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Confidential

FINAL

MINUTES
OF THE 278TH MEETING OF THE COMMITTEE OF GOVERNORS OF THE CENTRAL BANKS OF THE MEMBER STATES OF THE EUROPEAN ECONOMIC COMMUNITY

HELD IN BASLE ON TUESDAY, 13TH JULY 1993

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The *Chairman* opened the meeting by welcoming Mr. George and, in the absence of Mr. Schlesinger, Mr. Tietmeyer.

I Approval of the minutes of the 277th Meeting

The *Committee* approved the minutes of the 277th meeting.

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

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

III Renewal of the swap agreements with Suomen Pankki

The *Committee* agreed to renew, for a further year, the bilateral swap agreements between Community central banks and Suomen Pankki which were due to expire on 31st July 1993. The Committee noted that, following the decision of 8th September 1992 to let the Finnish markka float, Suomen Pankki had no intention of drawing on these swap lines under present circumstances.

IV Monitoring of economic and monetary developments and policies in the Community

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

The Monitoring Group had discussed two issues: the outlook for the US dollar; and the situation in the EMS in the light of the tensions that had affected the French franc and the trend in interest rates. With regard to the first issue, some members had felt that the dollar was on a strong upward trend because of: the strength of the recovery of US economic activity; the expected narrowing of interest-rate differentials between Community countries, where rates were likely to decline further, and the US where rates might firm somewhat; and the weakness of the Japanese economy and the prospect of lower Japanese interest rates. Other members had felt that the strength of the US economy was not yet clearly established and that interest-rate differentials would remain positive in favour of Community countries for some time. This latter group of members had expected the US dollar to remain volatile, possibly around a moderately rising trend.

With regard to the EMS, the Group had reviewed the background to the sudden change in market sentiment about the French franc against which some pressure had developed since the last week of June; market participants had begun to anticipate the emergence of a dilemma between the need to lower French interest rates further to support economic activity and the need to maintain the stability of the French franc in the ERM. This perception had been heightened at the end of the previous week by the release of a pessimistic outlook for growth and employment by an economic forecasting institute. The markets had seemed eager to test the state of Franco-German co-operation; the French authorities had reacted by conducting interventions and by allowing some flexibility both in the exchange rate, which had declined somewhat, and in short-term market interest rates which had risen considerably. In this connection, the need had been underlined to send a clear signal to the markets that the interest-rate weapon was still available and would be used. The markets would also welcome indications that Franco-German co-operation was again operative, as demonstrated by the joint interventions that had been conducted on the previous day. As regards the trend of interest rates in EMS countries, the Group had noted the widespread desire for lower rates in the light of the disappointing evolution of economic activity. The prevailing attitude, however, was to pursue this objective cautiously as the room for manoeuvre to decouple interest rates from those in Germany was limited, and might only be temporary.

2. Statement by Mr. Papademos, Chairman, Monetary Policy Sub-Committee

The Sub-Committee's ex post review of monetary policy had been carried out against the background of unsatisfactory economic developments in the Community. Although inflationary pressures had continued to ease, economic activity had weakened sharply and public finances had deteriorated further. The average consumer price inflation was projected to be 3.7% in 1993, about 0.5 percentage point less than in 1992, unchanged since the ex ante report despite the weaker economic activity. The deceleration of inflation primarily reflected favourable wage developments and productivity improvements in most countries; by contrast, external pressures had on average increased and fiscal policies in several countries had not contributed to disinflation. While various indicators showed that inflationary pressures in the Community were in general abating, there were clear differences among countries in the pace of reduction and in the risks of a reversal. Inflation remained resilient in a number of countries including Germany, reflecting structural and/or external factors.

The economic downturn was sharper than had been envisaged in the ex ante report, mainly as a result of developments within the Community, including a further drop in private sector confidence. Instead of the 1% growth forecast last autumn, a slight contraction in output was currently expected for 1993 with unemployment projected to rise to an average of 11.5%. The degree of economic slack was substantial and was increasing in a number of countries, as illustrated by the data in the Economic Unit's supplementary note. There were, however, some positive developments which could contribute to an improvement in activity, such as the reduction in interest rates and indications in some countries of a turnaround in business and consumer confidence. Nevertheless, the timing of the recovery was uncertain and only modest output growth was projected for 1994.

