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(Translation)

MINUTES*

OF THE 232nd 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 FEBRUARY 1989 AT 9.30 a.m.

Those present at the meeting were: the Governor of the Bank of Greece and Chairman of the Committee, Mr. Chalikias, accompanied by Mr. Papademos, Mr. Karamouzis and Mr. Brissimis; the Governor of the Banque Nationale de Belgique, Mr. Godeaux, accompanied by Mr. Rey and Mr. Michielsen; the Governor of Danmarks Nationalbank, Mr. Hoffmeyer, accompanied by Mr. Mikkelsen; the President of the Deutsche Bundesbank, Mr. Pöhl, accompanied by Mr. Gleske and Mr. Rieke; the Governor of the Banco de España, Mr. Rubio, accompanied by Mr. Linde and Mr. Durán; the Governor of the Banque de France, Mr. de Larosière, accompanied by Mr. Waitzenegger and Mr. Cappanera; the Governor of the Central Bank of Ireland, Mr. Doyle, accompanied by Mr. O'Grady Walshe and Mr. Reynolds; the Governor of the Banca d'Italia, Mr. Ciampi, accompanied by Mr. Dini and Mr. Santini; the President of De Nederlandsche Bank, Mr. Duisenberg, accompanied by Mr. Szász; 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. Loehnis and Mr. Arrowsmith; the President of the Commission of the European Communities, Mr. Delors, accompanied by Mr. Mingasson and Mr. Dixon; the Director General of the Luxembourg Monetary Institute, Mr. Jaans; the Secretary of the Monetary Committee, Mr. Kees. 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 14th March 1989, which incorporates some drafting changes.

I. Approval of the minutes of the 230th and 231st meetings.

The Secretariat had received no suggestions for amendments to the two drafts. As no comments were made at the meeting, the draft texts of the minutes of the 230th and 231st meetings were approved by the Committee unchanged.

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

Since the Committee's last meeting the dollar had remained volatile but on a firm upward trend. It had appreciated by 10% vis-à-vis the Deutsche Mark since the beginning of December, moving back to its level of the summer of 1988. Against the yen, the dollar was still 10% lower than in early 1987. Several factors accounted for the strengthening of the US currency: high and rising interest rates in the United States; expectations regarding the policy of the new Administration; a perception on the markets that the central banks' stance had not changed, which had been confirmed by the G-7 meeting on 3rd and 4th February and the actions of the monetary authorities. Recently the central banks' interventions had been less convincing and the regular, moderate sales of dollars had not proved effective. Over the last few weeks the Deutsche Bundesbank had intervened only when the initiative had been taken by the Fed. Although the interventions had had only limited effect, they had added up to a sizable total. During January and the first ten days of February dollar sales had amounted to US$ 5.5 billion and purchases of Deutsche Mark to the equivalent of US$ 11 billion. In 1988 as a whole the Bundesbank's interventions had reduced its reserves by DM 35 billion.

The rise in interest rates in the United States had been followed by increases in the Federal Republic of Germany and in other European countries. However, these increases had also been dictated by domestic considerations. Domestic factors had been the primary concern in Germany, where inflation was now running at an annual rate of 2.6%, high for that country, though the raising of indirect taxes had played a role. Moreover, M_3 growth was still above target.

Not least, the appreciation of the dollar brought the adjustment process to a halt. The German trade surplus was rising again, in particular vis-à-vis its European partners but also vis-à-vis the United States. A further firming of the dollar could not be ruled out. If US growth continued or inflation accelerated a rise in US interest rates would become likely, which would push up the dollar even further and thus aggravate the present problems. On the other hand, a slowdown in US growth would probably lead to a decline in interest rates, which could push the dollar down. This would to some extent be welcome, but if the movement went too far other problems would arise. For the immediate future, however, it seemed more likely that US interest rates would continue on an upward trend.

Within the EMS there had been no tensions and no realignment rumours. There had, however, been a number of developments. The Deutsche Mark had remained at the top of the band but had shown signs of weakness: interest rate differentials vis-à-vis the other currencies in the exchange rate mechanism had narrowed and it had been supported by large-scale intervention. German economic fundamentals remained strong but there had been substantial capital outflows, triggered largely by the interest rate differentials but perhaps also under the influence of the withholding tax. The Dutch guilder had as usual closely followed the Deutsche Mark; it had weakened slightly because the intervention purchases of Deutsche Mark had not been matched by foreign purchases of guilders. De Nederlandsche Bank had stabilised the exchange rate vis-à-vis the Deutsche Mark by intervening on a moderate scale and in particular by adjusting interest rates. The Danish krone had declined quite significantly, moving to the bottom of the EMS band. The reason for this was that the authorities had decided not to match the interest rate increases elsewhere since the situation in Denmark was different, with zero growth and rising unemployment. The narrowing of interest rate differentials had caused the krone to weaken somewhat, but it had stabilised without any need for intervention. The French franc had firmed within the EMS even though interest differentials had contracted. In Belgium, the central bank had been able to make some purchases of foreign exchange. For both currencies, the French franc and the Belgian franc, interest differentials vis-à-vis other currencies were now back at the same level as in December 1988, when the two countries had had to intervene and raise their interest rates. The

Irish pound had remained stable. The Italian lira had shown the strongest performance within the EMS, despite substantial intervention purchases and a narrowing of interest rate differentials. The firmness of the lira was due not to economic and political developments, which were not particularly favourable in that there were no signs of a determined fiscal policy, but to the high level of interest rates, combined, since the liberalisation of capital movements, with easier access to foreign borrowing.

Turning to the other EEC countries, mention was to be made of the continued strength of sterling. The UK economy was still experiencing strong expansion and rising inflation, now running at an annual rate of 7% (5% excluding the effect of mortgage rates). The authorities were reluctant to raise interest rates further before the effects of the previous increases had worked through. The peseta had strengthened further. Spain had the strongest economic growth in the Community, but as a result inflation had accelerated (+5.8% in 1988) and the current account had deteriorated. As fiscal policy could not be tightened interest rates had been raised, and this had led to large-scale capital inflows and a firming of the peseta. Monetary policy had been tightened on 1st February with an increase in reserve requirements, combined with the introduction of special deposits against new foreign borrowing. After some confusion on the markets the peseta had stabilised at a high level at the end of January. In Portugal the policy of allowing the escudo to gradually depreciate had continued. A similar policy was pursued in Greece, where the effective exchange rate of the drachma was slowly declining. For both countries, the policy of managing the effective exchange rate had recently resulted in an appreciation against the Deutsche Mark, which was not without problems.

The experts had concluded their review with the following comments. All the foreign exchange markets now seemed to be dominated by capital movements; current-account balances were comparatively less important, even in those countries with large surpluses or deficits. Capital flows were triggered primarily by interest rate differentials, though other factors had also played a role, for example major LBOs in the United Kingdom. For some time capital had been flowing principally towards those countries with the highest interest rates. The markets did not entirely ignore exchange rate risks but they expected capital flows to keep those currencies with high interest rates stable or even on an upward path. This sentiment had been evident in relation to the currencies in the exchange rate mechanism: when no realignment was expected interest rate differentials were attractive compared with the exchange rate risk, even though the theoretical risk might be significant (5% between the Deutsche Mark and the lira, for example). The same phenomenon was at work outside the exchange rate mechanism, even in the absence of a safety net, and was in particular behind the capital flows into the dollar, sterling and the peseta. In a number of cases the markets had been right. Over the last two years it had, for example, on average, been more profitable to invest in dollars, and even more so in pesetas, than in Deutsche Mark; their interest rates had been higher and the exchange rate had been stable or had risen steeply. As market confidence in exchange rates had grown, smaller interest rate changes had sufficed to influence capital flows and stabilise the markets.

