were reticent about participating systematically in numerous ECOFIN Council meetings and preferred to be represented by the Chairman of the Committee. However, the Ministers of Finance should not be discouraged from involving the Governors in a macro-economic exercise that would be undertaken at lengthy intervals. An attempt could be made to centre this exercise on the informal meetings that were often taken up by fiscal matters, to which the Governors were unable to make any contribution. It would therefore be advisable, as suggested by Mr. Crockett, to maintain an open position in response to Mr. Bérégovoy's letter.

Mr. Doyle broadly agreed with Mr. de Larosière's approach and felt that a distinction could be made between participation by the Governors, for which representation by the Chairman of the Committee would be preferable, and their presence, which could be more acceptable. In any case, this matter could be left open, as it deserved further consideration.

Mr. Doyle asked Mr. Delors to specify the texts which, in accordance with the wishes of the European Council, would have to be revised by the end of 1989 and wished to know how urgent this area was.

Mr. Ciampi explained that the urgency of the work of the Alternates to which he had referred applied only to what had to be ready for the forthcoming informal ECOFIN Council meeting. As regards the internal organisation of the Committee, which was solely the responsibility of the Governors, there was more time for discussion and the necessary time would have to be devoted to it, which would take until well after September.

With regard to Mr. Bérégovoy's letter, the remarks made so far suggested that a somewhat negative reply should be given, but without ruling out the possibility of a co-ordination or multilateral surveillance exercise with the participation of the Governors on certain occasions, such as the informal ECOFIN Council meetings. The greater autonomy which the Governors intended to pursue, at both the national and Community levels, meant that they should avoid adopting positions which could be interpreted by outsiders as an admission of weakness, the admission perhaps that the Governors were unable to exert and affirm this autonomy in all circumstances. Consequently, if it was felt that a multilateral surveillance exercise could be organised within the framework of an informal Council meeting, this possibility should not be ruled out; on the contrary, it should be tried, to verify whether such an exercise was in fact a way of limiting the Governors' autonomy.

Mr. Rubio endorsed the observations made by Mr. Duisenberg regarding the implications and drawbacks of participation by the Governors in the ECOFIN Council meetings; it would be very difficult, in such circumstances, to express divergent views and participation could then be reduced to a mere silent presence. To state, however, that the Governors did not wish to participate in, or even be present at, the multilateral surveillance exercises, was a delicate matter. The reply to Mr. Bérégovoy's letter could therefore be delayed, so that more thought could be given to it. As Mr. Pöhl had suggested, it could perhaps be discussed at Antibes in order to find a formula which would leave the future open.

Mr. Pöhl stressed that he saw the question in different terms. The issue was not about participation in this or that ECOFIN Council meeting; until the early 1970s the Governors had participated regularly but without being able to make a real contribution, and therefore the practice had fallen into disuse. This was a very important question of principle: the President of the Deutsche Bundesbank could not accept that the monetary policy conducted in Germany should be subject to surveillance either by the Commission or by the Ministers of Finance; such a procedure was incompatible both with the law in the Federal Republic and with the independence of the Bundesbank. The Governors must emphasise very clearly that co-ordination and surveillance of monetary policies was the sole responsibility of the Committee. Of course, the Chairman of the Committee would present the results of this co-ordination and surveillance process to the Ministers, but they must not and could not participate in it. The Chairman of the Committee should therefore reply along these lines to Mr. Bérégovoy, for there should be no misunderstanding in this area. If the Committee intended to have a higher profile, it had to be independent of governments and Ministers of Finance. This in particular was a very important test of the strengthening and independence of the Committee.

In the Federal Republic this question of principle was fundamental, and it was quite inconceivable that the Government should undertake surveillance of the Bundesbank's monetary policy. If the Minister of Finance wished to make a contribution, he could attend a meeting of the Central Bank Council. He had no voting right but could express opinions; the Council took them into consideration and decided as it saw fit. Clearly there was no question of the President of the Bundesbank then going to an ECOFIN Council meeting and having to justify himself in that forum and explain that the measures taken recently were reasonable.

Mr. Verplaetse concurred with Mr. Duisenberg's proposal regarding participation by the Governors in the formal ECOFIN Council meetings. If the prestige of the Committee was to be increased, the prestige of its Chairman also had to be increased. To that end, the term of office of the Chairman could be lengthened. Increasing the prestige and profile of the Chairman might perhaps help resolve the problem in a non-dogmatic manner.

Mr. de Larosière recognised that Mr. Pöhl could not agree to a national or European body dictating to the Bundesbank what it had to do, as that was incompatible with its charter. Since there was no urgency about replying to Mr. Bérégovoy's letter, the Governors could reflect upon the following idea. If monetary policy was to be geared to ex ante Community analysis, it would be desirable to participate, say twice a year, in an ECOFIN macro-economic exercise during which one would seek to clarify the Community's objectives with regard to growth and stability, to achieve EEC macro-economic cohesion, but not to specify the monetary policy to be conducted by a particular country. In fact, some EEC countries already undertook this type of exercise within the framework of the Group of Seven, without regarding it as a violation of the central banks' independence. The Governors should therefore approach the question raised in Mr. Bérégovoy's letter pragmatically and try to find a positive, constructive solution, such as the idea of undertaking the multilateral surveillance exercise at the informal ECOFIN Council meetings in which the Governors participated in any case. Such an approach would not encroach upon the independence of the Governors and would not affect the quality of their work; it would also avoid getting embroiled in a kind of conflict which seemed unnecessary.

<u>Mr. Tavares Moreira</u> agreed that the question was a delicate one and that, as Mr. Pöhl had stated, it was the true test of the independence of the Committee and the central banks. Two aspects could be distinguished, however:

- on the one hand, the Governors could rule out regular participation in the formal ECOFIN Council meetings devoted to multilateral surveillance, since they were fully represented by the Chairman of the Committee;
- on the other hand, the Governors could accept the possibility, twice a year, of joint meetings with the Ministers of Finance at which all the participants would freely discuss economic, budgetary and monetary matters. In other words, the Governors would discuss budgetary matters in the same spirit and same capacity as the Ministers of Finance would discuss monetary matters, without arriving at decisions on matters for which the Governors were responsible; in such a spirit, the suggestions made by Mr. de Larosière and Mr. Ciampi could be followed up.

<u>Mr. Delors</u> replied first to the questions raised by Mr. Hoffmeyer and Mr. Doyle. The European Council had said that the report was a good basis for studying economic and monetary union, but it had also stated that, for the first stage, it was <u>the</u> basis. Therefore, as some had already

said, it was a matter of applying paragraph 51 in the economic sphere and paragraph 52 in the monetary sphere. Secondly, the Commission had awaited the Committee's deliberations before organising its work and it was at the disposal of the Alternates if the Governors so desired. Mr. Pöhl had said that one of the points in paragraph 52, namely the desirability of extending the scope of the central banks' autonomy, must be stressed. This point would be included in the working paper that the Commission would be preparing for the Council. It would also be useful to know whether the Committee wished to deal with another point in paragraph 52, namely the removal of all impediments to the private use of the ECU.

There were six legal texts which would have to be revised, namely:

(1) the Council Decision of 18th February 1974 on the attainment of a high degree of convergence of the economic policies of the Member States of the EEC.

This Decision had to be revised to conform with the first stage towards economic union;

(2) the Council Directive of 18th February 1974 concerning stability, growth and full employment in the Community.

This was a forgotten Directive, which corresponded to the state of economic knowledge and development at the time; it should be quite simply revoked;

(3) the Council Decision of 8th May 1964 on co-operation between the Central Banks of the Member States of the EEC (this was the text setting up the Committee of Governors);

(4) the Rules of Procedure of the Committee of Governors;

(5) the Council Decision of 8th May 1964 on co-operation between Member States in the field of international monetary relations;

(6) the Council Decision of 22nd March 1971 on the strengthening of co-operation between the Central Banks of the Member States of the EEC.

This Decision failed to provide the Committee with the status desired by the Governors and they should therefore revise the text.

The ECOFIN Council meeting of 10th July 1989, not the European Council's Madrid meeting, had laid down a timetable with, as its first item, a discussion on all the work relating to stage one and the subsequent stages, to be held at the informal ECOFIN Council meeting on 9th and

10th September, in which the Governors would participate. The Council had requested that an amended draft of the 1974 Decision on economic convergence should be available at the Antibes meeting, and it was for the Governors to decide what they wished to say at the meeting regarding the texts which concerned them. The President of the Commission had not given any undertakings in that connection and had simply told the Ministers of Finance that the Governors would discuss the matter at their meeting on 11th July. It was clear that the Ministers would want to have an overall view and that they would also devote a certain amount of time to organising the work for the subsequent stages. During August the Commission would draw up an informal working paper designed to be of assistance in the discussions. The President of the ECOFIN Council had stated on 10th July that he would like the Heads of State or Government at the December 1989 European Council meeting to be able to note that stage one of the economic and monetary union had been prepared, even if the texts had to be adopted somewhat later, in December. In that way, the texts would be ready six months before the first stage was launched.