Assessment of the monetary policy stance and of the mutual compatibility of national policies remained difficult given the uncertain economic outlook and differences in economic and monetary conditions. The Sub-Committee had considered that the lowering of official rates in the Community since autumn 1992 had been an appropriate response to economic and monetary developments. The effects of the fall both in short and long-term interest rates had not yet been fully transmitted to output. On average, broad money growth had remained so far this year at levels similar to those in 1992, although there was currently some overshooting in Italy and Germany and some undershooting in France. Against this background, the Sub-Committee had underlined the importance of maintaining the medium-term orientation of monetary policy aimed at price stability. On balance, a gradual further reduction in short-term interest rates in the second half of 1993 would be compatible with these goals. However, the extent to which monetary policy in different Community countries might be eased would depend on several factors: the evolution of monetary aggregates, exchange rates and long-term interest rates; the development of wages and other production costs; and the prospects for fiscal consolidation. Progress on the fiscal front was vital in order to establish the conditions for a further rapid reduction in interest rates. Without fiscal adjustment, an easing of monetary policy might be perceived as accommodating and might not lead to a decrease in long-term interest rates.

The assessment of the mutual compatibility of policies had pointed to positive developments but also to risks. Movements in exchange rates in September 1992 seemed to have contributed to the restoration of a more balanced and sustainable pattern of competitiveness between Member States. In this regard, the recent marked reduction in interest-rate differentials suggested that markets did not expect renewed exchange rate tensions and viewed the present central parities as credible. Taking into account favourable inflation developments, national monetary policies could currently be considered to be mutually compatible. The strengthening of central bank independence in some countries, and improved expectations about the eventual ratification of the Maastricht Treaty, could also enhance exchange rate credibility.

Nevertheless, tensions might resurface during the remainder of 1993. One risk was the possibility of a more severe economic slowdown in some countries than was currently projected, which would also aggravate fiscal problems. In principle, a further easing of monetary conditions would be appropriate in such a case and would be consistent with a medium-term orientation of monetary policy. But, a cautious approach was advisable. If monetary growth and inflationary pressures remained strong, further interest-rate reductions would be delayed and might even be prevented, and exchange rate tensions might reappear. A further risk was that of increased inflationary pressures, especially in those countries whose currencies had depreciated significantly, or where indirect taxes or administered prices were raised substantially. In these cases, monetary policies should prevent such pressures feeding through into wages, prices and expectations. Another risk was that a further sharp appreciation of the US dollar might add inflationary pressures in the Community. Given these uncertainties, the Sub-Committee had concluded that monetary policy should avoid over-reacting to short-term economic developments as this could jeopardise the attainment of the primary goal of price stability.

However, monetary policy alone could not ensure low inflation and satisfactory economic growth, especially in countries with structural problems; structural reforms and sound fiscal policies were essential. The Sub-Committee's review of public finances had confirmed that they were currently deteriorating rapidly in many Member States. For the Community as a whole, the general government net borrowing requirement was projected to increase to more than 6% in 1993, more than twice the level recorded in 1989. In combination with a slowdown in nominal GDP growth, this would lead to a sharp increase in the gross public debt/GDP ratio to 69% in 1993. In the light of these disappointing developments, the Sub-Committee had reviewed the adverse implications for economic growth and the conduct of monetary policy of an unbalanced fiscal stance. It had underlined in its report the potential positive effects of prompt fiscal consolidation which could stimulate a "virtuous" circle of decreasing interest payments, lower deficits and lower interest rates.

Although the Sub-Committee had been aware of the policy dilemma that existed in the current conjuncture, a delay in fiscal retrenchment could only be justified if combined with a clear and credible commitment to fiscal consolidation in the medium term. Budgets covering additional years, including a pre-commitment to reducing deficits to more sustainable levels, as recently announced in some countries, were significant steps forward. A medium-term approach should not prevent governments from taking more immediate action in order to avoid unfavourable public finance developments. Allowing deficits to increase in response to, or to counteract, the economic slowdown might result in a large underlying deterioration in public finances. The distinction between cyclical and structural components in deficits was not unambiguous and there might be a temptation to loosen the stance on other-than-cyclically-related government expenditure, which would be more difficult to reverse at a later stage. Recent experience was not encouraging; advantage had not been taken in many countries of favourable economic conditions in the second half of the 1980s in order to speed up fiscal consolidation, but tax rates had been reduced or expenditure increased. As a result, the fiscal position in many Member States on the eve of the present economic slowdown had been worse than a decade ago. This, in turn, was likely to have reduced the authorities' credibility in postponing austerity measures until the current recession was over. The prospects for sustained growth, and for the completion of the EMU process, depended upon the prompt implementation of credible fiscal consolidation plans.

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

The Alternates' discussion could be summarised under three broad headings: firstly, the immediate outlook for economic activity; secondly, trends in public finances; and, thirdly, monetary and exchange rate policy issues in the Community and the evolution of the US dollar.

