10th December 1991

Confidential

Final

MINUTES

OF THE 260th MEETING OF THE COMMITTEE OF GOVERNORS

OF THE CENTRAL BANKS OF THE MEMBER STATES

OF THE EUROPEAN ECONOMIC COMMUNITY

HELD IN BASLE ON TUESDAY, 12th NOVEMBER 1991 AT 9.45 a.m.

Table of contents

I. Approval of the minutes of the 258th meeting

The Committee approved the minutes of the 258th meeting. It was agreed that the minutes of the 259th meeting - the special meeting on 28th October 1991 - would be approved formally at the December meeting.

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

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

The recent sharp fall in the US dollar had been relatively orderly given the magnitude of the cuts in the discount rate. A further reduction in short-term interest rates was not being ruled out, although long-term rates were not expected to decline because of the continuing upward pressure exerted by the growing Federal budget deficit. The Group felt that there might now be a consolidation in the value of the US dollar, but it saw no reason to expect a rebound in the near future. The dollar was likely to remain weak vis-à-vis the Deutsche Mark, not only because of the large interest rate differential favouring the latter, but also because the market appeared to be less pessimistic about the consequences of unification for the German economy.

Fluctuations in the US dollar appeared to have had only a modest effect on ERM currencies during 1991; a greater impact might be expected from factors affecting the internal cohesion of the EMS. Although this did not seem to be the case at present, a weaker US dollar could magnify any such internal tensions. It was therefore important that the EMS countries should avoid showing any sign of policy divergences, particularly with regard to interest rates. In situations of uncertainty short-term placements, which were estimated to be very large, could be moved quickly from one currency to another in response to even minimal changes in interest rate differentials.

Exchange rate stability in the EMS had been helped by the impact of German unification, which had resulted in a strong demand-pull effect throughout the Community and a relatively weak Deutsche Mark. However, recent data had indicated that the demand-pull factor was weakening as economic activity in Germany slowed down. Indeed, in the third quarter of

1991 there appeared to have been a significant slowdown in German imports, accompanied by a strong increase in foreign orders for German goods. The Group felt that the Deutsche Mark would continue to be affected by the prospects for inflation in Germany, which were related to the outcome of the current wage negotiations, and the budget deficit. Concern about domestic price trends was felt to have been the cause of the upward pressure on interest rates in the bond market since mid-October. On the whole, the Group continued to characterise the state of the foreign exchange market as one of unstable equilibrium.

There had recently been a brief period of tension in the ERM affecting the French franc, and to a lesser extent the Italian lira, against the background of a weakening dollar and a decline in interest rates brought about by market forces. However, the downward pressure on the two currencies had not lasted long. The Group noted that all the instruments provided for by the Basle/Nyborg Agreement had been used, thereby contributing to the removal of the conditions for profitable speculation.

In France the decline in market interest rates and a slowdown of domestic inflation had led to a reduction of key official interest rates by 25 basis points in mid-October. Subsequently, however, short-term interest rates had been allowed to rise above those in Germany, thus eliminating the negative interest rate differential which had prevailed for some days previously, whilst the Banque de France had undertaken interventions and permitted a moderate weakening of the French franc in the band. In Italy the lira had been allowed to decline a little from its position near the top of the narrow band while the Banca d'Italia had conducted some smoothing interventions. Short-term interest rates had also been allowed to firm slightly. Overall, the Group felt that the situation had been properly handled, with the result that the tension had abated before the end of the previous week.

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

Recent market developments had raised some interesting policy issues which were closely connected with the material in the report drafted by the Monetary Policy Sub-Committee. In reporting on the Alternates' discussion, Mr. Rey limited his comments to recent exchange rate developments and related issues.

The recent depreciation of the US dollar had brought it to a level which, in itself, was not a cause for concern, although the speed of the fall had contributed to some tensions within the ERM. The increase in the short-term interest rate differential between the ERM currencies and the US dollar, which now exceeded 4%, had led to a situation which could not be considered either stable or sustainable. Regarding the Japanese yen, the Alternates had noted some inconsistency, perhaps not innocent, between Japan's need to support weakening domestic demand through lower interest rates and the desirability of allowing for the yen to strengthen to prevent a new build-up of current-account surpluses.