Mr. Rubio wondered whether it would be necessary to have a draft Decision replacing that of 8th May 1964 ready for the informal meeting in early September.

Mr. Delors said that the Committee should at least be able to present an outline draft and describe how the Committee visualised its strengthening under stage one.

Mr. de Larosière stressed that it was in the interests of the Governors to act quickly in this area, or others would do so, and that it was therefore important that the Alternates should begin working on these questions in order to examine and prepare the texts concerning the Committee.

The Chairman noted that there was general agreement on the work programme.

Firstly, priority had to be given to drafting the Council Decision that would replace that of 8th May 1964 and which would have to confirm the strengthening of the Committee. Secondly, the reply to Mr. Bérégovoy's letter raised a delicate question and it would be wiser to devote further thought to it and not take any decisions today. The Governors could examine this matter again at their next meeting. A possibility would be participation by the Governors in multilateral surveillance exercises on the occasion of the informal ECOFIN Council meetings; as this could not take place at the September meeting, the first occasion would not arise until spring 1990.

Mr. Duisenberg suggested an idea for the reply to Mr. Bérégovoy's letter. In the famous paragraph 52 of the report on EMU, it was stated that the Committee of Governors should "express opinions to individual governments and the Council of Ministers on policies that could affect the internal and external monetary situation in the Community, especially the functioning of the EMS. The outcome of the Committee's deliberations could be made public by the Chairman of the Committee..." This text, which had been accepted by the Governors, not without difficulties, was a guiding principle for the new Council Decision concerning the Committee; it could also serve as a guiding principle for the reply to Mr. Bérégovoy's letter.

I. Approval of the minutes of the 235th and 236th meetings

The Committee approved the minutes of these two meetings, 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

For half a year up to mid-June the dollar had been very firm; it had risen, particularly in May, in spite of heavy interventions. The main reasons for this development had been high US interest rates (which had risen until March and had subsequently fallen, but amid expectations of higher rates), the political problems abroad (in particular in Japan, Germany and China) and the withholding tax in Germany. Net sales of dollars had reached record figures, viz. more than US$ 19 billion in May and US$ 15.5 billion in June, the largest interventions having been made by the Bank of Japan and the Federal Reserve.

A new trend had emerged in mid-June, and the dollar had fallen steeply, by approximately 9% in three weeks. However, this had not brought the dollar down very far but merely corrected the May-June surge, so that it stood at the upper end of the DM 1.70 - 1.90 range within which it had fluctuated in 1988 and during the early months of 1989. The reversal of the dollar's trend seemed to be related chiefly to changed expectations regarding economic developments in the United States: growth was expected to be weaker, and hence interest rates were expected to fall. In any case, interest rate differentials were already lower than they had been for some years. It was difficult to say what role the interventions had played in the fall of the dollar, and opinions differed in this regard. The experts from the Bundesbank had thought it unlikely that the interventions had had any significant effect and, while they were not opposed to interventions in principle, they took the view that circumstances recently had not been propitious for effective interventions. Other experts had felt that, although the interventions had not always been carried out as effectively as might have been wished, they had nonetheless contributed to the dollar's change of direction and that, in any event, it would have been damaging if, after having intervened for so long, the central banks were now to give the impression of losing interest in the dollar exchange rate. Although no consensus had been reached on this question of interventions, the experts had nevertheless thought that it would be helpful if the EEC central banks were able to agree on a common stance in situations of this kind.

The experts had also briefly discussed the dollar purchases made in June by the Banco de España and the Banco de Portugal, at a time when other central banks had been selling dollars in an attempt to bring the dollar down. These sales had been undertaken in part for technical reasons and in part because the Bundesbank had not authorised major purchases of Deutsche Mark. The Banco de España had attempted to diversify its interventions by purchasing ECUs, but the restricted size of this market had limited the amounts which it had been able to buy. It should be mentioned that, in spite of its scepticism, the Bundesbank had sold more dollars than most other EEC central banks, with the exception of the Bank of England and the Central Bank of Ireland, which had both used the dollar to support their own currencies.

A further fall in the dollar could not be ruled out now that the rising trend had been broken. If this were to happen, problems might arise for the EMS, firstly because the capital flows could affect the currencies in the exchange rate mechanism in different ways, and secondly because a weaker dollar would reduce competitiveness in Europe, but in varying degrees among the countries concerned.

The yen had appreciated less vis-à-vis the dollar than the European currencies, against which it had thus weakened. This decline was probably connected with the political problems in Japan and with the expected repercussions on the Japanese economy of events in China. By contrast, the Deutsche Mark had fundamentally strengthened, this movement being illustrated by its exchange rate against the dollar and the yen and by the fact that purchases of Deutsche Mark had been markedly smaller than in the preceding months. These purchases, which had been made mainly by central banks other than the Bundesbank, had amounted to the equivalent of US$ 3.5 billion in March and in April and US$ 9.5 billion in May, but only US$ 2.5 billion in June and virtually nothing during the first ten days of July. A turn-round in long-term capital movements seemed to be the main reason for the strengthening of the Deutsche Mark. Following outflows at the rate of DM 11 billion per month during the first quarter of 1989, the figure had been only DM 1 billion in April, and net inflows had been recorded in May for the first time in a lengthy period. The abolition of the withholding tax in Germany had played an important part in this development, but its effect had only become apparent after a certain time because many German residents seemed to have waited to make sure the tax would not be reintroduced at Community level or replaced by another tax. On 30th June the Bundesbank had raised its official interest rates by half a point, primarily for domestic reasons. Economic growth was continuing in Germany: between the fourth quarter of 1988 and the first quarter of 1989 the increase had been 3% in seasonally adjusted terms, and a rate of 4% was expected for 1989 as a whole. At the same time prices were rising faster than the Bundesbank thought desirable, with an underlying annual rate of increase of 3 to 4%.

Germany's raising of interest rates had been followed by many other countries, both within the Community and elsewhere. In some cases, this had simply been a matter of preserving differentials with the Deutsche Mark, as had been the case in Denmark, for example. In other countries, the domestic situation had made increases useful, and the German lead had provided a good opportunity to act. On the whole, market interest rates had not risen by much; most EEC countries had kept their differentials with the Deutsche Mark more or less unchanged, albeit not at the lowest levels.

As far as the other EMS currencies were concerned, attention had been concentrated on the peseta, which had joined the exchange rate mechanism on 19th June with the wider 6% band. A change had been noted owing to the fact that two currencies and not just one were now using the wider band. This was apparent from the new "monitoring" graph on positions within the EMS, which showed that currently the lira would not be able to fall much below the lower limit of the narrow band or to return to the level which it had maintained for most of 1988. It could also be noted that the peseta would be unable to reach its intervention rate against the Deutsche Mark while the latter was at the upper limit of the narrow band. In fact, given the current pattern of exchange rates, the maximum level for the peseta against the Deutsche Mark would be about Pts. 62.3, which was not far off the rate of Pts. 62.8 which had been reached on 10th July. The Banco de España had explained that the Spanish banks had not properly understood the working of the exchange rate mechanism and the fluctuation band, which accounted for the large interventions required on the first day.

The economic situation in Spain had changed little, save for the recent fiscal tightening of which Mr. Rubio had just spoken. The economy was still overheating, with very strong domestic demand, inflation of the order of 7% and a deteriorating current-account balance. In spite of the appreciation of the peseta in the last two years and the relatively sharp rise in costs, the Spanish authorities did not think that industry lacked competitiveness. Exports had in fact been performing very strongly. In reality, it was demand which needed to be brought under control, and, since fiscal policy had been insufficient, monetary policy had had to be especially tight. Recently, however, the Government had tightened fiscal policy; a first set of measures had been taken in May, and a second set had been implemented in June. Although these measures had not been very forceful, they were steps in the right direction, and they would take a few months to produce their effects. In the meantime, the Banco de España intended to maintain a firm monetary policy.

The experts had only been able to touch briefly upon other major problems, such as the sharp decline in sterling and the difficulties related to the overheating of the Italian and Portuguese economies.

B. Statement by Mr. Papademos

The Alternates' discussion had concentrated on the entry of the Spanish peseta into the exchange rate mechanism of the EMS, recent developments in the dollar exchange rate, the effectiveness of interventions and economic developments in a number of EEC member countries.

The Alternates had congratulated their Spanish colleague on Spain's decision to join the EMS exchange rate mechanism. The Spanish Alternate had discussed the reasoning behind the choice of the central rate of Pts. 65 to DM 1 and had described some of the difficulties encountered in the first few days following the entry of the peseta, which had been partly due to the Spanish commercial banks' limited understanding of the functioning of the system. In addition, he had described the policy measures that the authorities had introduced to manage the overheating economy. The Banco de España had raised the intervention rate by 0.75% and had increased the reserve requirement from 18 to 19%. In the fiscal area, the withholding tax had been increased from 20 to 25%, the price of petroleum products had been adjusted upwards, and plans had been introduced to reduce ministries' expenditure. It was expected that, by improving the policy mix, these measures would reduce the need for further interest rate increases.