For the Community as a whole, no rebound in economic activity seemed in sight; indeed, recent Commission surveys suggested that the slide in activity had not yet been halted. It had been stressed, however, that the emphasis on Community-wide indicators should not be allowed to blur the emerging signs of improvement in some parts of the Community. In the UK, the recovery was continuing, albeit at a modest rate as growth was held back by the debt overhang and the weakness of demand in the rest of Europe. In Germany, activity might have reached the bottom in the second quarter and there had been some signs of improvement in recent weeks. However, all Alternates had agreed that activity in the Community had deteriorated by far more than had been expected, the impact of which was now being felt in public finance trends which were still worsening in most Member States - in some countries, even beyond what had been described in the Sub-Committee's public finance report.

With regard to monetary and interest-rate developments, the recent weakness of the French franc had been discussed. The French Alternate had stressed that, contrary to some market perceptions, the French authorities did not see themselves faced with a policy dilemma and had shown their determination to use all available instruments to counter exchange rate pressures. There had been some discussion about the limits of the room for decoupling interest rates from those in Germany. It had been stressed that each decision to lower official French interest rates over the past month had been preceded by a strengthening of the franc in the markets. However, market sentiment towards the

French currency had suddenly shifted, starting with arbitrage in the bond markets by non-residents. The sudden weakness might be explained by factors such as the downward revision of growth prospects in France and the market's perception of the implications of some public statements.

The Dutch Alternate had said that, in the Netherlands, a negative interest-rate differential vis-à-vis the Deutsche Mark was allowed only when the guilder was above parity with the German currency; de Nederlandsche Bank was careful to play down the significance of any downward movements in official interest rates. It had been pointed out that a normalisation in the behaviour of the Deutsche Mark in the exchange markets could be predicted.

In Germany, the margin of manoeuvre to lower interest rates was carefully monitored on the basis of: money stock growth, inflation indicators; fiscal developments; and movements in the dollar. The German Alternate had pointed to recent data which did not indicate that the margin had increased since the beginning of July when official interest rates in Germany had been lowered; if anything, the reverse seemed to be true with money supply and inflation data having recently been revised upwards and with the continuing upward rise of the dollar. The British Alternate had observed that inflation was a lagging indicator and that spare capacity in the Community was now reaching levels where inflation risks were receding, implying that there might be scope for further interest-rate reductions without endangering the credibility of the anti-inflationary stance of monetary policy.

With regard to the development of the US dollar, views had differed as to the implications for monetary policy and competitiveness in the Community. The German Alternate had made it clear that an abrupt dollar appreciation would not be welcomed and that it would reduce the scope for interest-rate reductions in Germany. Others had been less concerned by current trends. The French Alternate had pointed to a more normal exchange rate configuration in terms of real exchange rates while, in the opinion of the Spanish Alternate, an orderly appreciation in the dollar could help stabilise the French franc/Deutsche Mark relationship within the ERM. This Alternate had also pointed out that it would be dangerous for the ERM as a whole if the markets were to see the Banque de France and the Bundesbank intervening on opposite sides of the dollar in the context of the recent French franc/Deutsche Mark depreciation and the dollar/Deutsche Mark rise.

Finally, the Economic Unit's note on the measurement of competitiveness had contained some practical proposals which might be of use in the monthly monitoring of exchange market developments, as well as in the context of the Committee's examination of the sustainability of central rates. Central banks had been invited to react before the end of July on the proposals made in the note.

4. Discussion by the Committee

The ***Chairman*** said that on the previous day he had attended the ECOFIN Council meeting which had been devoted to the semi-annual multilateral surveillance exercise. He had delivered the Governors' opinion on fiscal developments in the Community, which had been agreed at their June meeting; this had been well received by the Ministers who had recognised the need for deficit reduction and for strengthening structural policies. He invited Mr. Christophersen to outline the Commission's proposals, which had been presented at the meeting, for the convergence programmes to be periodically updated and discussed at more frequent intervals. These had generally been endorsed by the Ministers. No mention had been made of "exchange rates" during the discussions.

