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(Translation)

MINUTES *

OF THE 239th MEETING OF THE COMMITTEE OF GOVERNORS

OF THE CENTRAL BANKS OF THE MEMBER STATES

OF THE EUROPEAN ECONOMIC COMMUNITY

HELD IN BASLE ON TUESDAY, 14th NOVEMBER 1989 AT 10.30 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, Mr. Michielsen and Mrs. de Wachter; the Governor of Danmarks Nationalbank, Mr. Hoffmeyer, accompanied by Mr. Mikkelsen; the President of the Deutsche Bundesbank, Mr. Pöhl, accompanied by Mr. Schlesinger 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; the Governor of the Banco de Portugal, Mr. Tavares Moreira, accompanied by Mr. Pêgo Marques and Mr. Amorim; the Governor of the Bank of England, Mr. Leigh-Pemberton, accompanied by Mr. Price; the President of the Commission of the European Communities, Mr. Delors, accompanied by Mr. Pons, Mr. Boyd 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. Raymond and Mr. Dalgaard, Chairmen of the Groups of Experts. The Secretary General of the Committee, Mr. Morelli, his Deputy, Mr. Bascoul, Mr. Scheller and Mr. Giles, and Mr. Bockelmann and Mr. Dagassan also attended.

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

I. Approval of the minutes of the 238th meeting

The Committee approved the minutes of the 238th meeting on the understanding that the editorial amendments suggested would be incorporated in the final text.

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

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

A. Statement by Mr. Dalgaard

The experts had noted that the dollar had weakened by almost 7% since the beginning of September and that there was no longer any talk of an upward trend. There were several reasons for this decline, in particular the narrowing of interest rate differentials and the declaration by the Group of Seven, which had been followed up by sizable interventions. A further weakening of the dollar appeared more probable than renewed firmness if various factors came into play, for example if there was no improvement in the US trade balance and budget, if interest differentials narrowed further and if the political situation in Europe stabilised.

As far as the EMS was concerned, the experts had focused on two events, viz. the interest rate rise in Germany and the rumours of a realignment. German market rates had risen gradually by 1% at the short-term end and 0.5% for the long term; official rates had been raised by 1% on 6th October. The majority of the other EEC countries had immediately followed this increase. Spain and Italy, with already high rates and firm currencies, had not raised their official rates and had allowed their currencies to weaken.

Rumours of a realignment had begun to be heard in the first half of October and had become very strong around the 15th of the month; based on statements made in Germany, the rumours had been felt in most ERM countries, and especially in Denmark, Italy, France, Spain and Ireland. These countries had had to undertake at times massive interventions, such as Denmark's record sale in a single day of DM 3 billion on Friday, 13th October.

The experts' views had differed as to the conclusions that could be drawn from the last two months' experience in the EMS. An optimistic view had been that the exchange rate mechanism had handled the problems without too much difficulty, despite the advanced stage reached in the liberalisation of capital movements and the long interval of almost three years since the last realignment. Another view had held that recent experience had shown that the situation in the EMS might be precarious; even relatively vague rumours could trigger very large interventions. This highlighted the need to ensure that exchange rates were convincing at all times. In this connection the Bundesbank expert had mentioned that the Deutsche Mark had depreciated by 5% in real terms in the period since the last realignment, in the course of which Germany had had a very large and increasing current-account surplus.

B. Statement by Mr. Papademos

The Alternates had first had an exchange of views on the recent weakening of the US dollar. It had been noted that the market sentiment towards the dollar appeared to have turned neutral or even bearish, which was a welcome development. There had been general agreement that the further narrowing of interest rate differentials had contributed to the recent decline of the dollar, but there was less agreement on whether it had been the main contributing factor. Some Alternates had emphasised the important role that concerted interventions and public statements had played in triggering the dollar's fall, following the G-7 meeting. It had been pointed out that the importance of reduced interest rate differentials should not be over-emphasised, as there had been periods in which lower interest rate differentials had been associated with a strengthening of the dollar.

The Alternates had also discussed the appropriate policies for dealing with the large and growing intra-Community current-account imbalances. The German Alternate had stressed that the imbalances reflected fundamental disequilibria and should be remedied through a realignment of exchange rate parities. Without a change in parities, Germany would be importing inflation and its role as stability anchor in the EMS could be jeopardised. Most Alternates had considered that current-account imbalances could be addressed more effectively by employing domestic policy measures and by closer policy co-ordination. The importance of improving the policy mix in some countries had also been stressed. Exchange rate adjustments should not be ruled out, but they should play a secondary role. Demand management produced its impact with a time-lag, but its effects in lessening disequilibria were more permanent.

In connection with this discussion, reference had been made to the effects on the markets of public statements concerning the desirability of a realignment. The markets' interpretation of these statements as relating to particular currencies had been unfortunate; nevertheless, it had been a free expression of public opinion. A number of Alternates had pointed out that the utmost restraint should be exercised in discussing the issue of a possible realignment.

The Alternates had, finally, discussed interest rate policies in some Community countries and the use of intervention currencies.

The recent weakening of the Belgian franc, despite the positive economic developments in Belgium, had appeared to be due to the narrowing of the differential between Belgian and German interest rates.

The British Alternate had reiterated the UK policy-makers' commitment to continue the fight against inflation by pursuing a policy of high interest rates and maintaining a strong currency. However, the recent depreciation of sterling would contribute to the adjustment process, while the slowing-down of the domestic economy would free resources for an expansion of net exports.

With respect to the use of intervention currencies, the German Alternate had underlined that, according to the Basle-Nyborg Agreement, intra-marginal interventions could be carried out only with the consent of the central bank issuing the intervention currency. However, he had pointed out that it would be unfortunate to reopen the debate on the use of currencies in intra-marginal interventions. The Bundesbank had accepted the Basle-Nyborg Agreement on the condition that other countries respected the requirement of prior notification of the issuing central bank of intra-marginal interventions in its currency. If there were some technical difficulties in meeting this requirement during fixing sessions, they should be tackled, and to this end the German Alternate had suggested examination of this issue by the Dalgaard Group.

The Spanish Alternate had endorsed this proposal and had said that in certain cases during the fixing session compliance with the notification requirement would imply a compromise of exchange rate objectives which was not acceptable. He had suggested that the present rules and procedures had become outdated and would have to be re-examined. Interventions could in practice be carried out in a disguised manner, but the Banco de España did not intend to resort to such practices.

It had also been stressed by the French Alternate that conditions in the foreign exchange markets changed rapidly and intervention decisions had to be taken quickly, and this might make it difficult to communicate interventions prior to their implementation. A possible solution to the problem might be the establishment of minimum amounts of balances for interventions in different currencies for which notification would not be required.

Replying to a remark by Mr. Rubio, the Chairman indicated that the Group of Experts under the chairmanship of Mr. Dalgaard would indeed be examining the problems that had been mentioned with regard to interventions and would be reporting to the Governors.

III. Adoption of the Committee's report to the EEC Ministers of Finance on developments on the foreign exchange markets of the nineteen countries participating in the concertation procedure during September, October and the first few days of November 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 the Report from the Committee of Alternates on the organisation of the Committee of Governors in view of Stage One of Economic and Monetary Union

The Chairman said that in view of the limited time available to the Governors and the fact that the issues dealt with in the Alternates' Report required in-depth study, he proposed to postpone discussion of this item until December. He reported briefly on the discussion which had taken place on Monday, 13th November at the ECOFIN Council meeting on Economic and Monetary Union, confining himself to the part which he had attended, viz. Stage One. Mr. Delors might then present some comments regarding the Ministers' discussion of Stages II and III, which had taken place later.

As far as Stage One of Economic and Monetary Union was concerned, the ECOFIN Council had indicated its agreement in principle to the texts of the two proposals concerning the 1964 and 1974 Decisions, it having been understood that formal adoption should take place at the next meeting on 18th December 1989 once the necessary opinions from the European Parliament and the Economic and Social Committee had been delivered.

The texts agreed by the Ministers reflected the versions including the amendments suggested by the Monetary Committee with a few exceptions; those mentioned below were of direct interest to the Governors and concerned in particular the 1964 Decision.

Firstly, in the second recital of the 1964 Decision, the Commission had added the word "social" (which had not appeared in the Governors' draft) to the idea of economic cohesion between the Member States. The Monetary Committee had suggested deleting the word but, at the request of the Commission, the Council had agreed to reinstate it.

Secondly, in Article 2(a) of the 1964 Decision, the Council had adopted the Governors' wording, viz. "the Chairman of the Committee [and not the members] shall be invited to participate in the meetings of the Council of Ministers, whenever it deals with issues involving the tasks of the Committee of Governors". The Council had adopted the same position regarding the representation of the Committee of Governors in the Council's multilateral surveillance (Article 7 of the 1974 Decision), with the following entry to be made in the minutes of its meeting: "The Council agreed that at each of its informal meetings, where the Governors of the central banks of the Member States participate, an exchange of views will take place on the economic and monetary policy in the Community".

Thirdly, in Article 3, paragraph 1, of the 1964 Decision, the words "and including" would be replaced by "as well as" issues within the competences of the central banks affecting the stability of financial institutions and markets.

Fourthly, the Monetary Committee had suggested removing the European Council from the list of Community bodies to which the Committee of Governors would send its annual report. The Council had reinstated the reference in conformity with the Governors' draft and the Commission's proposal. However, it would be stated in the minutes of the Council session that this was purely a transmission, not a submission for discussion or approval.

The Chairman concluded his report with two remarks. Firstly, he thanked the Commission, and in particular President Delors, for the support they had given to the consensus reached by the Governors and reflected in their draft of the 1964 Decision. Secondly, he suggested that, after having listened to the remarks of President Delors on the Ministers' discussion of Stages II and III of Economic and Monetary Union, the Governors might have an exchange of views on the procedure which could be followed by the Committee to participate in the preparatory work for the inter-governmental conference, in line with the conclusions of the Presidency of the European Council in Madrid.