The recent weakening of the US dollar had been welcomed by several Alternates as facilitating the international adjustment process and contributing to the moderation of inflationary pressures in the Community. The dollar's weakness had been attributed to the following factors: less favourable growth prospects for the US economy relative to Europe, anticipations of an easing of US monetary policy, a further narrowing of interest rate differentials and the turn-round in long-term capital flows in Germany after the decision to abolish the withholding tax. It had been argued that interventions had not played a major role in reversing the rising dollar trend. The view had also been expressed that, if the dollar continued to decline, central banks should not act to stop such a decline too soon, but only when tensions arose and in a co-ordinated fashion.

On the issue of the effectiveness of interventions, it had been pointed out that, although co-operation in carrying out interventions could be improved further, central banks should not convey the impression to the markets that they were aiming at preserving nominal exchange rate stability at all costs and thereby lessening exchange rate risks. Interventions could be effective in some circumstances but not in others; their effectiveness was enhanced if they were co-ordinated, carried out in large amounts and in a timely fashion, pushing with the market trend and supporting other developments. In any case, interventions could never replace fundamentals. The German Alternate had explained that the Bundesbank had abstained from joining intervention efforts on some occasions because, under the circumstances in which they had been carried out, they had been considered indecisive and ineffective, while, in some cases, they had contradicted the monetary policy pursued in some of the participating countries.

The Alternates had also discussed the issue of the choice of intervention currencies. The existence of two fluctuation bands could, in certain cases, create problems when a currency which was close to its upper limit in the narrow band was used for interventions and there was thus a danger that the weak currencies might hit their lower limits. It had been suggested that the use for interventions of the weakest currencies in the exchange rate mechanism, or currencies outside it such as the pound sterling, might lessen these problems.

The Alternates had examined economic and exchange rate developments in a number of Community countries. The pound sterling had come under pressure mainly for two reasons: firstly, the published economic statistics had given mixed signals regarding the success of the anti-inflation strategy being pursued; secondly, the market had perceived disagreements within the British Government on economic policy. The British Alternate had argued that the anti-inflation strategy was bearing fruit, and that the authorities in the United Kingdom had clearly reached a common view on the appropriate policy course. Consumer and investment spending were slowing down, and the trade balance, excluding oil, had improved marginally. Although the rate of increase of prices and wages had not decelerated, it was expected that the anti-inflation policy would produce an effect without necessitating a further increase in interest rates.

The Banque de France had joined other European central banks in raising short-term interest rates, mainly for domestic reasons. In France domestic demand and credit expansion were strong, and the trade balance had recorded a wider deficit in May.

Italy was confronted with the rapid growth of domestic demand, a widening current-account deficit and rising inflation. Domestic demand had to some extent been boosted by increased foreign borrowing by the industrial and banking sectors prompted by the strong lira. It had been necessary to act on the fiscal imbalance to curb aggregate domestic demand growth. There had been signs of a slowdown in some sectors, and the recent decision to bring forward tax payments, thereby lowering disposable income, should contribute to the official objective.

In Ireland short-term interest rates had been increased by 1% to check the erosion of official exchange reserves. Four factors had contributed to this depletion: the weakening of the pound sterling, the abolition of the withholding tax in Germany, portfolio diversification by institutional investors mainly as a result of the removal of certain foreign exchange controls early in the year, and the narrowing of interest rate differentials prior to the interest rate increases which had been undertaken in June.

The Alternates had ended their discussion with a brief exchange of views on the likelihood of a slowdown in the world economy in 1990 and the appropriate policy stance. One Alternate had thought that if a major slowdown was expected, it would be desirable to discuss possible policy responses now. The other Alternates, however, had doubted that there were signs of a recession and had stressed that inflationary pressures remained strong.

C. Discussion by the Committee

Mr. Duisenberg informed the Committee of a monetary policy innovation in the Netherlands, viz. the application of a system of monetary cash reserves. In 1988 the rate of growth of the money supply in the Netherlands had been very high (+14%) owing in large measure to the sharp expansion (+14%) in the banks' net money-creating operations. This development had persisted in the first few months of 1989, while the inflow of liquidity, which had already decreased substantially in the course of 1988, gave way to an outflow. Had it continued, this trend would have put pressure on the Dutch guilder. This factor, together with the acceleration in the rate of inflation and the record levels of capacity utilisation, had prompted De Nederlandsche Bank to take measures to curb the growth of the banks' net money-creating operations.

The instrument used was more market-oriented than that previously used. In the past, when De Nederlandsche Bank had considered it necessary to limit the expansion of the banks' net money-creating operations, it had imposed absolute ceilings on the expansion of individual banks' operations.

Such a system of direct restrictions had the drawback, when applied over a prolonged period, of leading to a rigidification of balance-sheet structures and of competitive conditions within the banking system. Furthermore, since small banks had only limited opportunities for raising additional long-term funds, a restriction of the growth of their net money-creating operations effectively put a brake on the growth of their lending operations. In view of these disadvantages and of the international trend towards deregulation and the use of more market-oriented policy instruments, De Nederlandsche Bank had decided to employ an alternative instrument, viz. a monetary cash reserve arrangement. Under this arrangement each bank was, in principle, required to hold a non-interest-bearing cash reserve against the growth of its net money-creating operations in excess of a certain standard rate (or permitted exemption). The proportion of any expansion over and above the permitted exemption which was to be held in the form of a cash reserve was determined by the cash reserve percentage. The banks could exceed the permitted exemption, but were discouraged by the costs involved. In principle, the permitted margin equalled the growth rate which De Nederlandsche Bank considered desirable for the net money-creating operations of the banking system as a whole. This rate had been set at 5% on an annual basis and the cash reserve percentage at 10%, although this could rise as high as 25%. In order to prevent interference with money market policy, the banks were not actually required to hold any monetary cash reserves at the central bank; the corresponding costs were settled at the end of the cash reserve period.

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 June and the first few days of July 1989

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

IV. Examination of Report No. 35 prepared by the group of experts chaired by Mr. Raymond on current monetary policies in EEC member countries

V. Exchange of views on recent developments in public finance and policy implications

The Chairman proposed that items IV and V on the agenda be discussed together, given that the topics dealt with in Report No. 35 and in the note on public finance were closely linked.

A. Statements by Mr. Raymond

1. Annual note on public finances

As it did every year by means of a written procedure and without a working meeting, the group of experts on monetary policy had reviewed the state of public finance in Community member countries in 1988 and at the beginning of 1989. Analysis of the data showed that in 1988 the overall situation had continued to improve. However, this generally positive finding had to be qualified by reservations concerning both the factors behind the progress and its distribution among countries.

(1) The average reduction in public deficits in 1988 was certainly associated for the most part with that in public expenditure (expressed as a percentage of GDP). However, it was the greater-than-expected acceleration of growth that had reduced public sector spending in broad terms (including welfare transfers). This acceleration had also increased revenues from fixed rate taxation. Denmark was an exception because of its unfavourable cyclical situation. Thanks to this strong growth, some countries had been able to reduce certain tax rates without increasing their budget deficits, again expressed as a percentage of GDP.

Among the countries which needed to improve their budgetary situation, only Ireland and, to a lesser extent, Belgium and the Netherlands had drawn nearer to equilibrium. By contrast, there had been only limited progress in Portugal and Italy, while in Greece the already high deficit had widened by 3 percentage points (or 4 points if interest payments were included).

(2) The need to finance new deficits had led to an increase in the public debt ratio in the majority of the member countries, with Denmark,

Luxembourg and the United Kingdom being the only exceptions. Unfortunately, the debt/GDP ratio had widened above all in those member countries where it had already been above the Community average, whose rate of increase had continued to decelerate.

The trend towards financing deficits less through money creation and more via issues on the financial markets had persisted, as had the tendency towards increasing the share of medium and long-term instruments, except in Italy, where the Treasury bill market continued to expand.

Mention should be made of the emergence of issues of government securities denominated in ECUs, viz. Treasury bills in the United Kingdom in the autumn of 1988 and long-term instruments in France in April 1989.

Finally, to take up an expression popular in Italy, a further "divorce" between a central bank and the government as regards the automatic financing of the budget deficit had been announced in 1988, this time in Portugal.

(3) The conclusion which could be drawn from these results was quite a complex one. Without any doubt, economic growth had made it easier to weather 1988. Only some of the countries which needed to do so had seized this opportunity to undertake structural adjustment. However, those which had made no progress along this path (Italy, Portugal and above all Greece, which had deviated in the opposite direction) had had cyclical reasons for either tightening their policy or at least not relaxing it.