Mr. Christophersen said that most Finance Ministers seemed to be aware of the difficult position that Community countries were in as far as fiscal policy was concerned. The note prepared by the Economic Unit which had been circulated by the Chairman of the Committe had confirmed his view that all Member States would have to make structural deficit reductions; it would not be sufficient to rely on cyclical developments, or the lowering of interest rates, to meet the Maastricht convergence criteria. Most Member States were therefore faced with the need to establish medium-term fiscal consolidation policies covering the next five or six years. The convergence programmes of some Member States already included such policies, although the Commission was critical of the heterogeneity of the various national programmes. To help overcome this, he had proposed that all convergence programmes should be based on common assumptions for growth in the Community, the US and Japan otherwise the targets would not be comparable. Furthermore, these programmes should be updated annually to include confirmation of the national targets together with details of any macro-economic policy adjustments which were to be made. This should also apply to countries whose currencies were outside of the ERM. With regard to the British convergence programme, he would have preferred that it included targets instead of projections, but the difference would not be big as long as the British government was prepared to make adjustments as necessary in the light of the projections; the British Chancellor of the Exchequer had confirmed that this would be done. He added that the following reports were due to be presented by the Commission in accordance with the Maastricht Treaty. Firstly, a recommendation for the "broad guidelines of the economic policies of the Member States and of the Community", which would have to be approved by the European Council in December (Article 103); and, secondly, the "convergence report", which had to be presented to the Council of Ministers before the start of Stage Two (Article 109e). The latter would necessitate a profound examination of the macro-economic performance of each Member State. The fiscal consolidation question would therefore be reverted to during the course of the preparation of these reports and on which the Commission would find it useful to consult the Committee.

The *Chairman* said that the French Finance Minister had announced at the ECOFIN meeting that France's convergence programme would be submitted in September or October.

With regard to the situation in France, *Mr. de Larosière* said that the objective of French monetary policy was to ensure price stability and made four points in this regard. Firstly, consumer prices, unit labour costs, production costs and prices, and wage and salary increases were developing favourably. The CPI in June was broadly unchanged on a month-on-month basis and had risen by 1.9% on an annual basis. Secondly, the most recent figures available for M3 growth (calculated on the basis of the fourth quarter of 1992), whose target range for 1993 was 4%-6.5%, indicated an annualised growth rate of 3.3%. He added that the target range had been calculated at a time when it had been felt that the French economy would grow more strongly than it had since done. During the previous twelve months, credit granted by French banking institutions had increased by just 1.7% with a decrease of 0.4% recorded in recent months. There was currently no sign of a re-emergence of inflation, indeed, the slack in the French economy was significant, as indicated by the current level of unemployment (11.5%) and production capacity indicators. Thirdly, in August 1992, long-term market interest rates in France had been about 9.3% whereas the yield on ten-year State paper was currently 6.8%. This improvement in market sentiment reflected the markets' positive expectations for the evolution of price developments the medium term. Long-term interest rates was one of the parameters which the French authorities tracked in assessing whether or not their monetary policy was appropriate. Fourthly, the French franc's competitiveness vis-à-vis other EMS countries' currencies was becoming increasingly satisfactory. According to the charts and tables circulated by the Secretariat, the French franc appeared to be very competitive; this was due to the fact that relative inflation in France, and in particular wages and salaries, remained at a very moderate level. The balance of trade was in surplus, not only as far as the agricultural and food sectors were concerned, which had for a long time been the backbone of France's balance of trade, but also in respect of the trade in manufactured and industrial goods.

Since the new French government was established at the end of March, official interest rates had been gradually reduced from their crisis levels. The Banque de France had been cautious in making cuts and had been guided by market sentiment, the evolution of short-term market interest rates and exchange market developments. The markets had responded well to the French authorities' policy of making moderate interest-rate reductions, in 0.25 percentage point steps, as the French franc had firmed; it had also been possible to replenish France's official reserves. However, market sentiment towards the French franc had changed recently, led by the action of investment managers who had taken their profits on the French franc component of their portfolios and had focused their attention on the UK and on German securities as areas in which they expected to make greater profits. A change in sentiment vis-à-vis the state of the German economy had occurred; it was beginning to be felt that the bottom of the recession had been reached and that the German economy would begin to pick up. Furthermore, psychological factors had made their influence felt. Statements about the need to cut interest rates might cause disturbances in the markets. Furthermore, the recent publication of data by the National Statistics Institute in France had been interpreted more negatively than they deserved.

In response to the market pressure, the French franc had been allowed to move down in the ERM band, in order to discourage speculation, and market interest rates had been allowed to rise; the three-month market interest rate had increased from around 7.3% to 9.25%. The interventions carried out by the Bundesbank in support of the French franc, together with supporting statements by German officials, had helped to reassure the markets as to the will of France and Germany to continue co-operating with each other. The statements by the French Prime Minister underlining the government's policy of preserving the stability of the franc within the EMS had also helped. The competitiveness of the franc and France's economic fundamentals did not justify any deviation from the existing monetary policy.

Mr. de Larosière added that he fully agreed with the remarks made by Mr. Papademos but felt that the ex post report had not sufficiently taken into account the fact that western European countries were in recession with relatively high interest-rate levels, whereas the US and Asian countries were better placed. However, the lowering of interest rates in the Member States had an impact on the exchange rates of European currencies vis-à-vis the dollar and the yen which had allowed an improvement to begin in Community countries.

