14th January 1992

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Final

MINUTES

OF THE 261st MEETING OF THE COMMITTEE OF GOVERNORS

OF THE CENTRAL BANKS OF THE MEMBER STATES

OF THE EUROPEAN ECONOMIC COMMUNITY

HELD IN BASLE ON TUESDAY, 10th DECEMBER 1991 AT 9.30 a.m.

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I. Approval of the minutes of the 259th and 260th meetings

The Committee approved the minutes of the 259th and 260th meetings.

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

- Preparation by the Foreign Exchange Policy Sub-Committee (Monitoring):
- Statistical charts and tables prepared by the Secretariat

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

The Monitoring Group had concentrated on the tensions in the EMS in November which had been evidenced by: increases in interest rates in almost every EMS member country; a widening of interest rate differentials vis-à-vis Germany; interventions by a number of central banks; and greater movement of currencies in both the narrow and wide bands although no currency had been pushed to its margins. The tensions had arisen largely as a result of factors external to the Community. The continuing decline of the US dollar had destabilised exchange markets, which had anticipated a further reduction of the discount rate as a result of the poor performance of the US economy although it might have benefited temporarily from events in the former Soviet Union. While the present level of the US dollar was not felt to be a problem, a further decline might make concerted stabilising action desirable. Tension had also been caused by the devaluation of the Finnish markka, which had highlighted the fragility of unilateral links to currency baskets and had led to a speculative attack on the Swedish krona necessitating an exceptionally large increase in official Swedish interest rates.

These factors had further increased the demand for Deutsche Mark at a time when it was already strong because of: a large favourable interest rate differential against the US dollar; the expected increase in official German interest rates; and a seasonal upward movement of money market rates as market participants covered short Deutsche Mark positions. The tension had abated as interest rates had been allowed to raise elsewhere, particularly in France and Italy, although the Deutsche Bundesbank's decision not to raise its official rates in early December had not fully dispelled market expectations of a future rise, particularly given the outlook for inflation and wage settlements in Germany.

In France, substantial intervention had been required and market interest rates had been allowed to increase by about 1 percentage point despite a continuing good performance in terms of inflation, the current account and budgetary development. In Italy, insufficient progress had been made in reducing domestic imbalances and, in addition to strong intervention, the Banca d'Italia had let interest rates rise by about 1 percentage point whilst allowing the lira to decline from its position near the top of the narrow band. A similar situation had occurred in Ireland, where capital outflows had been triggered by the decline of both the dollar and sterling. In the United Kingdom, sterling had declined vis-à-vis the narrow band currencies whilst keeping a relatively constant spread against the Spanish peseta, which continued to occupy the top position in the wide band. No capital outflows had occurred in either Spain or Portugal. The decline in the Portuguese escudo had been entirely due to the impact of the Finnish markka's devaluation, which had led the market to reconsider the risk of holding currencies unilaterally linked to a basket. The Greek drachma had also been subject to downward pressure, mostly on account of seasonal factors, necessitating intervention on several occasions. Interest rates had risen in Belgium, the Netherlands and Denmark in line with those in Germany. In the Netherlands, the increase had taken place against a background of accelerating domestic inflation and an interest rate differential of 50 basis points vis-à-vis the ten-year German government bond.

Although the tension experienced by the EMS had been widespread, the credibility of the ERM parity grid had not been questioned and the response of the monetary authorities had been consistent with the Basle/Nyborg Agreement. However, further tension could not be ruled out since several determinants of the recent market unrest continued to prevail.

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

The Alternates had observed that, when currencies depreciated for reasons unrelated to fundamentals, the movement could easily be stabilised within the intervention limit, as had occurred in the case of the pound sterling. While the Danish krone had also been allowed to slip within the narrow band in response to interest rate driven capital outflows, its parity had not been tested despite turbulence in the Finnish and Swedish foreign exchange markets. Whilst the tensions did not appear to have called into question the credibility of central rates in the ERM, the turbulence in the Nordic region had increased market awareness of foreign exchange risks. For example, some pressure had been brought to bear on the Portuguese escudo in the wake of the Finnish markka's devaluation. The Portuguese authorities had considered this to be only a temporary phenomenon and the resulting depreciation of the currency should not be misinterpreted as representing a change in policy.