Mr. Delors confirmed that on Monday the Finance Ministers had given their agreement in principle to the texts of the 1964 and 1974 Decisions; the adoption of the Decisions, which had been unable to take place solely on procedural grounds, i.e. the availability of the necessary opinions, would take place in December.

As far as the Council's discussion of the subsequent stages of Economic and Monetary Union was concerned, the Ministers had heard two introductory reports. The first had been presented by Mrs. E. Guigou on behalf of the group of personal representatives of the Finance Ministers and the Ministers for Foreign Affairs which had been established by the French Presidency. This document had doubtless been submitted to the Governors and did not require comment. It sufficed to say that Mrs. Guigou had pointed out that the group's mandate had been solely to raise the questions posed by the implementation of the subsequent stages of Economic and Monetary Union, and that she had mentioned the reservations of the United Kingdom which were explicitly included in the report; for the rest, her report had been unanimously adopted by the group. Thereafter, the Chairman of the Monetary Committee, Mr. Sarcinelli, had made a long speech in a personal capacity, which could be summarised as follows:

- Economic and Monetary Union would require new institutional arrangements;

- the European system of central banks should be independent, but there would have to be discussion of the responsibilities it might assume, in the final stage, in terms of external relations;
- unless Stage One succeeded, it would be impossible to go on to Stage II;
- a transfer of additional resources at the Community level would have to be envisaged in the context of economic union;
- there was the question of "democratic accountability", i.e. the accountability of authorities to elected representatives and governments;
- the budgetary questions were complex; the report on Economic and Monetary Union had proposed binding rules on budget balances and financing, a proposal which had given rise to lively discussions within the Monetary Committee as well;
- finally, the Committee had not yet had time to deal with the structural problems.

The Chairman of the Economic Policy Committee, Mr. Molitor, had reminded the Ministers of the recent distribution of an opinion drafted by the Committee on budgetary policy co-ordination.

The Chancellor of the Exchequer, Mr. Major, had presented the document drawn up by the UK authorities; he had confirmed that in the course of Stage One the pound sterling would join the exchange rate mechanism when the time was ripe; he had pointed out that while he was in agreement with the objectives for the subsequent stages of Economic and Monetary Union, he was not in agreement with the means chosen for achieving them, and had expressed strong reservations about the need for institutional changes in particular. This position was not that of the UK Government alone, but was shared by all the political parties, a<s had emerged from a recent House of Commons debate. Mr. Major had expressed the fear that the system proposed in the report, in which the Governors had been involved, would take the EEC countries not in the direction of the lowest inflation rate, but in the direction of an average (this point had subsequently been the object of considerable controversy among the Ministers); he had concluded by pointing out that full and proper preparations for the inter-governmental conference were not complete and that it would, therefore, be premature to set the date for the conference.

Without going into detail regarding the various contributions of the participants in the debate, it could be said that eight out of twelve countries had stated explicitly that the UK proposal did not constitute an alternative to the Report of the Committee for the Study of Economic and Monetary Union. Three countries, Denmark, Germany and Luxembourg, had made no explicit statement. Nine countries, viz. the Twelve less Denmark, Luxembourg and the United Kingdom, had said that the Committee's report should remain the focal point of discussions, some speaking of a "basis for discussion", others of "a point of reference". The German Minister, Mr. Waigel, had dwelt upon the conditions for the success of Stage One and had summarised them in four points: a market economy open both internally and externally, monetary stability, budgetary discipline and application of the principle of subsidiarity; he had also, for the first time, mentioned the word "federalism".

As far as the question of setting the date for the inter-governmental conference was concerned, eight countries had thought that the preparation for it was full and proper; two countries, Germany and Denmark, had made no comment; two countries, Luxembourg and the United Kingdom, had thought that the preparation was not full and proper.

The Commission had said that next April it would submit a document to the Irish Presidency expressing its point of view on the advantages and constraints of Economic and Monetary Union and would endeavour to respond to the questions raised. This document would be submitted for discussion by the Committee of Governors and by the Monetary Committee as well as by the Foreign Affairs and Finance Councils. Moreover, the Commission would study the UK document with an open mind and without political preconceptions.

Several countries, in particular Belgium, France, Italy, the Netherlands and Portugal, had criticised the UK proposal on economic grounds and had not seen it as the right way to achieve the chosen objectives. A number of Ministers had, however, noted with satisfaction the change in position of the United Kingdom as regarded Stage One and, in particular, the positive assessment of the European Monetary System. Other Ministers, leaving aside the purely economic aspect, had considered that the discussion of Economic and Monetary Union actually revealed two different visions of the political future of Europe.

Mr. Ciampi thanked President Delors for his most interesting report and said that, without wishing to be formalistic, in future an effort should be made to avoid texts being submitted by the Committee of Governors and subsequently closely scrutinised by the Monetary Committee; such a procedure was undesirable.

Mr. de Larosière agreed with Mr. Ciampi's remark.

Mr. Doyle also agreed with Mr. Ciampi's remark and asked a question concerning the text adopted by the Council for Article 2(a) of the 1964 Decision. Under the terms of Article 2(a), the Chairman of the Committee of Governors would be invited to participate in the meetings of the Council of Ministers and would thus represent the Governors, which was quite in order. But would the Governors themselves, who were already entitled to participate in the meetings, lose that entitlement under the new Decision?

Mr. Delors pointed out that the only problem which had been discussed in the presence of the Governors at the informal meeting of the ECOFIN Council in Antibes had been the following: could the Governors be compelled to participate in formal meetings of the ECOFIN Council when there was a so-called multilateral surveillance exercise? Since several Governors had expressed reservations on the matter, the Council had not insisted. Thus the situation could be summed up as follows: the Chairman of the Committee of Governors would be invited to all the meetings of the Council of Economic and Finance Ministers; secondly, the Governors would participate in the Ministers' two informal meetings each year; and, thirdly, there was nothing to prevent a Governor, with the consent of his Minister, from accompanying the latter to all the meetings of the ECOFIN Council if he so desired. The point of view which had been expressed by the Committee of Governors had thus in the end been adopted by the Ministers.

Mr. Pöhl understood that the Chairman of the Committee of Governors was to be invited to participate in the meetings of the Council if there were items on the agenda which touched on the tasks of the Committee, but that he would not participate routinely in all the meetings. He wished to know whether this interpretation was correct.

Mr. Delors confirmed that the Chairman of the Committee of Governors was to be invited each time the Council was to deal with questions involving the work of the Committee but that, naturally, he would be at liberty not to participate in the meetings.

Mr. Pöhl understood that each Finance Minister could be accompanied by the Governor of the central bank, but he recalled that in Antibes he had spoken out against this. On legal grounds and as a matter of principle, the monetary policy of the Bundesbank could not be subjected to the Council of Ministers' surveillance procedure. The monetary policies of the Community central banks had to be discussed and co-ordinated within their Committee between the Governors, who would then, independently, make a report to the Ministers.

Mr. Pöhl appreciated that the constitutional framework varied from country to country, but said that the situation in Germany explained his opposition, voiced in Antibes, to the Governors' being obliged to participate in the multilateral surveillance procedure.

Mr. Duisenberg referred to the hope voiced by Mr. Ciampi that, in future, the Committee of Governors would abstain from drafting texts which were subsequently closely scrutinised by the Monetary Committee. Such an attitude called for a number of comments. The Governors had already pointed out in the Report of the "Delors Committee" that their Committee's tasks would have to be revised; they had drawn up a first draft, but it seemed more or less unavoidable that their views would have to be co-ordinated with those of the Finance Ministers. The Finance Ministers themselves, like the Commission, were thus free to ask the opinion of the Monetary Committee as well concerning a document drawn up by the Committee of Governors, without this implying that the latter was subordinate to the Monetary Committee.

Mr. de Larosière recalled that the Governors had been invited to submit their views on the functions of the Committee of Governors and that they had done so in writing. The formal decision obviously resided with the Council, and it was normal that the Ministers might have a somewhat different opinion from that of the Governors. On the other hand, it was not normal that the proposal for a text submitted unanimously by the Governors and relating to the tasks of their Committee should be revised in detail and redrafted by a body on which the Governors were represented by their colleagues. It would have been preferable if the Governors' text had passed directly to the Council and if each Treasury Secretary had submitted his comments, if any, to his Minister, who might, or might not, have taken them into account. It was important to avoid a situation where a body in which central bank officials sat alongside their Finance Ministry colleagues usurped the work of the Committee of Governors and rewrote its texts.

Mr. Delors pointed out that the Commission had adhered strictly to the Governors' text and had defended it up to the moment when the Ministers had reached agreement in principle on the text. The Commission had understood quite clearly that the draft prepared by the Governors had reflected an agreement between them and that any change would constitute a negation of the efforts made to adopt a unanimous position. The President of the Commission had drawn the Council's attention to this point.

Mr. Pöhl said that he was in agreement with the substance of a change which the German State Secretary for Finance had proposed in respect of Article 3, paragraphs 3 and 4, of the 1964 Decision. The Ministers were entitled to modify the draft drawn up by the Governors, but it was unacceptable for the Monetary Committee to become a kind of supervisory or higher authority above the Committee of Governors. This had already been said in the past and might be reiterated in an informal manner by the Chairman of the Committee of Governors.

Mr. Duisenberg and Mr. Ciampi concurred with the gist of the remarks made by Mr. de Larosière and Mr. Pöhl on these problems of procedure.

The Chairman invited Mr. Papademos to report on the Alternates' discussion of the monetary policy monitoring system proposed by Mr. Hoffmeyer.