B. Statement by Mr. Papademos

The Alternates had focused their attention on three topics: the recent strengthening of the dollar, interest rate developments and the EMS, and the effectiveness of interventions.

1. The recent strengthening of the dollar

The Alternates had accepted the conclusion of the "Monitoring Group" that the recent strengthening of the dollar appeared to be in response to the tightening of US monetary policy in order to fight inflation. US wholesale price figures and employment data had added to market sentiment that monetary policy would be tightened. There was no way of judging whether the dollar's appreciation was a temporary phenomenon. However, a similarity existed between the present situation and the rise of the dollar in June 1988. It had also been pointed out that the foreign exchange markets were perhaps influenced by the outcome of the G-7 meeting, which did not seem to offer any specific guidance on exchange rates. The US budget proposals had been considered disappointing and implied that monetary policy would have to bear the burden in the fight against inflation.

2. Interest rate developments and the EMS

The rise in interest rates in the United States had been followed by increases in most EEC countries, where, however, domestic considerations had also played a role. In Germany, restrictive monetary policy aimed at containing inflationary pressures. The annual rate of inflation was on a rising trend, while the economy was facing capacity constraints. The increase in interest rates was justified by higher monetary growth than targeted but it was also consistent with external developments. In the United Kingdom, Italy and Spain, growing concern about increasing economic expansion called for a tightening of monetary policy which, in turn, resulted in an appreciation of their respective currencies. In other countries participating in the exchange rate mechanism, such as Belgium and the Netherlands, whose monetary policies were aligned with that of Germany, interest rates had also been raised. The Danish authorities, concerned with weak economic activity and rising unemployment, had not raised their interest rates. Some Alternates had expressed concern about the possibility of a new round of competitive interest rate increases if there was a further rise in US rates.

The markets had been very sensitive to interest rate differentials, especially when exchange rate risks were perceived as limited. Capital movements had been sizable and the authorities were conscious of the effects of interest rate movements in neighbouring countries on capital flows.

Long-term interest rates had not mirrored the upward trend of short-term rates. In the case of France this could be interpreted as reflecting the credibility of the policy pursued by the central bank. It should be noted, however, that in general the relative unresponsiveness of long-term rates should not be interpreted as meaning that the markets regarded the present circumstances as temporary. Owing to the increasing sophistication of the markets, transfers between the two ends of the maturity spectrum were easier. It had also been pointed out that periods of flat or inverted yield curves, resulting from a tightening of policy, were followed by weaker economic activity, though the timing was uncertain.

Overall, the EMS had been free of tensions, thanks in particular to good management of interest rate differentials. The behaviour of the Danish krone had been an exception, but the Danish Alternate had said that the possibility of a realignment had not been considered at all, both because inflation and the current account were moving in the right direction and because the authorities wished to show their commitment to exchange rate stability, especially at a time when employers and trade unions were negotiating wage increases for the next two years.

Because trade imbalances within the Community had not improved, the stability of the EMS might be threatened in the future. The current exchange rate of the Deutsche Mark vis-à-vis other EMS currencies could exacerbate the imbalances. Some Alternates had suggested that a realignment when it was not expected by the markets could correct certain disequilibria.

Others, however, had pointed out that a realignment would be counter-productive; moreover, an unexpected realignment could be successful only the first time.

The Spanish Alternate had explained in detail the reasons which had led the Spanish authorities to adopt exceptional measures to curb credit and liquidity growth. The Alternates had discussed whether some of these measures were wholly compatible with the Directive on the liberalisation of capital movements.

3. The effectiveness of interventions

Some Alternates considered that interventions could only be effective if they were accompanied by appropriate monetary policy measures. If central bank interventions could be anticipated by the markets they lost their effectiveness; the techniques employed were therefore of critical importance. Interventions were more effective if they were carried out when the markets were uncertain about the prospects for exchange rate movements or when the pressure on an exchange rate lost its momentum. Other Alternates had noted that interventions could be effective if the exchange rate movements were temporary. If, on the other hand, these movements reflected changes in fundamentals then interest rate adjustments should be employed. The effectiveness of interventions could be enhanced if they were carefully organised, concerted, visible and sizable. One Alternate had wondered whether the smaller volume of interventions during the present rise of the dollar had reflected decisions taken by the G-7. Some Alternates had regretted that the Bank of Japan had not participated in the recent round of interventions; in their view this would have been helpful, if only for symbolic reasons.

C. Discussion by the Committee

Mr. Rubio set out the reasons for the recent monetary measures. There had been a change of direction in Spanish monetary policy since the summer of 1988 in response to domestic developments, which had seen very buoyant economic growth (+5%) leading to problems on the prices front, with a rate of price increase of 5.8% in 1988, well above the original target (+3%). The Banco de España had raised its principal rate by 2 percentage points during the summer but it had quickly become apparent that this was not enough. Monetary expansion had, indeed, accelerated in the last few months of 1988 and the objective set for the growth of ALP last year (8-11%) had been exceeded (the objective for 1989 was 6.5-9.5%).

The Banco de España had been faced with substantial capital inflows in 1988; the peseta had appreciated by about 7% vis-à-vis the Deutsche Mark and large-scale intervention had led to an increase in reserves of around US$ 10 billion. The increase in interest rates of 1 percentage point in early February 1989 had had to be flanked by other measures, as capital inflows were becoming excessive and the appreciation of the peseta intolerable in view of the deterioration of the current account, which had swung from surplus in 1987 to a deficit of almost US$ 4 billion in 1988. These measures included the introduction of a compulsory deposit on foreign borrowing; in the opinion of the Commission they were not incompatible with Spain's obligations with respect to the liberalisation of capital movements. It was not certain that the measures taken would in fact curb domestic demand. In addition, the 1989 budget projections did not foresee any notable reduction in the deficit; the borrowing requirement was estimated at 2.9% of GDP, which was much the same as in 1988. Moreover, while the deficit was expected to be relatively modest, public expenditure would rise sharply (+13%), which meant that overall the budget would in fact have an expansionary influence. A firm policy was also important with a view to the current wage negotiations; corporate profitability was in general high, which might encourage laxism. Finally, if monetary growth remained strong and the overheating grew worse other, perhaps fiscal, measures would be adopted.

Mr. Godeaux said that he had no particular comments to make on the statements by Mr. Dalgaard and Mr. Papademos, but he would like to give a brief account of the import of the constitutional and legislative measures that had recently been taken in Belgium and their potential impact on the monetary front. The last elections had produced a shift towards federalism and the Government that had been formed, after the longest political crisis in recent Belgian history, was engaged in implementing this major development. In 1980 new public-law entities had already been created, viz. the three Dutch, French and German Communities and the three regions of Flanders, Wallonia and Brussels. These entities had been given wide powers and responsibilities under the Law of 8th August 1988. The Government's programme was in three parts. The first consisted essentially in the devolution of education policy to the Communities and of certain economic policy powers to the regions. The second phase, which had just been enshrined in law, would establish the basis for financing these new public-law entities; they would receive approximately 32% of the revenue of the former national budget, not an uncommon share in countries with federal structures. The Law recognised in the most formal terms the need and the political will to preserve the country's economic integrity and monetary unity. Fairly complex arrangements made provision for monitoring, consultation and the central authority's right to intervene with respect both to the new entities' freedom to set different levels of taxation (the example of federal states showed that taxation levels must not be allowed to diverge too much) and to methods of financing. The new entities' borrowing would be monitored by the central authority and for this purpose a new section had been created within the Superior Finance Council, in which the central bank was represented by the Governor, the Deputy Governor and a member of the Board of Directors. It would be possible to curb the entities' powers if their borrowing or divergences in levels of taxation should threaten the country's monetary unity. This was a compromise which should make it possible to preserve monetary unity and continue the fiscal adjustment efforts made in recent years (in five years the budget deficit had been reduced by half as a percentage of GNP). A third phase of devolution, purely political, would modify the powers of the Senate, extend the competence of the Arbitration Court, which would become a kind of constitutional court, and give citizens the right to appeal to that Court in the event of conflicts of jurisdiction between the various entities of government. The calendar for implementing this third phase had not been fixed.