Among those countries whose public finances did not require major correction, the Group had found that the emphasis between short and medium/long-term considerations was neither uniform nor constant. In its ordinary reports the Group had noted that direct taxation of households had been relaxed in the United Kingdom in 1988 at a time when domestic demand was already very buoyant and that fiscal policy had been tightened in Germany in 1989.

The prospect for 1989 was for a continuation of the 1988 trend, i.e. a slight overall improvement, in which some of the worst-placed countries would, unfortunately, not share.

2. Report No. 35 on monetary policies

The July report was one of the year's two weighty reports, the other being that prepared in November. Report No. 35 painted a general picture of the economic situation - in particular of intra-Community divergences - and of the conditions under which monetary policies were conducted.

It ended, in Chapters III and IV, with an examination of a number of issues requiring consideration.

(1) The economic situation

The monetary policy environment was characterised by sustained activity, a resurgence of inflationary pressures and disappointment with regard to the adjustment of external disequilibria. These features were present in Europe as they were in the rest of the world.

Activity had remained buoyant in the first half of 1989, as in 1988. The forecast of a cyclical downturn was constantly being postponed, currently to the autumn. Estimates for 1989 were being revised upwards. Growth of 3.25% was expected for the year in the OECD, with an increase of 3.50% in the first half, and the Community would follow this trend, with faster growth than in the United States but slower than in Japan. Within the EEC the impetus of domestic demand in countries outside the exchange rate mechanism was being transmitted via foreign trade to the industrial and commercial activity of other countries, in particular Germany, where activity was export-driven.

Price increases had accelerated. There were two points to make in this regard: firstly, inflation appeared to have peaked in May; secondly, the deterioration varied from country to country, being, for example, small in Canada and the Netherlands but large in Spain and the United Kingdom. Greece, Portugal and, to a lesser extent, the United Kingdom and Spain had high rates of inflation.

Most of the causes of the acceleration in inflation were shared by all countries: the rise in commodity prices, especially the price of oil (although here the trend was expected to reverse); the full utilisation of production capacity despite heavy investment; and, finally, very pronounced wage pressures in the overheating economies. An additional factor in the EEC was the inflationary impact of the appreciation of the dollar since the beginning of 1988.

Turning, finally, to current-account payments, the US deficit was slowly decreasing, Japan's surplus was higher than in the previous year, and contrasts were becoming very pronounced within the EEC, with the German surplus set to reach 4.3% of GDP.

(2) Monetary policies

Although it had slowed down somewhat, the growth of the monetary aggregates appeared to be too rapid in most European countries and was tending to overshoot the targets, in some cases markedly. France was an exception, and, since the drafting of the report, data on M_3 had been published in Germany showing that it was getting closer to thè 5% growth target. In most countries, even the most prudent ones, domestic lending was being fuelled by a dynamic real sector - consumption, investment and production.

Apart from a few specific responses, such as the adoption of restrictions on the growth of bank lending in the Netherlands, the central banks' general reaction to the following three interrelated factors - rising inflation, the relative depreciation of European currencies on the foreign exchange markets and the strong growth of monetary and credit aggregates - had consisted in a series of increases in the central banks' intervention rates on their money markets. And indeed, the latest move to tighten official rates in Germany and other countries had come just after Report No. 35 had been completed on 27th June.

It should be noted that long-term interest rates had risen less than short-term rates and less than current inflation, which was a reassuring sign with regard to the credibility of monetary policies.

(3) Questions posed by the experts

The experts had asked - and commented on rather than answered - the following questions:

Question 1. With respect to imported inflation, the experts had noted that if the dollar continued to appreciate - a development not in keeping with fundamentals (and for once the economists' arguments seemed to have been heard by the markets) - the EEC countries would be faced with the dilemma of having either to raise interest rates appreciably or to import inflation; the choice could not be evaded.

Differences of interpretation had emerged regarding the effectiveness of intervening on the foreign exchange markets independently of movements in interest rates, with the representatives of the Bundesbank expressing doubts based on a now familiar reasoning.

Question 2. On the subject of domestic inflationary factors, it was too early to say whether the recent increases in interest rates, say those of the first half of 1989, would be sufficient or not to reverse the price trend. On the one hand, a further tightening might prove necessary if after some time pressures were seen to persist, but equally there might be a downturn in activity in the second half of the year and an easing of inflationary pressures.

Question 3. The divergences in fundamentals between countries were still marked on the prices front and were widening in the case of current-account balances. They had not yet jeopardised the credibility of the parity grid in the exchange rate mechanism. However, if the danger of a rude awakening on the markets was to be avoided the divergences between member countries would have to be reduced. In this respect the Group had noted that at present it appeared difficult to implement a greater differentiation of interest rates, except perhaps in the case of the United Kingdom, since this would risk provoking an even greater overvaluation of the currencies of countries with high inflation and a large external deficit. This was what some had called the paradox of the exchange markets. Admittedly, there had been instances in which currencies with a high rate of inflation had seen their nominal exchange rate rise, like the dollar between 1982 and 1984, but the philosophy of the EMS prohibited members from exporting their inflation to their fellows.

Question 4. The experts had noted that among the non-monetary policies, little use was currently being made of incomes policies in most of the member countries, and that structural measures had been slow in terms of either their implementation or their effects, but that, in contrast, the policy mix was often being guided in the wrong direction. Thus, fiscal policies had tended to move towards restrictiveness in the low-inflation and surplus countries and to become more (and even highly) expansionary in overheating economies. In the overheating economies the conflict between fiscal and monetary policies partly explained the need to raise interest rates and the overvaluation of exchange rates. The Spanish delegation had requested that the Report mention that, to mark the peseta's entry into the exchange rate mechanism, the Spanish authorities planned to improve the policy mix, and, as Governor Rubio had reported, measures had already been taken to this end.

In conclusion, the experts considered that the central banks had done their duty in the first half of 1989. They were now at a crossroads. They might be required either to maintain for a time, or even step up, their restrictive stance or, conversely, to relax it. The choice would have to be made on the basis of a country-by-country analysis of economic indicators, taking into account the time required for monetary policy to act, and in the light of the development of the dollar exchange rate.

B. Statement by Mr. Papademos

The Alternates had congratulated the Chairman of the Group, the experts and the Secretariat on the highly professional analysis which they had produced, and in general they had endorsed the conclusions of the report on developments in public finance and of that on monetary policies in the EEC countries. The Alternates had considered that these documents highlighted some unsatisfactory features of macro-economic developments within the Community. The discussion had focused principally on fiscal policies, their co-ordination and their contribution to macro-economic convergence within the EEC. It had been felt that some countries had adopted fiscal policies which placed an excessive burden on monetary policies. In some countries the policy mix was clearly inappropriate. One Alternate had been worried about the fiscal relaxation planned for 1990 in Germany. Should the economic performance in this country remain strong throughout the rest of 1989 and into 1990, the introduction of measures which reduced the tax burden could lead to higher interest rates not only in Germany but also elsewhere in the Community. The German Alternate had explained, on the one hand, that this matter had been addressed in the budget, which provided for strict control of public expenditure and, on the other, that the decision to relax the fiscal stance had been taken as part of a medium and long-term strategy and, as such, could not readily be adjusted.

One Alternate had pointed out that in the context of stage one of economic and monetary union, the interdependence of budgetary and monetary policies was reaching a critical phase. Convergence in the budgetary field remained limited. It was certain that both the Committee of Governors and the Monetary Committee would be called upon to review budgetary divergences and their implications for the co-ordination of economic policies in the Community. The question had been raised as to what procedure should be adopted when the budgetary policy objectives of one country were either inappropriate or not achieved. Another Alternate had felt that a slightly more frank and direct approach would, on occasion, be more appropriate than the diplomatic phraseology employed in the reports at present. To conclude, the Alternates had thought that:

- the evidence revealed the limited success in budgetary convergence within the Community;
- a better policy mix was necessary to reduce the burden placed on monetary policy;
- in the context of stage one of economic and monetary union, the question of a better co-ordinated approach between budgetary and monetary policies would have to be taken into consideration.

C. Discussion by the Committee

The Chairman offered a few remarks on the current budgetary and monetary situation in Greece. The budgetary position had deteriorated in 1988, with the public sector borrowing requirement reaching 16.3% of GDP, compared with 13.2% in 1987, representing a deterioration of more than 3 percentage points, whereas in 1986 and 1987 an improvement of 5 percentage points had been recorded. The main problem lay with revenues, and one of the causes of the shortfall was widespread tax evasion. What was needed, therefore, was a more efficient tax administration, but also reforms aimed at widening the tax base. In this connection a growing consensus was emerging in Greece on the need to put in place a medium-term fiscal consolidation plan. Moreover, government spending had risen sharply in the 1980s, with interest payments increasingly becoming a major component.