With respect to ERM developments, it had been noted that in two countries prudent use had recently been made of the scope for movement of their respective currencies within the narrow band, to allow lower short-term interest rates in response to domestic developments including both low inflation and slow growth. It thus appeared that when the markets had a high degree of confidence in the stability of the parity grid, the ERM might allow some degree of flexibility in the conduct of monetary policy. However, the margin of manoeuvre was felt to be limited. As the case of France had recently shown, when a risk of tension emerged even as a result of exogenous factors, it was appropriate to give a clear signal to the market that all available instruments, including interest rates, would be used if necessary to safeguard the stability of the currency within the band. It had been observed by the British Alternate that any doubt as to the availability of the interest rate instrument in such circumstances would imply the need for greater caution when using up apparent margins of manoeuvre.

The Alternates had also raised the issue of the most appropriate way to deal with rumours of a realignment, which might appear in the run-up to major political deadlines linked to decisions on EMU insofar as these were seen to present a last opportunity to achieve a realignment. This could still occur before the Maastricht summit but appeared more likely to be an issue in the context of the entry into the final stage of EMU. It was felt useful to reflect on the need for the Committee of Governors to devise an appropriate response to such concerns, even though it might not be an urgent matter.

3. Discussion by the Committee

The Chairman said that he appreciated the concern about how to deal with rumours of a realignment although he felt that, if sufficient convergence was achieved by the member states during Stage Two to enable the transition to Stage Three to be made, it would be difficult to imagine that there would be a need to discuss a realignment.

Mr. Schlesinger noted that the recent uncertainty about the introduction of a withholding tax in Germany seemed to have had a negative impact on the Deutsche Mark. New legislation, which would shortly be published by the German Government, was likely to contain two important elements: foreign investors would be exempt from the tax; and there would be a rather high ceiling (probably an annual interest income of around DM 6,000 per individual) for domestic investors below which the tax would not apply. This being so, a very high proportion of domestic investors would also not be affected by the new tax and thus might show a greater interest in holding long-term investments. Whilst long-term interest rates in Germany might decline as a consequence, the new bill might enhance the confidence of non-residents in the Deutsche Mark, which could strengthen further.

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 and October and the first few days of November 1991

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

IV. Common framework for the monitoring of monetary policies: ex ante exercise devoted to the examination of monetary policy objectives envisaged for 1992

- Preparation by the Monetary Policy Sub-Committee of Report No. 6, entitled "Monetary Policy Intentions for 1992"

1. Statement by Mr. Borges, Chairman, Monetary Policy Sub-Committee

Mr. Borges began by thanking the Secretariat for its help in preparing and drafting the report and the Economic Unit for its significant contribution.

The Sub-Committee's report contained some methodological improvements, including the use of common external assumptions for the forecasts, Community-level measures of key variables and, in particular, harmonised monetary aggregates and counterparts to broad money. With regard to the more sensitive issues of monetary policy co-ordination, the analysis was preliminary and any conclusions were tentative.

The Sub-Committee had reviewed performance in 1991, particularly in the aftermath of the first co-ordination exercise. It was a matter of concern that inflation remained resilient despite a relatively more favourable external environment and a rather serious economic slowdown, or outright recession, in many areas of the Community. Although some convergence had been achieved, this had been partly of the wrong kind, since inflation had risen in low-inflation countries. Most progress at the Community level had been due to the United Kingdom; in the high-inflation countries current efforts were still insufficient to bring about rapid convergence. Difficulties had been found to lie in the areas of fiscal policy, labour market developments or structural rigidities rather than with expansionary monetary policies.

An important new development was the high degree of credibility of the ERM parity grid, which greatly reduced the autonomy of national monetary policies. The need to co-ordinate monetary policy decisions was therefore pressing and the highest priority had to be given to the issue of the policy mix.

An important consequence of higher inflation in Germany, together with the credibility of the parity grid, was the ERM's potential loss of effectiveness as an anti-inflation system. For high-inflation countries exchange rate commitments were no longer sufficient to generate a tight policy stance; sometimes they even prevented it. Furthermore, some of the low-inflation countries were those with the weakest currencies in the band. However, financial markets continued to express great confidence in the medium-term prospects for German inflation. The Deutsche Mark would therefore continue to play a key role as ERM anchor. In the short term, however, a source of discipline might disappear if German wage settlements exceeded prudent levels.

As other countries achieved low inflation rates, additional sources of discipline might emerge, since, with virtually fixed exchange rates, competitive pressures would force an anti-inflation stance throughout the Community. It was necessary for the commitment to price stability to be perceived as both permanent and very determined.