A law had been passed on 23rd December 1988 concerning the monetary order and the Banque Nationale de Belgique. The Bank's charter had been due to expire on 31st December 1988. Henceforth it would have permanent legal status.

Finally, the Banque Nationale had devised a new technique of lending to the financial intermediaries through a tender of very short-term funds, which it was due to begin using in March. It had wished to complete the range of interest rates subject to its influence, strengthen its market links with financial intermediaries, and ensure that interest rate changes could be made without triggering announcement effects that might run counter to its objectives.

Mr. Leigh-Pemberton made a few comments on the situation in the United Kingdom. A cut in interest rates was certainly not to be expected and a further increase was not desired as rates were already high and the restrictive policy was showing results. Retail sales figures for December 1988 had recorded a decline; monetary growth had been less strong in the fourth quarter than in the third, partly reflecting the contraction resulting from the current-account deficit. The deficit on current account had still been large in December, at £1.3 billion, but it seemed to have stabilised in the fourth quarter. The rate of inflation was still rising and continued to give cause for concern; the annual rate had been running at about 7% at the beginning of 1989; however, it should slow down later in the year. Economic growth remained buoyant and neither the rise in interest rates nor the strength of sterling seemed so far to have adversely affected investment plans. There was therefore reason to hope that it would be possible to continue to expand productive capacities and at the same time keep domestic demand under better control.

The Chairman noted that a number of recent developments not confined to the foreign exchange markets merited the Governors' attention. The rise in US interest rates was one of the main reasons for the strength of the dollar and it also provoked rate increases in the rest of the world, even in countries where they were not warranted on domestic grounds. In some countries inflationary pressures were growing under the influence of buoyant domestic demand and necessitated restrictive monetary measures, in particular if the policy mix could not be changed. Exchange market volatility would probably continue to make itself felt and the European economies would continue to face certain dangers. It was therefore important that the Governors should keep a close watch on economic and monetary developments. In this respect, they will rely, as usual, on the excellent work of the experts and the Alternates.

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 January and the first few days of February 1989.

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

IV. Examination of Report No. 65 prepared by the Group of Experts chaired by Mr. Dalgaard on the impact of the forthcoming review of the ECU basket.

At the invitation of the Chairman Mr. Dalgaard briefly introduced Report No. 65, highlighting the most important elements of the analysis and some proposals made by the experts.

A. Statement by Mr. Papademos

The Alternates had expressed their appreciation of the high quality of the report and had largely shared the views put forward by the experts. They all agreed that the revision of the basket should not result in any change in the ECU central rates, bilateral central rates or compulsory intervention rates of the currencies participating in the exchange rate mechanism and that the imputed parities of non-ERM currencies should be adjusted accordingly. This was desirable in order to avoid the risk of confusion with a realignment.

The majority of the Alternates agreed with the experts' conclusion that a two-stage procedure, whereby the new weights were fixed and announced some time prior to the entry into force of the new ECU, would contribute to reducing the uncertainties in the ECU market associated with the revision.

The Italian Alternate was not in favour of the two-stage procedure and proposed that the 1984 approach be adopted instead. He argued that there was no compelling reason to justify an early announcement of the weights and that if a realignment occurred during the grace period it would create problems and be embarrassing. In addition, he felt that a two-stage procedure could be unsuitable for the process of fixing the weights. A balanced approach should be adopted in setting the weights and the criteria to be used should be clearly identified. In determining the weight of each constituent currency a balance should be maintained between the economic importance of the country in question and the need to preserve the stability of the ECU. In this respect, any significant increase in the weights of non-ERM currencies would undermine the attractiveness of the ECU, which it owed precisely to its low variability.

The representative of the Commission had pointed out that in 1984 the weights had not reflected only objective criteria but also value judgements. In all likelihood, a similar approach would be followed in 1989 and the weights would reflect the objective of preserving the strength and stability of the ECU.

The Alternates had also exchanged views on the procedure to be followed in sending Report No. 65 to the Commission and to the Monetary Committee.

B. Discussion by the Committee

Mr. Leigh-Pemberton thought that the Governors could accept the experts' report and take up the Alternates' suggestion that it should be sent to the Commission and the Monetary Committee. It would be desirable to send the report with the Governors' endorsement, emphasising the advantages of a two-stage procedure for the revision of the ECU basket. One member of the Committee was not in favour of such a procedure but it had to be recognised that circumstances had changed a great deal since 1984 and that it would be as well to initiate the procedure fairly soon and not to add to the uncertainty and hesitation on the private ECU markets by waiting until September 1989. As had been said in Report No. 65, the goal was not to assist the banks but to ensure a flexible transition between the two ECUs and the most orderly market conditions possible, which was a natural responsibility of the central banks. By proceeding in two stages, with an announcement three months in advance, one would not be helping the banks but protecting the ECU itself and giving it greater permanence.

Mr. Leigh-Pemberton concluded by expressing the hope that, notwithstanding one central bank's reservations, the experts' report would be sent to the Commission and the Monetary Committee with the Governors' approval.

Mr. Delors thanked the Committee for having initiated a study of the revision of the ECU basket, which required a Regulation of the ECOFIN Council by unanimous decision on the Commission's proposal after hearing the opinions of the Monetary Committee and the Board of Governors of the EMCF. The experts' report was very instructive and would be of help to the Commission in formulating its proposal. The experts advised caution in view of the change in the dimension of the private ECU market since 1984; the large short-term operations carried out by the UK Treasury were also a reason for approaching the revision with care. The experts also emphasised that the revision was not to be confused with a realignment. This was very true and one only had to recall the unpleasant climate of the last realignment in January 1987 to wish to avoid the kind of confrontation that had then arisen for reasons of national pride or prestige. To this end Mr. Christophersen, Commissioner for economic affairs, should make a tour of the capitals in order to consult Finance Ministers and Governors with a view to formulating an approach that would reconcile objective and other criteria.

Mr. Delors added that he would ask the Commission to follow the report of the "Dalgaard Group" in its wisdom and opt for a two-stage procedure. If the Commission adopted this approach, the ECOFIN Council could decide on the weights of the ECU component currencies at its meeting on 19th June 1989, and the Commission would then, in the last week of September, determine the constituents of the basket on the basis of the currencies' market rates. Without going into details at this stage, it was important to stress the desirability of a strong ECU and the need to convince those who might not care for this idea at national level. The difference between a strong ECU and a weak ECU was perhaps very small but the market no doubt expected a signal that would maintain confidence in the ECU and secure its future. It was not sure that the Commission would manage to convince all member countries that such an approach was the right one; it was, however, important to announce it at once as the revision of the ECU basket was the subject of numerous commentaries and was already affecting operations, in particular those at medium and long term.

The two-stage procedure seemed to invite only one objection, namely that the major decision on the currencies' weights would fall in the period between the presentation and publication of the ad hoc Committee's report on economic and monetary union and the European Council at the end of June. If this report provoked animated debate, with or without a revision of the basket the ECU would be affected. The experts' proposal was therefore undoubtedly the best approach.