Statement by Mr. Papademos on the establishment of a mutually agreed system of monetary policy monitoring

As had been stated in the letter dated 7th November 1989 with which the Chairman of the Committee of Alternates had sent the Governors the Report of the Alternates on the organisation of the Committee of Governors, the Alternates had had an exchange of views on the issue raised by Governor Hoffmeyer's letter dated 28th July 1989. The discussion had been based on a note prepared by Mr. Mikkelsen, dated 7th November 1989, which had been distributed to the Governors on the day of the meeting. The main points of this first exchange of views on this issue could be summarised as follows.

1. All the Alternates had been in favour of a more systematic analysis of monetary policies in a forward-looking direction in order to

strengthen the co-ordination of member countries' monetary policies. This would comply with the new tasks of the Committee of Governors provided for in Stage One of Economic and Monetary Union.

2. The Alternates had agreed that any kind of more systematic and Community-minded monetary policy monitoring system should be based on a common understanding about the final objectives to be pursued. The primary objective should be price stability, as had been stated in the proposed amendment of the 1964 Decision. As this objective could not be instantly achieved in some countries, it would be necessary to take into account differences in the speed and method with which to attain this goal.

3. As far as methodology was concerned, most Alternates had expressed their preference for a flexible system of monitoring. Among the reasons given had been the following considerations:

- in Stage One policy decisions would remain within the competence of the national authorities;
- the lack of practical experience of such a system was an argument for implementing it on the basis of a "learning-by-doing" approach, as envisaged in the proposed Council Decision on the convergence of macro-economic policies during Stage One;
- there was a diversity of financial structures and economic environments within the Community;
- there was instability, at least in some countries, in the relationship between monetary aggregates and final economic objectives;
- there might exist potential conflicts with exchange rate commitments.

These arguments had tended to favour a system of common monitoring rather than a system of common monetary targets. However, one Alternate had remarked that there was a trade-off between the flexibility and the credibility of the system.

4. A central issue for the successful implementation of a system of common monitoring was the choice of the intermediate variable to be monitored. Interest rates were not considered appropriate intermediate objectives, and the Alternates had wondered whether monetary aggregates or domestic credit would serve as the most reliable indicator of policy. It had been stressed that the choice between indicators should be based on a

number of criteria: their effectiveness in helping to achieve the domestic final policy objectives, their usefulness in providing information concerning developments in the balance of payments and their controllability by the national monetary authorities. Also, consideration should be given to the possible effects of deregulation and liberalisation of capital movements on the reliability of monetary aggregates as indicators.

The Alternates had thought that work should start with a review of the intermediate monetary objectives in the various Community countries and an examination of the reasons behind the existing diversity of intermediate objectives. It would also be useful to analyse the informational content and the effectiveness of the intermediate targets currently adopted.

5. The Alternates had agreed that the questions raised needed careful examination. They recommended that the group of experts under the chairmanship of Mr. Raymond be asked to examine the note prepared by Mr. Mikkelsen and to report to the Governors in due course.

Mr. Leigh-Pemberton said he accepted that the "Raymond Group" might undertake a study of these questions, but he recalled that similar studies had been carried out in the 1970s by another group, without any real conclusions having been reached. It should thus be borne in mind that the subject was not an easy one. Moreover, given that the Committee of Governors would have its own research unit as from July 1990, the "Raymond Group" could conceivably carry out a preliminary study and report at the end of spring or early summer 1990 in order to avoid having the group of experts and the research unit working simultaneously on the same subject.

V. Examination of Report No. 36 prepared by the group of experts chaired by Mr. Raymond on current monetary policies in EEC member countries

A. Statement by Mr. Raymond

Report No. 36 was the second detailed semi-annual report presented to the Governors by the group of experts in 1989. Chapters I and II analysed in turn real and monetary data, while Chapter III discussed the possible remedies for the existing difficulties.

- Growth was still vigorous. A slowdown in 1989 had been foreseen a year earlier; it had not taken place. It was now forecast to occur in the course of 1990. On average, it was likely to remain moderate. The overheating in the countries outside the zone of narrow fluctuation bands was only just beginning to show signs of flagging. In the meantime, it had helped boost activity and increase the German trade surplus. Only Denmark was in an atypical conjunctural situation.

The average rate of inflation in the Community was more than one percentage point higher than in 1988. It had peaked in July. The decline was likely to be be modest in 1990. There was widespread concern about wage pressures, with wage claims taking recent inflation into account in a climate of strains on production capacity.

Divergences between inflation rates within the Community remained substantial. Among countries linked by the exchange rate mechanism, rates ranged from 1 to 6%. There had been no reduction in the divergences in 1989, and little or no progress was discernible in the forecasts for 1990. This situation was not in line with the spirit of Stage One, which was to begin in July 1990 with a view to establishing a zone of monetary stability.

The trend was still less favourable in balance-of-payments terms, since the divergences had widened. The current-account surpluses of Germany and Ireland had increased to 4 and 2.4% of GDP respectively. Symmetrically, several deficit countries had seen their position deteriorate. Spain's deficit was expected to reach 3.1% of GDP in 1989 and 3.8% in 1990, and that of Greece forecast to rise to 3%. The deficit in the United Kingdom was likely to decline slightly.

- Monetary expansion had generally been stronger than expected, although a deceleration was discernible. The most active source of money creation was usually bank lending to the private sector. The financing of the public sector had gained weight in Greece.

In the last six months, monetary policies had been tightened, firstly, during the summer by means of a rise in interest rates in the countries participating in the exchange rate mechanism, with the exception of Italy owing to the firmness of the lira. In Spain this measure had been supplemented by an increase in compulsory reserves and by the publication of guidelines for bank lending growth. Outside the exchange rate mechanism, the Bank of England had raised its rates in May, Greece had done likewise in September, and Portugal had applied restrictive measures in April and in July.

A second round of interest rate rises had occurred in early October. The countries which had abstained were Spain and Italy, which had just begun to benefit from an improved policy mix and wanted to halt their currencies' tendency to appreciate, and also Portugal and Greece. Greece had just adopted new measures.

Monetary policies had not yet had the expected impact on activity, which was running up against the limits of production capacity, any more than on inflation and the external imbalances. The lag was being prolonged by the profits situation in the corporate sector. Thus, as a general rule, it would be premature for countries to lower their guard.

The relative calm which had reigned on the exchange markets, welcome as it was at first sight, had not permitted interest rate differentials to widen sufficiently to trigger an improvement in current-account and price convergence. However, the "paradox of the exchange markets" mentioned in Report No. 35 had diminished: the Spanish peseta was less strong than it had been; the Italian lira had ceased to be conspicuous by its firmness; finally, the weakening of the pound sterling had led the monetary authorities to raise interest rates in the United Kingdom.

Virtually all the experts had taken the view that if there were a change in market sentiment, a realignment should be resisted. The effect of a realignment on current-account positions would be uncertain. In the first instance, the J-curve would aggravate the imbalances in value terms and the very high level of capacity utilisation in the deficit countries would prevent them from increasing their exports. To obtain favourable effects in volume terms, forceful accompanying measures would have to be applied.

As far as inflation was concerned, a realignment would cause an immediate widening of divergences. If the authorities of the member countries were actually to provoke a realignment rather than just suffering it, this would imply a relaxation of macro-economic control in the high-inflation and deficit countries, which would be undesirable. These countries preferred on the whole the "hard currency option".

Finally, it might be feared that operators' confidence in governments' will to cohere might be shaken by a realignment.

Conversely, the delegation from the Bundesbank had stressed that the development of real exchange rates, above all in 1989, ran counter to a balance-of-payments adjustment and to the maintenance of price stability in Germany. They had expressed the view that this development of real exchange rates could not be allowed to continue and that the longer correction was postponed the larger it would have to be.

To improve convergence, since it was not possible to rely on interest rates alone, better co-ordination of budgetary policies would be required. Fortunately, in 1990 these were expected to be more restrictive in Spain and Italy, and more expansionary in Germany. The developments in prospect elsewhere would not contribute to reducing divergences and, in some cases, might even exacerbate them.

The experts had been of the opinion that in spite of the practical difficulties to be feared, the intermediate objectives announced for 1990 would be consistent with the general aim of improving convergence.

B. Statement by Mr. Papademos

The Alternates had had a short discussion on the report prepared by the group of experts under the chairmanship of Mr. Raymond. The discussion, which had taken place in the morning just before the meeting, could be summarised as follows.

The Alternates had agreed that the group's latest report was again of excellent quality and that it conveyed an accurate picture of the state of the EEC economies and their degree of convergence. They had also noted with satisfaction that the report tackled policy questions in a more direct and more forward-looking way than in the past.

The Alternates had broadly endorsed the analysis and conclusions of the report, in particular the recommendations aimed at maintaining the current restrictive stance of monetary policies throughout the Community, given the persistence of the risk of inflation. However, monetary policy had to be supported by appropriate fiscal policy measures. It was extremely important to implement an appropriate policy mix in several EEC countries, because this would make it possible to improve convergence in the external sector and simultaneously to reduce inflation. The growth in the budget deficits in some countries meant monetary policy had to be tightened more than would otherwise have been necessary.

The Alternates had also addressed the question of whether it was desirable to change intra-Community exchange rate relationships and had continued the discussion which they had started in the framework of the monitoring exercise. Most Alternates had agreed that at this juncture a realignment would not be helpful and that it was unlikely to contribute to the adjustment process. The arguments put forward in support of this position were the following:

- as experience in some countries had shown, devaluations had had only a short-lived effect on foreign trade while tending to jeopardise the effectiveness of anti-inflationary efforts;
- a devaluation would intensify inflationary pressures in countries that were pursuing anti-inflationary policies, thereby contributing to a further divergence of inflation rates in the Community;
- the price responsiveness of exports and imports tended to be low; consequently, a small realignment would only produce marginal results while a large realignment could undermine stability;
- realignments could not be a substitute for domestic policy measures but had rather to complement them;
- the weakness of the Deutsche Mark in real terms was not only an ERM problem but also involved currencies outside the ERM and even the EMS, thus necessitating a more general approach.