As far as the fiscal policy stance for 1989 was concerned, the public sector borrowing requirement had been projected by the Government to remain, as a percentage of GDP, at approximately the same level as in 1988. The data available for the first few months of 1989 indicated that it would not be easy to reach this target. This increased the need for flexibility in interest rate policy. In 1988 this policy had proved sufficient to finance a higher proportion of the borrowing requirement on the non-bank market. However, developments in the first four months of 1989 showed that public sector demand for bank credit was high and that the objective of increasing the non-monetary financing of the public deficit through sales of government paper to the non-bank sector could be jeopardised. Furthermore, considerable tensions had arisen in the balance of payments in May.

In response to these developments, the interest rates on Treasury bills had been raised twice in April and May, and this had resulted in substantial increases in banks' lending and deposit rates. Finally, in order to facilitate further the non-monetary financing of the public deficit, the Government had issued medium-term bonds with an ECU clause in May. Sales of these bonds had exceeded those of government paper in the first four months of 1989.

The Chairman recalled that every year since 1984 the examination of public finance undertaken by the Governors had been brought to the attention of the Ministers of Finance of the EEC countries. The experts' note was sent with a covering letter from the Chairman of the Committee summarising some of the main points of the Governors' discussion. The Secretariat would prepare this letter, and the note would as usual be dealt with under a written procedure to enable the central banks to propose any amendments before it was submitted to the Ministers.

VII. Other matters falling within the competence of the Committee

The Chairman said that the Bank for International Settlements was happy to inform the Committee that the ECU Banking Association had admitted nine new members to the private ECU clearing and settlement system with effect from 4th December 1989. As from that date the total number of member banks would be forty-five.

VIII. Date and place of the next meeting

The Committee's next meeting would be held in Basle on Tuesday, 12th September at 9.30 a.m.

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

11th July 1989

Confidential

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

JUNE 1989

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 June and the first few days of July 1989.

I. EXCHANGE RATE DEVELOPMENTS

The main features of the foreign exchange markets in June 1989 were:

- a continued strengthening of the US dollar until mid-month, followed by a fall towards the end of the month;
- a weakening of the Japanese yen and pound sterling;
- official interest rate rises in several European countries;
- the entry of the Spanish peseta into the exchange rate mechanism of the EMS, where for a transitional period it will observe fluctuation margins of 6%.

The US dollar rose rapidly during the first half of June, then retraced its movement to close the month relatively little changed on balance. Upward pressure was triggered by concern that unrest in China would lead to large speculative flows from Asia and as investors continued to reduce their hedges on their dollar portfolios. The dollar reached its high of Yen 151.90 against the Japanese yen and 2.0470 against the

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

Deutsche Mark around the mid-month release of the report of the US trade deficit for April. The dollar then moved lower as market attention refocused on signs of a slowdown in the US economy and narrowing interest differentials favouring US investments. The US monetary authorities and foreign central banks intervened persistently and in sizable amounts to counter the dollar's upward momentum. The dollar closed the month approximately 0.75% higher against the Japanese yen and 1.75% lower against the Deutsche Mark.

The EMS remained without tensions and relative positions were on the whole little changed. The Spanish peseta entered the exchange rate mechanism where it stabilised in the upper part of the wide band.

The Deutsche Mark firmed against most of the currencies officially quoted in the Federal Republic; its weighted index vis-à-vis eighteen industrial countries rose over the month by 0.9% to stand at 174.6 at the end of June (1972=100). Much of the strengthening can probably be attributed to the announcement of the abolition of the withholding tax and the consequent slackening of capital outflows. The Deutsche Mark's performance vis-à-vis the currencies participating in the EMS exchange rate mechanism was uneven, with gains counterbalanced by losses. With effect from 30th June the Bundesbank raised its discount and lombard rates by 0.5 percentage point to 5% and 7% respectively.

The French franc remained relatively stable for the greater part of the period under review against the background of an upsurge in domestic interest rates. However, the announcement on 29th June of a marked deterioration in the trade balance in May (a deficit of Fr.fr. 6.64 billion in seasonally adjusted terms, compared with a deficit of Fr.fr. 3.69 billion in April) caused the exchange rates to fall slightly. With effect from 30th June the money market intervention rates were raised by 0.5 percentage point to 8.75% and 9.5% respectively.

The Belgian franc remained stable. In the wake of the decision taken by the Deutsche Bundesbank, the Banque Nationale de Belgique raised its discount and lombard rates by 0.5 percentage point to 9.25% and 9.5% respectively. Its interventions resulted in some net sales of currencies.

The position of the Dutch guilder near the top of the band remained virtually unchanged. In line with similar moves elsewhere in Europe, the Nederlandsche Bank raised its official interest rates by 0.5 percentage point effective 30th June, bringing the discount rate to 6% and the lombard rate to 6.75%.

The Danish krone remained the weakest currency in the band. Following the rise in official German interest rates, Danmarks Nationalbank raised its main interest rates by 0.5 percentage point, effective 30th June 1989.

Outflows by residents, having moderated in May, resumed on a substantial scale in June. While allowing the Irish pound to weaken somewhat in the upper half of the EMS band, the Central Bank also responded with sizable net sales of foreign currency. On 30th June, following increases in official interest rates by other European central banks, the Bank increased its Short-Term Facility lending rate by 1 percentage point to 10%.

During the period the Italian lira remained relatively stable in the upper part of the EMS band and the Banca d'Italia conducted limited interventions to smooth the oscillations of the exchange rate.

Up to 9th June the Spanish peseta continued the depreciation initiated at the end of the previous month. Later on, after a period of stability, the inclusion of the peseta in the EMS exchange rate mechanism on 19th June gave rise initially to strong capital inflows and subsequently to a stabilisation of its rate in the upper part of the wide band. In all, it ended 0.6% higher with respect to the ECU and 1.9% higher with respect to the US dollar.

Sterling came under pressure in June as the market perceived signs of dissension within the government over UK economic policy. In spite of persistent official support, it fell sharply against all currencies during the first half of the month. Although sterling subsequently recovered against the softer dollar, the atmosphere remained nervous and the Deutsche Mark cross-rate continued to edge lower. The publication of better than expected UK trade figures for May on 26th June sparked a strong rally, but the pound later fell back towards its low in the wake of the increases in European interest rates. Sterling's trade-weighted index fell by 2.2% to 90.2 (1985=100).

The first half of the month the Greek drachma came under some pressure, mainly due to the national elections. However, following the national elections this pressure diminished. On balance the drachma depreciated vis-à-vis the ECU by 0.5% while against the US dollar it appreciated by 0.8%. In effective terms the drachma declined by 0.6%.

In effective terms, the Portuguese escudo depreciated by 0.25%, in line with the objectives defined by the authorities. Against the US dollar the escudo rose by 0.9%.

The interest rate shock that had been induced by the introduction of the flexible lombard rate eased at the beginning of June and euro-franc rates dropped by more than 1 percentage point. Despite this development the Swiss franc stabilised at an increased level; it firmed by about 1.5% vis-à-vis the EMS currencies and by 2.5% against the US dollar. On an export-weighted basis, the rise amounted to 2.25%.

In line with other central banks the official discount rate was raised by 1 percentage point to reach 5.5% with effect from 30th June 1989. The purpose of this step was not to tighten further central bank money supply but to adapt the discount rate to the domestic interest rate level. Nevertheless, this measure was received by the market with rising interest rates.

The Austrian schilling appreciated vis-à-vis the US dollar by 1.7%. It fluctuated against the Deutsche Mark by only 0.07%. In line with the corresponding interest rate increases in other countries, the discount rate was raised from 5% to 5.5% and the lombard rate from 6.5% to 7.5% with effect from 30th June. The higher rate of increase in the lombard rate is primarily intended to provide scope for fine-tuning of interest rate policy in the context of the open market policy. The rate for short-term open market operations was increased from 6.25% to 6.5%, also with effect from 30th June.

The Norwegian krone moved within a fairly narrow range around the central value of the currency index. On 22nd June Norges Bank reduced its overnight lending rate by 0.5 percentage point to 10.0%. The krone weakened somewhat towards the end of the month and the central bank intervened in order to stabilise the market. The krone ended 0.2% weaker in effective terms.

The Swedish krona traded in a narrow range and the currency index fluctuated between 130.4 and 130.8. On 1st June the Riksbank announced that it would abolish virtually all the remaining currency regulations effective from 1st July.

The Finnish markka weakened in effective terms by 0.5% towards the end of the month as interest rate differentials vis-à-vis the major currencies decreased.

The Japanese yen depreciated sharply against the US dollar in the first half of the month mainly due to heavy speculative dollar buying reflecting the political turmoil in China. However, massive and aggressive intervention by the Japanese and foreign monetary authorities pulled the yen back up in the second half for it to close at Yen 143.95/US$. Meanwhile, the yen depreciated by 2.2% against the ECU.

The Canadian dollar closed the month at US$ 0.8355, up 0.9% against the US dollar. The appreciation of the Canadian dollar took place against the background of a widening in interest rate spreads between comparable Canadian and US money market instruments and, later in the month, the sharp drop of the US dollar against the major currencies.