Mr. Ciampi observed that in his statement Mr. Papademos had mentioned the dissenting position of the Italian Alternate regarding a two-stage procedure for the revision of the ECU; he confirmed the Banca d'Italia's reservations in this respect and wished them to be put on record. The question could in fact be viewed differently. It was now necessary to take note of Mr. Delors' preference for a two-stage procedure, with the first coinciding with the ECOFIN Council meeting on 19th June and the second falling in the last week of September 1989. The report of the "Dalgaard Group" was at all events a good basis for discussion and a valuable document; it would certainly be highly appreciated by the Monetary Committee, to which it could be sent with the reservations of the Banca d'Italia.

Mr. Rubio agreed with the comments made by Mr. Delors; however, he wondered how the criteria would be laid down to ensure a strong ECU; it would be necessary to be very specific but this would not be easy and difficulties were to be expected.

Mr. de Larosière thought that Report No. 65 was a good document and endorsed Mr. Leigh-Pemberton's remarks on the subject. The markets were important and had to be protected. Moreover, a two-stage procedure already existed in a similar case, i.e. a change in the composition of the SDR by the International Monetary Fund. To warn the markets by telling them that the composition of the ECU had been revised, that it would take effect in three months' time and that they could organise themselves accordingly was an appropriate way for the monetary authorities to meet their responsibilities.

The Chairman was of the opinion that the experience of the 1984 revision of the ECU should be taken into account but within certain limits. Although the risks run by the markets were perhaps exaggerated, it was better to be prudent and, from this point of view, the two-stage procedure would give the markets more time and flexibility to take the necessary precautions and hedge the risks created by the revision of the ECU.

There was general agreement among the Governors on emphasising that the ECU central rates, bilateral central rates and compulsory intervention rates of the currencies participating in the EMS exchange rate mechanism should remain unchanged when the composition of the ECU basket was revised. Any confusion with a realignment was to be avoided. With regard to the experts' second recommendation, viz. a two-stage procedure, the Governors were not unanimously in favour. In these circumstances Report No. 65 should be sent to the Commission and the Monetary Committee with a letter from the Chairman of the Committee of Governors. This letter would, firstly, emphasise the importance attached by the Governors to the stability of central rates and intervention rates and, secondly, mention that technical considerations, described at length in the experts' report, argued in favour of a two-stage procedure but that a minority of Governors felt that a single-stage procedure, as in 1984, was to be preferred.

The Chairman wondered whether his letter should also note that a balance should be maintained in setting the currencies' weights by taking account of their relative economic importance, the need for a stable ECU and that giving too great a weight to non-ERM currencies might weaken the ECU.

Various comments were made by some of the Governors on the Chairman's question.

Mr. Rubio pointed out that it was difficult at present to make a distinction between strong and weak currencies and that, in particular, it was not possible in reality to attach a weak-currency label to the new currencies that would enter the ECU basket.

Mr. de Larosière agreed with Mr. Rubio that one could not speak of weak currencies. Moreover, that was not the point. It could, however, be said that the Governors wished to preserve the attractiveness of the ECU and that one factor in this attractiveness was that certain component currencies had close exchange rate relationships with one another, which did not necessarily mean that there was no place for the other currencies in the ECU.

Mr. Delors wished to reassure the Governors. Firstly, the Commission was aware of the delicate aspect of the revision of the ECU, and the proposed tour of capitals would, indeed, make it possible to listen to the authorities of each country. Secondly, the Commission had no intention of making two distinctions a priori, between strong and weak currencies and between currencies belonging to the exchange rate mechanism and those outside it, for there was nothing to say that some of the latter would not join the mechanism in the fairly near future. The criteria should therefore rather be based on objective factors and on a close analysis of the markets. In this context the consultations already referred to appeared very important.

The Chairman concluded from the comments just made, in particular by Mr. Delors, that it was better not to mention the question of weights in his letter to the Commission.

V. Exchange of views on a note prepared by the Group of Experts chaired by Mr. Raymond on sterilised and unsterilised interventions.

The Chairman noted that the Alternates had not had sufficient time for a proper examination of the note prepared by the "Raymond Group" and that they had agreed to come back to this document in the near future. The Governors could therefore themselves hold an exchange of views at one of their next meetings, after the Alternates' discussion.

VI. Other matters falling within the competence of the Committee:
- Allocation of the expenses for 1988 of the Committee's Secretariat.

The Chairman said that the Secretariat had prepared a note and tables which had been given to the Governors and Alternates.

In accordance with the usual practice, and as was done in the note, the expenses of the Committee of Governors and the EMCF (Secretariat of the Board of Governors and Agent) could be dealt with together.

The Chairman added that the Alternates had made no comments in this connection and noted that the Committee approved the note and tables presented by the Secretariat.

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Before closing the meeting the Chairman addressed Mr. Loehnis in order to express the Governors' high regard and gratitude for his contribution to the Committee. Mr. Loehnis, who would shortly be joining the private banking sector, had taken part in the Committee's work for nine years as International Director of the Bank of England and Alternate to the Governor. He had acquired a reputation in particular as a pragmatist and a first-rate technician, qualities which he had amply demonstrated in his command of the subject-matter and at the head of the Committee of Alternates, which he had chaired twice, in 1981 and 1986.

The Chairman conveyed to Mr. Loehnis the Committee's very best wishes for his future.

Mr. Loehnis thanked the Chairman for his kind words, which he greatly appreciated; he added that he would continue to follow the results of the Committee's work in another environment but with just as much interest as hitherto.

VII. Date and place of the next meeting.

The next meeting would be held in Basle on Tuesday, 14th March 1989 at 9.30 a.m.

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

Annex

14th February 1989

Confidential

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

JANUARY 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 January and the first few days of February 1989.

I. EXCHANGE RATE DEVELOPMENTS

The main feature of the foreign exchange markets was a further strengthening of the US dollar against most currencies. This was despite persistent concerted sales of dollars, mainly against Deutsche Mark, and further increases in official interest rates in some European countries.

The US dollar came under persistent upward pressure. It benefited both from expectations that continued strong US economic growth would keep dollar interest rates firm and from an improvement in sentiment towards the new US Administration. Renewed investor interest in US dollar denominated securities also appeared to add to the dollar's firmer tone. The report of a widening of the US trade deficit in November provided only a temporary lull in the demand for dollars; sales of the dollar through co-ordinated intervention were undertaken at various times throughout the month to counter the dollar's rise. The dollar closed approximately 5.25% higher against the Deutsche Mark, 3.5% higher against the yen and 2.75% higher against sterling.

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

There were no tensions within the EMS. The Danish krone replaced the French franc at the foot of the narrow band when Denmark did not follow the interest rate increases elsewhere in Europe. The Italian lira continued to strengthen, moving close to the middle of the narrow band.

The Deutsche Mark continued to weaken against almost all the currencies officially quoted in Germany. The weighted nominal external value of the Deutsche Mark (1972= 100) went down by 1.4% from 169.9 to 167.5; it thus fell back to the level obtaining at the beginning of August 1988. The Bundesbank raised its discount and lombard rates by 1/2 percentage point to 4% and 6% respectively, with effect from 20th January.

The French franc improved its position within the Community's exchange rate system, moving from sixth to fifth place. It benefited from sizable foreign currency sales by residents and from the positive effect of the announcement of an inflation rate of only 3.1% for 1988. Moreover, the increases on 19th January in the Banque de France's intervention and 5-10 day repurchase rates to 8 1/4% and 9%, respectively enabled the franc to maintain a generally favourable trend.

The Belgian franc performed well throughout the period, enabling the Banque Nationale de Belgique to purchase foreign currency. However, following the general upward movement in rates, the Bank raised its discount and advance rates on 23rd January by 1/2 percentage point to 8 1/4% and 8 1/2% respectively, and the three-month Treasury certificate rate by 0.10%, on two occasions, to its current level of 7.70%.