The policy intentions of the Community countries for 1992 had received a positive assessment from the Sub-Committee. Monetary policy intentions should provide significant anti-inflationary impetus, in spite of the limited contribution of fiscal policy, and should lead to some progress towards lower inflation and improved convergence. On the basis of current assumptions and forecasts, policies were judged to be broadly compatible, in the sense that exchange rate tensions might be avoided.

However, substantial risks still existed, the most serious being: the possibility that the recovery would be weak, leading to pressure for expansionary policies; a further deterioration in the policy mix; and less favourable developments in unit labour costs, owing to excessive wage growth or insufficient productivity improvements. Tensions might also arise if German inflation exceeded current forecasts or if, as a result of the policy responses to the different cyclical positions of France and Spain, interest rates were to diverge further. In addition, if Italy failed to implement its ambitious policy programme, this would be a further source of risks. Unfavourable developments on any front should be dealt with through more effective central bank co-operation; otherwise, if the response was left to individual or bilateral efforts, it would not always be clear that price stability was to be the overriding objective.

In conclusion, Mr. Borges encouraged the Committee to endorse the policy intentions presented in the report and to recommend that the implementation of monetary policy should be monitored closely so that a co-ordinated response by all Community central banks could be prepared and implemented should a significant deviation from current forecasts occur.

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

Mr. Rey said that the Alternates had praised the Sub-Committee and its Chairman very highly for the quality of the report, which raised fundamental issues for monetary policy. As far as the main issues were concerned, the Alternates had focused on three points.

Firstly, the report contained a strong message, which the Alternates found appropriate, to the effect that the present average Community inflation rate remained unacceptably high despite cyclical conditions which were more favourable to disinflation than had been expected. Progress had been made in some countries, notably the United Kingdom, but more needed to be done in several countries, whilst a setback had been registered in two of them. The report noted in this connection that the monetary policy intentions for 1992 did address this problem and were broadly appropriate.

A second key issue was the increased credibility of the EMS parity grid and the implications of this for monetary policies in the Community. The Alternates had noted that in certain respects the members of the ERM were already in a de facto currency union. Although the greater credibility of exchange rate parities in itself was to be welcomed, it meant that interest rates had a tendency to converge and that interest rate policy could be constrained. In this situation a successful anti-inflation policy would have to rely on the use of additional instruments which could directly tackle the fundamental sources of inflationary pressures. Depending on the particular circumstances, this could mean changes in fiscal, labour market or structural policies; in any case, the appropriateness of the policy mix was an issue of even greater importance than before.

The third issue was the recent price performance in Germany and its implications both for policy in Germany and for its anchor role in the ERM. No one had disputed the importance of an early restoration of price stability in Germany. It had been pointed out by several Alternates that the burden of bringing about that result should preferably be borne by a range of instruments and actions which addressed the sources of the problem rather than by monetary policy alone. As the Deutsche Mark no longer had the best price performance in the ERM but still appeared to be benefiting from the best price expectations over time judging by the level of long-term interest rates, opinions had differed as to whether the anchor role for the system should be viewed as unchanged or could henceforth be shared among several of the more stable currencies.

The Alternates recommended that the Governors should endorse the monetary policy intentions for 1992, as described in the report, and that the Sub-Committee should be asked to monitor developments closely and to report any deviations which might warrant examination and discussion.

3. Discussion by the Committee

Mr. Rubio remarked that the constraint which the greater credibility of the ERM parity grid imposed on interest rate policy at a national level should not be exaggerated. For instance, the reduction in Spanish interest rates in 1991 had been made against a background of slower economic growth and some progress on inflation. Furthermore, he did not believe that the tension between the Spanish peseta and the French franc during part of 1991 would recur in 1992.

Mr. de Larosière agreed with the report's conclusion that stronger co-ordination of monetary policy was needed in the Community, although he felt the report's tone to be a little too pessimistic about inflation performance. Given the changed ERM context, he warned that exchange rate stability was not in itself enough to achieve price stability; countries whose currencies were strong in the ERM band should not feel that this exempted them from the need to bring non-monetary policies to bear on inflation. It was essential for the stability of the ERM that the policy mix of its main participants be adequate.

Mr. Schlesinger welcomed the clear statements in the report concerning possible problems in 1992 and said this provided a good basis for discussion. He noted that in spite of many worthy declarations, only Denmark was at present achieving price stability. He did not feel that it would be correct to describe the ERM as a de facto currency union, since exchange rate realignments could still take place in the future. With regard to the setting of its 1992 monetary target in early December, the Deutsche Bundesbank would take into account, inter alia, the fourth quarter growth of M3. This was likely to be very high and might point to a need for a lower target range than the 4 to 6% mentioned in the report.