Mr. Fazio said that the protocol on the cost of labour agreed two weeks previously would be an important contribution to price stability in Italy. It was the follow up to a preliminary agreement put in force in 1992 which had been effective in stabilising prices despite the devaluation of the lira. The inflation rate in Italy had fallen in 1992 to levels not seen for 20 years, although one should be aware of the fact that the economy was in a situation of under-employment. Medium and long-term interest rates had continued to decline; ten-year bonds currently yielded around 9.5% to 9.7% with the yields on shorter-term bonds at even lower levels. On 5th July, the central bank had reduced both the discount rate and its official fixed-term advances rate by 1 percentage point to 9% and 10%, respectively; money-market interest rates were now between 9% and 10%. The situation needed to be consolidated by a good budget which was at present being prepared by the government. Subject to the adoption of the budget, inflation in the order of 3% could be expected over the coming year, which would imply an average inflation between 1993 and 1994 of 3.5% to 3.7%. With regard to the competitiveness of the lira, the available data showed that exports had performed well while imports had slowed down, not least because of the weakness of internal demand.

Mr. George said that the economic indicators for the United Kingdom were currently mixed. However, it was felt that the recovery was firmly established although it was expected to be slow. The debt overhang was still affecting the behaviour of the personal and, to some extent, the corporate sectors, which was reflected in the very slow growth of credit and broad money; the external environment also was not conducive to an acceleration of the recovery. The current situation suited the UK authorities well; a relatively moderate rate of improvement in the economy would help cement internal stability. The inflationary impulse prompted by sterling's depreciation, which had partly been offset by the recent improvement in the exchange rate, had not been excessively severe. At the same time, domestic inflationary pressures were subdued with unit labour costs, particularly in the manufacturing sector, having declined over the previous twelve months. Consumer price inflation was currently running at an annualised rate of 1.3% with an underlying rate of increase of not more than 3%. The policy framework which had been put in place following sterling's departure from the ERM had already done better than might have been feared. Having left the ERM and given the UK authorities' experience that monetary targets were not sufficiently robust in the current UK context, an inflation target had been adopted. The credibility of the latter had been helped by the request that the Bank of England should produce a quarterly inflation report setting out its objective assessment of the prevailing economic situation in relation to the inflation target. Despite the fact that a major readjustment of monetary policy had been made after sterling had left the ERM to meet domestic objectives rather than the exchange rate constraint, credibility had improved and long-term interest rates had declined to around 8%. However, yields at that level still implied that the inflation target was not fully accepted. The possibility of a further modest reduction in UK interest rates could not be excluded, but this might only be likely if the recovery in economic activity stalled, if the growth of monetary and credit aggregates was even slower, and if interest rates in other European countries were reduced further such that a strong appreciation of sterling's effective exchange rate was prompted. An even less likely condition would be a reduction in interest rates in the context of further fiscal consolidation in the budget to be announced in November. The need for further consolidation seemed to have been accepted by the UK government; the March budget had already put in place a delayed adjustment and the indications were that the government expected to proceed further in this direction in November. A more likely scenario with which the UK authorities would be faced was one in which economic activity developed strongly, giving rise to the need to indicate a preparedness to increase interest rates early in the upturn in the business cycle; this had been the weakness of UK monetary policy in the past. However, raising interest rates at this stage of the cycle might be difficult, especially if it were accompanied by a marked appreciation in sterling. He was comfortable with the rise in sterling that had occurred in recent months, but, given the weakness of the external position, he would, in the face of strong appreciation of the exchange rate, hesitate to rein back the acceleration of economic activity.