The Dutch guilder weakened slightly vis-à-vis most EMS currencies, but remained in the upper part of the intervention band. In line with similar moves elsewhere, the Nederlandsche Bank raised its official interest rates by 1/2 percentage point with effect from 20th January, bringing the discount rate to 5% and the lombard rate to 5.75%.

The Danish krone declined somewhat and ended the month as the weakest currency within the EMS band as interest rates remained relatively stable despite the increases in many countries. The interest rates were kept stable because of weak growth in Denmark.

The Irish pound remained relatively stable in the upper half of the EMS band. Net inflows of foreign currency continued for most of the month and resulted in net purchases of foreign currency by the Central Bank of Ireland. At the end of the month there were some outflows of foreign currency, offset by sales by the Bank.

The Italian lira continued its upward movement within the EMS narrow band, as short-term inflows continued despite the narrowing of the interest rate differential. The Banca d'Italia resisted this trend by purchasing Deutsche Mark and selling US dollars in concertation with other central banks.

Sterling was on the sidelines for much of the month, losing ground to the dollar but edging quietly firmer against most European currencies. It dipped briefly when rises in continental interest rates were not matched in the United Kingdom, but moved up again on the back of the rising dollar to end the month at its high against the Deutsche mark. Sterling's trade-weighted index rose by 0.8% to 98.2 (1985=100).

The Greek drachma depreciated by 4.7% and 0.2% against the US dollar and the ECU respectively. In effective terms the drachma weakened by 0.6%.

The Spanish peseta firmed further due to substantial short-term capital inflows, driven by the existing positive interest rate differential. It ended 2.8% higher against the ECU, but depreciated 1.8% against the dollar.

The Portuguese escudo depreciated by 0.25% in effective terms in line with the foreign exchange policy defined by the authorities. Against the US dollar, the escudo fell by 3.8%.

The Swiss franc weakened further vis-à-vis most currencies. Against the US dollar it fell by more than 5%; against the Deutsche Mark it fell by 0.3%. By the end of the month the export-weighted index of the franc was 1.5% below its December level. Interest rates in the domestic money market rose once again by almost 1 percentage point to 5 1/2%-6%. Official discount and lombard rates were raised by 1/2 percentage point to 4% and 6% respectively, from 20th January.

The Austrian schilling weakened by 4.4% vis-à-vis the US dollar, with a monthly spread of 6%. Against the Deutsche mark, however, it fluctuated by only 0.2%. On 20th January the discount and lombard rates were raised by 1/2 percentage point to 4 1/2% and 6% respectively, and at the end of January it was announced that the rate for short-term open market operations was to be increased from 4 3/4% to 5 1/4%.

The Norwegian krone continued its gradual appreciation, ending nearly a full percentage point stronger in effective terms. A deceleration in domestic credit expansion and inflation rate, together with firm oil prices and improvements in the external balance, allowed a further

1/2 percentage point reduction in the Central Bank's overnight lending rate to 11 1/2% to be made from 10th January.

The Swedish krona, unaffected by somewhat lower interest rates resulting from the government's proposal to abolish exchange controls in Sweden, was restricted to a narrow trading range.

The Finnish markka remained, in effective terms, rather stable at the strong end of its fluctuation range. Short-term money market rates fell by about 1 percentage point during the first three weeks of the month, but subsequently rebounded strongly.

The Japanese yen depreciated by 2.5% against the US dollar to close at Yen 129.13. This was due mainly to active dollar purchases by speculators overseas and Japanese institutional investors, reflecting wider interest rate differentials between Japan and the United States, and higher oil prices. Meanwhile, the yen appreciated slightly against the ECU.

The Canadian dollar appreciated by 0.8% against the US dollar and by 1.6% on a trade-weighted basis. It continued to be supported by firm domestic interest rates, associated with robust economic growth, and by a record level of new Euro-Canadian dollar bond issues. Several large transactions relating to corporate take-overs in Canada were undertaken during the month, resulting in some net demand for Canadian dollars.

II. INTERVENTIONS

A. Interventions in US dollars

Concerted sales of dollars were made on several occasions from mid-January. Net sales during the month amounted to US$ 4.1 billion, compared with net purchases of US$ 0.6 billion in December 1988. They consisted of gross purchases of US$ 1.7 billion and gross sales of US$ 5.8 billion (of which US$ 4.1 billion were against Deutsche mark). The US monetary authorities and the Deutsche Bundesbank were the major sellers of dollars; the largest purchases were made by the Banco de Portugal, Finlands Bank and, at the beginning of the month, by Norges Bank.

B. Interventions in Community currencies and in private ECUs

Interventions in EMS currencies by Community central banks amounted to the equivalent of US$ 4.2 billion compared with US$ 1.4 billion in December

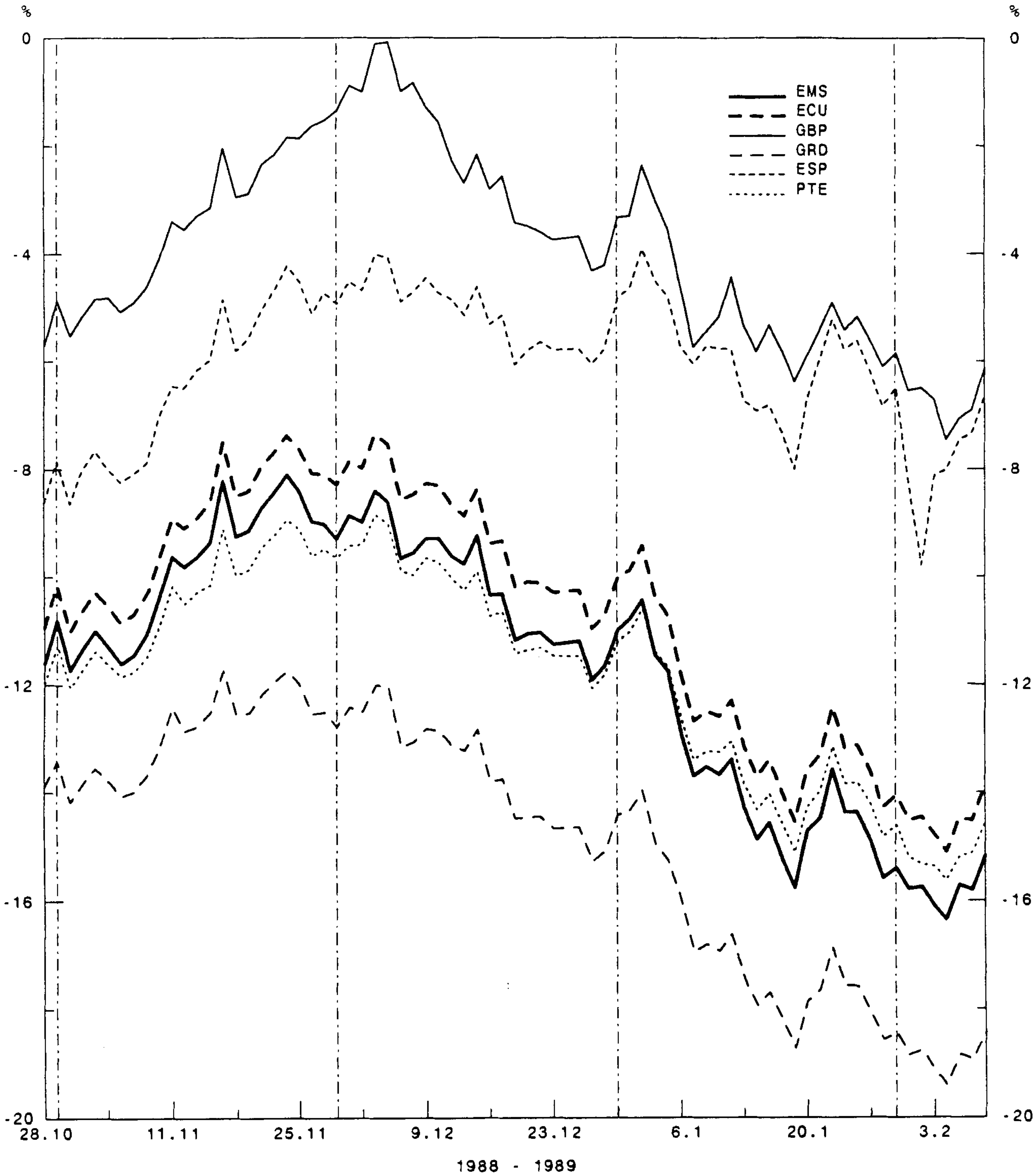
1988. The interventions consisted mainly of purchases of Deutsche Mark, with the Banca d'Italia and the Banco de España the main buyers.