II. INTERVENTIONS

A. Interventions in US dollars

Net sales of US dollars amounted to US$ 15.5 billion, compared with net sales of US$ 19.1 billion in May. The main sellers were the Bank of Japan, the Federal Reserve and the Bank of England. The Banco de Portugal and the Banco de España were the largest net purchasers.

B. Interventions in Community currencies and in private ECUs

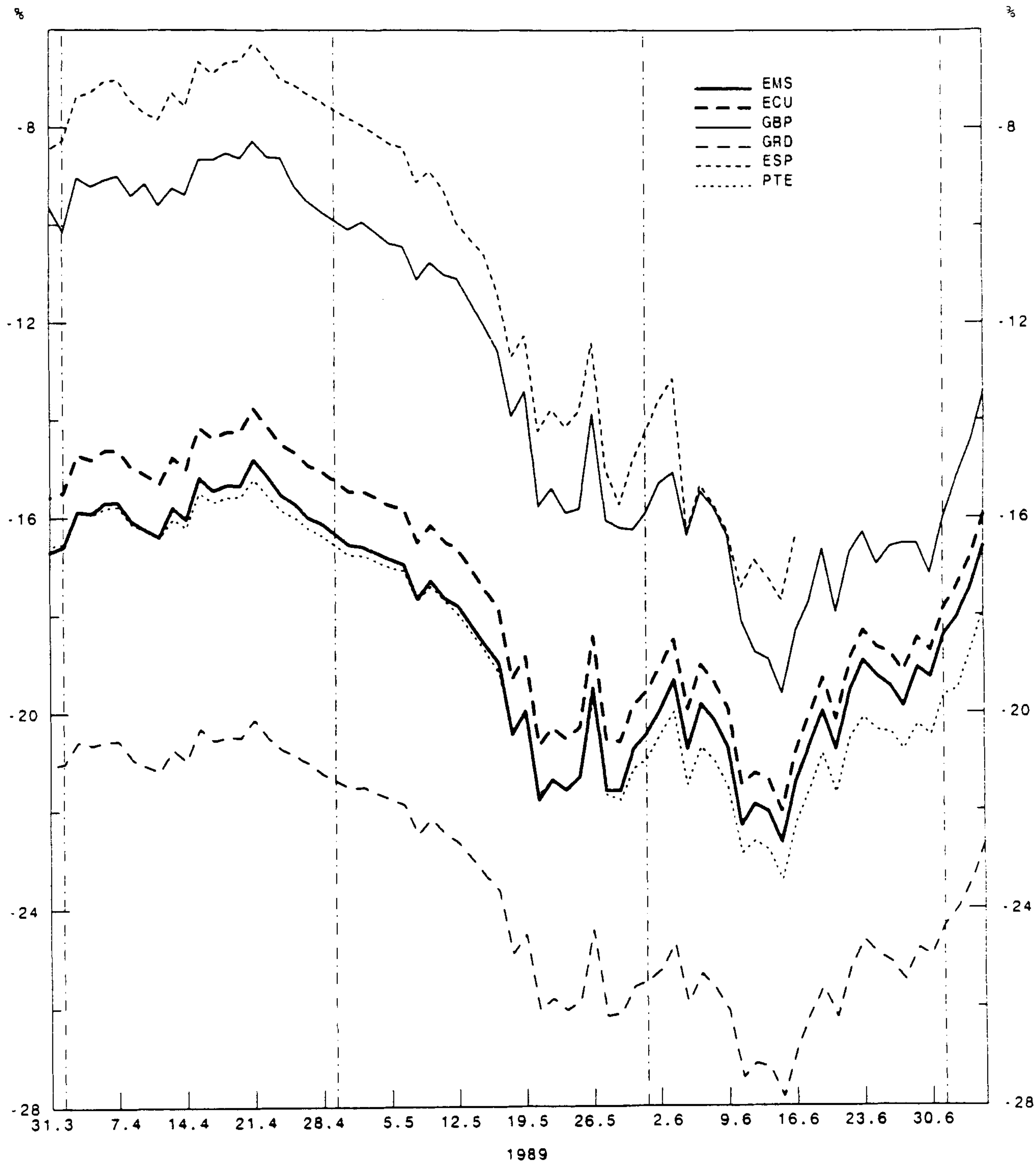
Interventions in EMS currencies and private ECUs by Community central banks amounted to the equivalent of US$ 0.4 billion, compared with US$ 3.7 billion in May. The interventions consisted mainly of purchases of ECUs by the Banco de España. The Sveriges Riksbank purchased a substantial amount of Deutsche Mark.

III. DEVELOPMENTS IN THE CURRENT MONTH, UP TO 7TH JULY

Downward pressure on the dollar continued during the first few days of July as a result of persistent expectations of an additional easing of monetary policy in the US.

The Spanish peseta resumed its firm tendency and strengthened further its position in the upper half of the wide EMS band.

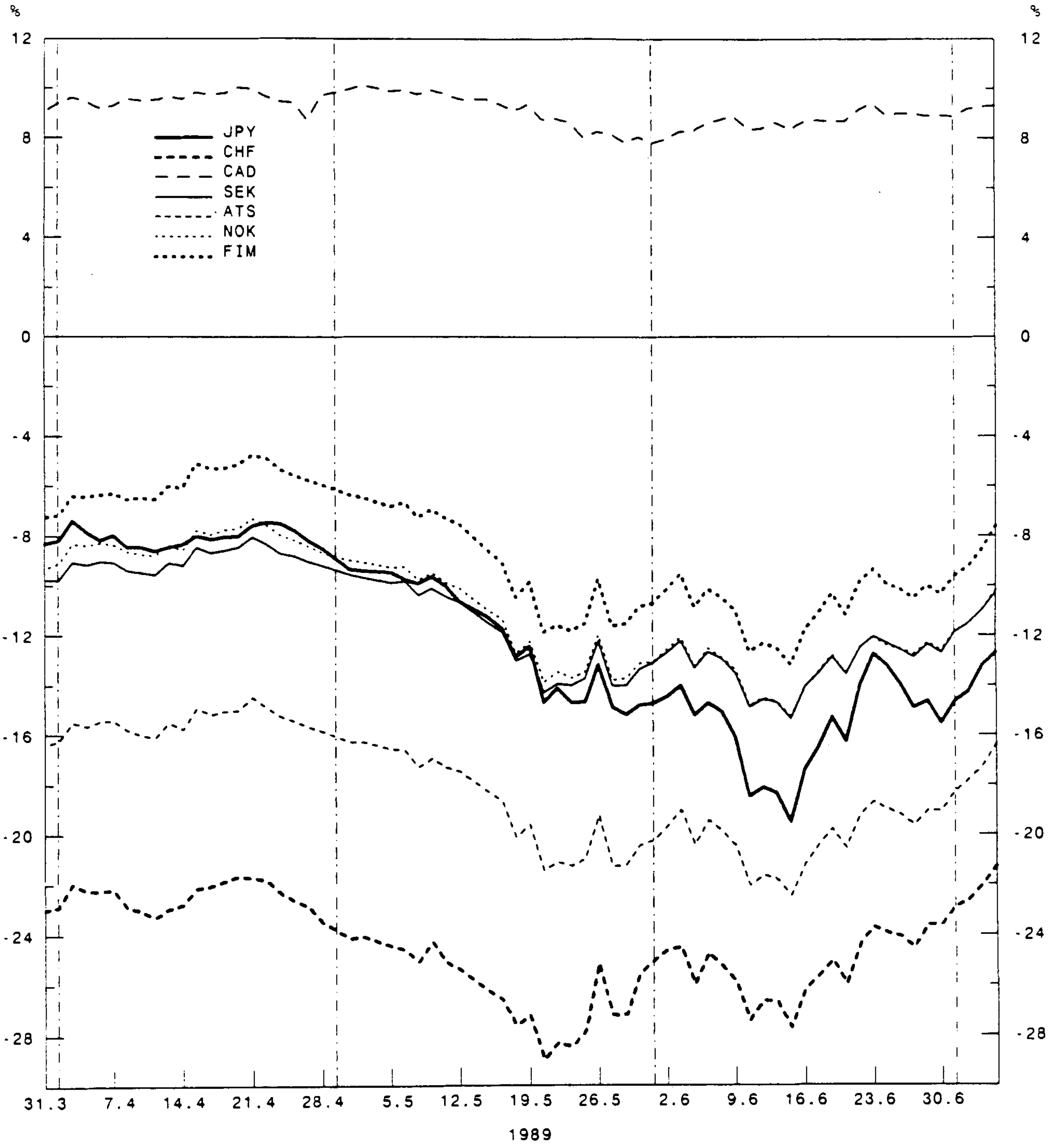
EVOLUTION OF THE ECU, THE MIDDLE RATE OF THE CURRENCIES PARTICIPATING IN THE EXCHANGE RATE MECHANISM OF THE EMS, AND THE CURRENCIES OF THE EEC CENTRAL BANKS WHICH DO NOT PARTICIPATE IN THAT MECHANISM, ON THE BASIS OF THE EXCHANGE RATES PREVAILING ON 31ST DECEMBER 1987 AGAINST THE USD*



* See next page.