Other Alternates had expressed different views:

- in view of the growing external surplus of Germany vis-à-vis most other EMS countries, persistent undervaluation of the Deutsche Mark would continue to generate structural problems in Germany and in the Community. Delaying corrective action could exacerbate the problems and might necessitate the adoption of more drastic measures later;
- those not favouring a realignment argued that the devaluation of their currencies would import inflation into their countries. However, the undervaluation of the Deutsche Mark was importing inflation into Germany, which undermined the function of the Deutsche Mark as an anchor of stability in the EMS;
- if a realignment were eventually required, the credibility of the EMS would be damaged more if the realignment were forced by the markets rather than if it were decided by the authorities.

C. Discussion by the Committee

Mr. Rubio agreed that it was necessary to slow the growth of demand in Spain and pointed out that the Government had already taken action. The budget deficit was likely to fall from 2.7% of GDP in 1988 to 2% this year and to 1.5% in 1990. The new Government would be formed in a few weeks and was expected to ensure continuity in matters of fiscal policy. The development of the monetary aggregates had changed radically in the course of the last three months. Thus the growth of lending was now only 6% at an annual rate, compared with 22% in the first quarter of 1989. The current-account deficit was still substantial, at around US$ 6 billion for the first nine months of 1989, but in this period direct investment had represented twice that amount. The current-account deficit thus seemed almost necessary, otherwise the peseta would be much too strong.

Mr. Leigh-Pemberton, referring to Mr. Papademos' comments, was of the view that a realignment forced by the market would be very bad; it would, for example, be extremely unfortunate if a realignment were to take place around 1st July 1990, the moment when the liberalisation of capital movements would be completed in most of the member states of the Community.

Mr. Pöhl understood the arguments of the countries which did not want their currencies to depreciate against the Deutsche Mark. But it had to be recognised that Germany's trade and current-account surpluses were growing rapidly while the deficits in several countries were also rising or remained high. This, moreover, was a purely European problem: Germany's surplus with the United States had greatly decreased in the past two years, whereas that with the EEC countries was continuing to widen, having risen from DM 52 billion for the first eight months of 1988 to DM 65 billion for the same period in 1989. Increasing domestic demand in Germany was one response to the problem, and this had been done, for example, by means of a very large housing construction programme. Such a solution was rather unrealistic given the very high level of production capacity utilisation, and it was dangerous in terms of inflation, which was a major concern of the central bank. The other solution would be to reduce the deficits in the high-inflation countries, i.e. principally in the wider-band countries or those which did not participate in the exchange rate mechanism. The markets had already penalised, in exchange rate terms, the build-up and the size of the current-account deficit in the United Kingdom. Other countries, such as Spain and Italy, were opposed to a realignment so as not to import inflation but to import stability instead, which meant that it was Germany which was importing inflation. Leaving aside the exchange rate as an instrument of adjustment (which was not stipulated by the EMS), there was only one response: a common policy of price stability. Within the core of narrow-band currencies appreciable progress had been achieved, but the divergences had widened in particular vis-à-vis the countries outside the exchange rate mechanism.

The four increases in German official interest rates undertaken this year had to be seen in this context and as a response to the refusal by practically all the governments of the Community countries to contemplate a realignment and a revaluation of the Deutsche Mark. It was thus important, in this context, to look at other ways to act and to find an instrument, as Mr. Hoffmeyer and Mr. Mikkelsen had suggested, which would make it possible to define and conduct monetary policies which were consistent with a system of fixed exchange rates. Fiscal policies had, of course, a vital contribution to make, above all in certain countries, but monetary policies were still far from being based on a common standard of price stability, which was indispensable to ensure compatibility with a system of fixed exchange rates.

Mr. Hoffmeyer pointed out that the discussion of these problems was virtually endless since there were advantages and disadvantages on both sides. It would, however, be interesting to examine in greater detail the rise in prices in Germany and to break it down according to different components, for example the share attributable to imported inflation and the domestic share, the source of which was primarily agricultural. Furthermore, according to Report No. 36, if German residents' Deutsche Mark deposits abroad were included, monetary growth would be 8% at an annual rate. That was a fast pace, which raised the question why the Bundesbank did not systematically include these data in its calculations.

Mr. Rubio accepted that, even though its share in total German foreign trade was small, Spain was a contributor to the German surplus; in his opinion the work of the Committee ought to be forward-looking, based on the Governors' responsibility in the area of a common policy of price stability.

Mr. Pöhl pointed out that the German economy was approaching a situation of overheating generated, in particular, by the very buoyant demand for German products, above all from the European countries with high inflation and excessive domestic demand growth. Importing inflation via import prices occurred essentially as a consequence of the weakness of the Deutsche Mark vis-à-vis the dollar, which meant that the recent developments between these two currencies had brought about an improvement and that a continuation of this trend would be desirable. As far as the growth of the money stock was concerned, it was true that it was considerable if German residents' deposits abroad were included. These deposits were not taken into account in the official target; in the past, movements in these deposits had corrected themselves and had given no cause for concern, but the current increase constituted a further major argument for maintaining a strict monetary policy.

Mr. de Larosière observed that, as far as inflation was concerned, convergence had improved in the group of countries belonging to the narrow band, but at a higher rate, except in the Netherlands. On the other hand, divergences had widened outside the narrow band of the mechanism. Two conclusions could be drawn at a policy level. The countries of the first group had to continue to improve their convergence and had to ensure that their inflation level did not rise, which meant that they had to make sure there was no deterioration in the monetary and fiscal policy mix. In that regard, monetary growth of 8% in Germany, if German residents' deposits abroad were included, was not very reassuring. The countries outside the narrow band had to reduce their widening divergences and, to that end, they had to correct and tighten their domestic policies. Report No. 36 of the group of experts sounded a rather worrying alarm; it would be desirable to bring this document to the attention of the Finance Ministers and to explain to them that policies had to be improved, and without delay.

Mr. Leigh-Pemberton said he thought it was dangerous to focus the debate too closely on exchange rates and on a sort of sharing-out of inflation between the countries participating in the exchange rate mechanism. In fact, the aim should be to ensure convergence on a minimum inflation rate. One could understand the Bundesbank not wanting to see its policies sapped by imported inflation, but a firm exchange rate policy was a major component of the anti-inflationary policies of many countries, in particular the United Kingdom. Thus there had to be greater differentiation of monetary and interest rate policies within the EMS, so that they would be more restrictive in countries with high inflation and large external deficits. By so doing it should be possible to avoid the pressures for a realignment. In fact, given sufficiently firm and appropriate policies in the deficit countries, capital flowed towards the countries which had need of it and did not cause disturbances.

As far as trade relations between the United Kingdom and Germany were concerned, there was indeed a serious imbalance due principally to imports of capital goods. The appreciable decline in the rate of investment in the United Kingdom should improve the bilateral balance.

The Chairman offered a few comments on the subject of Greece. Owing to the persistent uncertainty on the fiscal front, the Bank of Greece had had to take certain monetary policy measures aimed, in particular, at curbing lending to the private sector. The commercial banks and savings banks had been asked to restrict the growth in their lending to the private sector to 5% between the third and fourth quarters. Any bank exceeding this percentage would be penalised by being required to place an amount equivalent to 25% of the excess as a non-interest-bearing deposit with the central bank for a period of six months. In addition, new bonds with an ecu clause would be issued. These measures were expected to soak up liquidity and improve somewhat the effectiveness of the central bank's policy. Interest rates would probably have to be raised further, despite the fact that real lending rates were already very high. It was vital, however, that the budget deficit - which was wholly unacceptable - be reduced as a matter of urgency, otherwise monetary policy would not be able to right the situation.

In reply to the comments voiced by a number of Governors, Mr. Raymond said that the group of experts could undertake a preliminary study of the questions raised concerning monetary policy instruments, the interpretation of statistics and aggregates, and monetary policy co-ordination.

VI. Other matters falling within the competence of the Committee

The Chairman informed the Committee that Mr. Delors wished to make a brief statement concerning Poland and Hungary and their relations with the Community.

Statement by Mr. Delors on aid to Poland and Hungary

At the last Group of Seven summit meeting, held in Paris in July, the European Economic Community was entrusted with co-ordinating aid to Poland and Hungary. This co-ordination did not cover the action being taken by the International Monetary Fund, but the Community was in close contact with that organisation, in order to try and achieve consistency. Since the mutual recognition between Comecon and the Community, the latter had signed two trade and co-operation agreements, with Poland and Hungary respectively, and was preparing an agreement covering trade, and possibly co-operation, with the German Democratic Republic.

The obstacles to co-operation were numerous: the difficulties of obtaining timely information, the discrepancy between the statements made by governments and their implementation. Lastly, of the twenty-four countries which had agreed to take part in this effort (the twelve EEC countries plus twelve other OECD members), Japan had so far shown very little commitment.

The ECOFIN Council on 13th November had asked the President of the Commission to report on this matter, and the Monetary Committee had been convened as a matter of urgency on 15th November to take stock of the situation. The current results of the co-ordination could be summarised as follows:

- the Federal Republic of Germany had made large commitments to both Poland and Hungary, which should alleviate the financial situation in those countries in the short term;
- substantial food aid, of the order of ecu 260 million, had already been granted to Poland back in August, half of this aid coming from the Community;
- the trade agreements already signed had been improved by granting the two countries a generalised system of preferences designed to alter the pattern of exports, which were excessively concentrated on the Soviet Union;
- the European Investment Bank had pledged ecu 800 to 1,000 million, to be shared between the two countries.

The situation of these countries was currently very difficult: Poland was on the verge of bankruptcy; in Hungary, the political situation was extremely delicate, and in the last two months the economic situation had worsened appreciably.