III. DEVELOPMENTS IN THE CURRENT MONTH, UP TO 10th FEBRUARY

Fresh advances by the dollar in the wake of strong US employment data and the G7 meeting on 3rd and 4th February were checked by rounds of concerted intervention; and the US currency fell back in the wake of President Bush's budget address. However, it recovered strongly following news of a larger-than-expected increase in US wholesale prices as dealers foresaw some tightening of monetary policy to counter inflationary pressures. On 10th February the US prime rate was increased by 0.5 percentage point to 11%.

In a bid to curb rapid private sector credit growth, the Banco de España increased the amount of reserves that institutions are required to deposit with the Central Bank from 16 1/2% to 18%. In addition, in order to limit the effect on the exchange rate, the Banco de España imposed a 30% zero rate deposit requirement for all new foreign exchange credits taken up by non-bank residents and imposed a 20% zero rate deposit requirement for increases in banks' foreign exchange indebtedness. The peseta weakened sharply on 1st/2nd February but quickly recovered.

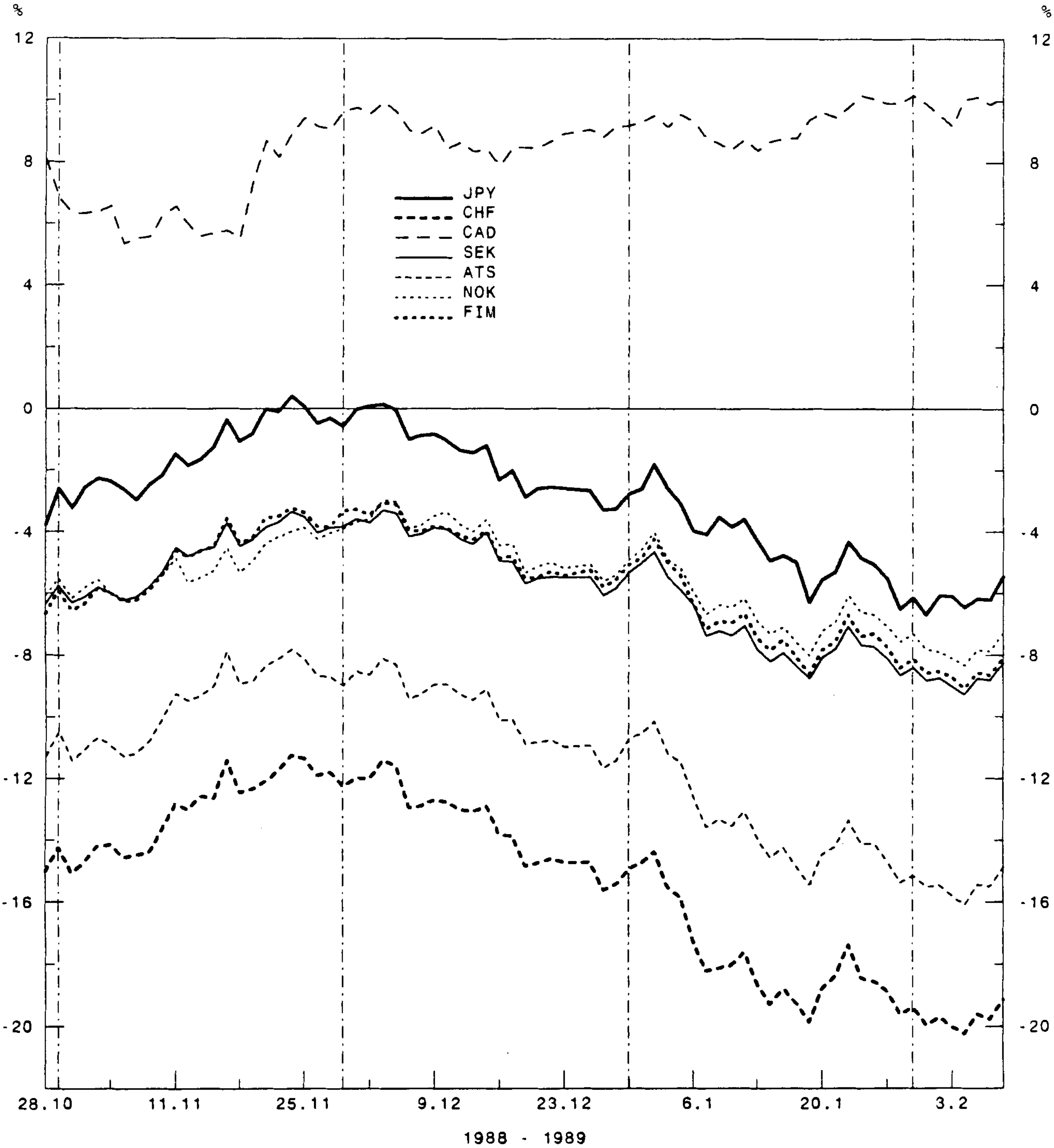
EVOLUTION OF THE ECU, THE MIDDLE RATE OF THE CURRENCIES PARTICIPATING IN THE EXCHANGE RATE MECHANISM OF THE EMS, AND THE CURRENCIES OF THE EEC CENTRAL BANKS WHICH DO NOT PARTICIPATE IN THAT MECHANISM, ON THE BASIS OF THE EXCHANGE RATES PREVAILING ON 31ST DECEMBER 1987 AGAINST THE USD*



* See next page.