Mr. Ciampi praised the report's thorough interpretation of recent developments and prospects for 1992. He agreed that there could be a dilemma next year between making lasting progress on inflation without slowing the economic recovery. He criticised the statement in the report on the Italian official discount rate cut in May. The cut, he said, had taken place in a situation which had seen the lira close to the upper intervention limit in the two years following the entrance in the narrow band of the EMS. It would have been inappropriate and damaging to the smooth movement of goods and capital within the EEC to keep the lira in the upper part of the band, irrespective of the deterioration in competitiveness, only through increasing interest rate differentials. He asked for a more appropriate comment of the episode to be inserted into the report. He felt that the general conclusions reached in the ex ante exercise should be communicated to ECOFIN.

Mr. Duisenberg said the key question was how monetary policies should react in 1992 if the risks identified in the report materialised. He understood the concern about high real interest rates in countries with weak activity levels, but it should be remembered that the achievement of low inflation would improve competitiveness and hence medium-term growth prospects.

Mr. Tavares de Moreira congratulated the Sub-Committee on an excellent report. He said that the CPI inflation rate in Portugal had fallen to single figures in October, the first time it had done so in three years. At 9.8%, it was now 4.6 percentage points lower than twelve months earlier, during which period both a presidential and a general election had taken place. He was hopeful that Portuguese fiscal policy in 1992 would be more consistent with price stability than in the past.

Mr. Chalikias noted that monetary policy had become increasingly tight in Greece during 1991 and real interest rates had risen. Some further steps towards financial liberalisation were also being taken. However, fiscal policy targets would be substantially overrun.

Mr. Verplaetse said that the Belgian system of wage indexation was unhelpful in fighting inflation and, furthermore, there was an urgent need for fiscal consolidation. He noted that three Community countries now had a borrowing requirement significantly above 5% of GDP: Greece, Italy and Belgium.

Mr. Leigh-Pemberton said the report was a very promising start to Mr. Borges' chairmanship. The Community inflation projection for 1991 was disappointing, given cyclical conditions. In the United Kingdom the Chancellor's Autumn Statement was broadly consistent with the data in the report.

Mr. Borges, responding to the comments made, said that the report had tried to be faithful to the national contributions. Some inflation forecasts were of a "normative" nature in that inflation rates were the levels above which the central banks in question were not prepared to accommodate price rises. The risks identified in the report were not expected to arise provided that the forecasts proved to be accurate. For the future it would be desirable if national central banks kept in mind Community, as well as national, price performance when determining policies in order to assist overall anti-inflation efforts. Furthermore, if tensions arose, a co-operative, rather than a bilateral, approach to them should be taken. The Committee of Governors should discuss any divergences from the report's forecasts; the Sub-Committee would be ready to prepare the ground for such discussions at any time.

The Chairman thanked Mr. Borges and the Sub-Committee for their excellent work. The Committee endorsed the monetary policy intentions for

1992 contained in the report and asked to be kept informed of future developments.

V. Economic and Monetary Union

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

Mr. Rey drew the Committee's attention to the draft letter addressed to the President of the Council of the European Communities which contained the guiding principles on which the Alternates had based their review of the Dutch Presidency's Treaty proposals. The Alternates proposed that the observations and comments of the Committee of Governors should be confined to the draft Treaty on Economic and Monetary Union and the draft Statutes of the ESCB and of the ECB and the EMI. In addition, the Alternates recommended that the Governors should not comment on those issues on which they held differing views. The comments which had been agreed by the Alternates had been formulated in a way that was felt to be the most useful to the negotiation process still under way, i.e. draft provisions with explanatory comments. Mr. Rey said that this was probably the last opportunity for the Governors to express their comments before the Maastricht summit.

In addition, the Alternates had reached a consensus on the majority of the provisions now before the Governors, and Mr. Rey therefore did not propose to comment on those. However, the same was not the case for a small number of provisions on which the Alternates had disagreed either with respect to the wording of the draft or as to whether the Governors would wish to make any comment at all.

2. Discussion by the Committee

The Committee adopted the proposed changes to the Dutch Presidency's proposals without substantial comment or discussion with regard to Articles 4, 14, 22, 27, 28, 30, 33, 35, 41, 42 and 51 of the draft Statute of the ESCB and of the ECB, Articles 106, 108 and 109 of the draft Treaty and Articles 5, 10, 19 and 20 of the draft Statute of the EMI.