In Poland, the difficulties were threefold: the population was starting to get impatient, despite the political changes that had taken place; progress in privatising businesses and above all dismantling monopolies in the agricultural sector was very slow; and inflation had recently soared from between 100 and 200% to more than 700% following the liberalisation of agricultural prices. A number of problems arose. The first, which was the subject of a very open political debate in Poland, was whether a package of extremely tough measures could be taken soon. The second related to an agreement with the IMF; here, it seemed doubtful whether a letter of intent would be signed by the end of the year. The third concerned the risk of a food shortage, in response to which further emergency aid of some ecu 200 million could be provided in the near future.

The financial and monetary aspects of the situation in Poland were also critical. Despite the advanced stage reached in the negotiations, the IMF was reluctant to pledge US$ 570 million instead of the US$ 700 million planned a few weeks ago. Monetary reform of the kind undertaken in Germany in 1948 appeared to be necessary, for the flight out of the zloty had assumed enormous proportions: in a matter of months, the zloty had lost 54% of its value, the dollar being worth Zl. 3,100 on the official market in mid-November and between Zl. 5,000 and 7,000 on the black market. Monetary reform should therefore be a priority and could be supported by the creation of a stability fund, as proposed by President Bush. The United States had promised a contribution of US$ 200 million and the Federal Republic of Germany DM 500 million. The external balance was also a serious problem: the current-account deficit was likely to increase from US$ 2 billion in 1988 to US$ 3 billion this year. The USSR had decided to freeze its 6 billion rouble loan until 1995, and this raised the question of what the Paris Club could do in conjunction with the IMF effort. Finally, the Polish Prime Minister had written to the President of the Commission to propose the establishment of a Euro-Polish bank. The latter could serve as a foundation for aiding the modernisation, or even the re-establishment, of a banking system in Poland. It could also provide guidance for investors, in order to try and revitalise the fabric of the Polish economy. Such a bank should not be a new public institution but should be established with the assistance of Western banks.

In Hungary, the main difficulty was of a political nature. There were currently 106 parties, and the main ones had failed to agree on the economic measures to be taken during an election campaign which was likely to be protracted. Inflation was increasing and now running at 17 to 18%, and the external balance was deteriorating, the current-account deficit rising from 2 to 4% of GDP. Chief among the current problems was the political agenda. A referendum was to take place on 26th November, the main issue being whether the election of the president of the republic should be held before or after the parliamentary election. If the Hungarians chose to elect the president first, the successful candidate would have more power, but this would also have the effect of postponing the parliamentary elections and hence of delaying the bold decisions that needed to be taken. Furthermore, an agreement with the IMF, which the Fund considered essential, would probably not be accepted by the political parties because of their failure to agree among themselves and would be put off until after the elections, i.e. until March or June 1990.

If there were no agreement with the IMF, Hungary would be faced with a liquidity problem in the months ahead, since its official reserves equalled only three months' imports. The IMF and Hungary differed, however, as to the content of the agreement, for example on devaluation of the Hungarian forint (the IMF wanted 50%, instead of the 10% agreed to by Hungary) and the cutting of subsidies. The Hungarians were currently seeking one of two things: the first was a US$ 1 billion bridging loan, of which the Belgian Minister of Finance had spoken as representative of the "constituency" in which Hungary was situated. Since such a loan was linked to an agreement with the IMF, if the agreement was not concluded Hungary would instead request cash aid to see it through the first quarter of 1990, which was the most difficult one for seasonal reasons (energy purchases and low revenue from tourism). Such exceptional cash aid was criticised by the financiers, who felt that it would create a precedent for granting assistance prior to the conclusion of an agreement with the IMF. Thus there was a dilemma.

The Chairman thanked Mr. Delors for his very interesting statement, which had described two very difficult economic situations.

* * *

The Chairman informed the Committee that Mr. Pêgo Marques was taking part in a meeting of the Committee for the last time; the Governors had greatly benefited from Mr. Pêgo Marques' experience and his contribution, and they expressed their gratitude for his collaboration and offered him their best wishes for the future.

Mr. Pêgo Marques thanked the Chairman and made the observation that everyone, no matter what their role, had a part to play in the construction of Europe. However, those in the market-place did not always have all the information at their disposal and had to act on the basis of their interpretation of the facts. Mr. Pêgo Marques offered the Governors and the Alternates his professional and personal good wishes for success at a time of great challenges presented by monetary union and relations between eastern and western Europe.

VII. Date and place of the next meeting

The Committee's next meeting would be held in Basle on Tuesday, 12th December 1989 at 2.00 p.m.

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

Annex
14th November 1989
Confidential

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

SEPTEMBER AND OCTOBER 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 September and October and the first few days of November 1989.

I. EXCHANGE RATE DEVELOPMENTS

The main features of the foreign exchange markets in September and October 1989 were:

- a limited further appreciation of the dollar to period highs until mid-September, followed by a strong depreciation in the remainder of the period;
- a round of increases of official rates in most European countries in early October;
- the emergence of temporary tensions in the exchange rate mechanism of the EMS in connection with rumours of a realignment;
- a pronounced decline of the Japanese yen and sterling against most other currencies.

The US dollar moved lower during the September-October period as market participants responded to official statements and actions indicating

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

concern at the dollar's rise. After reaching period highs of DM 2.0035 and Yen 148.95 by mid-September, the dollar began to ease as market participants grew cautious ahead of the 23rd September G-7 meeting. The dollar then declined more forcefully after the release of the G-7 communiqué and subsequent visible intervention operations. As the period progressed, narrowing interest rate differentials favouring dollar assets and concern about financial market volatility following a decline in equity prices in the United States on 13th October also served to lessen the market's positive sentiment toward the dollar. By the end of October, the dollar was trading narrowly about 6.5% lower against the Deutsche Mark and 1.5% lower against the Japanese Yen from its early September levels.

In the EMS the Spanish peseta and the Italian lira declined strongly. The Danish krone reached the lower limit vis-à-vis the Spanish peseta in September and vis-à-vis the Deutsche Mark in October. Tension emerged in mid-October because of rumours of an EMS realignment giving rise to substantial central bank interventions, some of which at the margins. The tension abated towards the end of the period. Official interest rates were increased in most EMS countries, effective 6th October; interest rate differentials remained unchanged except for the Italian lira and the Spanish peseta whose differentials vis-à-vis the Deutsche Mark narrowed.

The Deutsche Mark firmed appreciably. Its effective rate vis-à-vis the currencies of eighteen major industrial countries rose by 2.9%. Vis-à-vis the currencies of the countries participating in the EMS exchange rate mechanism, its appreciation amounted to 1.0%. The 1 percentage point increase in key German interest rates effective 6th October led to a corresponding rise in money market rates (day-to-day to six-month money). This resulted in a narrowing of interest rate differentials vis-à-vis some currencies, for example the US dollar, but no change vis-à-vis the majority of the EMS currencies as most EMS central banks followed the Bundesbank's move.

During the first half of September the French franc remained firm while it was later affected by substantial purchases of foreign currencies by French companies for investment abroad. After a slight improvement at the end of the month, the French franc was somewhat influenced by tensions within the EMS. The increase in official rates effective 6th October and the subsequent high level of domestic rates close to the upper limit (10.25%) favoured the stabilisation of the French franc for the rest of the month.

The modest increase in the retail price index (0.2% in September, 3.4% on an annual basis) had a positive influence on the market.

Due to the firming of the Deutsche Mark, the Belgian franc lost some ground in the EMS. This movement took place despite substantial interventions by the Banque Nationale de Belgique. Several increases in the official rates of the Treasury certificates, aimed at maintaining an appropriate interest rate differential vis-à-vis the Deutsche Mark, also had limited effect. Effective 6th October the discount rate was increased by 1 percentage point to 10.25% while the rate on advances was raised to 10.75% increasing by 1.25 percentage points.

The Dutch guilder lost a little ground vis-à-vis the Deutsche Mark as the latter currency moved towards the top of the narrow EMS band in September. Since then, however, there have been no significant changes in exchange rates between the two currencies. Effective 6th October, the Nederlandsche Bank raised its discount and lombard rate by 1 percentage point to 7% and 7.75% respectively.

The Danish krone continued to be the weakest currency in the narrow band. In early September the Danish krone touched its lower intervention point vis-à-vis the Spanish peseta; this led to modest interventions. In connection with the increase in German interest rates Danmarks Nationalbank raised its lending rates by 1 percentage point to 10.50% and 11%. On Friday, 13th October the krone came under heavy pressure due to rumours of an EMS realignment. The krone reached the compulsory intervention rate vis-à-vis the Deutsche Mark and substantial intervention sales of Mark were made. During the remaining part of the month there was no need for further interventions and the krone strengthened gradually in response to a sharp rise in market interest rates. On 31st October Danmarks Nationalbank increased its lending rates to a unified rate of 12% with effect from 1st November.

The Irish pound remained steady in the upper half of the EMS band during September. Capital inflows continued for most of the month and were offset by purchases of foreign currency by the Central Bank. Capital outflows re-emerged towards the end of September and intensified in October. The Central Bank responded with substantial sales of foreign currency, by raising its Short-Term Facility lending rate by 1 percentage point to 11%, effective 6th October, and by permitting the Irish pound to decline to the middle of the narrow EMS band.

During the first half of September, the Italian lira continued to appreciate in the EMS, reaching the upper limit of the narrow band. This trend was partly contained by substantial interventions by the Banca d'Italia. Since the beginning of October, changing expectations on the dollar and monetary policy changes in some European countries resulted in a reversal of this movement as the Banca d'Italia did not raise official rates. The lira also depreciated somewhat because of rumours of an EMS realignment but central bank interventions kept the movement within the narrow band. At the end of the period the lira stabilised without further interventions as market sentiment improved.

In the first part of September the Spanish peseta firmed further, driven by an increase in the positive interest rate differential, and reached the upper limit vis-à-vis the Danish krone. Later on, sentiment towards the peseta changed substantially, due to the round of interest rate rises in other European countries, the rumours of a realignment in the EMS and the uncertainty surrounding the result of the general elections. Consequently, the peseta experienced strong downward pressures. After the election in late October the Spanish currency recovered some ground. In all, it ended 0.2% lower with respect to the ecu.