10.2.1989

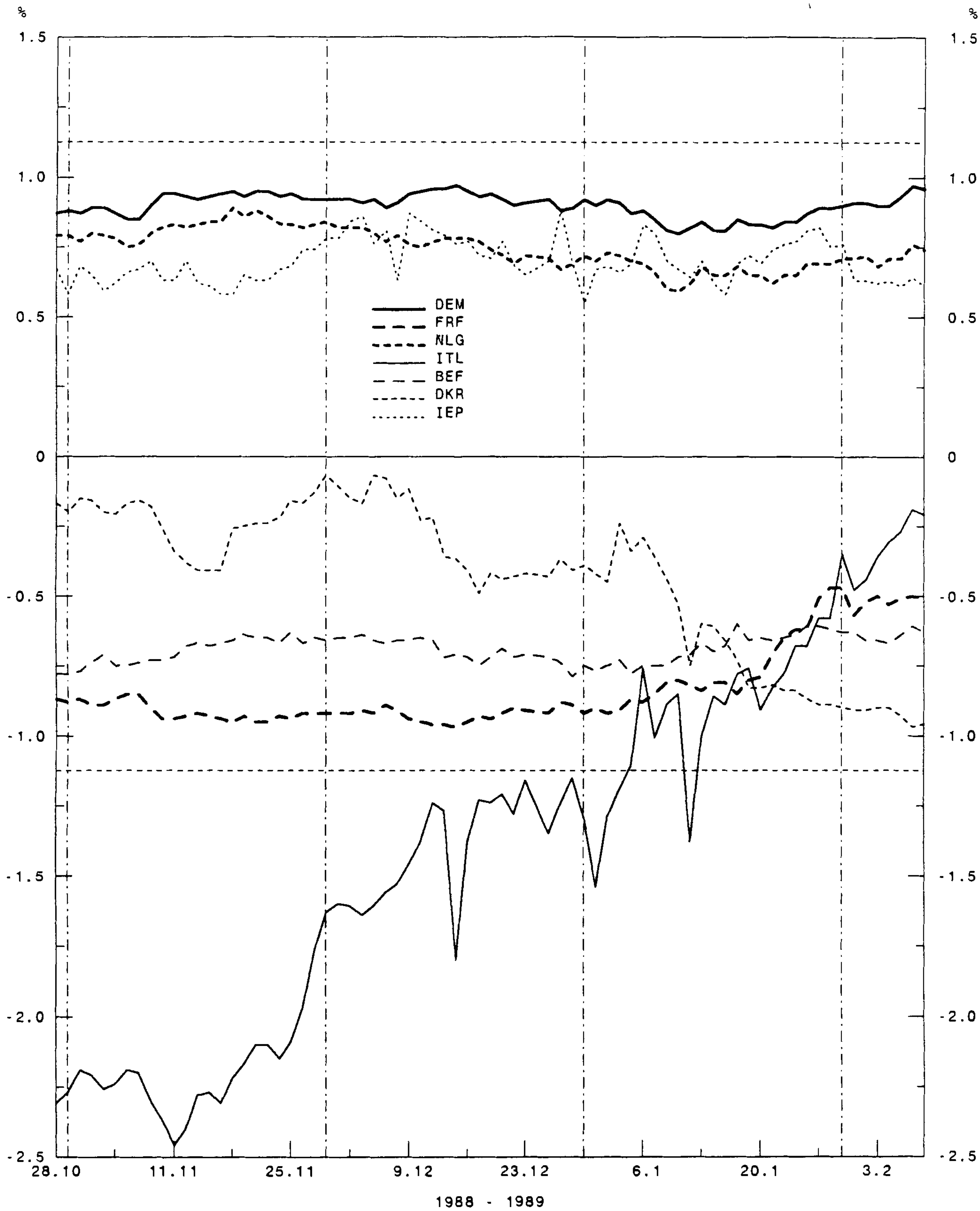
EVOLUTION OF THE CURRENCIES OF THE NON-EEC CENTRAL BANKS PARTICIPATING IN THE CONCERTATION, ON THE BASIS OF THE EXCHANGE RATES PREVAILING ON 31ST DECEMBER 1987 AGAINST THE USD*



* 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%.