However, more substantial discussion took place with regard to the following articles of the draft Statute of the ESCB and of the ECB, and Article 105 of the draft Treaty:

Article 16 - Notes - Mr. Rey said that the Alternates had agreed that the title should read "Notes and Coins" since coins were a component of the monetary base which had to be under the control of the ESCB if the indivisibility of monetary policy was to be preserved. After quite a lengthy exchange of views it was agreed to adopt, as it stood, the proposed redraft of Article 16.2, which stated that both the volume and denomination of coins issued within member states should be subject to the approval of the Governing Council of the ECB. However, the Committee agreed to delete the reference to the circulation of coins by the ECB and/or the national central banks. The current practice in the majority of member states was for circulation of coins to be handled by agencies other than the central banks; the Committee would be content to see this continue.

Article 29.1 - Key for capital subscription - Mr. Rey said that the Alternates had noted three areas of difficulty in the Dutch Presidency's draft. Firstly, the key should comprise objective indicators without the need for political assessment at the time of revision. Secondly, the Dutch proposal had introduced into the key a third criterion related to extra-EC exports to which most of the Alternates had objected. He noted, however, that the Dutch Alternate had expressed a reservation on this point. Thirdly, there was the issue of whether the Committee should comment on this article by restating the wording originally proposed by the Governors, or whether the Governors should just transmit a comment on the revised text.

Mr. Duisenberg recalled that he had all along been in favour of including a financial criterion in addition to those related to population and GDP. Other Governors were against rediscussing the text which had previously been agreed by the Committee, although Mr. Verplaetse said that he could agree to a financial criterion being added if it would be applied only in the first five years of the ESCB. After further discussion the Alternates' amendments to the Dutch proposal were adopted.

Article 40 - Privileges and Immunities - Although this was not a controversial issue, the Committee agreed with the Alternates that the Dutch Presidency's text left open the question of which privileges and immunities should apply to the ECB. The Committee agreed not to suggest a text but simply to draw attention to this deficiency.

Article 105 - Mr. Rey said that this Article was linked to Articles 3 and 31 of the draft Statute of the ESCB and of the ECB. The Alternates had felt that the wording of the Dutch Presidency's text was too vague. The wording of the proposed redraft sought to establish that, whilst foreign currency balances might be held by those public entities designated in Article 104, currency transactions above a certain limit should be subject to the approval of the ECB. Furthermore, it set out the means by which the definition of such balances and of official foreign reserves should be determined. He pointed out that the redraft had been broadly agreed by the Alternates, with a reservation on the part of the Spanish Alternate, although there was a common wish that this article should be examined carefully by the Governors. After a long and inconclusive discussion by the Committee it was decided that the Governors should delete the proposed amendments to this article and not comment on the Dutch Presidency's text. Although there was some agreement in the Committee that the definition of official foreign reserves should reflect that used in the context of the IMF, there was disagreement over the extent to which, and the means by which, public entities should be able to undertake foreign currency transactions and how the ECB should ensure that such transactions did not conflict with the tasks and objectives of the ESCB.

VI. Other matters falling within the competence of the Committee

1. Expenses incurred on behalf of the Committee in the third quarter of 1991

Mr. Hoffmeyer noted that third-quarter expenses were in line with the budget but that spending would be above the projections for the year owing to the establishment of the Ad Hoc Working Group on Payment Systems.

The Committee elected Mr. Jaans to replace Mr. Hoffmeyer on the Finance Committee.

2. Technical issues relating to the introduction of common bank-notes

It was noted that it would take at least six years to make the necessary arrangements to prepare a European bank-note. It was agreed that a letter would be sent to Mr. van Droogenbroeck thanking him and his Group of Experts for their work in this area, stating that the Committee of Governors would re-examine this matter after the Maastricht summit.

VII. Date and place of next meeting

The next meeting of the Committee of Governors would take place in Basle on Tuesday, 10th December 1991, starting at 9.30 am.

260th MEETING OF THE COMMITTEE OF GOVERNORS

12th NOVEMBER 1991

Those present were:

Chairman of the Committee of Governors	Mr. Hoffmeyer
Banque Nationale de Belgique	Mr. Verplaetse Mr. Rey* Mr. Michielsen
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. Redouin
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. Bakker
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. Guiomard Mr. Stone

* Chairman of the Committee of Alternates