After being sidelined for much of September, sterling fell sharply against most currencies following the publication of worse-than-expected trade figures for August. Aggressive intervention and a 1 percentage point rise in base rates (to 15%) effective 6th October briefly stemmed the downward pressure, but bearish sentiments resurfaced following renewed speculation about a rift between the Prime Minister and the Chancellor. Nervousness over the Government's political position and over fragility of the equity markets called into question the continuation of a high interest rate strategy, and the pound fell sharply. The weakness of the dollar subsequently helped sterling recover some of its losses, but the Chancellor's resignation caused a further sharp reversal and although modest support was provided, the pound fell to its lowest level against the Deutsche Mark since March 1987 before stabilising. Over the two months, sterling's trade-weighted index fell by 3.3% to 88.4 (1985=100).

The Greek drachma appreciated by 2.7% against the US dollar and depreciated by 2.5% against the ecu. In effective terms the drachma depreciated by 0.9% in September and by 1.1% in October.

The Portuguese escudo declined by 0.5% in effective terms in line with the objectives defined by the authorities. Against the US dollar the escudo rose by 4%.

The Swiss franc strengthened by 5% against the dollar while vis-à-vis sterling and the Japanese yen its value increased by 3 to 4 percentage points. Measured against the majority of the EMS currencies, the exchange rate tended to be lower. On an export-weighted basis the value of the Swiss franc rose by 0.6%. The Euro-franc rate went up from 7 3/8% to roughly 7 7/8%. In reaction to the market developments and in co-ordination with the measures introduced by other central banks, the official discount rate was raised by 0.5 percentage point to 6% on 6th October. However, central bank money supply was not tightened any further.

The Austrian schilling firmed by more than 6% against the US dollar. Vis-à-vis the Deutsche Mark it fluctuated by only 0.07%. Short-term liquidity support was given in October with DM 1.8 billion of DM/schilling swaps with an average maturity of ten days. In line with the corresponding interest rate increases in most European countries, the discount rate was raised from 5.5% to 6.5% and the lombard rate from 7.5% to 8.5% with effect from 6th October. The rate for short-term open market operations was also raised from 6.5% to 7.25%.

The Norwegian krone moved within a fairly narrow range of 112.00 to 112.50 measured by the basket index. The krone stayed mostly in the stronger end of this range in September but weakened towards 112.50 during October.

After a period of heavy inflows in September, partly due to non-residents' purchases of krona-denominated bonds, which at times brought the index for the krona to its limit of 130, the Swedish krona weakened to 130.5 in the second half of October when interest rate differentials vis-à-vis many foreign currencies narrowed.

In effective terms the Finnish markka continued to fluctuate within a narrow margin. Market interest rates have increased by almost 2%. The base rate was raised by 1 percentage point to 8.5%, effective 1st November.

The Japanese yen appreciated by 3.5% against the US dollar and closed at 139.35 in September. This was due to the concerted action of the central banks implementing the agreement of the G-7 of 23rd September. The Bank of Japan stepped into the markets selling US dollars against Japanese yen for a protracted period. However, the impact of these interventions was absorbed by the markets which pushed the Japanese unit down to 142.15 in October. Meanwhile, the yen depreciated somewhat against the ecu. Effective 11th October, the Bank of Japan raised the official discount rate by 0.5 percentage point to 3.75%, taking into consideration the developments of the exchange rate, interest rates abroad, domestic business activity, prices and money supply, as well as a rise in market interest rates. Over the period as a whole, the yen appreciated by 1.7% vis-à-vis the US dollar while it depreciated by about 5% vis-à-vis the EMS currencies.

The Canadian dollar traded in a narrow range for the period under review, appreciating slightly to close on 31st October at US$ 0.8522. The strength of the Canadian dollar continues to result from the capital inflows associated with relatively high short-term interest rate differentials vis-à-vis the United States, and an expectation among participants that Canadian interest rates will remain firm in the near term. The currency's strength has been tempered somewhat by concerns about Canada's current account deficit which has been increasing in recent quarters.

II. INTERVENTIONS

A. Interventions in US dollars

Net dollar sales by the central banks amounted to US$ 22 billion in September and October compared with net purchases of US$ 0.9 billion in July and August. The major part of these interventions took place in the last week of September and the first half of October. The main sellers were the Bank of Japan, the Federal Reserve Bank and the Bank of England.

B. Interventions in Community currencies and in private ecus

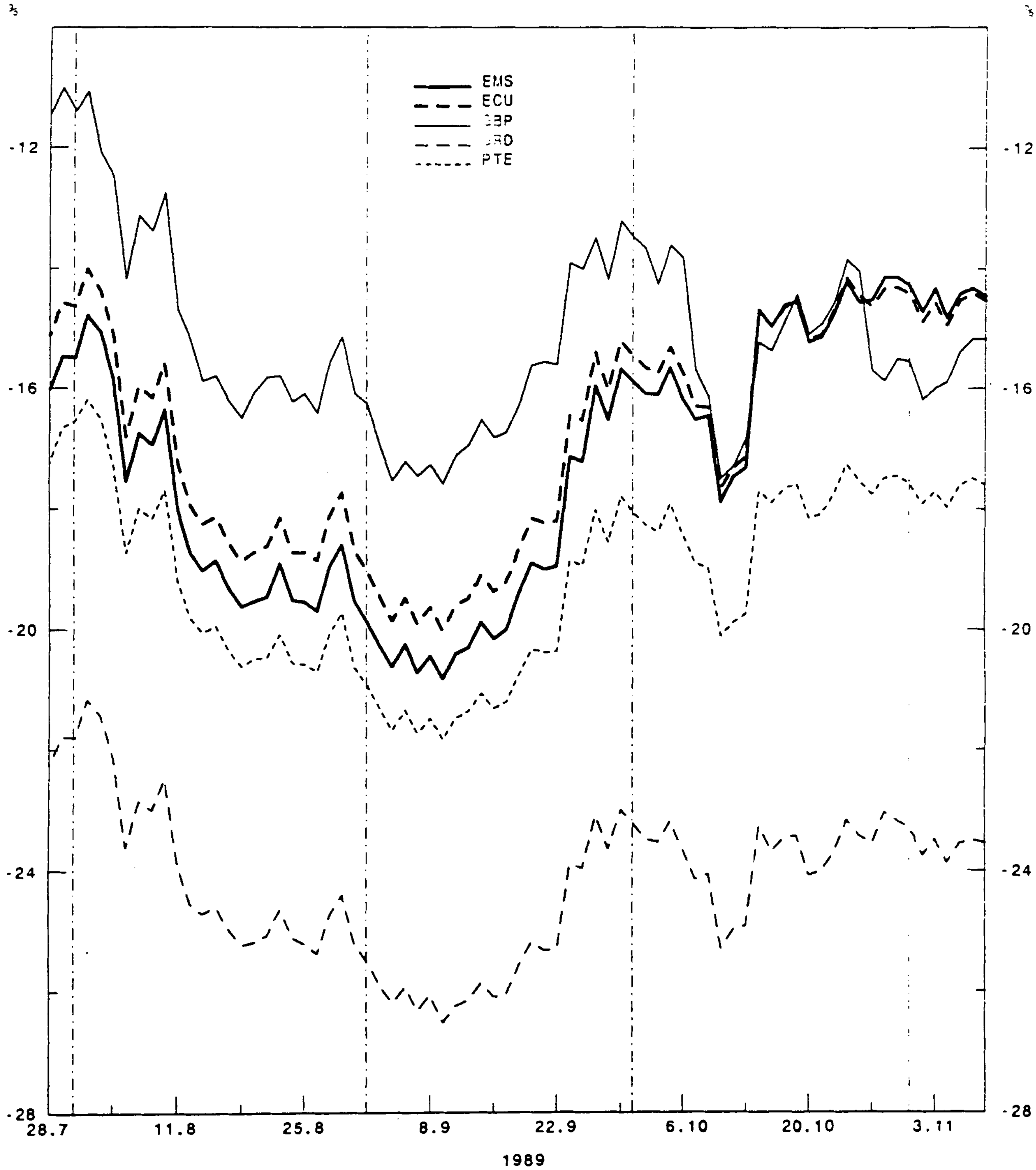
Interventions in EMS currencies and private ecus by Community central banks amounted to the equivalent of US$ 7.2 billion (US$ 1.9 billion at limit), compared to US$ 3.5 billion in July and August. The greater part of interventions was sales of Deutsche Mark (US$ 2.8 billion); the main seller was Danmarks Nationalbank. Intervention sales of ecus (US$ 2.3 billion) were greater than in previous periods; the main sellers were the Banca d'Italia and the Bank of England.

III. DEVELOPMENTS IN THE CURRENT MONTH UP TO 10TH NOVEMBER

Exchange markets were quiet during the first days of November. The dollar stayed in a narrow range; market participants remained cautious against the background of narrowing interest rate differentials favourable to dollar assets.

In the EMS the Deutsche Mark weakened slightly against most other currencies.