Tensions in the ERM had to some extent reflected unstable conditions in world currency markets. On the one hand, the US dollar had been subject to downward pressure, which had only been occasionally reversed by safe-haven reactions linked to political developments in the Soviet Union; on the other hand, the Deutsche Mark had strengthened. A further decline in US short-term interest rates might renew downward pressure on the US dollar even if some support could be expected from a steepening yield curve. The strengthening of the Deutsche Mark had been due to the expectation of a firm policy stance on the part of the Deutsche Bundesbank in response to wage and price pressures, and had occurred despite heavy intervention sales of the German currency, particularly in the Nordic area, and a widening of the interest rate differentials in favour of some other ERM currencies. While the commitment to the existing parity grid had been demonstrated, business conditions in Europe did not in themselves warrant a general rise in interest rates. Thus it was important that the firm anti-inflationary stance of the Deutsche Bundesbank should produce the desired effects on wage negotiations and that the policy mix be corrected in countries where it was a problem.

3. Discussion by the Committee

Mr. de Larosière said that France had recently announced a tightening of the target range for M_3 growth from 5 - 7% in 1991 to 4 - 6% in 1992. The underlying growth rate of M_3 was around 5%. Taking into account changes in velocity of money, the target would be consistent with economic growth of 2 - 2.5% and a decline of inflation to 2.5%. The charts prepared by the Secretariat showed that since 1986, the French franc had gained in competitiveness by 9% in terms of unit labour costs and approximately 7% in terms of the CPI. This had been a product of the anti-inflationary policy pursued in France over a number of years. Of the current 1.5% annual rate of growth in France 1 percentage point had been contributed by exports which had grown by 8% in real terms. France had avoided a recession in 1991 because improved competitiveness of the French economy had enabled it to take advantage of external demand, notably originating in Germany. The authorities' response to tensions in the ERM had been in line with the "Basle/Nyborg" principles; tensions would settle by themselves if, as pointed out by Mr. Rey, the fundamentals were sound.

Mr. Tavares Moreira said that Portugal remained committed to a firm exchange rate policy as a basic instrument to control and reduce inflation. Since October 1990, the policy had been to shadow the ERM in such a way that the Portuguese escudo had been allowed to fluctuate within a band which resembled the wide ERM band. When the Portuguese escudo had come under pressure following the devaluation of the Finnish markka, the currency had been allowed to slip since it was at the top of the "band". The thinness of the market, however, had made it necessary to intervene on a small scale when the level of Esc. 89.2 per 1 DM had been reached. This had been perceived by the market as a signal of the central bank's determination to keep the currency under control. He added that the Portuguese authorities had recently informed the EC Commission of their decision to extend controls on the purchase by non-residents of Portuguese escudo-denominated floating rate bonds for a further four months.

Mr. Schlesinger said that he fully supported the Alternates' critical assessment of the recent situation which, indeed, raised questions about the credibility of the parity grid. Statistics showed that two-thirds of the interventions undertaken during the year had occurred in November. Given the unstable conditions surrounding the US dollar, the divergent economic trends in Community countries and the steps that had been taken to defend the parity grid, the overall situation could not be considered particularly balanced. The Deutsche Bundesbank's Central Bank Council had agreed on a monetary growth range of 3.5 - 5.5% for 1992, which was half a percentage point higher than the target for 1991. The emphasis was very much on the pursuit of a very tight monetary policy. The rediscount quotas for eastern German banks would be reduced during the coming year to levels closer to those in western Germany. There had been much discussion about whether price stability in Germany would be endangered in 1992 in view of the current fairly high wage claims and whether the Deutsche Bundesbank should take action or not. So far, German interest rates had not been increased but, unless there was fundamental change in the present situation, some upward adjustment might be necessary in the near future.

Mr. Ciampi observed that the sizable interventions undertaken in November 1991 should be evaluated in the light of the enlarged dimensions of short-term capital flows: it follows that central banks would have to intervene in amounts which, abnormally high in the past, might be now considered normal. To the extent that the tensions had been caused by events outside the EMS, in particular the behaviour of the US dollar, efforts should be made to limit such external effects; in particular co-ordination between monetary policies, not just between exchange rate policies, should be reinforced.

Mr. Leigh-Pemberton said that, after a very satisfactory year of remaining within the narrow band, sterling had made some use of the scope provided by the wider band. However, whilst there was no doubt about the United Kingdom's commitment to the ERM, a dilemma existed on the use of interest rates. The United Kingdom Government would find it extremely disappointing if interest rates had to be increased before next year's general election; any such move could be perceived as a failure of government policy which might give rise to further pressure on the exchange rate. If, following the Maastricht summit, the prospects for the present Government improved, sterling would perform better, although the past month had been difficult in terms both of the prospects for the British economy's recovery and of those for the present Government.