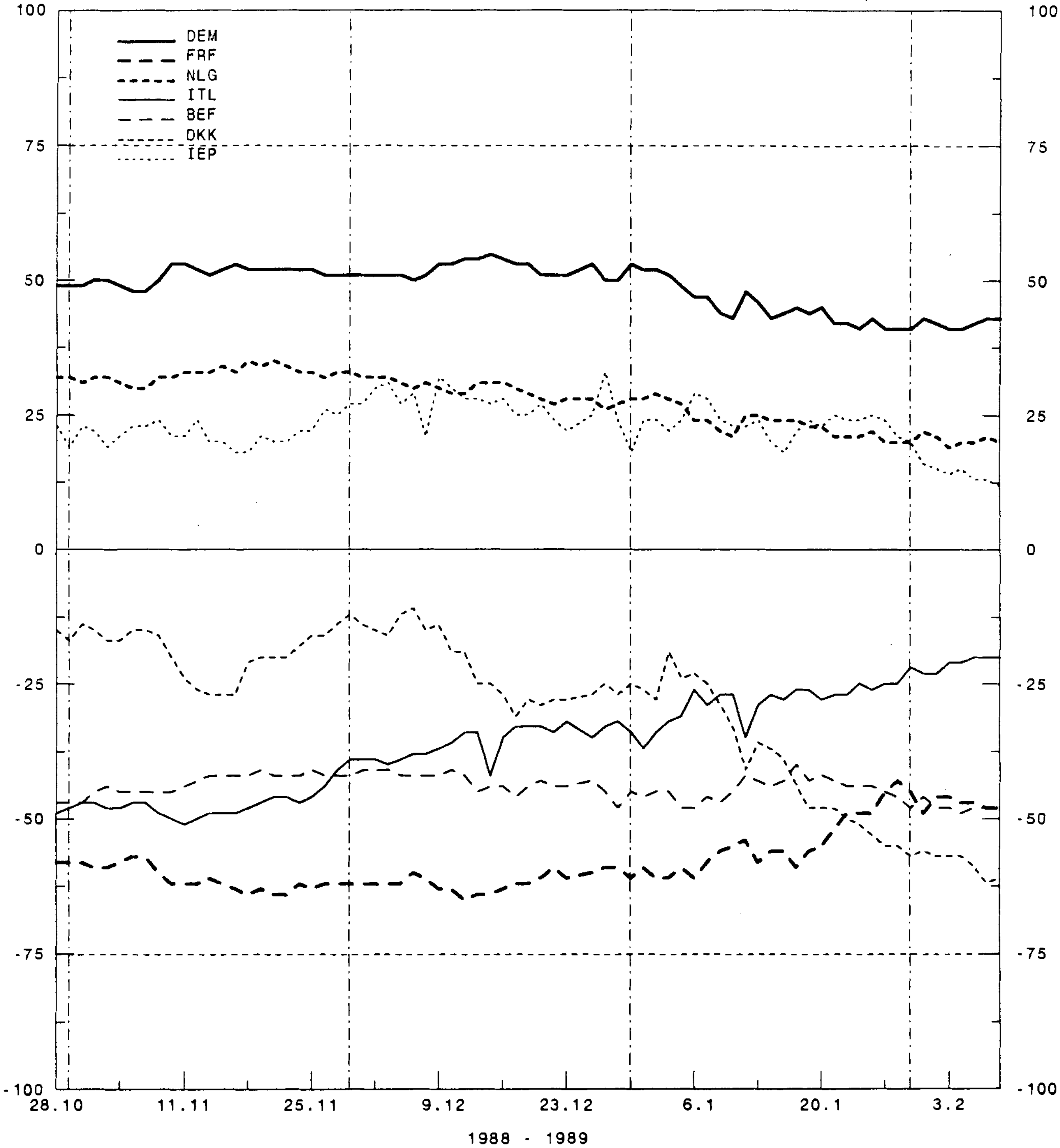
10.2.1989

MOVEMENTS IN THE EMS PARITY GRID



10.2.1989

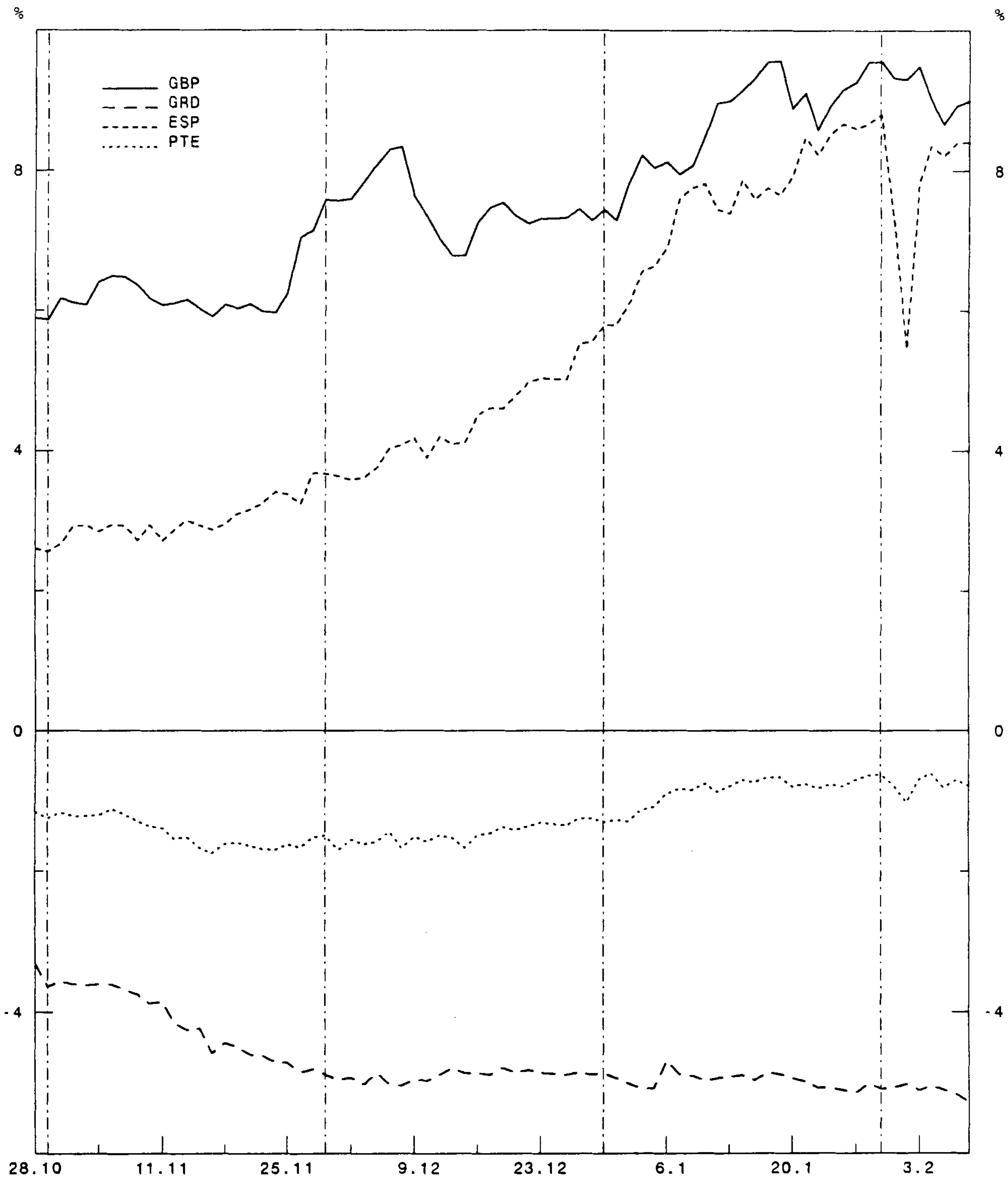
EVOLUTION OF THE DIVERGENCE INDICATOR*



* 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 pound sterling and the Greek drachma outside the 2.5% margin against the other currencies participating in the EMS.

10.2.1989

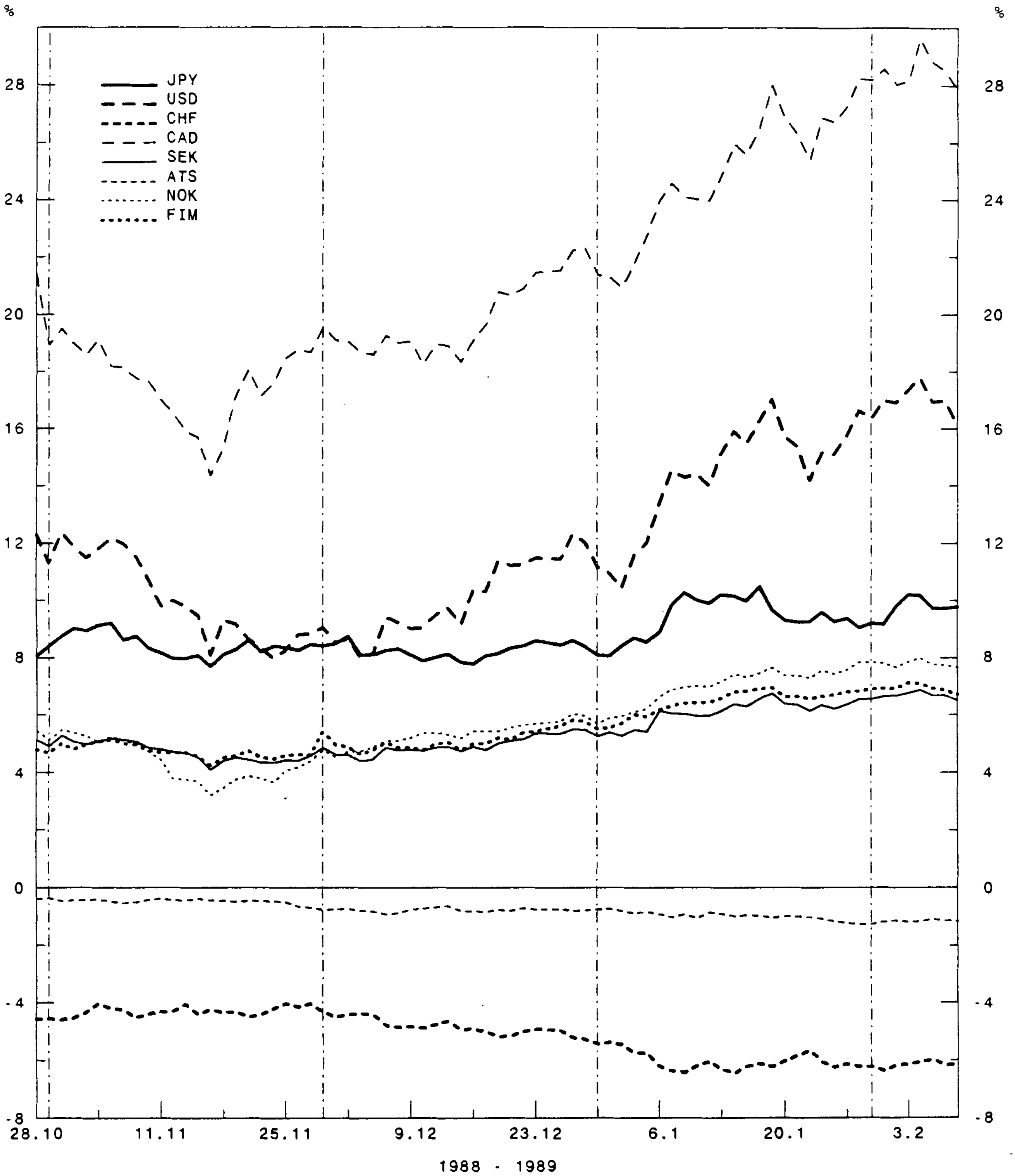
EVOLUTION OF THE POUND STERLING, THE GREEK DRACHMA, THE SPANISH PESETA AND THE PORTUGUESE ESCUDO, ON THE BASIS OF THE MARKET RATES PREVAILING ON 31ST DECEMBER 1987 AGAINST THE ECU*



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

10.2.1989

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.

10.2.1989