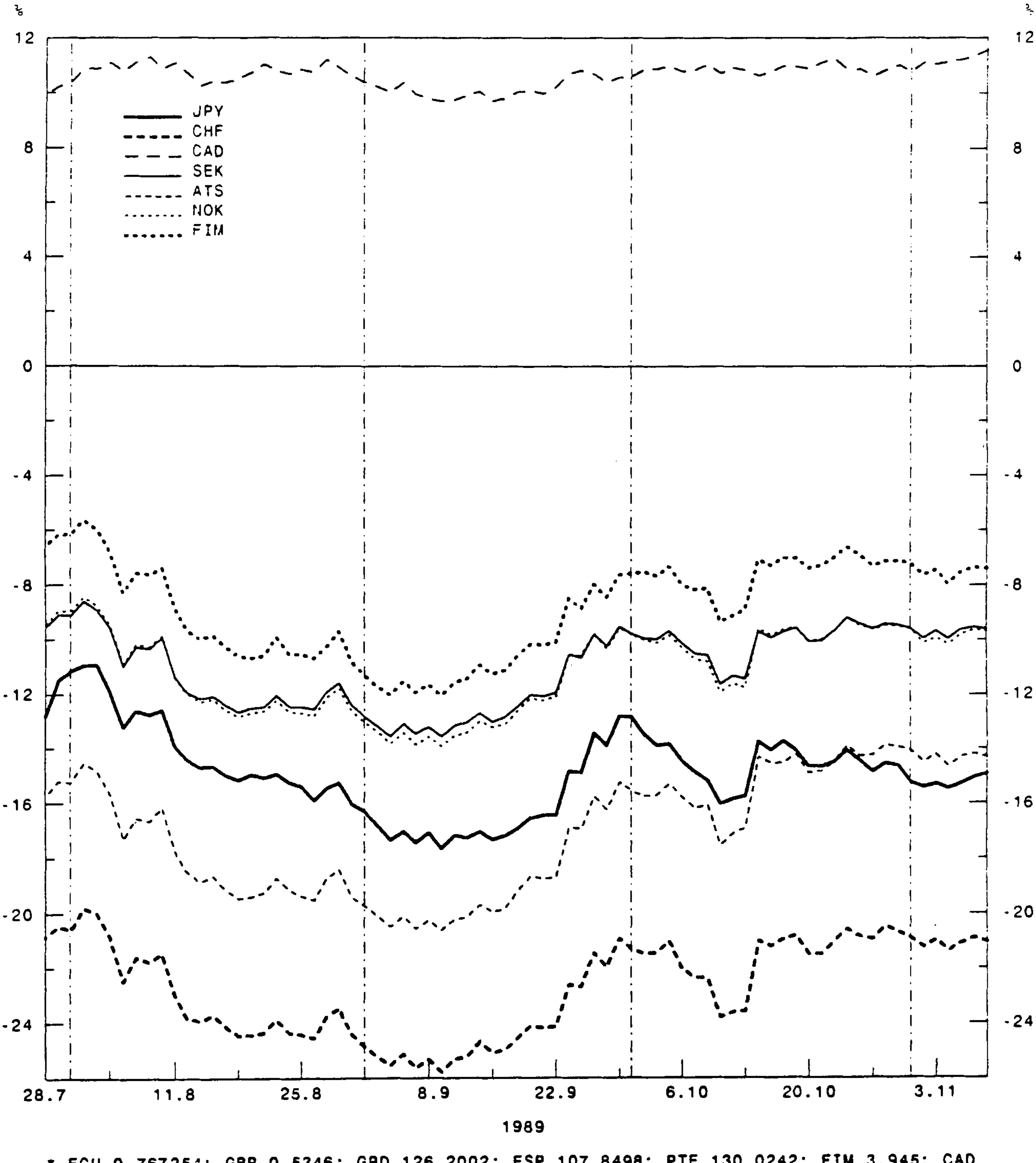
EVOLUTION OF THE ECU, THE MIDDLE RATE OF THE CURRENCIES PARTICIPATING IN THE EXCHANGE RATE MECHANISM OF THE EMS, AND THE CURRENCIES OF THE EEC CENTRAL BANKS WHICH DO NOT PARTICIPATE IN THAT MECHANISM, ON THE BASIS OF THE EXCHANGE RATES PREVAILING ON 31ST DECEMBER 1987 AGAINST THE USD*



* See next page.

10.11.1989

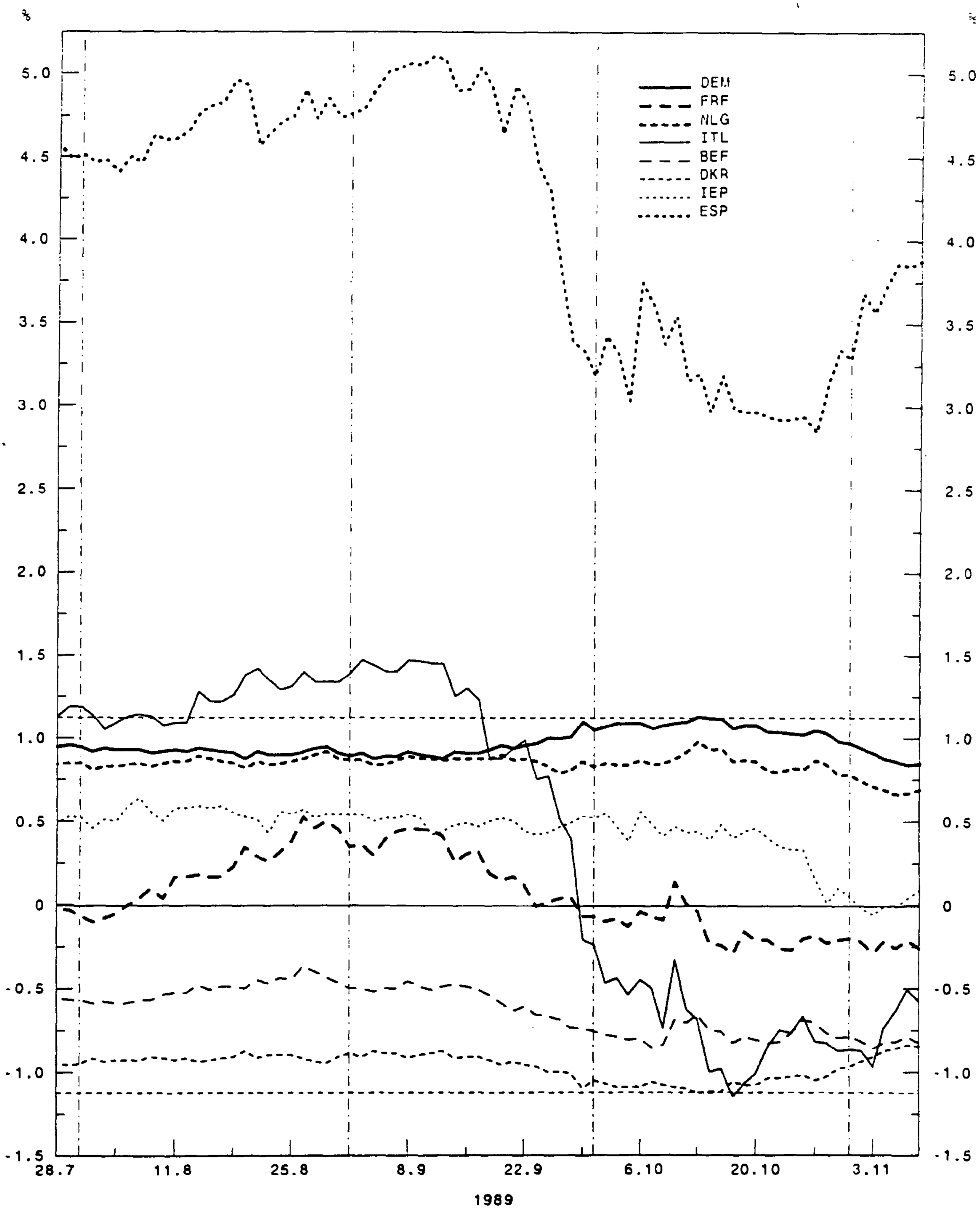
EVOLUTION OF THE CURRENCIES OF THE NON-EEC CENTRAL BANKS PARTICIPATING IN THE CONCERTATION, ON THE BASIS OF THE EXCHANGE RATES PREVAILING ON 31ST DECEMBER 1987 AGAINST THE USD*



* 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%.