The Chairman said that, in Denmark, interest rate adjustments had been de-dramatised by taking interest rate changes out of the political debate. This was necessary in order to preserve the credibility of the system.

Mr. de Larosière shared the view of the Chairman. It was important to de-dramatise adjustments of interest rates effected with a view to monetary stability in the ERM. However, one would have to bear in mind that when economic activity in European economies was weak, a decision to tighten monetary policy because of factors which appeared to be more related to the weakness of the dollar could lead to tension within the EMS and complicate the pursuit of monetary policies. He hoped that the policy mix in Germany, especially a strong hand on budgetary policy and public sector wages, would permit a more muted use of monetary policy in future.

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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 November and the first few days of December 1991

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

IV. Annual review of developments in the EMS exchange rate mechanism

- Preparation by the Foreign Exchange Policy Sub-Committee of Report Number 6
- Statistical Supplement
- Preparation by the Economic Unit of two papers entitled "Credibility in the ERM" and "Competitiveness, Relative Cyclical Performance and Recent Developments in the Trade Positions of EC Countries"

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

Mr. Saccomanni stressed that the Sub-Committee had sought to assess the impact on the EMS of the Gulf crisis, the unification of Germany and the collapse of communist regimes in central and eastern Europe. Despite these events, and against a background of a slowdown in economic activity worldwide and pronounced divergence in relative cyclical positions within the Community, the ERM had functioned smoothly. Relatively stable conditions had prevailed during most of the period, there had been no realignment and occasional tensions had not seriously threatened the parity grid.

Particular attention had been paid to the factors affecting the stability of the ERM: the policy response by monetary authorities to situations of tension in the ERM; the performance of member countries' economies; and the progress towards EMU. The markets had increasingly taken into account the changed attitude of monetary authorities vis-à-vis the objective of exchange rate stability, having tested the determination to defend the prevailing ERM parities. Less weight had been attached by the authorities of ERM countries to exchange rate changes as an instrument, whilst stability of nominal exchange rates had been used to reinforce the impact of anti-inflation monetary policies.

Uncertainty about the impact on monetary stability of German unification had led to a temporary change in market sentiment vis-à-vis the Deutsche Mark. The demand-pull effect of unification and a slowdown in economic activity in other ERM countries had contributed to the narrowing of external imbalances. The Sub-Committee had identified the following risks for the ERM: divergent wage developments, which might call for differentiated policy responses; failure to make substantial progress towards fiscal consolidation; widening external imbalances; and speculative pressures which might arise during the process of transition to the final stage of EMU if the markets expected that it could entail exchange rate adjustments. Potential disturbances might also result from external developments, particularly from a further decline in the US dollar.

The Sub-Committee had concluded that the Basle/Nyborg principles could only help preserve stability in the ERM in the case of transitory tensions which were not fundamental. Should more fundamental shocks occur, a greater role would have to be assigned to other policies, especially fiscal and incomes policies. Improvements in the policy mix and the implementation of appropriate supply-side policies were the means to reduce inflation differentials and to cope with the problem of a deteriorating competitive position of countries with current-account deficits. Such prescriptions also applied to the prospective members of the ERM, Portugal and Greece, where progress towards price stability should be the central objective.

The Sub-Committee felt that the risk of speculative pressures in the expectation of a "last realignment" in the run-up to the final stage of EMU was potentially disruptive and should be considered by the Governors. It was considered doubtful whether public reaffirmation of the principles set out in the Basle/Nyborg Agreement would have a sufficiently stabilising effect on the markets. Finally, sharp fluctuations of the US dollar, which gave rise to disturbances in the ERM, should be addressed through concerted actions involving the US authorities, although this presupposed that a common view could be reached on the appropriate level of the US dollar exchange rate.

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

The Alternates had focused on three main issues. Firstly, how Member States should manage the "capital of credibility" built up in the ERM over the past five years. While the enhanced credibility of ERM central parities constituted a valuable asset, it ought to rest on firm economic ground. It would thus be necessary to improve the economic policies of those ERM countries which had an unbalanced policy mix, particularly those whose size and impact on the Community was the greatest. In the absence of increased support from non-monetary policies in the form of more favourable wage and fiscal developments, it was likely that monetary policy would remain overburdened in the pursuit of price stability. The forthcoming adoption of programmes of economic convergence, such as that already adopted in Italy, could be helpful in this respect.