Mr. Tietmeyer said that, during the past two months, production and orders had been much better than in the previous two months although the figures were lower than for the same period in 1992. It might be concluded from the recent improvement that western Germany was approaching the bottom of the recession. He felt that the second quarter of 1993, compared with the first, was likely to show zero or a very slight positive growth, but not a further decline. This view was also shared by German industrialists whose expectations were becoming a little more optimistic. In eastern Germany, progress was more notable with continuous, albeit not strong, economic growth. The decisions taken by the Central Bank Council at its meeting in Leipzig the previous week had been based on the following assessment. Firstly, German M3 was still growing at a rate above its target range of 4%-6.5% although it was moving back towards the upper level. Secondly, the inflation rate in June, at 4.2%, had remained the same as in May. However, the inflation rate was a lagging indicator; the consolidation that was taking place in the public sector, both at the local authority and Länder levels, was pushing up administered prices. Nevertheless, it was hoped that during the next few months the rate of inflation would fall below 4%. Thirdly, with regard to fiscal policy, the German government had provided for substantial expenditure cuts, particularly relating to personnel expenditure and transfers, in its proposed budget for 1994 and subsequent years rather than concentrating on increasing revenue as it had done in the past. The German parliament was due to consider the budget proposals in September. All of these factors had made it possible for the Bundesbank to reduce German interest rates, but the room for manoeuvre had now been utilised; interest rates should not be expected to be cut whenever the Bundesbank Council met. Short-term rates had fallen to 7.4% while long-term interest rates had responded with a degree of uncertainty and had initially increased slightly as a result of portfolio shifts. There was currently a reflow into the Deutsche Mark but this "credibility bonus" could not be relied upon. Care had to be taken to ensure that long-term interest rates did not increase; therefore, the Bundesbank would proceed cautiously. The Bundesbank Council would analyse the monetary aggregate target at its meeting on 15th July; he felt that the target range was not likely to be changed. Exchange rate developments were also monitored carefully. There was less concern about the absolute level of the dollar exchange rate than about whether the fluctuations in its exchange rate reflected volatility or a continuous development. He would prefer politicians not to make statements about the dollar being undervalued because they further eroded the Bundesbank's room for manoeuvre. With regard to the Economic Unit's note which analysed various measures of competitiveness, he was concerned about the emphasis which had been placed on labour costs in the industrial sector in the determination of real exchange rates; he felt that it was the overall economic development which was important. Before any conclusions were reached about the competitiveness of currencies, the issues ought to be discussed in some depth. It was felt that the French franc and the French economy were competitive, although care was needed against being tempted by protectionism; it was not helpful for politicians to make statements about the need to take protective measures as these could have a negative impact on a currency's exchange rate. With regard to the EMS, the Deutsche Mark's current position was the result of normalisation. After previous realignments in the ERM, the Deutsche Mark had weakened because of reflows into devalued currencies. As far as Mr. Christophersen's suggestions were concerned, he considered it essential that convergence programmes were put into practice; multiplying the number of programmes produced by the Member States would not be helpful.

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

(a) Practical arrangements for the transition to the EMI and the necessary steps to be taken by the Committee of Governors

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

The Alternates had welcomed the Secretariat's paper and had broadly endorsed the suggested practical arrangements for the transition from the Committee of Governors to the EMI. The starting point of the paper was that the EMI would automatically be established on 1st January 1994 by virtue of the Treaty of Maastricht, provided that it had been ratified before the end of the year. At the same time, the delay involved in the decisions on the seat of the EMI and on its President, which were not expected before mid-October, made it impossible to have a fully-operational EMI, with its staff at the place of the seat, from 1st January 1994.

It was considered inevitable that arrangements should be made which would allow the EMI to perform its tasks and functions in the first phase of its existence. To the extent that these were largely identical to those of the Committee of Governors, the Alternates had felt it appropriate that the EMI should work on a provisional basis with an infrastructure similar to that of the Committee, with minor adjustments as the need arose. The only function which could not be performed within such a structure would be the management of foreign exchange reserves at the request of, and as agent for, national central banks. The Alternates had not considered it useful to delegate this function to another institution during the transitional period as this would run counter to the rationale of this activity.

If the EMI's infrastructure were, initially, to remain the same as at present, it was felt particularly important to reduce the uncertainties for the staff of the Committee. Most Alternates had been of the opinion that the Secretariat should continue to work on the basis of its present terms and conditions and that the current arrangements with the BIS should be continued. It had been stressed that: firstly, such arrangements would only be for a limited period; secondly, the employment of a few members of staff at the place of the seat of the EMI on terms and conditions appropriate for the new institution would not be ruled out; and, thirdly, steps to organise the transition should not be construed as a political decision involving a delay in the establishment of the EMI in its final form.

Finally, one Alternate had expressed concern that the consideration of such provisional practical arrangements could put central banks in the position of being accused of slowing down the political process towards the operation of a fully-fledged EMI.

2. **Discussion by the Committee**

The ***Chairman*** said that the subject had also been raised at the ECOFIN Council meeting during lunch. He had suggested, and it had been understood by the Finance Ministers, that the most pragmatic way to proceed would be to make use of the current infrastructure of the Committee of Governors for a brief period of, for instance, six months. Furthermore, he noted that, in accordance with Article 9.6 of the EMI Statute, the terms and conditions of employment of the President "shall be fixed by the Council of the EMI on a proposal from a committee comprising three members appointed by the Committee of Governors .... and three members appointed by the Council (of Ministers)". Although the President of the EMI had not yet been designated, he suggested that the Governors should meet in a restricted session before their September meeting to consider possible members and that he should contact the Chairman of the Council of Ministers to recommend similar action by the Council.