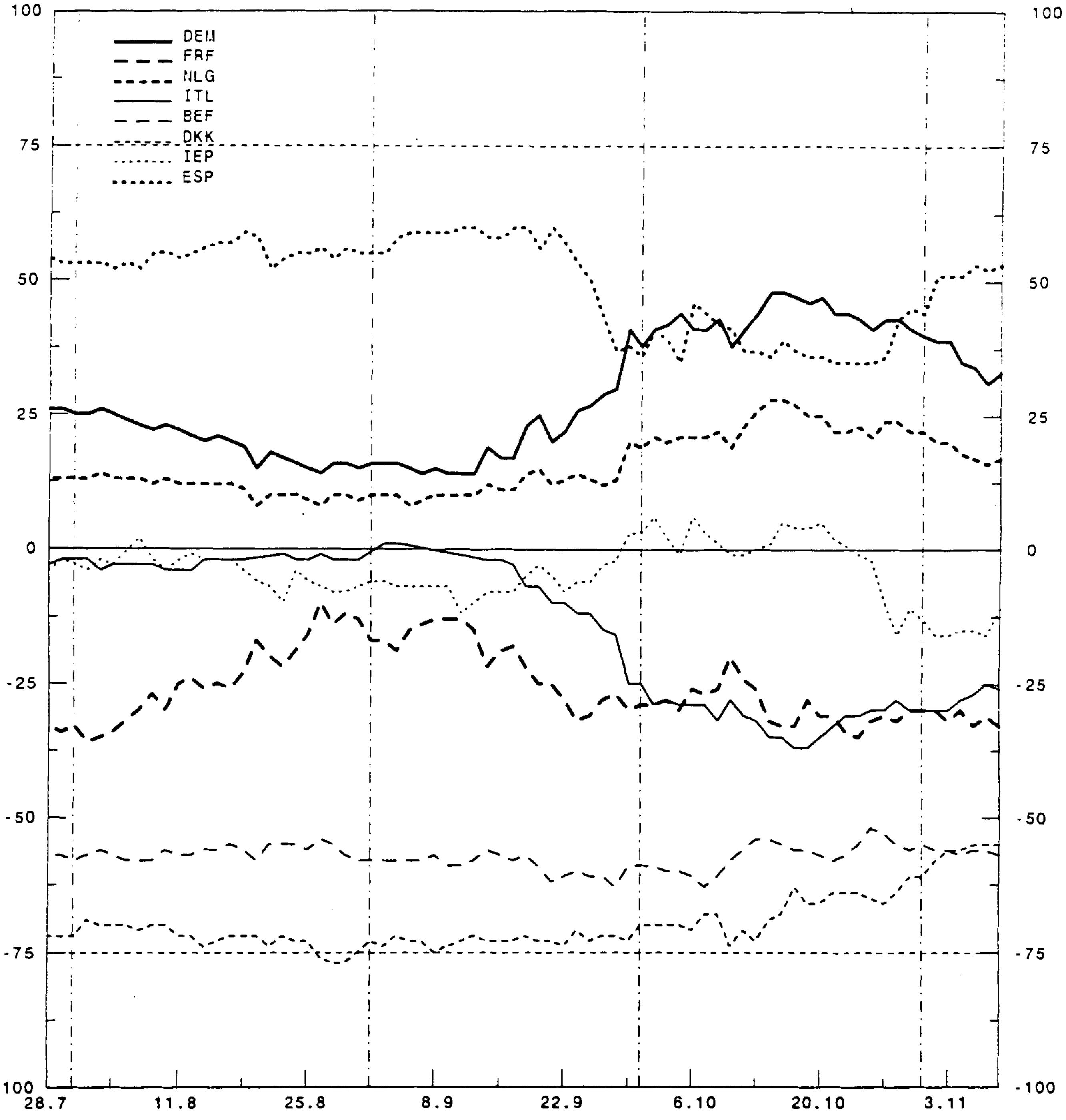
10.11.1989

MOVEMENTS IN THE EMS PARITY GRID



10.11.1989

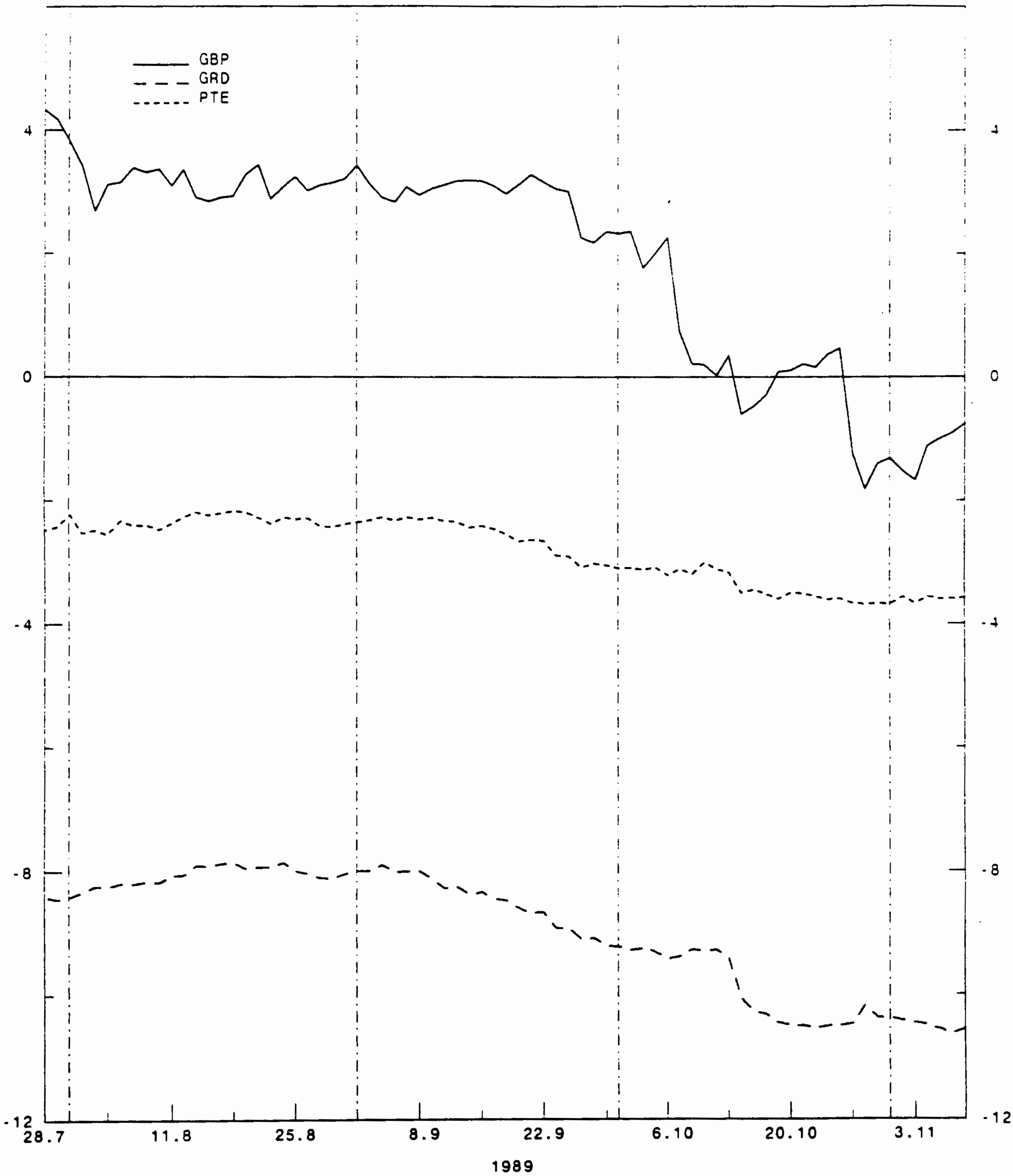
EVOLUTION OF THE DIVERGENCE INDICATOR*



* 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.

10.11.1989

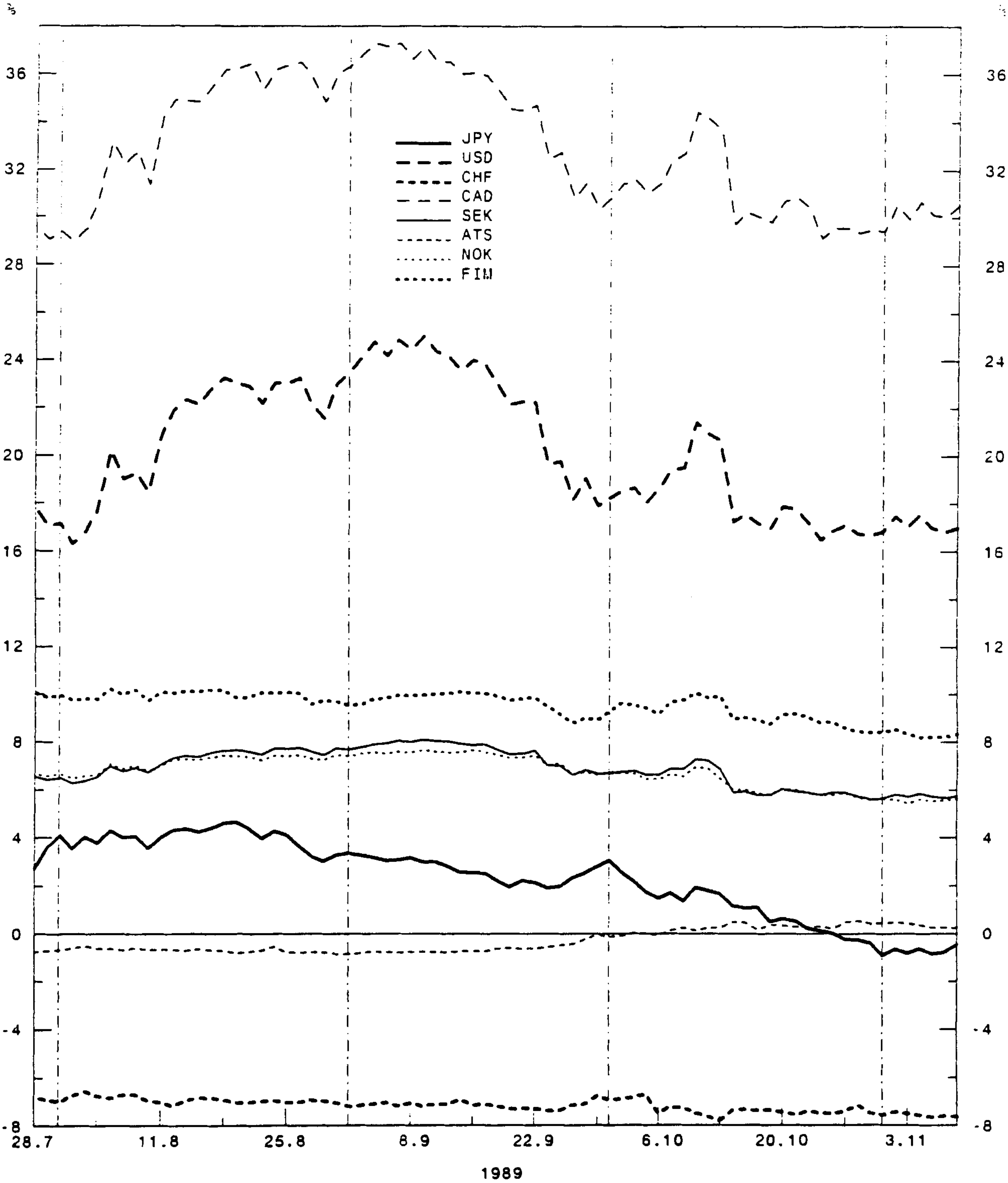
EVOLUTION OF THE POUND STERLING, THE GREEK DRACHMA, AND THE PORTUGUESE ESCUDO, ON THE BASIS OF THE MARKET RATES PREVAILING ON 31ST DECEMBER 1987 AGAINST THE ECU*



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

10.11.1989

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.

10.11.1989