The credibility of the ERM parities would not be enhanced if central rates were artificially kept unchanged in the face of persisting and unsustainable divergences. If such a situation were to lead to a loss of confidence in existing exchange rate relationships and to serious speculative pressures, a realignment might become unavoidable. It was not suggested that such conditions were approaching, much less that a decisive case could be made for the existence of a fundamental disequilibrium among any of the ERM countries. It was also not clear that it would be easy to develop common views on the appropriate way of measuring critical divergences beyond which such a disequilibrium could emerge since competitiveness was very difficult to assess. The Alternates thought it would be useful to discuss such questions before market or political perceptions became too sensitive.

The third issue concerned the lessons to be learned from the establishment of unilateral links between several Nordic currencies and the ecu. Insofar as unilateral links had, or might be, put to the test by the market, tension could arise and adversely affect exchange rate stability within the ERM. Since Member States had no influence on factors which underpinned a credible, stable, unilateral link to the ecu, such as the choice by non-ERM countries of the central parity of their respective currencies vis-à-vis the ecu or their domestic policies, the Alternates felt that this matter merited further consideration.

3. Discussion by the Committee

Mr. de Larosière congratulated the Economic Unit for its paper on competitiveness and relative cyclical performance, which had established that demand conditions were probably stronger in their impact on balance-of-payments and trade positions than price elements. Thus, if Member States wished to stabilise conditions amongst themselves, a mix of policies which would achieve the best possible growth and disinflationary conditions should be aimed at. All Community countries, particularly those with an anchor role, had responsibility for ensuring that the mix of policies was aimed at stabilising the system to provide the most durable conditions for non-inflationary growth.

Mr. Schlesinger felt that the report was very balanced. German monetary union, which had occurred at the beginning of the period covered by the report, had had a considerable impact on Germany's foreign trading position and thus had contributed to stabilising the ERM. However, this could not be expected to continue. Indeed, the move into current-account deficit was likely to be reversed as the recovery of productive capacity in eastern Germany would help to satisfy domestic demand to a larger extent than in the past. Under these conditions, imbalances in the ERM were likely to re-emerge. He referred to the conclusions set out in the Sub-Committee's report and observed that consideration needed to be given as to whether the present parity grid would continue to be appropriate in the future, or whether tensions within the EMS, such as those seen in November, would increase to such a degree that an adjustment might need to be considered in the context of the move to the second stage of EMU.

Mr. Leigh-Pemberton asked Mr. Schlesinger to what extent he felt that the current strength of the Deutsche Mark was helping to reduce inflationary pressure in Germany and whether this strength obviated the necessity of tightening monetary policy. He wondered whether the current inflationary tendency derived from cost-push factors and whether these might be better dealt with by the use of persuasion, rather than a tightening of the overall monetary situation which would be the classic remedy for demand-pull inflation.

Mr. Schlesinger confirmed that the current strengthening of the Deutsche Mark had helped to diminish inflationary pressures, but it had to be borne in mind that over the last two years the Deutsche Mark had not strengthened in nominal terms and had weakened in real terms. Thus, the present upward movement of the Deutsche Mark was only the correction of a previous downward trend. Concerning Mr. Leigh-Pemberton's second point, Mr. Schlesinger said that the current level of wage demands could not be compensated through productivity gains either in western or, especially, in eastern Germany. Alternative policies might be more appropriate, although any form of incomes policy conducted by the German Government using persuasion had not in the past been very productive. Much might depend on the stance that the German Government took on wages as an employer. As far as monetary policy was concerned, the Deutsche Bundesbank was very sensitive to the various options and the impact that any policy stance would have on Germany's Community partners. Looking to the future, the existing parity grid might not be sustainable if relatively strong imbalances occurred.

Mr. de Larosière said that the plausibility of the exchange rate grid would be assessed by the markets using a number of indicators, principally inflation. He noted that, in terms of unit labour costs, the Deutsche Mark had lost competitiveness over the period since 1986 whilst other currencies had fared similarly against a range of indicators. He did not feel that it was in the interests of the EMS to question the sustainability of the parity grid, so as not to complicate the task of those countries which had to make necessary adjustments. There was no single answer to the question. If a country had an inflationary tendency that resulted from a mix of factors such as excessive budgetary deficits and wage formation that were not under control, it should orientate its various policy instruments in the manner which would be most appropriate for the country concerned. This meant that if the countries did not consider exchange rate adjustments to be an appropriate tool, this choice should be respected. All present imbalances were correctable through economic policy measures; they did not necessarily or inevitably need to be corrected by exchange rate variations.