7.7.1989

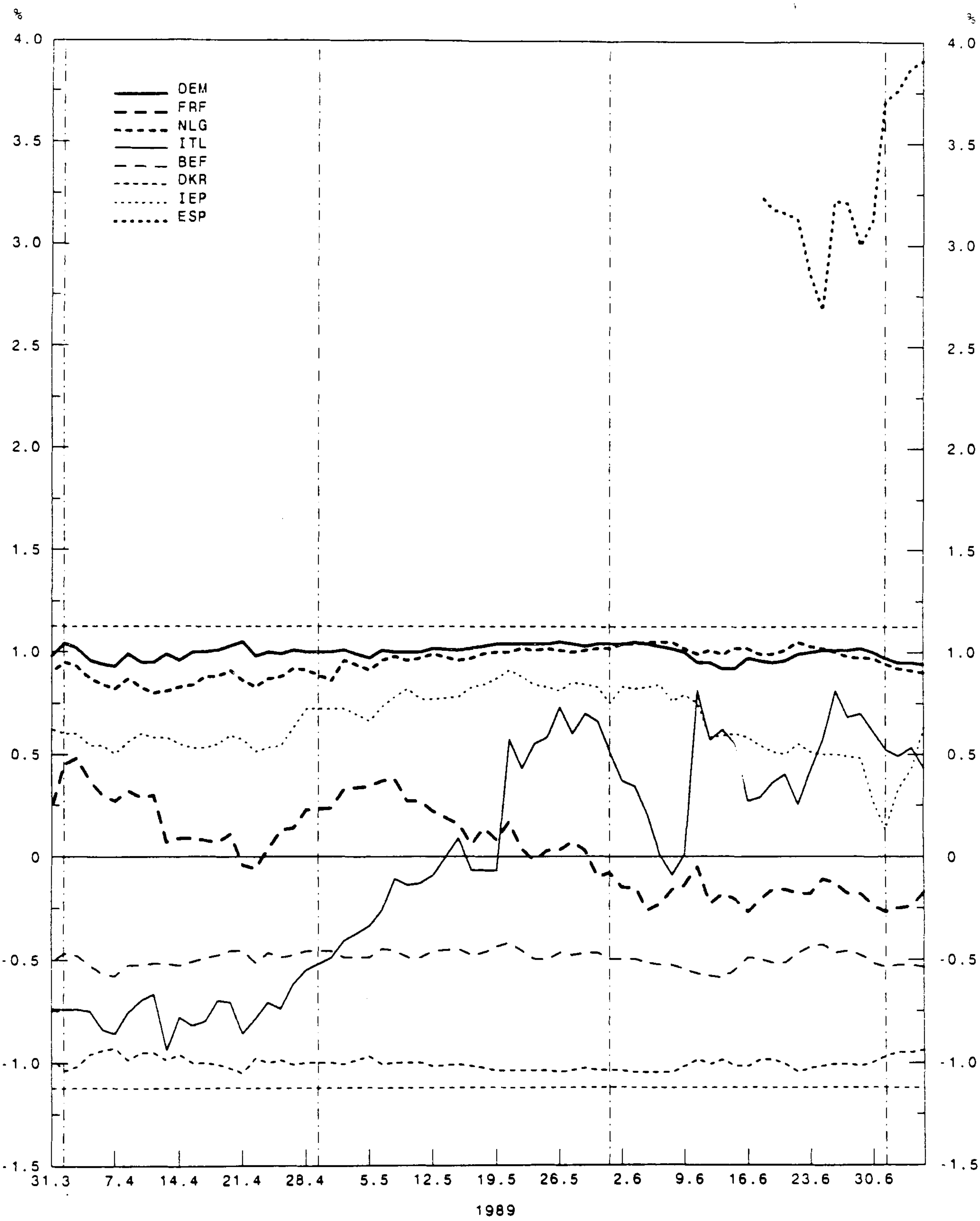
EVOLUTION OF THE CURRENCIES OF THE NON-EEC CENTRAL BANKS PARTICIPATING IN THE CONCERTATION, ON THE BASIS OF THE EXCHANGE RATES PREVAILING ON 31ST DECEMBER 1987 AGAINST THE USD*



* ECU 0,767254; GBP 0,5346; GRD 126,2002; ESP 107,8498; PTE 130,0242; FIM 3,945; CAD 1,302; CHF 1,2775; JPY 121,4501; SEK 5,795; NOK 6,233; ATS 11,129; middle rate of the currencies participating in the EMS 0,77324. The middle rate of the currencies participating in the EMS represents the daily average of the exchange rates of those two currencies which have the largest divergence from their current bilateral central rates, with a maximum fluctuation of 2.25%.