Mr. de Larosière said that the French Alternate had expressed his reservation about the negative publicity which would be given to the EMI beginning its existence outside of the Community; that could be interpreted as the manifestation of discouragement or stalling of the process towards EMU. The political sensitivities of this issue should be appreciated and care should be exercised not to give the impression that the Governors were retarding the implementation of the Treaty. However, he understood the practical difficulties which were faced given the uncertainties over the location and Presidency of the EMI and withdrew the Banque de France's reservation; nevertheless, he urged that the Chairman exercise caution in presenting the Governors' view of this issue so as to avoid any negative repercussions.

Mr. Christophersen said that he understood the practical constraints and felt that everybody would accept a pragmatic transitional arrangement. However, from the perspective of the Commission's task of seeing that the Treaty of Rome and the Maastricht Treaty were duly respected, he queried whether it would be possible for the EMI as a Community institution to hold its official meetings outside of the Community. It could not be excluded that the European Parliament, for example, would be critical.

The ***Committee*** agreed that it would proceed along the lines proposed by the Secretariat and endorsed by the Alternates.

(b) Secondary Community legislation for the start of Stage Two

Mr. Rey said that the Alternates had reviewed and finalised the draft letter to be sent by the Chairman to the President of the European Commission together with the accompanying notes on issues relating to secondary Community legislation, which was currently being prepared by the Commission with a view to the start of Stage Two of EMU. One major amendment concerned the note on the prohibition of central bank credit to the public sector (Article 104). The first full paragraph on page 2, dealing with the implications of the terms and conditions of the required conversion operations, had been accepted in the spirit of compromise between those who would have liked to point to the need to eliminate all claims on the public sector in non-marketable form, or on preferential terms, during Stage Two, and those would have preferred the absence of any comment in the opinion which went beyond a strict interpretation of Article 104. A second amendment related to the note on the provision of statistical data by the Commission for the establishment of the key for the financial resources of the EMI (Article 16.2 of the EMI Statute). The revised draft spelt out that purchasing power standard exchange rates would have certain advantages over market exchange rates, but had not been recommended because of statistical and practical constraints. The recommendation to use market exchange rates should not prejudge secondary legislation to be adopted for Stage Three and should be without prejudice to the ongoing work on establishing reliable purchasing power standard exchange rates.

Mr. Tietmeyer said that he endorsed the contents of the letter and the notes. He added that it was the Bundesbank's view that the question of the treatment of "old debt" provided by central banks to the public sector should be resolved in such a way that, at the end of Stage Two, all "old debts" must be marketable and attract market interest rates.

Mr. Christophersen said that, on 22nd July, he was due to submit to the Commission draft proposals for secondary legislation relating to: the prohibition of central bank credit to the public sector (Article 104); the prohibition of privileged access to financial institutions (Article 104a); the excessive deficit procedure (Article 104c); and the provision of statistical data for the determination of the key for the financing of the EMI (Article 16.2 of the EMI Statute). He hoped to be able to submit a draft proposal concerning consultations of the EMI by the national authorities of the Member States in September (Article 5.3 of the EMI Statute). Arrangements had been made with the European Parliament and the Council of Ministers such that, as soon as the Maastricht Treaty had been ratified by all Member States (which was expected in the first half of October), an opinion on the Commission's proposals could be adopted by the European Parliament in its October session; the Council of Ministers could then adopt the legal texts in November. He added that the Commission was very grateful for the assistance provided by the Committee of Governors in the preparation of the proposals for secondary legislation and assured that all of the main suggestions made by the Committee would be taken into account.

The ***Committee*** agreed that the letter and the accompanying notes be sent to the President of the European Commission and that copies be sent to the EFTA central banks.

(c) Proposal for an accounting method for the EMI

The ***Committee*** endorsed the proposals made in the report by the Working Group on Accounting Issues with respect to the accounting method for the EMI. It noted that the proposals, in particular those relating to the valuation of assets and liabilities and for the recognition of income, did not prejudge the choice of the accounting method and practices to be adopted by the European System of Central Banks in Stage Three. The Committee also agreed with the proposals for the follow-up work which the Working Group intended to undertake, and decided that the report be released to the EFTA central banks.

(d) Guidelines for the implementation of information systems for the EMI

The *Committee* endorsed the second interim report by the Working Group on Information Systems and took note of the following two issues. Firstly, the disconnection from the BIS of the Secretariat's technical infrastructure, in order to allow its transportability to the EMI, would require the recruitment of additional staff in the Secretariat at least six months in advance of a physical move to the site of the EMI. Secondly, the implementation of new systems to support functions which were additional to those currently undertaken by the Secretariat would involve a lead time of at least six months from the date on which a decision was taken and the requirements defined. The Committee also agreed that copies of the Working Group's report be sent to the EFTA central banks.