In conclusion, the Chairman expressed his appreciation of the work done by the Sub-Committee and the Economic Unit.

V. Principles concerning prior agreements on interventions in Community currencies

The Committee approved the Foreign Exchange Policy Sub-Committee's recommendation that the trial period be extended for a further six months so that an assessment could be made of how the arrangement operated during a period of tension.

Mr. Saccomanni said that the Sub-Committee had appreciated the flexibility of the Deutsche Bundesbank in allowing central banks to use Deutsche Mark in interventions. This had demonstrated that the arrangements could be effective, although the size of some interventions had indicated that the current levels of bilateral limits were not adequate to cope with all situations.

VI. Renewal of the swap agreement with Norges Bank

The Governors agreed to renew the swap agreements of their respective central banks with Norges Bank with the incorporation of two small amendments recommended by the Foreign Exchange Policy Sub-Committee.

VII. Economic and Monetary Union

Summarising the most recent developments, Mr. Baer said that the only part of the draft treaty on EMU which was being discussed in Maastricht was the procedure on how to move to Stage Three. The other parts of the Treaty had already been finalised by the Ministers of Finance at their meetings on 1st to 3rd December 1991. In this context, it was noteworthy that only few changes had been made to Chapter I to VIII of the ESCB Statute as proposed by the Committee. These changes did not affect the basic principles of the Governors' statute proposals, i.e. the maintenance of price stability as the primary objective of the single monetary policy, the independence of the ESCB, the ban on monetary financing, the provisions concerning democratic accountability, financial arrangements and regulatory powers.

With regard to those provisions on which the Governors had not reached unanimity, Mr. Baer explained that Chapter IX of the ESCB Statute, as finalised by the IGC, reflected to a large extent the "Assembly formula" which had been supported by a majority of Governors. Although it was to be called the General Council, it would exist alongside the Governing Council of the System and the Executive Board. The responsibilities of the General Council would only be of a consultative nature; responsibility for the tasks and functions of the ESCB would rest with the Governing Council. The distribution of responsibilities for external monetary policy, which had also been an area of controversy among the Governors, had finally been agreed by the IGC. Article 109 of the Treaty conferred upon the Council of Ministers the responsibility for establishing an exchange rate system for the ecu vis-à-vis third currencies. The ECB would be able to make a recommendation or would be consulted in this context with a view to reaching consensus consistent with the objective of price stability. In the absence of such an exchange rate system, the Council of Ministers would be entitled to formulate general orientations for exchange rate policies vis-à-vis third currencies. However, these general orientations would not be legally binding and would have to be without prejudice to the primary objective of the ESCB to maintain price stability.

261st MEETING OF THE COMMITTEE OF GOVERNORS

10th DECEMBER 1991

Those present were:

Chairman of the Committee of Governors	Mr. Hoffmeyer
Banque Nationale de Belgique	Mr. Verplaetse Mr. Rey* Mr. van der Haegen
Danmarks Nationalbank	Mrs. Andersen Mr. Hansen
Deutsche Bundesbank	Mr. Schlesinger Mr. Tietmeyer Mr. Rieke
Bank of Greece	Mr. Chalikias Mr. Papademos Mr. Karamouzis
Banco de España	Mr. Rubio Mr. Linde Mr. Durán
Banque de France	Mr. de Larosière Mr. Lagayette Mr. Cappanera
Central Bank of Ireland	Mr. Doyle Mr. Coffey Mr. Reynolds
Banca d'Italia	Mr. Ciampi Mr. Dini Mr. Santini
Institut Monétaire Luxembourgeois	Mr. Jaans
Nederlandsche Bank	Mr. Duisenberg Mr. Szász Mr. Scholten
Banco de Portugal	Mr. Tavares Moreira Mr. Borges Mr. Bento
Bank of England	Mr. Leigh-Pemberton Mr. Crockett Mr. Foot
Commission of the European Communities	Mr. Pons
Chairman of the Foreign Exchange Sub-Committee	Mr. Saccomanni
Secretariat of the Committee of Governors	Mr. Baer Mr. Scheller Mr. Viñals

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* Chairman of the Committee of Alternates