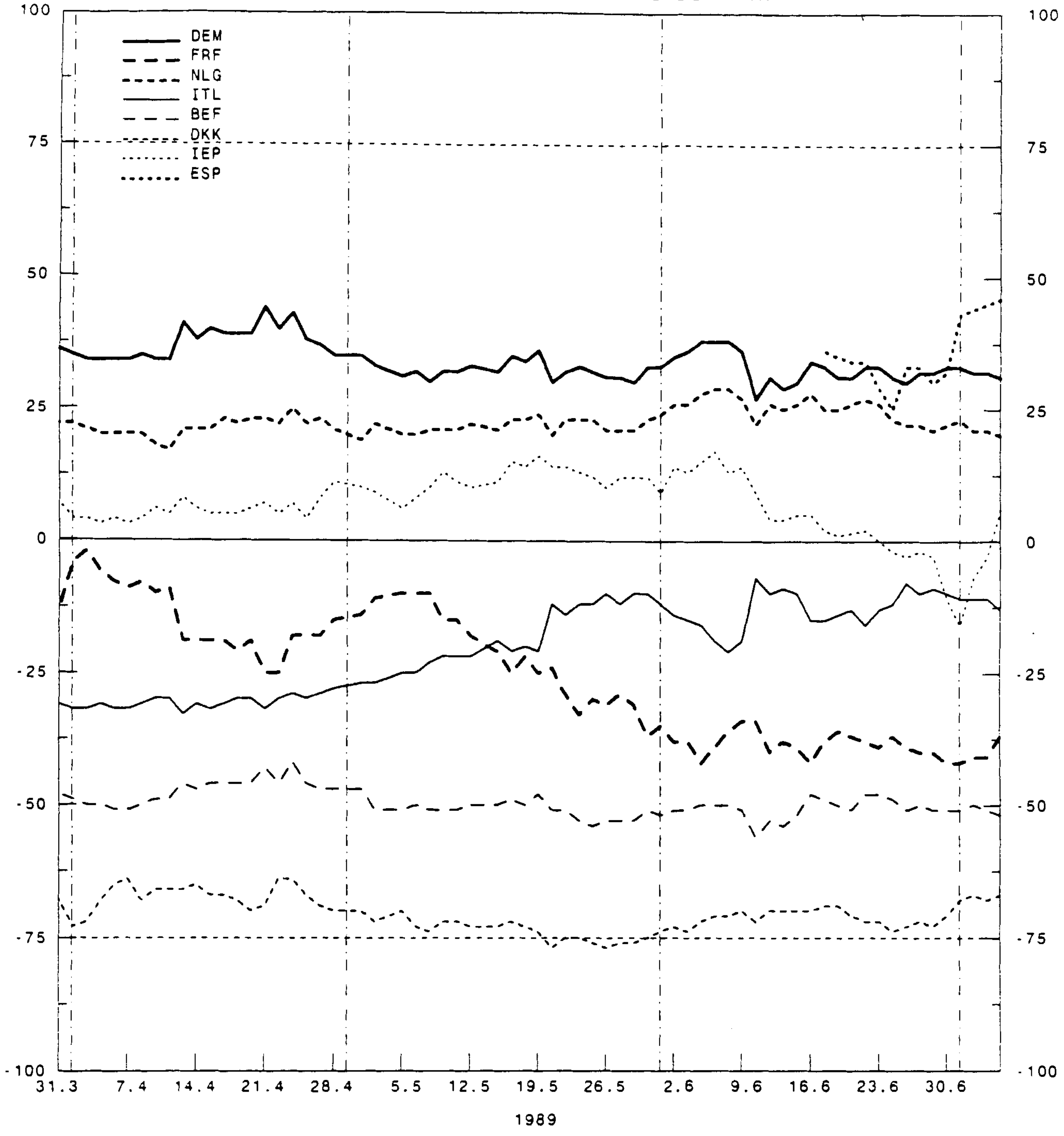
7.7.1989

MOVEMENTS IN THE EMS PARITY GRID



7.7.1989

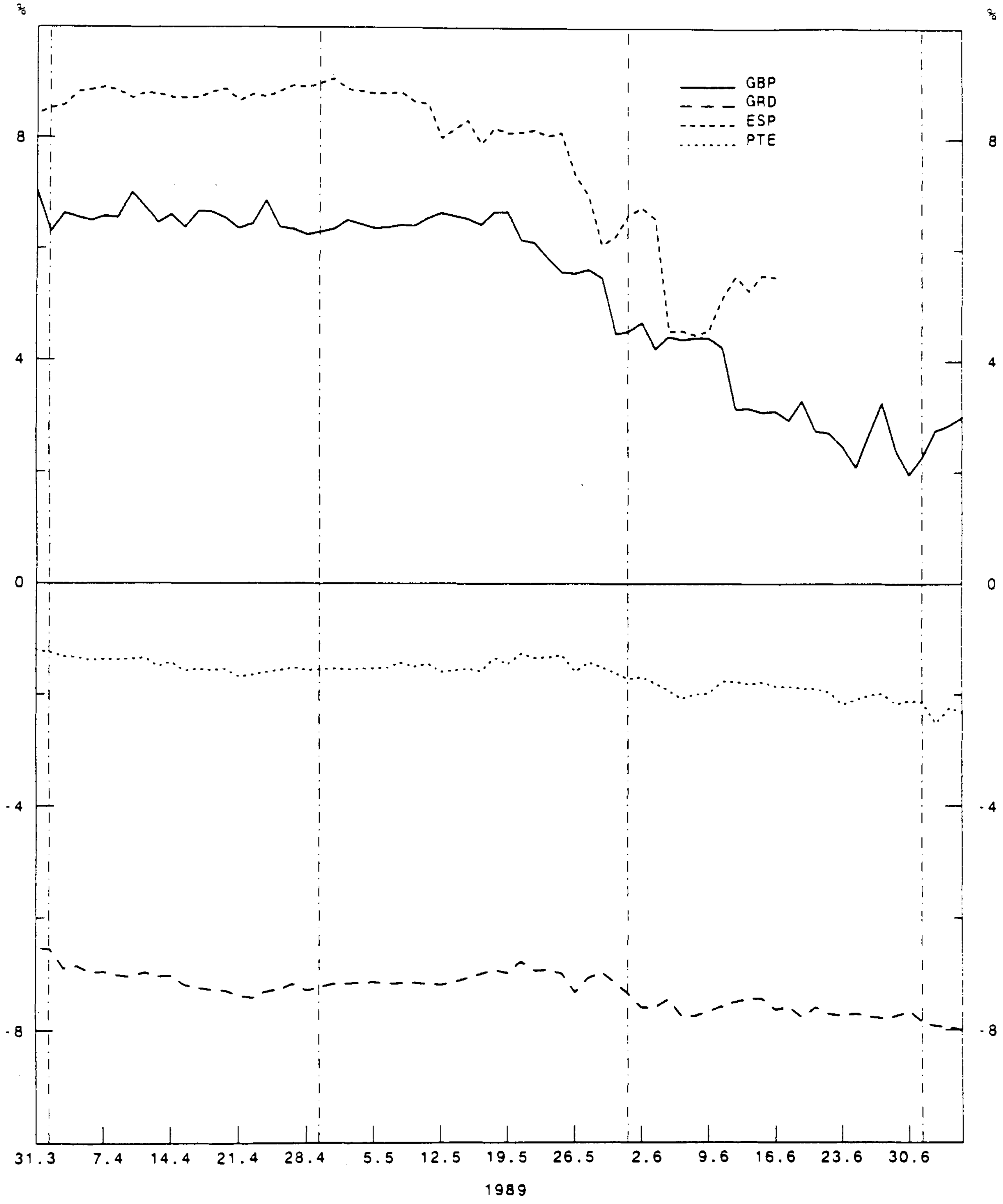
EVOLUTION OF THE DIVERGENCE INDICATOR*



* The divergence indicator provides a uniform measure of a currency's position in relation to its ECU central rate. The maximum divergence spread is the maximum percentage by which a currency's market rate against the ECU may appreciate or depreciate in relation to its ECU central rate; it is expressed as +/-100, the divergence threshold being +/-75. The data which has been used to draw this graph are the ECU rates against the different currencies, adjusted to eliminate the effect of the fluctuation of the Italian lira, the Spanish peseta, the pound sterling and the Greek drachma outside the 2.5% margin against the other currencies participating in the EMS.

7.7.1989

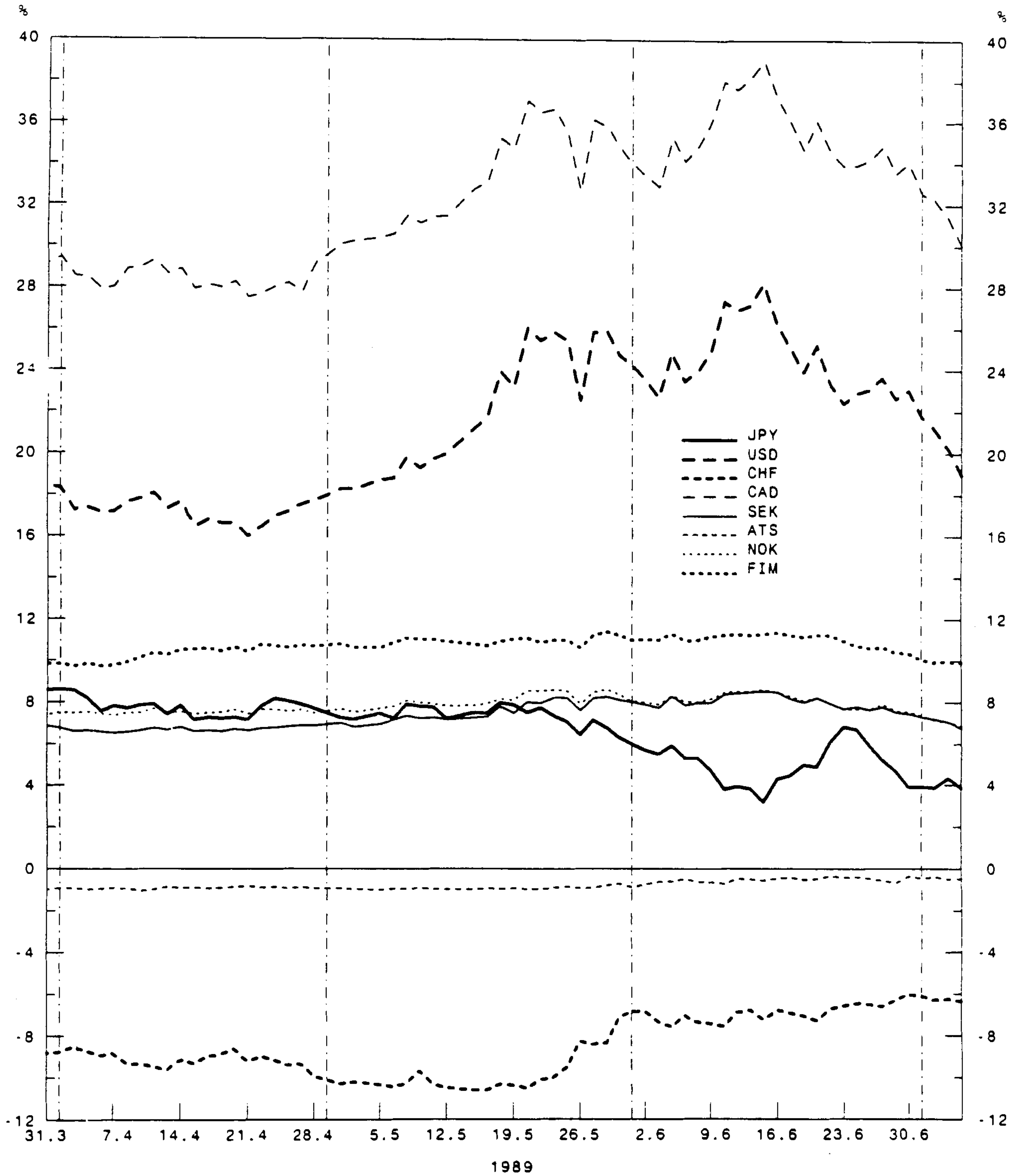
EVOLUTION OF THE POUND STERLING, THE GREEK DRACHMA, THE SPANISH PESETA AND THE PORTUGUESE ESCUDO, ON THE BASIS OF THE MARKET RATES PREVAILING ON 31ST DECEMBER 1987 AGAINST THE ECU*



* GBP 0,696793; GRD 164,483; ESP 140,566; PTE 169,467.

7.7.1989

EVOLUTION OF THE CURRENCIES OF THE NON-EEC CENTRAL BANKS PARTICIPATING IN THE CONCERTATION, ON THE BASIS OF THE EXCHANGE RATES PREVAILING ON 31ST DECEMBER 1987 AGAINST THE ECU*



* USD 1,30335; CAD 1,69696; CHF 1,66503; JPY 158,292; SEK 7,55292; NOK 8,12378; ATS 14,5050; FIM 5,14172.

7.7.1989