(e) Issues relating to the printing and issuing of a European bank-note

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

The Alternates had praised the high quality of the interim report by the Working Group on Printing and Issuing a European Banknote. However, in dealing with the technical aspects of note printing and issuing, the Working Group had touched on questions of a more political nature upon which it was premature to decide. Indeed, decisions would have to be carefully prepared through a wide-ranging consultation process. The British Alternate had recalled that, at the time of the decimalisation of sterling, it had been recognised that major costs would have to be borne by the users of the currency and a special commission had been set up to take account of the sensitivities of the process and to carry out the necessary consultations. The Alternates had suggested that, in endorsing the work done so far, the Governors should make it clear that they were not in a position to approve any of the report's recommendations. This should not prevent the Working Group from continuing work on the two scenarios representative of all options for the appearance of the ECU banknote; it should confine itself to technical investigations and should not assume that any option had been discarded at this stage.

Some further specific points had been raised. The Danish Alternate had stressed that, while the Danmarks Nationalbank was satisfied to be a member of the Working Group, Denmark's position under the decisions of the European Council taken at the Edinburgh Summit in December 1992 would have to be taken into account whenever this work was given publicity. Secondly, contact with the Mint Directors should only be made when the latter had received a formal mandate from the Finance Ministers; a draft mandate was apparently being prepared for submission to the ECOFIN Council. Thirdly, concern had been expressed that the Graphic ECU Competition, organised by Mrs. Bourdon, was proceeding amidst a lot of publicity and with the alleged support of the Commission and central banks. Finally, the question of transmitting the report to the EFTA central banks had not been discussed although the Working Group had itself felt that, for confidentiality reasons, the "Data Survey" should not be made available to parties outside of the Community central banks.

2. Discussion by the Committee

The *Chairman* suggested that the Working Group be asked to continue its work on the "common" and "national/common" options, although no decisions were to be taken by the Working Group. He stressed that the work of the group was to continue to be kept low-key and that not even the main report be released to the EFTA central banks.

Mr. de Larosière expressed his appreciation for the work undertaken by the Working Group to date, which should continue. He agreed with the Chairman's suggestions.

Mr. Christodoulou suggested that the Governors should ask the Working Group to elaborate on the lead times anticipated in the report in respect of the design and production of the new bank notes. He was surprised that these were so long.

Mr. Tietmeyer stressed that the Working Group should continue to work on a low-key basis. If its interim report was leaked to the public, it would receive widespread publicity which would lead to an unproductive, controversial debate.

Mr. Jaans agreed that the work should be kept low-key but suggested that the experience of note production in the US should be considered as, like the US dollar, the future European banknote would be expected to be used outside the common monetary area on a large scale.

The *Committee* agreed that the Working Group should continue its work, in a low-key manner, on the basis of the "common" and "national/common" options suggested in its report, and to elaborate on the length of the lead times needed for the design and production of a European bank note. It was also decided not to release any parts of the report to the EFTA central banks.

VI Other matters falling within the competence of the Committee

(a) Reply to the letter addressed by Mr. Christophersen to the Chairman of the Committee of Governors

In response to a letter from Mr. Christophersen dated 24th June 1993 addressed to the Chairman, the *Committee* approved the draft reply prepared by the Secretariat which emphasised that prepayments of financial contributions to the EMI did not imply a definitive form of financing.

(b) Professional staff in the Secretariat

The *Committee* approved the appointment of Mr. Davis and Mr. Escrivá as economists in the Economic Unit and noted that Mr. Viñals, the Head of the Economic Unit, would be returning to the Banco de España at the end of September.

(c) Other matters

The *Chairman* informed the Committee that he was due to have a meeting that afternoon with the Governors of the *EFTA central banks* to brief them on the state of the Committee's preparatory work towards Stages Two and Three of EMU, and that he would also be having a meeting with *representatives of trade unions* of Community central banks. That evening, he was due to present the Committee's 1992 Annual Report to the *European Parliament*. In responding to any questions raised in the parliament about the preparatory work, he would stress that the Governors' work was proceeding and that there was no tendency towards delaying the setting up of the EMI.

VII Date and place of next meeting

The next meeting of the Committee would take place at the BIS in Basle on Tuesday, 14th September 1993.

278TH MEETING OF THE COMMITTEE OF GOVERNORS
13th July 1993

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

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[1] Chairman of the Committee of Alternates